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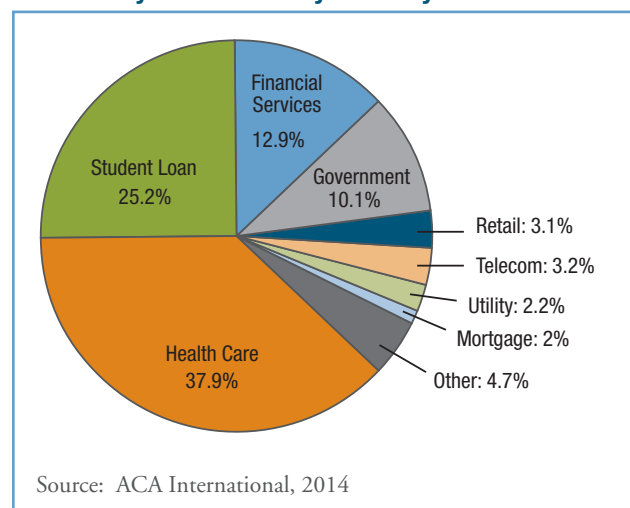
The Role of Third-Party Debt Collection in the U.S. Economy

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Introduction

The U.S. economy is heavily reliant on credit, and consumers depend on the availability of credit to access a range of goods and services from health care and education to automobiles and home loans. To support this credit economy, the debt collection industry serves a vital role recovering outstanding debts owed to creditors and service providers. As of the third quarter of 2015, there was \$12.07 trillion in outstanding consumer debt; \$672 billion of that debt is at some stage of delinquency (FRBNY, 2015). Creditors across a range of industries rely on third-party debt collectors to recover these outstanding balances. Figure 1 shows the distribution of debt collected by third-party debt collectors by industry for 2013. If this debt is not recovered, the excess costs are passed on to consumers via higher prices for goods and services as well as through increased interest rates and a decreased supply of credit.

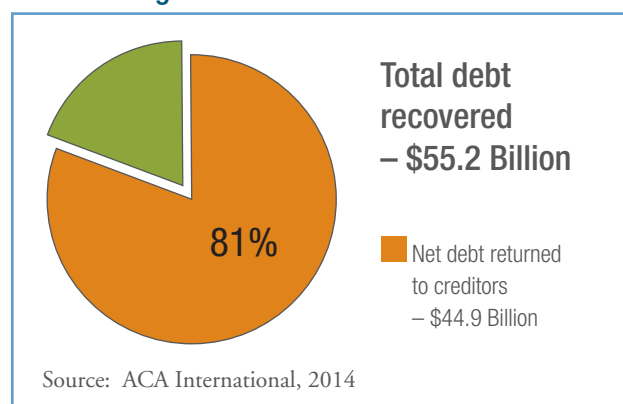
Figure 1. Percentage of Debt Collected through Third-Party Collections by Industry in 2013



The recovery of delinquent debts can have benefits for both lenders and consumers. For lenders, the

recovery of these outstanding debts allows them to keep costs down, maintain competitive prices in their local markets, and remain financially solvent. For consumers, when debts have been sent to collections, there is often the opportunity to negotiate the total outstanding balance, pay a discounted price on the initial balance, or develop a payment plan with the collection agency as a mediator (ACA, 2014). In 2013, third-party collection companies returned \$44.9 billion to creditors (see Figure 2). This return to creditors represents an average savings of \$389 per household, as businesses were not compelled to compensate for lost capital through increased prices (ACA, 2014).

Figure 2. Debt Returned by Third-party Debt Collection Agencies in the U.S. in 2013



Because of the distinctive nature of third-party debt collection, some have alleged that the industry targets low-income or economically insecure consumers. The industry is also often the subject of consumer complaints. However, researchers have noted that the collections industry is regulated by both the Federal Trade Commission (FTC) and the Consumer Financial Protection Bureau (CFPB), and that while complaints against the industry might appear to be frequent, the debt collection industry makes in excess

of one billion consumer contacts annually (Hunt, 2013) and as a proportion of the 30 million debts in collections on an annual basis “a relatively small number of consumers register formal complaints” (Zywicki, 2015, p. 15). This paper explores the role of the debt collection industry in the U.S. economy, with a particular focus on how debt collection performs a complimentary function to the credit and lending industries and positively influences creditor behavior. Furthermore, this paper examines how the debt collection industry provides support for consumers by sustaining an environment where lenders can make credit available and affordable to a wide range of consumers.

The Role of Debt Collection

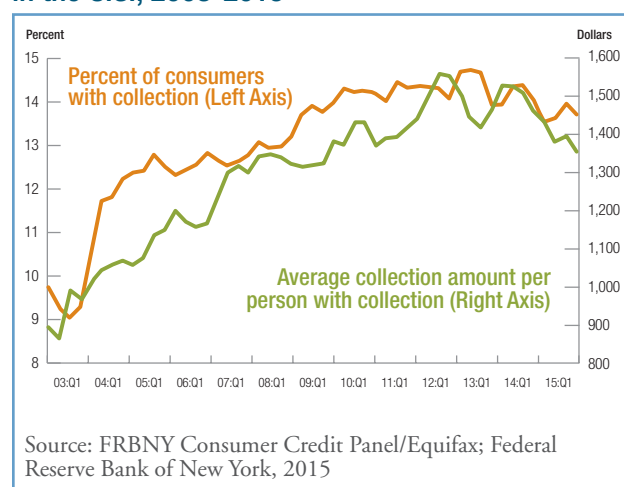
The debt collection industry performs a unique role in the marketplace. Broadly construed, the fundamental role of the debt collection industry is the enforcement of contracts, primarily between lenders and consumers (Fedaseyeu, 2014; Zywicki, 2015). This enforcement role provides a degree of security for lenders, via the presence of a third-party recovery mechanism, and allows lenders to more effectively account for risk in the marketplace. This is important to the overall credit market, because the ability to assess risk is necessary for lenders to profitably make loans and mitigate overall costs (Mitman, 2011; Zywicki, 2015).

Fedaseyeu (2014) describes this relationship, and the role of debt collection more generally, as “a creditor protection mechanism, which complements bankruptcy as a consumer protection mechanism” (p. 6). Specifically, the presence of debt collectors helps to offset moral hazard associated with making unsecured loans by providing lenders with a means of recovery in cases where consumers default. Indeed, the availability of debt collection as recourse for defaulted accounts introduces some degree of stability into the lending environment, allowing lenders to make more loans while managing their own risk (Dawes et al., 2009; Livshits, 2014).

Data from the Federal Reserve Bank of New York indicates only about 14% of consumers had debt in collections in 2015 (see Figure 3). Furthermore, prior research has found that between 90 and 95%

of all outstanding consumer debt is paid on time and in compliance with the consumers’ contractual obligations (DBA International, 2014; Zywicki, 2015). The reasonably high level of consumer repayment has been partially attributed to “the perceived effectiveness of the debt collection system in the event of nonpayment” (Zywicki, 2015, p. 5). As such, the debt collection industry, guided by complex laws and regulations, plays a pivotal role in the consumer credit marketplace as an external incentive for repayment.

Figure 3. Third-party Debt Collections in the U.S., 2003-2015



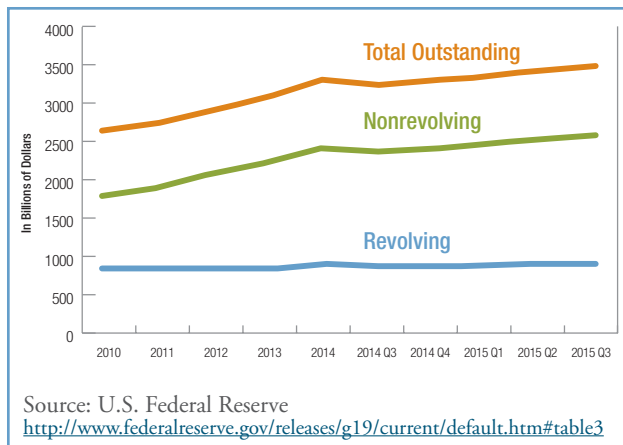
Debt collection companies are also uniquely positioned to recover past-due consumer debt. As specialized organizations, collection companies develop more efficient and effective methods of recovery than those of lenders. Additionally, lenders might not have the capacity to devote the necessary time or resources to recovery activities. In this instance, collection companies provide a service that compensates for these institutional limitations (Zywicki, 2015). Collection companies often have the advantage of being small businesses operating in a localized environment with first-hand knowledge of the economic conditions of their target consumers (Zywicki, 2015). Access to this type of specific information is integral for successful collection because, as Hunt (2007) notes, “collectors must be able to distinguish consumers who *can’t pay* from those who *won’t pay* even though they have the resources to do so” (p. 16). Effective debt collection helps reduce the overall risk for lenders and

subsequently increase the supply of unsecured credit, while reducing the cost of said credit for consumers (Zywicki, 2015). The remainder of this paper will further examine the role of the debt collection industry in supporting the availability of unsecured consumer credit.

Consumer Credit in the U.S. Economy

The U.S. economy relies heavily on the availability and accessibility of credit to consumers. As of October 2015 there were 3.5 trillion dollars in total outstanding consumer credit (see Figure 4). Zinman (2014) notes that in the United States, household participation in the leading consumer credit markets is roughly 70% for credit cards, 45% for mortgages, 30% for auto loans, and 19% for student loans (p. 2). The availability of consumer credit is important for two key reasons: credit allows consumers to purchase high-cost products outside the constraints of their pay-cycles and it enables consumers to absorb temporary shocks to their budgets (Durkin et al., 2015; Zywicki and Sarvis, 2012).

Figure 4. Total Outstanding Consumer Credit, 2010 – Q3 2015



Research has found that “most consumer credit is used to acquire consumer-oriented assets that provide their return not in the moment when they are purchased or soon afterward, but rather over a longer period” (Durkin et al., 2015, p. 5). These purchases can include tangible products such as household

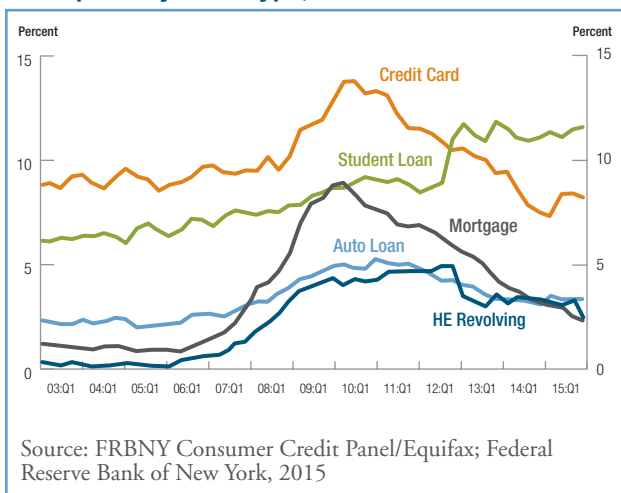
appliances, furniture, and vehicles or longer-term purchases, such as higher education via student loans. These purchases are best conceptualized as household investments facilitated by the availability of consumer credit. Having access to credit enables consumers to make these investments without being constrained by immediate cash on hand.

Similarly, Zywicki and Sarvis (2012) draw parallels between individual consumers and businesses, noting that both use available credit as a means of “smooth[ing] temporary mismatches between income and expenses” (p. 1). This smoothing function becomes increasingly important when households experience sudden or unexpected budgetary fluctuations. Medical emergencies, unforeseen auto repairs, or the necessary replacement of household appliances can present immediate budgetary challenges for consumers. The availability of consumer credit enables consumers to effectively bridge these short-term deficits.

Debt Collection and the Availability of Consumer Credit

Though it may not be readily apparent to many consumers, the debt collection industry plays an essential role in maintaining the availability of consumer credit. When making loans, lenders assume the risk of consumer default. Figure 5 shows the percentage of outstanding debts that are more than ninety days delinquent by primary loan type. The degree of risk informs the cost of the loan, and when lenders are unable to reliably calculate the potential risk of a loan, that cost is distributed across all consumers. Mechanisms for predicting the likelihood of repayment (i.e., credit scores) inform the calculation of risk, and subsequently the cost of the loan, for individual consumers. This individual-level measure does not account for the distributed risk of all other borrowers and their respective potential for default, thus those costs are likely to be passed on to all borrowers and increase the overall cost of consumer credit. However, the debt collection industry can alleviate some of this risk, thereby reducing costs for all borrowers and maintaining the availability of consumer credit.

Figure 5. Percent of Balance 90+ Days Delinquent by Loan Type, 2003-2015



Higher interest rates on the front end of a loan or a robust collection process on the back end of a loan can be conceptualized as “substitutes for each other” (Zywicki, 2015, p. 42), each functioning to compensate for loss. An effective debt collection industry lets lenders offer lower interest rates and a greater availability of credit, as it provides support for mitigating loss in the event of a default (Hunt, 2007). Additionally, the availability of debt collection as a remedy for lenders allows for stronger enforcement of credit contracts. Fedaseyeu (2014) notes that strong enforcement of consumer credit contracts is important as it discourages default. Subsequently, as the likelihood of defaults decreases, the willingness of lenders to provide credit increases.

Research has found that a system with reasonably lenient debt collection regulations and an efficient debt collection industry facilitates an expanded supply of consumer credit (Drozd and Serrano-Padial, 2013; Fedaseyeu and Hunt, 2014) and generally lower interest rates (Zywicki, 2015). This dynamic is particularly essential for consumers who are considered high-risk, as they are more likely to be able to access affordable credit in an environment where lenders are able to mitigate losses through post-default collection.

Because credit is made available based on an assessment of risk and the borrower’s ability to repay, it is not equally available to all consumers (Ratcliffe

et al., 2014). Those borrowers that are considered to be high-risk will, in many instances, either not qualify for credit or find credit to be prohibitively expensive, particularly if the lender cannot be satisfied that the loan will be repaid. Yet, when there is an effective debt collection industry in place “lenders will extend credit to riskier borrowers when expected recoveries after default compensate for the higher default probability” (Fedaseyeu and Hunt, 2014, p. 27). Those same high-risk borrowers might also “benefit the most if the increase in post default recoveries leads to a reduction in interest rates and expansion of supply to riskier borrowers” (Zywicki, 2015, p. 51).

Consequently, the debt collection industry grants lenders the latitude to extend credit to a larger and riskier population that would ordinarily be excluded from the credit market (Fedaseyeu, 2014). This can be especially beneficial for low-income consumers who, if priced out of or excluded from the credit markets, might resort to alternative forms of credit which can be costly or require collateral (Zywicki, 2015). Because the debt collection industry provides a degree of security for lenders and a mechanism for them to mitigate losses, it facilitates a marketplace where credit is more available to a broader range of consumers across a variety of income categories and credit histories.

Conclusion

The debt collection industry plays a distinctive and integral role in the stability of the U.S. economy. Through the recovery of outstanding debts, the debt collection industry provides lenders with the latitude to continue extending credit to consumers, helps businesses that provide goods or services on credit remain solvent, and prevents passing the costs of both monetary loss and risk on to consumers. Furthermore, the debt collection industry makes tangible contributions to the overall economy through the debt returned to creditors and subsequent savings to household consumers.

Without the efforts of the debt collection industry, much of the recovery of defaulted debts would go unrealized. These losses would be passed on to consumers initially through higher retail prices, as businesses work to compensate for expected losses.

Similarly, as lenders become more risk averse without the safeguard of the collections industry, consumers could expect increased interest rates on credit and an attendant decrease in the overall supply of credit. These changes would most adversely impact lower-income and high-risk consumers as they would bear the brunt of the increased costs for credit. This population of consumers would also be more likely to use less traditional modes of credit which often have a higher cost than more traditional types of credit. As such, the collections industry provides an essential service that ultimately benefits both consumers and creditors in the marketplace.

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