

# How Does Bankruptcy Affect Your Credit Rating?

By Mark Saiki  
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**1. Filing for Bankruptcy.** In a sense, a Bankruptcy discharge is a forgiveness of debts. It marks an end point and a new beginning. In a very real sense, your “fresh start” is the first step on your journey back to fiscal solvency. According to Harvard Law School Bankruptcy Professor Elizabeth Warren, “Bankruptcy is . . . financial death and financial rebirth. Bankruptcy laws literally make debts vanish. When a judge signs a paper entitled, ‘Discharge,’ debts legally disappear. This is the fate of billions of dollars of debt discharged in bankruptcy every year. Hundreds of thousands of debtors are released from their obligations, free to earn and spend as they choose.”<sup>1</sup> Bankruptcy is a safety valve. If you are in way over your head with burdensome debts, you can pull the plug and start over. You can admit your mistakes, and begin anew with a clean financial slate.

**Credit Rating.** Filing for Bankruptcy hurts your credit rating, as do late payments, missed payments, court suits, garnishments, foreclosures and/or repossessions. In many cases Bankruptcy erases problems that also tend to weigh down your credit score. W.D. Adkins notes, “True, the bankruptcy is on your credit history and will be there for 10 years. Much of the other negative information is expunged as part of a bankruptcy, however.”<sup>2</sup> In one sense, Bankruptcy is financial death, while on the other hand, it is the first step on your road to recovery.

Many of my clients have: way over-extended their ability to pay, are underwater on their secured debts, and face court suits, repossession, foreclosure and garnishment. For them, filing for Bankruptcy probably helps their credit ratings. SmartMoney.com journalist, Aleksandra Todorova, notes, “Part of the reason why your score isn't likely to suffer all that much is that most folks seriously struggling with debt aren't exactly maintaining a top-notch score to begin with. ‘In virtually every instance, the consumer will already have repayment problems such as late payments, very high balances, charged-off accounts or collection accounts,’ says Rod Griffin, a spokesman for Experian, one of the three major credit bureaus.”<sup>3</sup> As a result, many credit card companies and vehicle lenders send out applications to persons who have recently filed for Bankruptcy. Their logic is that filing for Bankruptcy has erased pre-existing credit

<sup>1</sup> Teresa A. Sullivan, Elizabeth Warren, Jay Lawrence Westbrook, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America* (New York: Oxford University Press, 1989), 4.

<sup>2</sup> W D Adkins, "When You Have No Alternative But Filing For Bankruptcy, There Are, Paths For Financial Recovery And Credit Repair Afterward," *Happy Living Magazine*, 2009, <http://www.happynews.com/living/money-budgeting-financialkecover-bankruptcy.htm>.

<sup>3</sup> Aleksandra Todorova, SmartMoney.com journalist, “Declaring Bankruptcy Can Improve Your Credit Score,” *Wall Street Journal*, January 22, 2007, [www.smartmoney.com](http://www.smartmoney.com).

problems.

In many cases filing for Bankruptcy may improve your credit rating. Aleksandra Todorova writes, "Some consumers may even see a slight boost in their credit scores after filing bankruptcy, according to John Ulzheimer, president of Credit.com Educational Services, a consumer credit education group. Why? To start with, your credit report is largely wiped clean when you declare bankruptcy."<sup>4</sup> If these clients want to get new loans, their creditors do not have to wait last-in-line for payments behind earlier debts, court suits and wage assignments. Bankruptcy probably makes it more likely that post-filing creditors will be repaid.

**2. How is your FICO Score Calculated.** Credit scores are subjective numbers, that are designed to estimate how likely it is that you will pay back your loans and debts on time. "Each agency basically uses the same formula though to calculate your score. Your payment history of timely or untimely bills counts for 35% of your score. The next 30% is based on your debt-to-available credit ratio. Then the length of your credit history accounts for 15%. Finally you have your types of credit and new credit applications each making up 10% of your score."<sup>5</sup> Two key factors are prompt monthly payments and not over-extending yourself. If your annual income is \$20,000, it will be very difficult to pay back \$40,000 in debts, or even to make required minimum payments of 1-2% per month.

Your credit rating is expressed as a range of numbers. W.D. Adkins states, "Your credit score/rating (also called a FICO score) is a number between 300 and 850 that summarizes your credit risk as a borrower. Paying bills on time is vital to having a good credit score (this is 35 percent of a FICO score). The second most important factor is how much you owe compared with your income. Opening or closing credit accounts frequently is a negative. Making limited use of credit and being selective about what accounts you have help raise your credit rating."<sup>6</sup> On the low end, 300 is a bad score, while 850 is a solid gold credit rating, which means you are eligible to borrow more money at a lower interest rate.

Whether or not you qualify for certain loans, is up to your creditors. Todorova states, "When calculating scores, the formulas developed by Fair Isaac (the company that calculates the most widely used credit score, known as the FICO score) are set up to grade someone's credit standing as compared with that of consumers in a similar financial position. To do that, Fair Isaac divides consumers into 10 groups, using what it calls "score cards." It then ranks the consumers in each group based on the others in the group."<sup>7</sup> Traditionally, some creditors extended credit based upon how much outstanding credit that you had (how much debt you were carrying) and what payments you were making, whereas more recently many creditors are basing lending decisions

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<sup>4</sup> Aleksandra Todorova, [www.smartmoney.com](http://www.smartmoney.com).

<sup>5</sup> Homeloanbasics.com, "How Long Does it Take to Repair Your Credit?" March 7, 2007.

<sup>6</sup> W D Adkins, supra.

<sup>7</sup> Aleksandra Todorova, supra.

as a comparison, between your annual income and your overall debt load.

**3. What Actions Can to Take to Restore Your Credit Rating.** Another thing to remember is that how you conduct your financial affairs, after you file for bankruptcy, is sometimes more important than past problems. If you pay your bills on-time, and keep your debts modest, more in line with your ability to pay, you can rebuild your credit rating. Brent T. White notes that a 660 credit score is a good rating that will enable you to purchase a house. He states, with wise financial planning, after foreclosure, you can regain that favorable credit rating. “. . . [M]ost people can expect to recover from the negative impact of foreclosure on their credit score within a two years (and, meanwhile, two years of poor credit need not seriously impact one’s life).”<sup>8</sup> The same analysis can be applied to filing for Bankruptcy. In the long run, filing for Bankruptcy may help you learn to live within your means, and to handle debts more responsibly in the future.

**Pay Down Debt.** “Some suggest that paying down your balances on your credit cards will bring you the fastest results. This will decrease your debt ratio, providing you with more available credit. Remember, this section of your credit counts for 30% of your score. Estimates are that you can see your score rise by 20-30 points over a 60-day period by seriously paying down your credit card debts.

**Make Payments on Time.** This is the largest factor . . . but it does take some time to establish a history of timely bill payments. The agencies only get an update to your account once a month from each of your lenders, so each month makes a difference. You should know that a two-month past due bill on your record is much worse than a one-month past due bill. This is because some of the agencies will report the one month late charges, but they all definitely record the two month overdue bills. To truly boost your score in this area, make sure you are paying all your bills on time, even before the grace period ends. You will need to do this consistently for six to 12 months in order to see real improvement to your score.”<sup>9</sup>

**Prudent Use of Credit.** Liz Pulliam Weston suggests, “Maxing out your credit cards hurts your credit score. You don’t want to charge more than 30% or so of your credit limit, and you want to pay the balance off in full each month. Light, regular use of a credit card is what helps build your credit.”<sup>10</sup> Prompt payments and a low debt-to-income ratio are strategies that improve your financial picture.

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<sup>8</sup> Brent T. White, University of Arizona College of Law, “Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis,” *Arizona Legal Studies*, Discussion Paper No. 09-35, October 2009, 32.

<sup>9</sup> Homeloanbasics.com, *supra*.

<sup>10</sup> Liz Pulliam Weston, freelance journalist, “Bounce Back Fast After Bankruptcy,” MSN.Money, February 11, 2009, <http://articles.moneycentral.msn.com/Banking/BankruptcyGuide/BounceBackFastAfterBankruptcy.aspx>, 2.

Compare a couple that is struggling to make minimum payments, getting late fees, interest, collection costs and attorney fees added to each of their bills. Unless and until they are able to make some headway on their accumulated debts, their credit rating will remain unacceptably low. In the best of situations, perhaps a credit counseling agency can get all of your creditors to accept a fifty-percent settlement with monthly payments and no interest. By contrast, a Chapter 7 Bankruptcy will get rid of burdensome debts, and allow you to start over. In ten years time, whose credit rating will be higher?

**4. Time Line.** For most people filing for Bankruptcy is not the end of the line, but the first day in the rest of their life. If you work diligently and patiently, you can rebuild your credit score. Freelance writer, Barb Nefer said, “Fortunately, there are many steps you can take to improve your credit score. There is no quick fix, but if you're willing to put in the time, you can improve your score within a year to 18 months.”<sup>11</sup> Reasonable credit can be rebuilt within a period of years.

Likewise, W.D. Adkins noted, “It will take about one to two years to establish a good credit rating as you recover from bankruptcy . . . your use of credit should be limited so you don’t acquire a lot of debt, but yet enough to establish a record of consistently handling credit well.”<sup>12</sup> As many of my clients know, a modest amount of debt may be a blessing, while too much can bring your financial empire down.

Some examples support this point. Liz Pulliam Weston notes, “Ken from Chicago filed Chapter 7 liquidation after unemployment and overspending caused him to rack up more than \$20,000 in credit card and other unsecured debt. Four years later, his credit scores ranged from 655 to 719, decent numbers that are just below the cutoff to get most lenders' very best rates. ‘I . . . applied for a [secured credit card](#) (usually reserved for people with troubled credit) and was informed that I qualified for an unsecured card -- a possibility I hadn't even considered,’ Ken said. ‘While I am going to be very careful with my new credit (card), I am heartened that creditors consider me an acceptable risk.’<sup>13</sup> In four years, Ken is on the verge of restoring his credit rating, so that he can qualify for home loans.

**Car Loans.** Liz Pulliam Weston stated, “Auto loans can also help you rebuild your credit -- just be prepared to pay nose-bleeding rates at first. ‘My first vehicle out of bankruptcy (had an interest rate of) 21%,’ said Chance Nelson of Indianapolis, who applied for the loan just a few months after his debts were discharged. ‘After paying this for about two years, I went and traded it in and purchased another (at) 13.99%.’ Nelson refinanced this second loan a year later at 7.95%. Five years after his bankruptcy filing, Nelson was paying a reasonable 6% rate for his

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<sup>11</sup> Barb Nefer, freelance writer, “How to Increase a Credit Score After Bankruptcy,” eHow, 2009, eHow.com.

<sup>12</sup> W D Adkins, supra.

<sup>13</sup> Liz Pulliam Weston, supra., 1.

auto loan. If you go this route, try to make a big down payment and choose a loan that doesn't have a prepayment penalty. That way, you can refinance the car to a lower interest rate as your credit improves.”<sup>14</sup> Five years after filing for Bankruptcy, Chance once again is eligible for a prime interest rates. In addition, if you first post-filing loans are for used cars, with smaller payments, then you can pay-off those loans quicker. Defer your gratification for a newer car, when interest rates are more favorable.

**Home Loans.** “It's unlikely in the current credit climate, but you may be able to qualify for a high-rate mortgage as little as six months after a bankruptcy. You're probably better off waiting until you can qualify for an FHA loan, though. You can typically get one just two years after your bankruptcy case has closed, as long as you've maintained good credit habits since then. FHA loans have interest rates that are usually only half a percentage point higher than regular mortgage rates.”<sup>15</sup> Federal Housing Authority, government backed home loans, can help you progress on your road to recovery.

Likewise, Aleksandra Todorova said, “Granted, you won't be able to bring your score up to the perfect 850 as long as your bankruptcy stays in your report, but with good credit management after filing, a score in the 700s isn't impossible . . . if your debt payments are crushing you, bankruptcy will give you a much-needed fresh start. And with a few clever credit repair strategies, your score could be back in the 700s within two or three years.”<sup>16</sup> While most debtors will still need to borrow money for a house or car, keeping the rest of your debts well within your ability to pay, can restore your credit rating and help prevent you having to file another Bankruptcy in the future. Your goals, after filing for Bankruptcy, are to rebuild your credit rating and to avoid refilling. Keeping your debts modest, and paying your bills on time, are important financial strategies on your journey.

See also my memo on [How Can You Repair Your Credit Rating?](#) (or [.pdf file](#)).

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<sup>14</sup> Liz Pulliam Weston, id., at 2.

<sup>15</sup> Liz Pulliam Weston, id., at 2.

<sup>16</sup> Aleksandra Todorova, supra.