After Bankruptcy:
What You Need to Know

The Path to Creditworthiness

Bankruptcy offers some resolution to your financial worries. However, it also carries negative consequences and major responsibilities that you will have to assume, so you can conduct your post-bankruptcy financial affairs in a positive direction.

Many consumers think that if they declare bankruptcy, they can never get credit again. The fact is that the history of a bankruptcy will stay in one's credit bureau files for ten years. Also, once a person has filed for Chapter 7 Bankruptcy he or she is prohibited from declaring bankruptcy again for eight years.

Some lenders specialize in providing credit to consumers with prior bankruptcies. Those companies figure that if a person has just declared bankruptcy and has steady employment, he is likely to be able to handle repaying on a few new debts.

Lenders know that this person is prohibited from declaring Chapter 7 Bankruptcy again for eight years. Soon after a bankruptcy discharge, many people start to receive offers for new credit cards.

Sometimes auto dealers who specialize in used cars target recent filers who may have lost their vehicle through the bankruptcy process. Note, however, that the interest rates on these sources of credit are extremely high—24 to 30 percent is common.

If you take the proper steps after declaring bankruptcy and also manage your credit responsibly, you can rebuild an improved credit reputation in a few years. Studies show that 18 to 24 months after discharge of bankruptcy, most consumers can qualify for a home mortgage with terms just as good as consumers with the same financial characteristics who have not filed for bankruptcy.

Bankruptcy and Your Five "C"s of Credit

Let's use the five C's of credit to organize our discussion of bankruptcy and your credit.

We will focus on **capacity**, **capital**, **collateral** and **character**.

The last of the 5 C's—**conditions**—is not affected by bankruptcy.

THE EFFECT OF BANKRUPTCY ON YOUR "CREDIT CAPACITY"

Capacity refers to having sufficient income to afford the payments that would be required on a new loan or credit card account. Basically, lenders want to know if you can afford to repay your debts.

Judging your capacity includes comparing your income to your living expenses and to the amount of debt you already have outstanding.

Bankruptcy clearly affects the amount of debt you have outstanding. In a very real sense, bankruptcy improves your credit capacity because your debts are reduced. Before bankruptcy, most debtors have higher monthly debt repayment obligations than they could handle. The pressure to make those payments is often the major reason why people consider bankruptcy. But, after bankruptcy, most debt is gone.

Thus, certain ratios such as the debt payments-to-take home pay and debt service-to gross income actually look better to lenders.

Do not forget that some debts cannot be absolved through bankruptcy. Such debts include income taxes, child support or alimony, and debts for personal injuries you caused while driving under the influence of drugs or alcohol. Debtors with a high level of such debt may not see much of an impact on their credit capacity after bankruptcy. Non-discharged debts will need to be repaid as originally agreed and one's monthly payments may not change.

Finally, there is another type of debt that may continue after bankruptcy. There are certain assets in bankruptcy that are exempt from seizure by the courts. Your principal home is an example. Depending on your state's bankruptcy laws, you may be able to keep a specified dollar amount of equity in that home, and also an inexpensive vehicle and tools you need to use on your job. But what if you still owe money on a loan used to buy these assets? Would the court require that you turn over the asset to pay a portion of the debt? Possibly not.

For example, perhaps you own a vehicle worth $5000 based on its replacement cost at its age and condition, but on which you still owe $2600.

Assume that you live in a state where you are allowed to keep up to a $3000 value in a vehicle. In this case, the value of the vehicle qualifies for the exemption because the ownership equity in the vehicle is less than $3000.

$5000-$2600 = $2400

But, what about the debt owed on the vehicle?

Under Chapter 7 Bankruptcy, you must pay the remaining debt in a lump-sum during your bankruptcy process.

Under Chapter 13, you may be able to reaffirm this debt with the lender and repay the full amount through your plan.

THE EFFECT OF BANKRUPTCY ON YOUR "CREDIT CAPITAL"

Capital refers to your overall level of wealth. A lender wants to know that you have sufficient financial assets should they be needed to repay the debt. Basically, the lender wants to know what you own.

Bankruptcy affects your credit capital, but the effect depends on the type of bankruptcy you chose and the type of assets you owned.

Under Chapter 7 Bankruptcy, many of the debtor's assets are turned over to the court to pay some of the debt owed. Any money in a checking or savings account can be taken by the court. Also, a person's investments may be liquidated. Some tangible assets are sold.

The result can be a much lower overall roster of assets for the debtor. Depending on your state, however, you might be allowed to keep certain assets, such as a portion of the equity in your home, a vehicle, and a certain amount of personal property. Thus, your assets may not decline as much as you might think, thereby maintaining after bankruptcy a level of credit capital relatively comparable to that before bankruptcy. The particulars in your state may be obtained from an attorney who specializes in bankruptcy.

Chapter 13 Bankruptcy focuses on the income of the debtor. The court sets up a plan to pay as much as possible on the debts owed, given the level of income of the debtor.

This form of bankruptcy can allow the debtor to keep assets after bankruptcy as long as the debt payment plan set up by the courts is followed.

Thus, credit capital may be largely unchanged by Chapter 13 Bankruptcy.

THE EFFECT OF BANKRUPTCY ON YOUR "CREDIT COLLATERAL"

Collateral refers to assets that could be or are pledged as security on a debt. In most situations, if a person misses a few payments on an asset pledged as security, like a car or TV set, the lender takes legal action to repossess it.

After Chapter 7 Bankruptcy, debtors usually have few assets that could be used as collateral. That is because they were taken by the court and used to pay a portion of the debts owed.

But this situation is only temporary. Two factors can lead to improved access to collateral after bankruptcy:

1. The former debtor can build a savings account that can be used as collateral. After bankruptcy the debtor may find that he can begin a regular savings program and accumulate funds in a savings account. This is because debt payments will no longer be such a large part of the former debtor's budget. These funds may be able to be used as collateral on a debt; especially a secured credit card.

A secured credit card is a credit card backed by a savings account opened at the financial institution that issues the card. The savings account serves as collateral for the card. The credit limit on the card will be from 50 to 200 percent the amount in the account. So, perhaps a $1000 deposit will secure a credit card with a limit of $500 (50%) to $2000 (200%).

Generally, the amount in the savings account cannot be touched as long as the credit card account is open. If one does not repay on the secured credit card, the card issuer can take your savings as it "secures" your credit account.

You should be wary of certain aspects of secured cards:

• Some secured cards will have a very high application fee, perhaps $200. One can shop around for a lower fee.

• If a person wants a high credit limit on a secured card, he or she will have to deposit much more money into the savings account.

• With some secured cards, the issuer establishes the savings account by taking a cash advance against the credit card and then starts charging the minimum monthly fee that includes the interest on the card.

Consider this example. Jana Parsons is offered a secured card with a limit of $4000, at an interest rate of 24 percent (2% per month). The minimum payment per month is 3 percent of the balance on the card.

She can take a cash advance of $4000 against the card to set up the savings account. At first, she will not be able to use the card because the balance and the credit limit are the same.

Her first month's bill would have a $120 minimum payment (3% x $4000), of which $80 is interest (2% x $4000).

This means that she would pay only $40 ($120 - $80) on the $4000 if she made the minimum payment.

At that rate it would be several years before she would have access to any meaningful borrowing capacity on the card. The lender, of course, benefits greatly from this arrangement.

TIP: You should avoid any secured card that uses a cash advance to establish the savings account deposit.

You should shop very carefully for secured credit cards and read the rules and fees on the card very closely.

2. The former debtor might take out a loan to buy an item that can serve as collateral on the loan. Because of the former debtor's improved budget situation, the person can "afford" to make some debt payments should he want to borrow money.

Lenders know this and many are willing to make loans to recent filers provided there is sufficient collateral for the loan.

For example, assume that Peter Arnell has recently been through bankruptcy. He would like to purchase a more reliable vehicle but is worried that he may not be able to obtain a loan.

He has saved up about $2000 and thinks he could afford a monthly payment of up to $250. He could borrow up to about $6000 for $230 per month at 22 percent.

His rate might be this high because of his bankruptcy. Adding in his $2000 he might be able to purchase an $8000 vehicle. His down payment would be 25 percent ($2000/$8000).

The lender would feel confident that the vehicle holds enough value to pay the loan if repossession becomes necessary.

Persons who have gone through bankruptcy need to be very cautious about entering into loan agreements to purchase vehicles. This is especially true if the lender is one who targets lending to people with "bad credit" or who uses a "Buy Here—Pay Here" approach.

The most important negative is that these loans will charge a very high interest rate. A second disadvantage is that some of the terms of these loans can be really unfair.

For example, in some cases the title of the vehicle is not transferred to the buyer until the last payment is made. This makes repossession very easy. Third, most of these loans have very strict rules about late payments so that being even one day late might mean a steep late payment fee, perhaps $100.

And sometimes a fee, such as $25, might even be charged per day. Then it will quickly escalate into an unaffordable amount.

In some cases, the loan contract is written in such a way that it almost guarantees that the borrower will be unable to pay (e.g., through rapidly escalating late fees) and the vehicle will be repossessed.

Many of these lenders prey upon people who previously declared bankruptcy and who may have no other access to credit. You should shop very carefully for loans and read the entire contract.

THE EFFECT OF BANKRUPTCY ON YOUR "CREDIT CHARACTER"

Your credit character is the last of the 5 C's of credit but is the one most affected by bankruptcy. Lenders will be very cautious in the future about granting credit to you. They will not take into account any of your valid reasons for the bankruptcy.

They will only see that it occurred. You might ask if you will ever be trusted again when it comes to credit. Fortunately, the answer is yes. But it will take some time and certainly some effort and careful financial management on your part. The impact of bankruptcy will clearly be seen in your credit score.

Credit scores have a big impact on the availability of credit and the interest rate paid to get credit. Thus, it is wise to do all you can to rebuild your credit after bankruptcy. The section below describes the actions you can take to do just that.

What You Can Do!

You probably want to rebuild your credit as soon as possible. There are some steps that can help speed up the process. The key to obtaining an excellent credit status is to take the right actions in each of the four areas most likely to be affected by bankruptcy: Capacity, Capital, Collateral and Character.

There are a number of steps you can take to make sure that lenders rate you as highly as possible for "capacity" after bankruptcy:

• **KEEP TRACK OF EVERY DOLLAR YOU EARN AND SPEND FOR A MONTH OR TWO AFTER YOUR BANKRUPTCY**

Then develop an income and expense statement for each month. This will let you visualize your new income and spending patterns now that you are bankrupt. If you are not yet bankrupt, try to make estimates based on what you expect your income and expenses to be.

• **DEVELOP A BUDGET AND STICK TO IT AS BEST AS YOU CAN**

In your budget, set aside savings for an emergency fund that should grow over time to at least two or three times your monthly expenses. This fund will help you weather or survive unexpected expenses.

• **IN YOUR BUDGET YOU WILL NEED TO TAKE SPECIAL CARE TO PAY ON TIME, IN FULL, EVERY MONTH ANY DEBTS YOU STILL OWE AFTER BANKRUPTCY**

This is especially true for reaffirmed debts. Failure to make a payment as required can mean immediate repossession of the asset and another negative entry in your credit bureau files.

There are a number of steps you can take to make sure that lenders rate you as highly as possible for “capital” after bankruptcy:

- Update your list of assets: Monetary, Tangible, and Investment
- Identify assets that might serve as collateral should you need to use credit
- Make provision in your budget to build monetary assets and investment assets using the “pay yourself first” philosophy.

Even if you do not intend to use any of your assets as collateral on a loan, filling out the worksheet is a good idea because your asset mix is usually different after bankruptcy.

Building / Using Your “Credit Collateral” after Bankruptcy

Unsecured credit is difficult to obtain after bankruptcy. Access to secured loans is often still available (but at high interest rates). Secured loans are often backed up by collateral. Examples are secured credit cards and vehicle loans. But these sources of credit can be very expensive.

Plus, the contracts contain requirements or features that put the borrower at risk for high fees. They also add to the likelihood of nonpayment, thereby adding to an already negative credit status.

Comparing Secured Credit Card Offers

Once you have gathered information from three sources, you can compare the information available there to the information on secured cards.

And now you are in control of your financial life. You may feel that you never want to borrow money again. That is not such a bad idea. But in today's world it may not always be realistic.

Credit cards are needed by travelers when making reservations and for emergencies.

Once a bankruptcy is final, you can begin to take steps to rebuild your credit. What will you take in the next days and months to start rebuilding poor credit as a result of bankruptcy?

Summary

• If you take the proper steps after declaring bankruptcy and also manage your credit responsibly, you can rebuild an improved credit reputation in a few years.

• In rebuilding your credit, it is helpful to focus on the following four "C"s of credit: Capacity, Capital, Collateral, and Character.

• Capacity refers to having sufficient income to afford the payments that would be required on a new loan or credit card account. After bankruptcy, most debt is gone. In a very real sense, bankruptcy improves your credit capacity because your debts are reduced.

• Capital refers to your overall level of wealth. A lender wants to know that you have sufficient financial assets should they be needed to repay the debt. Basically, the lender wants to know what you own. Bankruptcy affects your credit capital, but the effect depends on the type of bankruptcy you chose and the type of assets you owned.

• Collateral refers to assets that could be or are pledged as security on a debt. After Chapter 7 Bankruptcy, debtors usually have few assets that could be used as collateral. That is because they were taken by the court and used to pay a portion of the debts owed. Steps that can be taken include:

- The former debtor can build a savings account that can be used as collateral
- The former debtor might take out a loan to buy an item that can serve as collateral on the loan.

• Your credit character is the last of the 5 C's of credit but is the one most affected by bankruptcy. Lenders will be very cautious in the future about granting credit to you.

They will not take into account any of your valid reasons for the bankruptcy. They will only see that it occurred. You might ask if you will ever be trusted again when it comes to credit. Fortunately, the answer is yes. But it will take some time and certainly some effort and careful financial management on your part.

• After bankruptcy, you can rebuild credit in the following ways among others:

- Set up a budget that provides for repayment of your remaining debts and the building of assets.

- Keep an existing credit card by reaffirming the debt.

- Getting a secured credit card or vehicle loan but only if it is affordable and the contract is fair to you the borrower.

- Do not take on any new debt unless you are absolutely positive that you can repay as agreed.

Rebuilding your credit reputation is important and doable. You can succeed by starting small. You can handle credit again. Over time, you will regain your good credit reputation. Your capacity for credit will be high.

You will have the capital needed to obtain low cost credit. You will be able to obtain credit on your own good name and not rely solely on collateral to obtain credit. And your credit character as measured by your credit reports and your credit scores will again be positive. Then you will qualify for credit at lower interest rates.

Good luck!