NERA
Economic Consulting

National Economic Research Associates, Inc.
1166 Avenue of the Americas
New York, New York 10036
+1 212 345 3000 Fax: +1 212 345 4650
www.nera.com

NERA
Economic Consulting

I. Introduction

This brief report, prepared by NERA Economic Consulting, analyzes the effect credit negotiation services are likely to have on creditworthiness after an individual completes the negotiation program. Credit negotiation may result in improved creditworthiness relative to other alternatives available and may lead to improved credit scores for some individuals after completion of a negotiation program.

First it is important to make distinctions among an individual's credit *score*, which usually refers to the FICO score, an individual's fundamental credit worthiness considered from an economic point of view, and an individual's ability to access sources of credit.

The FICO credit score is a one-dimensional numerical measure of a consumer's credit risk. It is calculated by the Fair Isaac Corporation based on credit reports provided by credit bureaus. The calculation is done by a fully computerized algorithm and does not depend on judgment. There are other credit scores commercially available, most notably the VantageScore, that are also calculated by computer. The exact impact of debt negotiation programs on these credit scores cannot be determined because both of them are based on proprietary scoring algorithms that are closely-guarded trade secrets.[1] As will be discussed below, however, some qualitative features of these scores are reported publicly and have some bearing on the effect of credit negotiation procedures. It is likely that, as noted in the promotional materials of some debt negotiation services, the initial effect of a credit negotiation plan on a consumer's credit score

[1] See, for example, The Scoring Game: FICO and Vantage Credit Scores explained, HSH Associates, available on the HSH website http://library.hsh.com/?row_id=86#. The fact that such credit scores are sold to potential lenders explains the need for secrecy.

will be negative. However, credit scores may rise afterwards and there is evidence that they have done so for some consumers.

From an economic point of view, the most important component of general creditworthiness is the ability to repay new loans. As will be discussed below, the improvement in the debt-to-income ratio that results from a credit negotiation plan will improve creditworthiness in this sense.

Finally, there is the question of the actual ability of a consumer who has engaged in a credit negotiation program to gain access to credit after the program. We do not have data that allow us to address this question directly. It is important to note that a credit score is not the only measure that is used by lenders when making a credit decision. Credit card lenders will typically access the entire credit report of a consumer when making a decision and will analyze these data themselves. Particularly, for car and mortgage loans, the debt-to-income ratio will also be a consideration. For credit card companies, the probability of repayment will be only one consideration as consumers who pay off their balances every month are not profitable.

The marketing materials of some debt negotiation services have been explicit in stating that credit ratings will fall during participation in the program. Marketing materials have clearly stated improvement would come through an improved debt-to-income ratio and that this was primarily used for determination of eligibility for car loans and mortgages.

II. Effect on Credit Scores

As discussed above, the exact effect of a credit negotiation program on the credit score of an individual cannot be precisely calculated. Further, the effect will vary depending on the prior credit history. The effect of a credit negotiation program on credit is best analyzed relative to likely alternative outcomes. These alternatives may in turn depend on the credit history of the individual.

Consider, for example, an individual with $20,000 of credit card debt and no other debt, who has never missed a minimum payment, never had a judgment against her or a bankruptcy and still has $10,000 of unused credit available. Under these conditions, she should have a nearperfect credit rating. Given an initial excellent credit rating, it is indeed unlikely that such an individual could improve her credit rating through a credit negotiation process. However, this type of individual was not the sort targeted by the marketers of debt negotiation services. Marketing materials of such services explicitly state that the program was not for people who are capable of continuing to make all of their payments into the future.

Instead, debt negotiation services are typically marketed to clients who faced a substantial likelihood of personal bankruptcy.[2] Whatever the effect of the debt negotiation program on an individual's credit score, it was likely to produce a better ultimate credit rating than would a declaration of bankruptcy.[3] Similarly, an organized credit negotiation program may provide a better ultimate credit rating than an individual would have with a slow slide into non-payment.

At least some clients who have completed credit negotiation programs in fact ended up with very good credit scores. NERA has been provided with credit reports of several such clients. One has a credit rating of from 718 to 730 across the three credit bureaus. According to Fair Isaac, the median credit score is in the range 700-749.[4] The FICO score lies in the range of 300-850. For many banks, the lowest mortgage rate is available for consumers with a score in excess of 650.[5] Mortgages made to consumers with scores above 620, other things equal, are normally considered prime loans.[6] Another consumer had a FICO rating of 697 from the Experian credit bureau, which Experian rated as "Good." This credit report clearly shows multiple accounts as having been closed with payment for less than the full amounts. This is important as it shows that this solid credit rating was not the result of the credit bureau failing

---

[2] This can be seen both from firm websites and phone scripts for solicitations. Further, high levels of credit card debt are generally correlated with bankruptcy rates. (See e.g., Stavins, Joanna ,"Credit Card Borrowing, Delinquency, and Personal Bankruptcy," *New England Economic Review*, July 2000, pg. 15-19.)

[3] Again, the exact effect on credit scores is impossible to determine. However, a bankruptcy can remain on credit reports for ten years, as opposed to seven years for a negotiated settlement. See the Fair Credit Reporting Act §605. Further, bankruptcy "can make it difficult to obtain credit, buy a home, get life insurances or sometimes get a job." ("FTC Facts for Consumers" December 2005, pg.4.)

[4] "Understanding Your Fico Score," Fair Isaac Corporation, 2005, pg. 7.

[5] According to Fair Isaac's website, myFICO.com, as of February 19th 2007, a perfect credit score would reduce the 30 year mortgage rate by fewer than 30 basis points as compared to a consumer with a credit score in the 700-759 range.

[6] See, for example, Remarks by Governor of the Federal Reserve Board Edward M. Gramlich, at the Financial Services Roundtable Annual Housing Policy Meeting, Chicago, Illinois, May 21, 2004. http://www.federalreserve.gov/boarddocs/Speeches/2004/20040521/default.htm

to record negative information that resulted from the negotiation program. Instead, it indicates that while such information may stay on credit reports for the full seven years, write-downs on the part of lenders do not necessarily lead to a poor credit rating for all that time.

Since the FICO score is computed by algorithm, not by individual judgment, these credit reports indicate that completion of a credit negotiation program can lead to good credit scores. This of course does not mean that every individual completing a credit negotiation program will have a high credit rating. Certainly some people who have had trouble with debt will borrow unwisely again, for example.

There are specific mechanisms by which a credit score may be raised, even in the presence of a weak credit history. First, according to Fair Isaac, payment history accounts for only approximately 35% of the FICO score.[7] On the other hand, 30% of the score is based on amounts owed. According to Fair Isaac, the total amount of all debt, as well as the amount of credit card debt, are factors in this category. By reducing the debt load through a debt negotiation program, these factors in the credit score will be immediately improved. Another factor in this category is the fraction of available credit lines utilized. This may be directly improved by a credit negotiation program as accounts are closed while other "emergency" credit cards are held open with low or zero balances.

Another approximately 10% of the FICO score is from a category Fair Isaac calls "New Credit." One of the factors in this category is whether the consumer has a good recent credit history following past payment problems. For consumers who have had trouble making payments before starting a negotiation program, which is to say the sort of consumers targeted by debt negotiation companies, reducing outstanding debt will make room for improved payment behavior in the future. This improved payment behavior will, according to Fair Isaac, have a positive effect independent of the effect on the overall credit history.[8]

Thus, while the exact effect of a credit negotiation program on a consumer's FICO score is impossible to predict, it is clear that Fair Isaac considers a number of factors that will be

[7] "Understanding Your Fico Score," Fair Isaac Corporation, 2005, pg. 10.

[8] "Understanding Your Fico Score," Fair Isaac Corporation, 2005, pg. 13.

substantial positives after completion of the program. These factors, according to Fair Isaac, have greater total weight than the consumer's credit history. It is clear that stopping payments on accounts at the beginning of a program will lead to a reduced credit score. It is equally clear, from the information disclosed by Fair Isaac, that there are other factors which will lead a credit score to improve after completing such a program. How important those other factors are will depend, in part, on the subsequent actions of the consumer. Further, as noted above, some individuals have completed a credit negotiation program and ended up with solid credit scores, while having the write-downs associated with debt negotiation clearly recorded in their credit histories. Given the algorithmic nature of credit scores, anyone with a similar pattern of behavior would end up with a similar score.

III. Debt Negotiation Improves Creditworthiness

From an economic point of view, creditworthiness is simply the economic ability to repay loans. For this, the critical factor is the debt-to-income ratio. This is the result of simple arithmetic. Debt service, the payment of interest and principle, comes from income. The higher income is relative to the level of debt the easier it is for the consumer to service the debt. As such, an individual will be better able to repay future debt if she does not have extremely high levels of current debt.

The idea that reducing debt levels can lead to a higher ultimate payment to lenders has been explored heavily in the context of sovereign lending. There is substantial agreement for this proposition in the academic literature.[9]

Indeed, this idea is the fundamental basis of the public policy role of Chapter 11 corporate bankruptcy. The bankruptcy allows relief from debt in the short term in order to maximize debt repayment in the long term. There is no analog for Chapter 11 bankruptcy for an individual, though there may well be a public policy case for such a law. Debt negotiation allows for what is in essence an analog of the Chapter 11 bankruptcy – it provides a respite for the consumer

[9] For a recent summary of practical ideas for sovereign debt see, Arslanalp, Serkan and Peter Blair Henry, "Debt Relief," *Journal of Economic Perspectives*, **20**, 1, 2006, pg. 207–220. The foundation work on this topic was done in the late 1980s.

while allowing a reasonable settlement for lenders. In essence, it is an individual level reorganization.

Finally, as discussed below, the debt-to-income ratio is considered an important indicator of creditworthiness by banks and other lenders.

IV. Debt Negotiation May Improve Access to Credit

A. Debt negotiation improves the debt-to-income ratio

As advertised by some debt negotiation services, debt negotiation will improve basic creditworthiness as a result of the reduced debt load. The debt-to-income ratio is in fact used by banks and other lenders when evaluating car loans, mortgages and home equity loans, although it is not an element in standard credit scores.

An important example is that of home mortgages, for which a 36% debt-to-income ratio for all debt, including credit card debt, is the usual maximum for a mortgage.[10] Some mortgage lenders will lend at somewhat higher debt-to-income ratios, but it is still an important determinant of creditworthiness. The debt-to-income ratio is also a consideration for auto loans and may be considered by credit card lenders as well.[11]

The debt-to-income ratio is particularly important for mortgage and home equity loans. As such, there is another way in which a lowered debt-to-income ratio may improve a borrower's creditworthiness. The reduced debt-to-income ratio may lead to easier access to home equity loans. Home equity loans can be used for debt consolidations that substitute low interest rate home equity debt for high interest rate credit card debt. Lowering the interest rate on a consumer's overall debt makes total interest payments lower and increases the consumer's overall creditworthiness.

---

[10] In mortgage lending this is referred to as the Fannie Mae DTI guideline – this is expressed as the ratio of interest rate payments to income.

[11] See, for example, "Debt-to-income ratio important as credit score," Erin Peterson, Bankrate.com.

B. Some debt negotiation clients have opened new credit card lines

As discussed above, NERA has been provided with credit reports for multiple debt negotiation clients. One important feature of these reports is that they clearly demonstrate the ability to access substantial lines of credit with charge-offs and settlements reported in the credit history. One client was able to open multiple store accounts, at least one bank credit card and a $100,000 line from a mortgage lender despite having write downs and settlements reported in the credit history. Other reports also show new credit activity after completing the program.

These examples simply show that the logic above – that credit negotiation does not necessarily have a long run negative impact on credit scores and that it improves the debt-to-income ratio – leads to the expected conclusion: borrowers who complete a debt negotiation program and then borrow sensibly are able to access credit.

C. Credit card companies extend substantial credit to individuals with imperfect credit histories

Even in the presence of a poor credit history, credit card lenders may choose to extend substantial credit limits to borrowers. The economic logic of this fact is simple: a consumer who pays her total balance every month will not prove very profitable for the lender. This is why American Express cards charge annual fees and higher merchant fees than cards that allow consumers to carry balances. Credit card companies make money when consumers maintain balances month after month. Consumers making only minimum payments are particularly attractive. It has been estimated that 75% of the revenues of credit card issuers come from interest payments.[12]

Indeed, credit card companies have increasingly targeted riskier borrowers as competition in the industry has increased. From 1983 to 1995, for example, the fraction of families with incomes below the poverty line holding at least one credit card more than doubled.[13] Net revenues are higher for credit card companies that charge higher interest rates, minimum

[12] Evans DS and RL Schmalensee, *The Economics of the Payment Card Industry* (Cambridge, MA: National Economic Research Associates, 1993).

[13] Stavins, Joanna, "Has Widespread Use of Credit Cards Contributed to the Increase in Personal Bankruptcy?" *Boston Federal Reserve Quarterly Review*, 2001Q1.

finance fees and late fees, while charging higher annual fees is associated with lower revenues.[14]

Thus, there is evidence to suggest that even were a debt negotiation to lead to a reduced credit score, this may not substantially limit access to credit card debt. For a credit card company, a customer may be profitable even if some portion of the outstanding balance is written down. Four years of 17% interest amounts to 87% over four years.[15] Even a substantial write-down of principal on such a loan would be profitable for the lender. As such, consumers who have engaged in credit negotiation may still prove to be attractive to credit card companies.

V. Conclusion

Credit negotiation will have different effects on creditworthiness and credit availability across individuals and across time. The initial halting of payments on existing credit card debts will limit credit availability in the short term. However, the reduction of the individual's debt load, gained by the successful completion of a credit negotiation program, will lead to an increased ability to handle new debt. It provides breathing space for a consumer pressed by debts. That reduced debt load may lead to an improved credit score for such a consumer, depending on their behavior both before and after the debt negotiation program. It will also directly improve a consumer's debt to income ratio, an important factor in mortgage and auto lending. Importantly, any black marks on an individual's credit record arising from debt negotiation will still be better than those created by a personal bankruptcy that might be avoided by debt negotiation.

[14] Ibid pg. 3.

[15] The State of New York's Banking Department, December 30, 2005 survey of credit cards lists many cards charging 17% or more annual interest rates.