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New rule cracks down on debt settlement industry

Tired of credit card debt? Vulnerable borrowers get some protection

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Candice Choi, AP Personal Finance Writer, On Thursday July 29, 2010, 4:08 pm EDT

NEW YORK (AP) -- Companies that promise to reduce or eliminate credit card balances and other debt for customers will no longer be allowed to charge an upfront fee.

The Federal Trade Commission said Thursday that the new restrictions are a crack down on the debt settlement industry, which flourished during the economic downturn as borrowers struggled to pay bills.

Debt settlement companies will now only be able to charge a fee once a customer's debt has been reduced, settled or renegotiated. The rule goes into effect Oct. 27.

Since the start of the recession, the Better Business Bureau has received more than 3,500 complaints about debt settlement companies. Customers complained that they ended up deeper in debt or were sued by creditors after failing to make payments. The bureau did not separately track complaints against the industry prior to the recession.

Debt settlement companies often charge an upfront fee, typically a percentage of the customer's outstanding balance. In exchange, the company promises to negotiate with creditors to reduce or eliminate the debt, sometimes by as much as half.

The new FTC regulations also require debt settlement companies to disclose to customers how long it will take to get results, how much it will cost, and any negative consequences that could arise from the process.

For example, customers can go deeper into debt when they hire a debt settlement company.

This is because customers stop making payments on their loans, and late fees and interest charges continue piling up.

Customers are also often required to start setting aside money in a separate account maintained by the debt settlement company. This money is intended to eventually pay off any remaining debt.

Under the new rule, however, companies will only be able to require such an account if it's maintained at an independent financial institution under a customer's name.

The customer must also be able to withdraw the money at any time without penalty.

The amendments to the FTC's telemarketing sales rule apply to any debt relief companies that sell services over the phone. They do no apply if the initial contact is in-person, or if the services are rendered entirely online.

The new rule will cover the vast majority of the debt settlement industry, however, because most companies use TV and radio ads to advertise toll-free phone numbers for customers to call, said Allison Brown, an attorney with the FTC.

Debt settlement companies that step outside the rules will be subject to a $16,000 fine per violation. The Federal Trade Commission's rules only apply to for-profit companies. The agency warned that it will go after companies that pose as nonprofits.

The Better Business Bureau cautions customers to be wary of any organization that charges steep upfront fees and makes promises that sound too good to be true.

The group also suggests that struggling borrowers first try contacting lenders directly to negotiate debt. Alternatively, borrowers can seek help from nonprofit credit counseling centers, which typically charge small nominal fees for help managing debt.

Nonprofit credit counselors can be located on the National Foundation for Credit Counseling's website at http://www.nfcc.org.