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REENGINEERING NONBANK SUPERVISION

Chapter Five: Overview of Debt Collection

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About This Paper

This paper, *Reengineering Nonbank Supervision*, serves two primary purposes. First, as a stakeholder awareness document covering state supervision of the nonbank marketplace, and second, as a change document or roadmap to assist state supervisors in identifying the current state of supervision and making informed changes to state supervisory processes. The paper is comprised of several standalone chapters that together will cover the industry supervised by state nonbank financial regulators, the existing system of supervision for nonbanks and the challenges and opportunities for state supervisors in "reengineering" that system.

The chapters provide a broad overview of the industry participants and how they are regulated by state nonbank supervisors. We combine these sometimes unlike participants into a single industry of nonbanks due more to jurisdictional coverage and supervisory constructs than similarities between the participants themselves. The common theme is that all these participants provide or facilitate consumer products and services and fall under the authorities granted to nonbank supervisors.

State financial regulators are the primary regulators of nonbanks operating within the United States. Together, they have forged a series of initiatives, collectively known as CSBS Vision 2020, to modernize nonbank licensing and supervision. This paper contributes research and engages discussion on possible actions that might be taken.

Chapters to date:

Chapter 1 – Introduction to the Nonbank Industry
Chapter 2 – Overview of State Nonbank Supervision
Chapter 3 – Overview of Nonbank Mortgage
Chapter 4 – Overview of Money Services Businesses

CSBS has established a webpage – found here – containing all published chapters.

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Chapter Five

Overview of Debt Collection

Most consumers do not want to be in debt, much less behind on debt payments, but delinquency often occurs after one of three major life events changes their payment plan: a divorce, an unexpected job loss or a medical issue. This chapter discusses the debt collection space including tangential services of debt relief. Since state laws and agency jurisdiction often combine debt collection, debt buying, debt relief or other forms of debt management services, this chapter may use debt collector or debt collection as master terms where appropriate. In doing so we are not implying that all forms of debt services are the same.

Debt relief is the generic name for various ways consumers can manage their bills. According to the National Consumer Law Center, a debt relief service is a business or non-profit that offers to help consumers deal with unsecured debt for a fee. There are two types of relief services. One is debt consolidation, which some companies offer to consumers to combine their bills into one new, larger loan. The other is a debt management plan, which is often offered by nonprofit organizations that work with a consumer's creditors to try to lower the interest rate, waive late fees and arrange a single monthly payment the consumer could make to the nonprofit. The nonprofit then distributes the money among the consumer's creditors. In both situations, consumers need to consider whether they can afford the fees and monthly payments (National Consumer Law Center (NCLC), 2018). While most companies engaging in this space are nonprofits, there are some for profit companies that are required to hold a state license. A consumer should be aware of a company's status and compare fees before entering any arrangement for debt relief.

If a consumer in debt is delinquent in paying one or more of their obligations and not using debt relief services, they may be in the debt collection process. According to a 2014 study by the Urban Institute, roughly 77 million Americans, or about one third of adults, have a debt in collection status (not including rent or mortgage debt) such as a credit card balance or medical or utility bill that is more than 180 days past due and has been placed in collections (Unifund, n.d.).

Debt collectors work with consumer and non-consumer debt. Consumer debt generally refers to any debt created to buy consumer products or services that are not business-related expenditures. Common examples of consumer debt include credit cards, rent, mortgages, auto loans and payday loans (Bankrate, n.d.).

First party debt collection, that is where the originating creditor collects its own debt, forms a significant part of debt collection. However, creditors often find it economically advantageous to either hire another party to collect their debts or to sell the debt, often at a substantial discount, to another entity. Other than direct collection, the consumer debt collection industry can be categorized into two major groups, with companies often conducting business in both:

<u>Debt Collection for Others:</u> Known as third-party debt collectors or collection agencies, these businesses contract with creditors to collect on delinquent, defaulted or charged-off debt, receiving a fee for their

efforts. Additionally, some states cover loan servicers under their debt collection laws, requiring these companies to be licensed.

Debt Buyers: These companies purchase delinquent debt from creditors and then attempt to collect on that debt, or contract out to third-party collectors, generating revenue from the difference between the cost of debt and the amounts recovered. These companies may utilize the services of third-party debt collectors.

Unlike other areas of the nonbank industry, we do not categorize debt collection as a bank or nonbank activity. This is due to the structure of the laws covering debt collectors. A financial institution, such as a bank, collecting its own debt is not categorized as a debt collector, even though it may clearly be expending resources to collect on past due accounts. Debt collectors are separate entities from the financial institution that created the debt, and, for purposes of this white paper, all debt collectors are nonbanks.

FAIR DEBT COLLECTION PRACTICES ACT

In 1977, the Fair Debt Collection Practices Act (FDCPA) created collection standards, regulating how, when and by whom people can be contacted by debt collectors. It is an amendment to the Consumer Credit Protection Act, as Title VIII of that Act.

History

As long as there have been loans there have been debt collectors. Debt collection companies were established in the 1800s, focusing on unsecured assets on which there was nothing to foreclose.

After the first credit bureau was established in 1923, companies began to share information to determine which buyers were creditworthy. They had common goals and objectives, which led to the establishment of the Association of Credit and Collection Professionals (ACA) in 1939. It brought together third-party collection agencies, law firms, asset buying companies, creditors and vendor affiliates.

Before the credit card, checks, aside from cash, were the most popular form of consumer payment for goods and services, and the collection industry focused on “bad checks,” or checks written when there are insufficient funds in the consumer’s account to cover the amount of a check. In the 1950s, a credit-based, risk-based U.S. economy grew with the granting of credit cards. A bad check is a single transaction, but revolving credit allows consumers to build debt, representing years of transactions. As such, the credit card has affected the debt industry more than any other consumer finance product.

In turn, consumer credit counseling services also entered the scene in the 1950s for individuals with serious debt and credit problems. Some of these services were coupled with programs to assist debtors in reducing interest charges and paying off debts over an extended time. Most of these services have collected a periodic amount from the debtors from which payment to creditors has been made. The general objective has been debt satisfaction without resort to bankruptcy (Uniform Debt-Management Services Act, 2005).

Prior to 1977 and the enactment of the federal Fair Debt Collection Practices Act (FDCPA), some states had their own debt collection statutes; for instance, Wyoming’s statutes were written in 1945 to protect businesses from out-of-state competition. Over time, many state statutes were updated to also protect consumers. The Federal Trade Commission (FTC) was the primary enforcer of the FDCPA until the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA) was passed into law and created the Consumer Financial Protection Bureau (CFPB). Under DFA, the FTC shares enforcement with the CFPB, which is the federal agency with primary regulatory and supervisory authority over debt collectors.

The Debt Collection and Relief Process[1]

Debt collection and receivables portfolios are often outsourced to third parties like many other business services such as payroll services. At some point, it is not cost effective for creditor companies to keep debt collection servicing in-house, and most creditors enlist third-party debt collection agencies at some point in the collection process. Debt collectors are separate companies under contract with a creditor to collect debts on their behalf for a fee or for some portion of the amounts collected. As a last resort, creditors sell off their delinquent, defaulted or charged-off debt portfolio to reclaim a portion of what is owed after exhausting other recovery attempts, often accepting as a sale price a fraction of the debt owed.

Industry subject matter experts identify several benefits to creditors using third-party debt collectors:

- They are specialized and regulated: Some collectors only deal with healthcare collections while others specialize in credit card debt. The ACA reports 60% to 70% of its members service the healthcare debt collection space. Those collectors tend to operate regionally, since healthcare facilities prefer to work with debt collectors in their area.
- They are or should be experts in the legal methods of communicating with debtors regarding delinquent accounts: They know the why, where and how of legally contacting consumers.[2]
- They are or should be experts in state laws impacting the debt collection business: These laws include those governing judgment liens, wage garnishment as well as state exemption laws that protect debtors’ income and property from seizure to pay a debt.
- They understand compliance under the FDCPA: For a creditor, it is not efficient or economical to train staff on debt collection compliance, in addition to other responsibilities.

Debt buyers are considered debt collectors even though they own the accounts. According to the Receivables Management Association International, the ability of debt buyers to purchase distressed accounts from originating creditors provides benefits to originating creditors and to consumers and businesses that rely on available credit and reasonable interest rates for their purchasing needs (Receivables Management Association International White Paper – the Debt Buying Industry, April 2015).

[1] The term “debt relief” is used generically here and may incorporate variations such as debt settlement, credit repair, or other similar services offering to assist borrowers with their debt.
[2] While this may be true for most debt collectors, the CFPB has filed 30 enforcement actions against debt collectors for illegal practices since 2012, and the FTC filed 52 actions in 2018 alone.

Today, debt buyers most often purchase medical or telecommunications accounts and occasionally the debt assets (receivables) of a collection agency going out of business. Then they offer debt settlements to consumers, earning revenue from the difference between purchase price and settlement amount.

There are various levels of debt collection agencies, some of which also act as debt buyers:

- Small companies – With an average of 25 employees, these companies often have several owners. The ACA reports 1,000 of its members have fewer than 10 employees.
- Large companies – With approximately 2,000 people working in call centers in different locations, these companies often attract more attention from regulators. These larger players may utilize new technologies and work toward increased efficiency in the debt collection process. They often are also debt buyers, collecting on large portfolios.
- Offshore collectors – According to the ACA, debt collectors have expanded into offshore outsourcing, as offshoring creates additional incentives for businesses. Such activity would require the offshore collector to comply with multiple country laws and requirements in addition to applicable state and federal laws.

Debt management allows consumers to work with a credit counseling agency to consolidate debts without opening another line of credit or taking on new debt. Debt management programs do not require a consumer's credit score as a qualifying factor to participate. Consumers participating in such programs may secure a lower interest rate and relaxed fees on existing debt and can cancel their commitment at any time (InCharge Debt Solutions).

However, if consumers miss a debt management payment, the agreement with the creditors to reduce interest rates and eliminate fees could be voided. In addition, consumers are often required to close all but one of their credit card accounts and to use that for emergencies only.

In terms of a debt consolidation loan, NCLC reports the lender is typically a bank, credit union or online loan company, and the expected payoff time is two to five years for these types of unsecured personal loans. The benefits of obtaining a debt consolidation loan include allowing consumers to secure the necessary funds to pay off multiple creditors, receiving a lower interest rate than on the existing debt and continuing to have access to their credit cards if repaying the balance owed (InCharge Debt Solutions).

Conversely, there are fees associated with consolidation loans that increase the amount of debt, and failure to make on-time payments results in late fees and possibly default. If the debt consolidation loan is used to repay credit card balances but the cards are not cancelled, the relief may be only temporary, and subsequent default of a consolidation loan can of course lead to further debt collection actions.

Industry experts recommend consumers first determine their credit scores when considering debt consolidation. Under federal law, consumers are entitled to a free copy of their credit report once a year from all three major credit reporting agencies: Equifax, Experian and TransUnion.

Lenders look at a consumer's credit report and credit score for evidence of a consumer's ability to repay a loan. The higher the credit score, the lower the interest rate the lender will charge for a debt consolidation loan.

The debt collection and debt relief processes are an integral part of the nonbank marketplace. When consumers fail to pay legally agreed debts, creditors have little choice but to seek repayment through collections. However, federal and state laws contain specific consumer protections that when violated not only harm consumers, they damage the marketplace and tarnish the industry's reputation.

According the FTC, debt collectors generate more complaints to the FTC than any other industry. Although many debt collectors are careful to comply with consumer protection laws, others engage in illegal conduct. Some collectors harass and threaten consumers, demand larger payments than the law allows, refuse to verify disputed debts and disclose debts to consumers' employers, co-workers, family members and friends. Some threaten legal action that is not intended or cannot be taken and threaten arrest or jail time. Debt collection abuses cause harms that financially vulnerable consumers can ill afford. As a result of abusive practices, consumers may pay collectors money they do not owe and fall deeper into debt, while others suffer invasions of their privacy, job loss and domestic instability.

The FTC enforces the FDCPA (See page 2), which prohibits deceptive, unfair and abusive debt collection practices. Among other things, the FDCPA bars collectors from using obscene or profane language, threatening violence, calling consumers repeatedly or at unreasonable hours, misrepresenting a consumer's legal rights, disclosing a consumer's personal affairs to third parties and obtaining information about a consumer through false pretenses. Because certain practices that violate the FDCPA also violate the FTC Act, the FTC also uses the FTC Act to halt unfair or deceptive debt collection practices.

The FTC has sued over 30 debt collection companies for violating the law, banning some from the business and making them pay steep financial penalties. The FTC also has recommended that Congress and the states modernize debt collection laws to reflect changes in consumer debt, the collection industry and technological developments that affect consumers and collectors alike. For example, a 2010 FTC report concluded that the process many debt collectors use to sue alleged debtors or force them to arbitration is seriously flawed and causes substantial consumer harm. The report recommended that government, industry and others adopt significant reforms.

ATTORNEY DEBT COLLECTORS AND IDAHO LAW

ID Title 26, Chapter 22, Exemptions: The provisions of this [Collection Agencies] act shall not apply to the following:

(1) Persons licensed to practice law in this state, to the extent that they are retained by their clients to engage in activities authorized by this act, and such activities are incidental to the practice of law. Such exemption shall not apply to an attorney engaged in a separate business conducting the activities authorized by this act.

The Role of Attorneys in the Debt Collection and Relief Process

Attorneys are active in all processes of debt collection and debt relief. State law may provide an exemption from licensing as a debt collector for attorneys that are primarily engaged in the practice of law and collect debts as ancillary to their practice. However, state law ranges from no exemption for attorneys to exemptions limited to certain or de minimis activities in the debt collection or relief space (see box) for attorneys that focus on, or that are actively engaged in, the practice of debt collection or providing debt relief services.

In general, attorneys should be aware of the licensing laws related to debt collection and debt relief in the states in which they intend to conduct such activities. Failing to do so may result in enforcement actions such as *Hamilton Law Association* brought by the Connecticut Banking Commissioner in 2019. In this case, a Florida law firm conducted activity covered under the Connecticut Consumer Collection Agencies law without proper licensing; it paid $10,000 in fines and agreed to not operate in the future without a Connecticut license.[3]

In some cases, law firms have assisted in illegal collections activity by allowing lawyers to participate in business activities that violated fair practices. In a 2017 case by the FTC and the Illinois attorney general, Stark Law, LLC was accused of not only deceiving consumers about the nature of the debt collection company, but also using attorneys inappropriately in that deception[4]:

As stated in the lawsuit: *"In numerous instances while operating as Stark Law, Defendants have represented to consumers that an attorney has been assigned to the consumer's file, and that the attorney has the authority to initiate, or has already initiated, a lawsuit relating to the alleged debt. When consumers talk to the attorneys assigned to their files, those individuals often have used their status as attorneys to convince consumers that Defendants' threat of legal action is real. In numerous instances, however, the attorneys who work for Stark Law have no authority to, do not intend to, and do not initiate lawsuits against consumers who do not pay Defendants the alleged debts."*

Such illegal activity can be very costly for defendants. In this case, Stark Law and its affiliates were enjoined from misrepresentations and fined over $47 million and other penalties such as relinquishment of assets. Debt collectors also falsely represent themselves as law firms when they are not such, as the FTC's 2018 case against Lombardo, Daniels & Moss, LLC[5] and the CFPB's 2019 case against Asset Recover Associates, Inc.[6]:

> FTC – *"Defendants have conducted their scheme to defraud consumers through and using a variety of trade names, including, but not limited to, Lombardo, Daniels & Moss; Barron, Gibson & Phillips; Cohen, Daniels & Moss; Montgomery, Hunter & Associates; Murray, Glover & Sellers; and Lombardo Group. Through the use of these names, many consumers have believed that their alleged debts have been referred to a law firm or an attorney for collection."*
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> CFPB – *"ARA, also known as Financial Credit Service, Inc., collects debts from consumers throughout the United States. According to the consent order, the Bureau found that ARA*

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https://portal.ct.gov/DOB/Enforcement/Administrative-Orders-Index-Pages/Index---Administrative-Orders-and-Settlements (see The Hamilton Law Association, P.A. – Nov. 2019)
[4] https://www.ftc.gov/enforcement/cases-proceedings/152-3243/stark-law-llc-dba-stark-recovery
[5] https://www.ftc.gov/enforcement/cases-proceedings/172-3037/federal-trade-commission-v-lombardo-daniels-moss
[6] https://www.consumerfinance.gov/policy-compliance/enforcement/actions/asset-recovery-associates-inc/

violated the Fair Debt Collection Practices Act by threatening to sue or arrest consumers even though it did not intend to take such action, falsely representing to consumers that company employees were attorneys, threatening to garnish consumers' wages or place liens on their homes even though it did not intend to so do, and representing that consumers' credit reports would be negatively affected if they did not pay, even though ARA does not report consumer debts to credit-reporting agencies. The Bureau found that these false statements were also deceptive, in violation of the Consumer Financial Protection Act of 2010. Under the terms of the consent order, ARA will pay at least $36,800 in restitution to affected consumers and a $200,000 civil money penalty to the Bureau. The consent order also prohibits ARA from continuing to engage in this conduct and requires ARA to record calls with consumers to help ensure collectors do not make false statements in the future."

Current State

Most debt collection takes place in student loans, credit cards, auto finance, mortgage lending and medical expenses. In 2016, the debt collection industry reported it employed 129,000 people and paid employees $4.9 billion. Industry participants combined returned $67.6 billion to creditors (International Association of Collection Services, n.d.).

Credit card debt is the second highest unsecured consumer debt in collection behind student loan debt (discussed below). Total outstanding credit card debt stood at $944 billion in December 2018, up 4% from the prior year, according to NERDWALLET, and Unifund reports that more than 90% is held by depository institutions.

Secured mortgage debt is the largest piece of the debt pie at nearly $11 trillion[7], but mortgages have a lower default rate at less than one percent and therefore do not constitute much of the debt collection industry. This is because residential mortgage debt is secured with liens that are subject to statutory foreclosure processes. While mortgage debt is sold as an asset, bad mortgage debt is typically not sold to debt buyers due to relatively efficient legal means of recapturing what is owed through foreclosure.

Unfortunately, delinquent or outstanding debt, frequently referred to as "bad debt," is likely here to stay, whether it be in large volume via the aforementioned areas or in smaller numbers reflected in library fines, back child support, utility payments, court fees or parking fines. If unpaid debt exists, creditors will need debt collectors to assist in recovery. Yet despite this integral role in the credit system, debt collectors are often stigmatized as a source of consumer harm, largely stemming from a history of questionable and sometimes illegal collection practices, some of which continues today. According to industry participants, there are two questions for debt collectors: What is the most efficient way to collect debt, and how can the industry rid itself of its stigma?

Experts believe the industry is in transition, with fewer collection agencies today than a decade ago. Some in the industry point to state licensing as creating a high barrier of entry since debt collectors need to be licensed in numerous states. In addition, as the economy changes and grows and debt collection becomes more technology-oriented, many locally operated debt collectors are closing or being absorbed

[7] Federal Reserve fourth quarter 2018.

by larger companies which can keep abreast of federal and state regulations. Larger debt collectors are often sophisticated institutions presenting different opportunities and challenges than their smaller more localized industry cousins.

The industry is struggling to keep pace with modern technology and changing consumer needs, but the FDCPA was written before current technologies were in place. The FDCPA still references answering machines and does not address email or texting, for example. According to industry debt collection experts, the most efficient way to communicate with consumers h is via telephone because collectors can talk directly to the consumers. However, this only works if the consumer desires to communicate verbally. Consumers may prefer a text message or some other means of handling their financial obligations, yet the regulations currently fail to address such modern means of communication.[8]

Debt collectors need account volume (many accounts) to be successful. And, the faster a collector can collect or get a judgment on a defaulted account, the better the return. Today, many large companies use automation for collection, with little human interaction. Where regulation allows, the industry is finding artificial intelligence (AI) to be a more efficient means of collection. For instance, AI can provide automatic outbound dialing, allowing collectors to increase the number of individuals they contact daily.

Student Loan Debt Servicing

Unifund reports that most consumer non-mortgage debt exists in the student loan space, which recently displaced credit cards from the top position. This finding makes sense as the level of student debt itself continues to grow at rapid rates (see graph below).

There are hundreds of private “debt relief” companies (also referred to as debt settlement companies) that solicit student loan borrowers with promises to help reduce monthly payments or assist with loan forgiveness. They often charge consumers for services they can acquire themselves, such as consolidating their loans. The FTC has cracked down on some of these companies for illegal practices, such as pretending to be affiliated with the Department of Education or charging up-front application fees. When it comes to seeking help managing student debt, the FTC says consumers should never pay up front and should contact the FTC about the solicitor (Consumer Reports, October 22, 2019).

[8] The CFPB currently has a Notice of Proposed Rule Making that would prescribe new Federal rules governing the activities of debt collectors. https://www.consumerfinance.gov/policy-compliance/rulemaking/rules-under-development/debt-collection-practices-regulation-f-extension-comment-period/

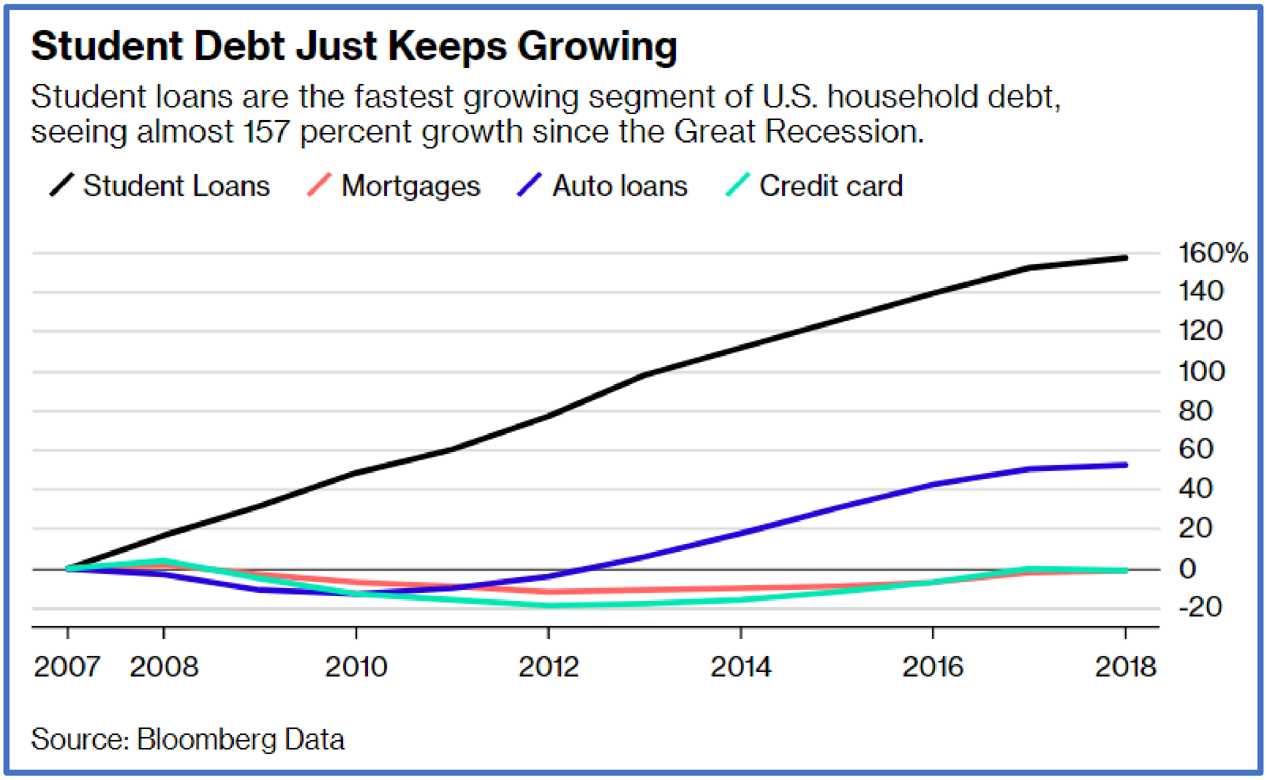
Student debt is unsecured and only private (non-government) debt is sold to specific agencies that deal with this type of collection. Government student loan debt is also unsecured and servicers are large institutions specializing in the servicing and collection of government funded student debt under contract with Federal Student Aid (FSA), an office of the Department of Education.[9] According to Forbes, 44.7 million Americans have student loans as of 2019, and while both types of student loan debt are unsecured, neither is dischargeable in bankruptcy absent very specific conditions that are difficult to meet. Estimates reveal that on average each borrower has nearly $40,000 in student loan debt. Student loan borrowers owe more than $1.56 trillion[10], which is roughly $620 billion more than the overall credit card debt in the country. According to Bloomberg L.P., student debt has grown faster than mortgage, auto and credit card debt combined. Perhaps most alarming is the default rate, with more than 11% of the debt 90 days or more past due.

According to Standard & Poor's Financial Services LLC, "[T]he total balance of student loans is now almost 6 [times] what it was in 2003. No other segment of consumer debt has a balance more than 2 [times] what it was in 2003 as student loans have grown for longer and more consistently than all other forms of consumer debt."

OPERATION GAME OF LOANS

The settlements with Student Debt Doctor (SDD) and American Student Loan Consolidation (ASLC) are part of Operation Game of Loans, a coordinated federal state law enforcement initiative targeting deceptive student loan debt relief schemes. "People struggling to repay student debt should know that an offer of debt relief with an upfront fee is likely to be a scam, and they should alert the FTC," said Andrew Smith, Director of the agency's Bureau of Consumer Protection. https://www.ftc.gov/news-events/press-releases/2017/10/ftc-state-law-enforcement-partners-announce-nationwide-crackdown

[9] We cover the student lending market in Chapter Six – Overview of Consumer Finance.
[10] Federal Direct Loans and other government-owned education loans comprise 92% of this part of the consumer finance market or $1.481 trillion as reported by the U.S. Department of Education's Federal Student Aid program in November 2019. https://studentaid.ed.gov/sa/about/data-center/student/portfolio



Most federal student loan servicing is performed by third party servicers, which are considered debt collectors under certain state's law.[11] This serviced market is approximately 79% of the nearly $1.6 trillion dollar student loan market. Federal student loan servicing is dominated by just three companies that administer more than 80% of the total federal loan portfolio:

- Nelnet Servicing LLC
- Pennsylvania Higher Education Assistance Agency (PHEAA or FedLoan Servicing)
- Navient Solutions LLC

Small, state-affiliated, non-profit servicers also service Federal Direct Loan Program (FDLP) and Federal Family Education Loan Program (FFELP) loans, programs that are administered by the U.S. Department of Education.

[11] The coverage and jurisdiction over student loan servicers and debt collectors collecting on student loans is varied and complicated. It is discussed more thoroughly under Debt Collection Supervision below.

Future Predictions

The amount of household debt in this country stood at $15.6 trillion year end 2018 (Federal Reserve Board of Governors).[12] Add to this medical debt and other unpaid accounts, and it becomes clear that U.S. households have a significant amount of debt. Consumers have desires for more goods and services and little patience for delays in obtaining them (e.g. high-priced automobiles, online food service, Amazon purchasing), which may have the result of increasing or quickening the accumulation of consumer debt. This means that the number of people that will be able to pay this increasing debt on time and in full is likely to decline. Because poor credit will always exist, debt collectors will too. As a result, the industry expects to see the following over the next five to 10 years:

- Automation will continue, but collectors need to be savvy. Less human interaction will not help the elderly who do not use technology or consumers with less access to technology. And younger people are leery of scams when everything is automated. On the plus side, some automation will result from consumer preference feedback, i.e. communicating via email and texting.
- Litigators think court involvement in this process will continue to be important. They claim the courts are not always fair to defendants in how the courts handle the volume of debt collection cases. First, the burden of proof for consumers is frustrating and difficult, i.e. disputing the

A GLOBAL VIEW OF HOUSEHOLD DEBT
CONNOR HAYS NOVEMBER 2018
BLOOM ECONOMIC RESEARCH DIVISION

United States – [W]hile household debt levels and ratios fell immediately in the wake of crisis as consumers deleveraged, household debt has been back on the rise in absolute terms since 2012 and surpassed pre-crisis levels in 2016. As of the second quarter of 2018, U.S. household debt outstanding stands at $15.4 trillion. Given that the US has surpassed its pre-crisis peak in household debt there has been some consternation among policymakers and commentators, with the New York Times remarking, “Americans have now borrowed more money than they had at the height of the credit bubble in 2008, just as the global financial system began to collapse.” Sam Fleming, writing for Financial Times (Bloom Economic Research Division, 2018), notes that increasing household debt has “exposed some categories of borrower to financial strain as they try to keep up with their obligations.” … Financial strain that is beginning to show up in the credit card market, as overdue credit card debt touched a seven-year high in early 2018. Increasing strain is especially true for student borrowers, who have had to take on ever increasing amounts of debt in order to finance their educations and keep their heads above water within the labor market. And while the Great Recession was precipitated by subprime mortgages and a cascade of defaults, it’s not the mortgage market that is facing a slew of loans in arrears, but the student loan market where the delinquency rate has shot up to worrisome highs. Student loan debt doesn’t present the same type of systemic risk as mortgage debt does in the US, but if incomes remain stagnant, rising interest rates could push a significant portion of borrowers into serious delinquency or default. Given that debt has been fueling consumer spending, a hit to a large portion of student borrower’s creditworthiness and thus their ability to take on loans for other purchases such as homes, cars, and consumer goods, could precipitate a credit crunch or greater macroeconomic downturn.

[12] Board of Governors of the Federal Reserve System, Z.1 Financial Accounts of the United States, 19 https://www.federalreserve.gov/releases/z1/20180920/html/d3.htm.

claimed amount of a debt or proving that the debt has been paid. Second, the consumers often do not appear in court because they were not aware of the court date or may not have been properly served. Third, summary judgements are ordered because the evidence the collectors produce is so overwhelming there is no need for trial. The dockets are so full of cases, the courts tend to automate the process which leaves little time to defend.

- Consolidation of collectors will continue, resulting in a few large companies, which could make the industry more efficient and effective, but concentrates the industry, thereby elevating institutional risk.
- The ACA believes new laws will be enacted to provide clarity and continued work toward bright-line regulations to avoid sensitive technical lawsuits that do not help consumers.
- The industry and law enforcement will continue to eradicate "bad actors," those pretending to be debt collectors, law firms or credit bureaus who threaten financially delinquent consumers.
- More avenues for collection will be allowed. The industry could adopt more consumer rebate or rewards programs in which companies engage and create consumer relationships.
- There will be continued progress in removing the stigma of the debt collector and increases in consumer privacy with encrypted transactions and private sites where consumers can make payments.

Debt Collection Supervision

The master area of debt collection supervision includes oversight of all the various debt services discussed in this chapter; however, the majority of states still do not directly regulate the market. And of those that do regulate the market, not all parts of the market are covered. Further, individual state law defines or describes the debt industry into categories that are similar but not the same with other state agencies (see chart below).

At the national level, state debt collection supervisors join forces under the North American Collection Agency Regulatory Association (NACARA). NACARA's stated purpose is to ensure fair and equitable administration and enforcement of collection regulatory laws in the several states, districts, territories, possessions and provinces in the United States and Canada. The Association works to achieve this purpose by providing its members with opportunities for communication on regulatory matters, for conducting research and obtaining and exchanging information on regulatory matters, assisting in the coordination of multi-state examinations, investigations, and enforcement matters, and professional improvement (http://www.nacaraweb.org/nacara-by-laws/).

NACARA membership totals 20 state supervisory agencies, New York City and two Canadian agencies (the Alberta Consumer Services Branch and the Saskatchewan – Financial and Consumer Affairs Authority). The following chart identifies the state agency members of NACARA and the categories of debt collection covered by these agencies.

State Agency	Category of Debt Collector
Arizona – Department of Financial Institutions	Collection agencies, debt management companies
Arkansas – State Board of Collection Agencies	Collection agencies
Colorado – Department of Law	Collection agencies, debt collectors
Connecticut – Department of Banking	Consumer collection agencies (including debt buyers), debt adjustors, debt negotiators, student loan servicers
Florida – Office of Financial Regulation / Division of Consumer Finance	Consumer collection agencies, commercial collection agencies
Illinois - Department of Financial and Professional Regulation	Collection Agencies, Debt Buyers, Student Loan Servicers, Debt settlement companies
Idaho – Department of Finance	Collection agency, debt counselor, credit counselor, credit repair business, debt buyer
Kansas – Office of the State Bank Commissioner	Debt buyer
Maine – Bureau of Consumer Credit Protection	Debt collector, debt management service provider
Maryland – Collection Agency Licensing Board	Collection agency (including debt buyers), debt management, debt settlement, credit services businesses, mortgage assistance relief services, foreclosure consultants, student loan servicers
Massachusetts – Division of Banks	Debt collectors
Minnesota – Department of Commerce	Collection agencies, debt management services, debt settlement services, credit service organization
Nebraska – Collection Agency Licensing Board	Collection agencies, debt management companies
Nevada – Department of Business and Industry / Division of Financial Institutions	Collection agency, foreign collection agency, uniform debt management services
North Carolina – Department of Insurance	Collection agency
North Dakota – Department of Financial Institutions	Collection agencies, debt settlement service providers
South Carolina – Department of Consumer Affairs	Credit counselors

Tennessee – Collection Service Board	Collection agency
Washington – Department of Licensing	Collection agencies
Wisconsin – Department of Financial Institutions	Credit services organizations (credit repair), collection agencies, debt management companies
Wyoming – Collection Agency Board	Collection agencies

Only 12 of the agencies identified above are members of CSBS and are responsible for chartering and regulating banks. Further, several agencies listed are regulatory boards comprised of members who are debt collectors, appointed to supervise that industry within a particular jurisdiction. With such supervisory structures, effective information sharing may be impacted as states and federal agencies are typically limited in sharing confidential supervisory information only with other government agencies.

In addition to state agencies, the debt collection industry is regulated by the CFPB, and the FTC. These federal supervisors are discussed more fully in the following section.

Federal Supervision

The Dodd-Frank Act gave the CFPB supervisory authority over a variety of institutions that may engage in debt collection, including certain depository institutions and their affiliates, and nonbank entities in the residential mortgage, payday lending and private education lending markets, as well as their service providers. The DFA also gave the CFPB supervisory authority over "larger participants" of markets for consumer debt collection, as the CFPB defines by rule, and their service providers. (12 U.S.C. 5514(a)(1)(B)). On Oct. 24, 2012, the CFPB issued a larger participant regulation in the market of consumer debt collection. The consumer debt collection larger participant rule, which appears in 12 CFR Part 1090, was effective Jan. 2, 2013. It provides that a nonbank covered person is a larger participant of the consumer debt collection market if the person's annual receipts resulting from consumer debt collection – as defined in the rule – are greater than $10 million. (consumerfinance.gov)

The CFPB reviews debt collectors for compliance with the following federal laws:

<u>The Fair Debt Collection Practices Act (FDCPA)</u> governs collection activities and prohibits deceptive, unfair, and abusive collection practices. The FDCPA applies to entities that constitute "debt collectors" under the Act, which generally includes: (1) third parties such as collection agencies and collection attorneys collecting on behalf of lenders; (2) lenders collecting their own debts using an assumed name; and (3) collection agencies that acquire debt at a time when it is already in default. The FDCPA applies to debts incurred or allegedly incurred primarily for the consumer's personal, family or household purposes.

<u>The Fair Credit Reporting Act (FCRA)</u> and its implementing regulation, Regulation V, require that furnishers of information to consumer reporting agencies follow reasonable policies and procedures regarding the

accuracy and integrity of data they place in the consumer reporting system. The FCRA and Regulation V require furnishers and consumer reporting agencies to handle disputes and impose other obligations on furnishers, consumer reporting agencies and users of consumer reports.

The Gramm-Leach-Bliley Act (GLBA) and its implementing regulation, Regulation P, impose limitations on when financial institutions can share nonpublic personal information with third parties. It also requires under certain circumstances that financial institutions disclose their privacy policies and permit customers to opt out of certain sharing practices with unaffiliated entities.

The Electronic Fund Transfer Act (EFTA) and its implementing regulation, Regulation E, impose requirements if an entity within the statute's scope of coverage obtains electronic payments from a consumer.

The Equal Credit Opportunity Act (ECOA) and its implementing regulation, Regulation B, apply to all creditors and prohibit discrimination in any aspect of a credit transaction on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to contract), receipt of public assistance income or exercise in good faith of any right under the Consumer Credit Protection Act (12 CFR 1002.2(z), 1002.4(a)). Credit transactions encompass "every aspect of an applicant's dealings with a creditor regarding an application for credit or an existing extension of credit," and include "revocation, alteration, or termination of credit" and "collection procedures" (12 CFR 1002.2(m)).

The CFPB conducts risk-based examinations of debt collectors including examinations coordinated with state regulators. Since 2012, the CFPB has filed 30 enforcement actions against debt collectors.[13] This count does not include several actions against non-debt collector financial institutions related to unlawful debt collection practices.

The FTC is primarily a law enforcement agency; however, the FTC plays a crucial role in overseeing the debt collection industry. The FTC's debt collection program is a three-pronged effort: (1) law enforcement; (2) education and public outreach; and (3) research and policy initiatives. Over the past year, the FTC has employed all three prongs to curb unlawful debt collection practices and protect consumers.

In 2018, the FTC filed or resolved seven cases against 52 defendants, obtained more than $58.9 million in judgments and banned 32 companies and individuals who engaged in serious and repeated violations of law from ever working in debt collection again. The FTC publishes a list of banned debt collectors.

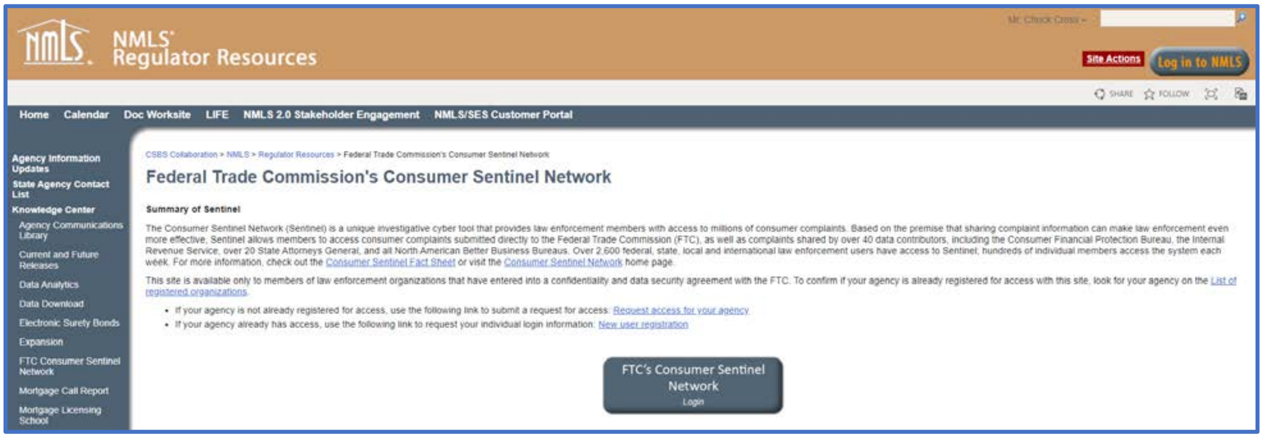
The FTC is an independent federal agency of lawyers, investigators and economists. The FTC operates under the direction of five commissioners appointed by the president of the United States. The FTC holds responsibility under more than 70 federal laws. In the credit and debt collection space the agency focuses primarily on the Federal Trade Commission Act, the Fair Debt Collection Practices Act, the Truth in Lending

[13] Debt collection is used broadly here to include debt collectors, debt management services, debt buyers and other services related to collecting debt or assisting consumers with debt problems.

Act, the Military Lending Act, the Fair Credit Reporting Act, the Fair Credit Billing Act and the Equal Credit Opportunity Act.

The FTC works closely with the CFPB and states in conducting enforcement against debt collectors. As part of its coordination efforts the agency connects state regulators with Consumer Sentinel, an investigative tool that provides regulators and law enforcement with access to a national database of millions of consumer fraud complaints. Based on the premise that sharing complaint information can make law enforcement even more effective, Sentinel allows members to access consumer complaints submitted directly to the FTC, as well as complaints shared by over 40 data contributors, including the CFPB, the Internal Revenue Service, over 20 state attorneys general, and all North American Better Business Bureaus. Over 2,600 federal, state, local and international law enforcement users have access to Sentinel; hundreds of individual members access the system each week. For 2018, Consumer Sentinel allowed the FTC to identify debt collection as the second highest complaint category.

Consumer Sentinel is linked with NMLS allowing regulators easy access to vital supervisory information.



State Supervision

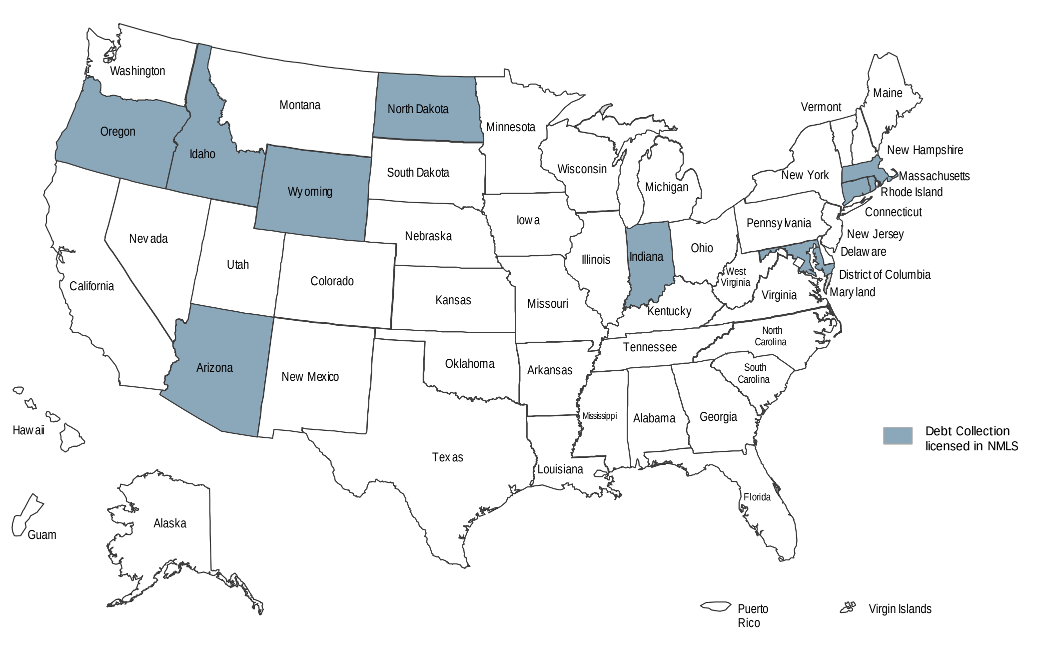
Licensing of Debt Collectors

In states requiring debt collectors to be licensed it is a violation of law for a debt collector to contact a debtor by almost any means unless first licensed. While state laws differ, common requirements include identification or separate licensing of a person responsible for the operations of the debt collector, background checks and a surety bond.

The Nationwide Multistate Licensing System is currently used by 10 states to process, issue and maintain debt collector licenses. As of June 2019, over 1,800 licensed companies held over 6,200 licenses through the system (includes individual licenses where applicable). However, not all states are utilizing NMLS at this time and the NMLS count of numbers should not be considered exhaustive of state licensing.

State Agency	License Description	Approved Licenses
AZ	Collection Agency License	583
CT	Consumer Collection Agency License	615
ID	Collection Agency License	535
IN-SOS	Collection Agency License	760
MA	Debt Collector	418
MD	Collection Agency License	1,135
ND	Collection Agency License	559
OR	Collection Agency Registration	784
RI	Debt Collector Registration	520
WY	Collection Agency License	348

(*source: NMLS data*)



Examination, Investigation and Enforcement

State supervisors with jurisdiction over debt collectors generally hold the authority to examine or investigate licensed debt collectors and where necessary undertake enforcement actions. While state authority is independent and sovereign within its jurisdictional coverage, debt collection supervisors join forces at the national level under NACARA for purposes of conducting examinations and enforcement. Regardless of whether a state is conducting its own examination or participating in multi-state examination, the review process typically includes:

- Trust account maintenance and proper use – trust accounts are required for holding other people's funds separate from the debt collector's funds.
- Payment tracing/transaction testing – payments must be processed and remitted to creditors and appropriately applied to consumers' accounts.
- Financial condition of the debt collector.
- Communications to consumers and third parties in connection with debt collection.
- Collection call and letter reviews – includes examiners sitting in on live collection calls.
- Documentation of collection notes.
- Compliance management system – how an entity:
    - Establishes its compliance responsibilities
    - Communicates those responsibilities to employees
    - Ensures that responsibilities for meeting legal requirements and internal policies are incorporated into business processes
    - Reviews operations to ensure responsibilities are carried out and legal requirements are met
    - Takes corrective action and updates tools, systems, and materials as necessary
- Board of directors and management oversight.
- Compliance program – including:
    - Policies and procedures
    - Training
    - Monitoring
    - Corrective action
- Consumer complaints – An effective compliance management system should ensure that a supervised entity is responsive and responsible in handling consumer complaints and inquiries.
- Compliance audit – A compliance audit program provides the board of directors with a determination of whether policies and standards adopted by the board are implemented and satisfactory.

In addition to reviews for compliance with state and federal law and regulations, examinations and enforcement investigations frequently focus on egregious collection practices, including:

- Phantom Debt Collection – fake debts
- False Threats – particularly threats of suit, wage garnishment, arrest and imprisonment
- Third-party disclosure – to employers, neighbors and roommates
- Bogus Fees – fake attorney's fees, interest charges and other unauthorized charges

A Note on State Supervision of Student Loan Servicing

Twelve states and territories claim jurisdiction over student loan servicing as of December 2019. Another nine states have laws pending.

States Laws

Enacted: California, Colorado, Connecticut, District of Columbia, Illinois, Maine, Maryland, Nevada, New Jersey, New York, Rhode Island and Washington.

Pending: Iowa, Massachusetts, Minnesota, Missouri, New Hampshire, North Carolina, Oregon, Pennsylvania and South Carolina.

Some states interpret their debt collection laws to cover student loan servicers in certain situations. Further, some debt collectors collect defaulted student loans, arguably making this activity covered under the state debt collection law. There are potential overlays and redundancies between servicing laws and debt collection laws in some jurisdictions and both servicers and debt collectors must be thoroughly versed in each state's requirements before conducting business. Connecticut recognizes this redundancy in its 2016 "No Action Position," where it notifies duly licensed debt collectors, "[T]his department recognizes that licensed consumer collection agencies are already licensed and regulated by this department in connection with the receipt of payments on defaulted or delinquent student loan debt and that the requirement a licensed consumer collection agency obtain a separate license as a student loan servicer from this department for such activities may be redundant and unduly burdensome."[14]

The emerging area of state supervision of student loan servicers is occurring in response to very real consumer protection concerns. State attorneys general and individual state regulators have filed enforcement actions against servicers. However, across the areas of licensing, examination, investigation and enforcement, the states face an uphill battle under the banner of federal preemption. With approximately 79% of the serviced market in federal student loans, this battle is very real and costly for state supervision.

In January 2016, the Maryland Office of the Commissioner of Financial Regulation contacted the Department of Education with an inquiry as to whether it objected to state licensing, asking whether third-party student loans servicers collecting on behalf of the Department under the Direct Loan program are subject to the Maryland Collection Agency Licensing Act (MCALA).[15] The Department responded to the Maryland regulator on Jan. 21, 2016, stating, "If the State determines that loan servicers or PCAs are 'collection agencies' under MCALA, the Department does not believe that the State's regulation of those entities would be preempted by Federal law. Further, such regulation would not conflict with the Department's contracts with those entities, which provide generally that loan servicers and PCAs must comply with State and Federal Law."[16]

In July 2016, the Department reinforced its position with the MD regulator by issuing a memo to FSA, the U.S. Department of Treasury and the CFPB regarding the Policy Direction on Federal Student Loan Servicing.

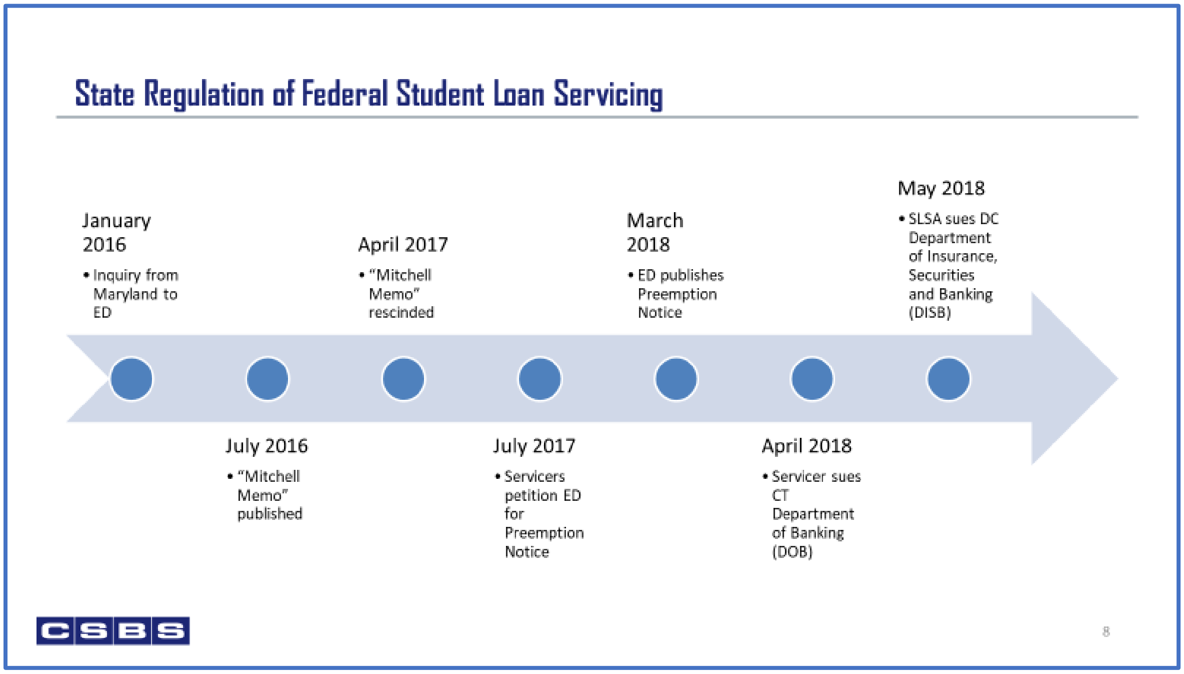
[14] https://portal.ct.gov/-/media/DOB/consumer_credit_nonhtml/NoActionPositionreStudentLoanServicingpdf.pdf?la=en
[15] https://www.csbs.org/sites/default/files/2020-01/Letter%20on%20Student%20Loan%20Servicers%20-%20Collection%20Agency%20License.%20OCFR%20to%20Dept.%20of%20Ed%20%2812.30.15%29.pdf
[16] https://na-production.s3.amazonaws.com/documents/Dept._of_Ed_Response.1.21.2016_dORyoLm.pdf

The memo, sent by Ted Mitchell, Under Secretary, came to be known as the "Mitchell Memo."[17] The memo laid out comprehensive policy direction for servicing federal student loans and included specific instructions on the handling of borrower issues. The memo opens with, "The direction below is driven by the experiences of federal student loan borrowers and is responsive to the need to establish a transparent and accountable system that allows for continuous improvement."

Page 38 of the Mitchell memo states: Servicing contractors should comply with federal and state law, taking any necessary steps to support oversight by federal or state agencies, regulators, or law enforcement officials.

Page 43 of the Mitchell memo states: Borrowers can expect their servicer to support external complaint handling functions administered by other federal and state agencies. There should be at least one management level employee to be the primary contact for the CFPB, any state attorney general, or any other state or federal official charged with assisting student loan borrowers regarding consumer complaints and inquiries. For each consumer complaint submitted through the CFPB, any state attorney general, or other state or federal official charged with assisting student loan borrowers, there should be a substantive written response to the entity or official who submitted such complaint.

However, in April 2017, the Department rescinded the Mitchell mem memo and, in March 2018, published a notice asserting its interpretation that state regulation of federal student loan servicers is preempted by the Higher Education Act (HEA).[18]



[17] https://www2.ed.gov/documents/press-releases/loan-servicing-policy-memo.pdf
[18] https://www.federalregister.gov/documents/2018/03/12/2018-04924/federal-preemption-and-state-regulation-of-the-department-of-educations-federal-student-loan

The Department's interpretive notice seeks to establish sweeping preemption of state regulation. But it is both procedurally defective and asserts an erroneous view of the law. From a rulemaking perspective, the notice itself is "informal guidance" outlining the Education Department's position that the HEA, the Education Department's regulations and its contracts with servicers preempt state servicing laws. As a result, it lacks the force and effect of law and does not itself preempt state law. Additionally, courts which have considered the notice have refused to defer the interpretation set out therein. Instead, courts have found that the notice is neither well-reasoned, nor sensible. One court even described the notice as "a retroactive, ex-post rationalization for the Education Department's policy changes" that "does not analyze in any real way the regulation it cites."

The interpretation it sets forth is also based on a mistaken view of the law. The notice asserts field preemption to displace state regulation, but courts have uniformly held that field preemption does not apply under the HEA. It also asserts that because state law disclosure requirements are preempted by the HEA, so too are regulatory reporting requirements imposed by state law -- a claim that courts have roundly rejected. Further, the notice asserts that state law conflicts with and thus is preempted by the HEA, but it does not cite a single instance of irreconcilable conflict. Lastly, the notice asserts that subjecting federal student loan servicers to state regulation would impose costs on servicers and, by extension, taxpayers. But, in fact, it is the failure to ensure servicers comply with federal law that costs taxpayers money because the government is overpaying for noncompliant, and thus low-quality, loan servicing.

In response to the HEA notice, CSBS objected to the education secretary's opinion on preemption of state law:

> *"Congress has deliberately preserved this cooperative state-federal regulatory framework for nonbank financial services activities for the benefit of consumers and providers of financial services alike. Consumers benefit because the proximity of the state regulatory framework has proven to be more accountable to local concerns and enables the public to conduct their own assessment as to whether the degree of consumer protections afforded by a State accords with their personal preferences."* (see https://www.csbs.org/csbs-opposes-department-education-plan-preempt-state-authority-student-loans-0)

Thus, the states have objected to the Education Department's position on preemption on legal and policy grounds. Preemption of state regulation will have significant consequences for student borrowers. As a recent Inspector General report found,[19] federal student loan servicers have exhibited failures in consumer protection by employing substandard servicing practices that include:

- Not informing borrowers about all repayment options
- Miscalculating payments under income driven repayment plans
- Repeatedly placing borrowers in forbearance

[19] https://www2.ed.gov/about/offices/list/oig/auditreports/fy2019/a05q0008.pdf

The Inspector General report further identifies that the Federal Student Aid office, as the oversight mechanism for the Department of Education, exhibits significant supervisory deficiencies, including:

- Loan allocation methodology misaligned
- Contractual accountability provisions rarely used
- Not tracking instances of noncompliance
- No oversight of servicer-directed borrower complaints

The loan allocation methodology is used by Federal Student Aid office to allocate new loan volume to servicers. It uses five performance measures but does not factor in compliance with federal rules. This means that routine noncompliance has no impact on the amount of loans allocated to a servicer. The five performance measures used are:

1. Customer service satisfaction, based on a survey of borrowers (worth 35% of servicer's overall score);
2. Percentage of borrowers in current repayment status, or less than 6 days delinquent (30% of score);
3. Percentage of borrowers more than 90 but less than 271 days delinquent (15% of score);
4. Percentage of borrowers more than 270 but less than 361 days delinquent (15%of score); and
5. FSA employee survey results (5% of score).

CSBS and the states have argued that the evidence of consumer harm is very real; however, the sufficiency of federal oversight and awarding of federal contracts based on performance is lacking.

Conclusion

Debt collection is a large and growing segment of nonbank financial services. The growth of all forms of consumer credit, and the too often unfortunate end state of that credit in delinquency will continue to fuel the need for debt collection and debt relief by both creditors and consumers. State regulation of debt collectors, debt relief and student loan servicing is an emerging area within the system of state supervision.

Greater effort in developing uniform and comprehensive standards for regulation throughout the state system would result in better supervision of debt collection practices. And as the need for consumer protection and industry oversight expands, regulators will undoubtedly sharpen their focus on this area and state legislatures will likely respond with new or enhanced laws focused on this important part of the nonbank marketplace.