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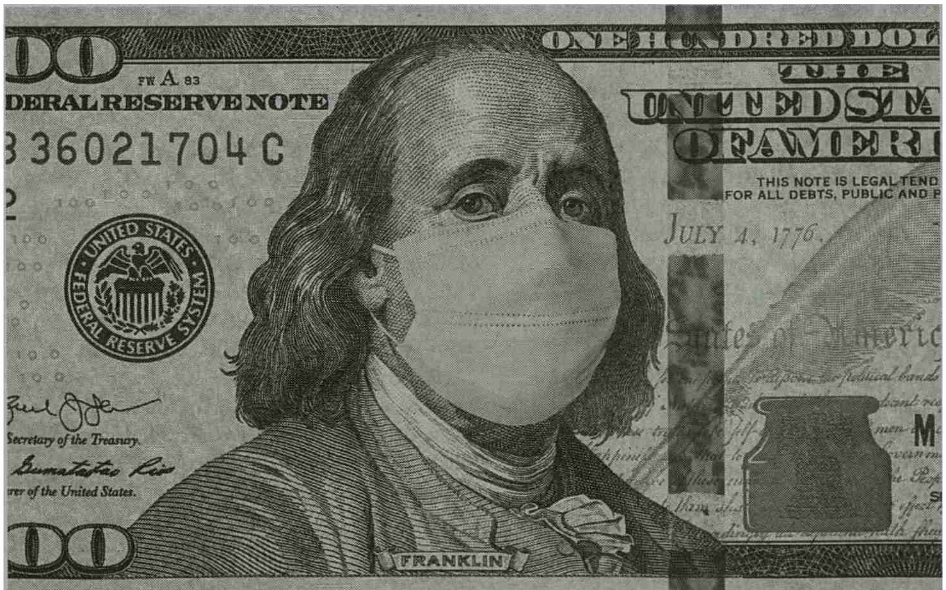
Financially stressed? What to know about your options



Even before the pandemic, when the economy was humming, many people were struggling with their finances. Now, many more are in trouble. These are resources to help. GETTY IMAGES/ISTOCKPHOTO

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The COVID-19 pandemic and economy-shutting measures to contain it came on quickly, over a matter of weeks. But the financial fallout — from job losses, reduced hours or wages, higher medical bills, mounting credit card bills and more — could linger as an unfortunate reminder for years to come.

Even before the pandemic, when the economy was humming, many people were struggling with their finances.

Several factors got Nicole Hudson in trouble.

"In 2005 I divorced and discovered that with credit cards I could afford the same lifestyle I was used to when I was married," she said in an email.

But when the Phoenix woman became unemployed in 2011, she realized the extent of her debt problem. "For the first time in my life, I found myself without a job but still had the bills to pay," said Hudson, 45.

"Before I knew it, I was swallowed up in trying to find a way to make minimum monthly payments on almost $19,000 in debt," she said, in addition to a car payment, rent, utility bills and other expenses.

Hudson sought to have some of her outstanding balances waived by contacting a debt-settlement company, but there are other options, too. If you are among those facing a severe strain, here are three processes that can help, though all come with different benefits and drawbacks.

Credit counseling/debt management

Many credit counseling companies and nonprofit agencies provide budget-

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ing and other financial education help to consumers in need, for free. Many of these entities also enroll struggling consumers in debt-management plans lasting up to five years.

In these latter programs, agencies negotiate with credit card companies and other creditors to lower interest rates on a consumer's debt, thereby also reducing payments and combining multiple payments into one.

"We try to negotiate single-digit rates," said Mike Sullivan, a spokesman for Take Charge America, a Phoenix nonprofit that offers credit-counseling and debt-management services.

For a consumer who might be paying 20% or more in interest on credit cards, a rate cut to 3% or 4% can represent significant savings. In addition, debt management entities often try to get lenders to waive late-payment and other fees, which also can lower payments, Sullivan said. However, these entities don't negotiate lower debt balances.

Types of debt included: Credit card balances are the focus but other unsecured debts can be addressed too, including unpaid medical bills and payday loans. Some agencies also give counseling guidance on student loans. (Secured debts are those tied to collateral or property such as a home mortgage or vehicle loan.)

Fees: Credit counseling is offered for free, though fees apply on the debt management programs. At Take Charge America, for example, debt management services cost $50 to $75 or so to set up and $50 to $75 a month after that, Sullivan said. Over a five-year program, a consumer might incur a few thousand dollars in fees.

Impact on credit scores: Enrolling in credit-counseling or a debt-management program usually doesn't result in lower credit scores. In fact, over time, scores should improve as more debt gets paid down.

Creditor phone calls: These typically stop, as creditors receive payments as part of a debt management plan. Take Charge America surveyed its clients six years ago and learned something surprising. "The No. 1 reason people contacted us wasn't to save money but to stop the calls," Sullivan said. "Collection calls are terrifying to most consumers."

Suitable for: The programs can make sense for people with modest financial stress who need an affordable payment plan featuring lower interest rates on credit card balances. However, participants in a debt management program also need sources of income so that they can start paying off those balances and other IOUs.

Potential drawbacks: As noted, debt management doesn't reduce the balance on debts, and the monthly payments still can be high. Consumers need income to pay down their obligations, and they must have the discipline to stick with these programs.

At Take Charge America, the typical debt management customer stays with the program for 38 to 40 months or so. "That's a long time to live on a tight budget," Sullivan said. "It requires some perseverance."

Consumers should realize that nonprofit debt management agencies receive funding from the banks or other creditors with which they are dealing on consumers' behalf. That might create a conflict of interest, but it also provides a way to make the model work.

"Without a partnership with the banks, we frankly wouldn't get those concessions," said Sullivan, referring to lower interest rates and fee waivers. "Concessions are the reason we're in business."

Debt settlement/negotiation

Debt settlement companies work on a consumer's behalf to lower principal balances owed. They encourage borrowers to stop making credit-card or other payments. The idea is to divert this cash into a savings account that can be used to fund an eventual settlement. But the process can be nerve-wracking.

"If you stop paying your bills, you will usually incur late fees, penalty interest and other charges, and creditors will likely step up their collection efforts against you," warned the federal Consumer Financial Protection Bureau, which oversees these businesses. "The period between initial delinquency and settlement often reflects a period of financial distress for consumers and uncertainty for creditors."

Creditors, though, have incentive to work out a deal, as that's often better than writing off a debt as a loss. Consequently, they might agree to cut your debt. What you spend building up that settlement fund is often less than the minimum payments on credit cards or the monthly payment in a debt-management plan, said Michael Micheletti, a spokesman for Freedom Debt Relief, a company with a large operation in Tempe.

Debt settlement companies work on behalf of clients, without receiving subsidies from banks or other creditors. The American Fair Credit Council is one place to look for reputable firms. Those like Freedom Debt Relief that have operated for many years often have good working relationships with creditors, which can help in negotiations. These companies are for-profit, unlike the many nonprofit debt management entities.

Types of debt included: Settlement programs deal with unsecured debts including credit card balances, personal loans and unpaid medical bills.

Fees: Debt settlement companies charge fees, usually based on the amount of debt enrolled or reduced. These costs can be sizable, though fees are supposed to be charged only after a lower debt has been negotiated. Freedom Debt Relief, for example, charges fees ranging from 15% to 25% of debt enrolled for negotiation, with an average of 22%, Micheletti said.

Impact on credit scores: People who pursue debt settlement usually see their credit scores drop after they stop making payments to creditors and their accounts go delinquent. But once consumers reach a settlement and start paying down their reduced debts, their scores often rise.

Creditor phone calls: Bothersome calls from creditors or collection agencies continue, and often intensify, once borrowers stop making payments, until a negotiation deal has been reached. Settlement firms including Freedom Debt Relief coach their customers on how to deal with calls, Micheletti said.

Suitable for: These programs are most appropriate for individuals who are struggling with serious debt, perhaps exacerbated by a job loss, divorce or other hardship, but who also have income to dig out. "These people have an ability to pay but they just can't pay it all back," Micheletti said. At Freedom Debt Relief, the average amount of consumer debt enrolled in the program is $25,000.

Hudson, who worked with Freedom Debt Relief to have her debt reduced, said the company gave her an honest assessment of her predicament. Although her representative "spilled some hard truths, I appreciated the transparency," she said. "At least I had a firm understanding of my responsibility."

Hudson, who now works in pharmacy benefits management, also resolved to live within her means. "It was hard, but it was the best learning lesson for me," she said. "It was almost exciting to see when each account was settled." Creditors waived about half of her $19,000 in debts over three years.

Hudson said she had a good experience with Freedom Debt Relief, though the Consumer Financial Protection Bureau fined the company last year for not clarifying certain policies to consumers and for other business practices. Micheletti said those problems were corrected.

Potential drawbacks: Besides lower credit scores, higher fees and other drawbacks, some creditors might not agree to settle and, instead, could pursue legal action against a consumer for unpaid bills. Also, debt settlement programs require a lot of discipline.

"It's an austerity program where you're forced to put money into the account, from which we'll make payments on your behalf while negotiating with creditors," Micheletti said.

Like individuals who give up on New Year's resolutions, some debt-strapped customers find the program too difficult to maintain, he said.

Bankruptcy filings

Bankruptcy is the court-supervised process of wiping clean certain debts or dealing with them through a debt repayment plan. Details vary depending on the type of filing.

Filings under Chapter 7 of the bankruptcy code eliminate most unsecured debts, though consumers can retain

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some protected or exempt assets such as a vehicle, necessary clothing, furnishings, appliances and other goods. Nonexempt assets subject to forfeiture include second homes, money in bank accounts and various investments (though generally not pension or retirement accounts). Nonprotected assets are sold, with proceeds distributed to pay off creditors.

It is more difficult than it used to be to qualify for a Chapter 7 filing, with a means test that eliminates higher-income individuals. In Maricopa County, for example, an individual can't file with gross income above roughly $52,000, or about $87,000 for a family of four. Those thresholds change periodically.

Another version, under Chapter 13 of the bankruptcy code, involves a court-supervised repayment plan. Debtors make monthly payments on certain debts but can have others such as credit card balances discharged or eliminated, said Diane Drain, a Phoenix bankruptcy attorney.

Chapter 13 filings frequently fail, Drain warned, such as when debtors don't stick with the plan or can't afford the monthly payments. When this happens, their credit issues don't get resolved. "The wolves are back at the door," she said.

Types of debt included: Bankruptcy can involve a wide range of debts to be wiped clean (Chapter 7) or subject to a repayment plan (Chapter 13). Debts that typically can't be discharged include federal student loans, child support and alimony, most types of taxes and court-imposed fines or penalties for a crime. Assets bought with a secured debt, such as a home, sometimes can be retained if the borrower wants to keep them and can make payments.

Clearly, there are strategies involved, and working with an experienced attorney can help you determine which assets to retain. The State Bar of Arizona (azbar.org) is one place to locate attorneys.

Fees: Court expenses run a bit more than $300 for both Chapter 7 and 13 filings. Attorney fees might cost another $1,500 to $2,500 or so for a Chapter 7 case or $4,000 to $6,000 for a Chapter 13, Drain estimated. Chapter 13 filings cost more because an attorney typically is involved for a lengthier period. (Attorney fees might be due up front or handled in a repayment plan.)

Impact on credit scores: A bankruptcy filing will damage your credit score, and the demerit with stay on your credit reports for seven years (for a Chapter 13) or 10 years (for a Chapter 7), according to credit bureau Experian. However, your borrowing ability might not be crimped all that much, for better or worse, because lenders realize you must wait eight more years to file another Chapter 7 and four years for a Chapter 13.

"My clients tell me that, within a week of filing, their (postal) mailboxes are stuffed full of credit card and auto loan offers," said Drain. "Creditors see them as ripe for the picking."

Even so, she recommends that anyone filing for bankruptcy wait at least a year to utilize credit again, so as to wean themselves from a reliance on borrowing.

Creditor phone calls: These usually cease once an attorney gets involved. Lenders or collectors who continue to harass borrowers who have filed for bankruptcy protection can face a court cease-and-desist order and possible penalties, Drain said.

Suitable for: A bankruptcy filing might be the right choice, and possibly the only choice, for people unable to repay their debts or, alternatively, those with sufficient income to manage a repayment plan.

As bankruptcy often is seen as a last resort, financially distressed people typically don't file until many months or even years after they get into trouble. Bankruptcy thus is considered a lagging economic indicator. Filings are still down so far in 2020 compared to last year, despite stress caused by the coronavirus pandemic.

Potential drawbacks: In addition to legal/court fees and a long-term negative credit-score impact, bankruptcy filings are a matter of public record, open to inspection. Nor will bankruptcy eliminate all types of debts, as noted, and debtors are limited as to how frequently they may file.

No one-size solutions

These are the basic differences among three common approaches to dealing with unmanageable debt. Is there a perfect solution? Not for everyone.

Howard Dvorkin, a certified public accountant who has studied the problem, feels that debt settlement companies have had an "especially bad reputation" in recent years, though he also noted that there are shady lawyers and incompetent nonprofits.

"Debt management is often better when you have fewer debts and more income because it gets the job done with the fewest complications," he wrote in a recent report. When you have a bigger problem, debt settlement is more complicated but might result in a "more robust solution."

At any rate, he suggests starting with credit counseling, regardless of where you end up. Why? "Because reputable nonprofit credit-counseling agencies give you a free debt analysis," he wrote. "By law, they must point you in the direction of the best debt solution for you, not them."

Drain agrees and said she often recommends a nonprofit group, the National Foundation for Credit Counseling, as a first step. But even after working with an agency, many debt-strapped people eventually return to her because they can't afford the payments. "By the time they come to me, they're broke," she said.

Still, taking those initial steps, such as through credit counseling and debt management, can be worthwhile.

"It helps them to understand the system," Drain said. "The benefit of working through the math of their finances is that it gets them to the emotional and logical stage of exercising their right to file for bankruptcy."

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