The Basics

Bounce back fast after bankruptcy

Carefully rebuild your credit, and you could qualify for almost normal rates, even a mortgage, in a year or two. Here's what you need to do.

By Liz Pulliam Weston

Almost anyone can get credit soon after a bankruptcy. It's just a matter of knowing how.

It's true that bankruptcy deals a devastating blow to your credit and your credit score, the three-digit number lenders use to gauge your creditworthiness. But the effects don't have to be lasting.

Long before the bankruptcy drops off your credit report, you could be qualifying for loans with good rates and terms.

Nothing is forever

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."If you're recently bankrupted, here are two things you need to keep in mind:

Nothing in credit is "forever." A bankruptcy legally can remain on your credit report for up to 10 years, but its effect on your credit score can start to diminish the day your case is closed -- if you adopt responsible credit habits such as paying your bills on time, using only a small portion of your available credit and not applying for too much credit at once.

You have to get and use credit to build your credit score. Living on a cash-only basis may be a smart choice for those who really can't handle credit. But if you want to rebuild your credit score, you can't sit on the sidelines.

Learn from your mistakes

Although repeat bankrupts show that getting credit after a Chapter 7 or 13 filing is possible, you shouldn't want to emulate those who file more than once.

At first glance, people who file more than one bankruptcy seem to be beating the system: They run up big bills and then walk away.

Think about it a little more, though, and you'll see these multiple bankrupts are really defeating themselves. Their debts and credit history often mean they're paying out big bucks in high interest payments during the time when they're prohibited from filing another bankruptcy. (The 2005 bankruptcy law provides that, under Chapter 7, eight years must elapse before you can refile. If you go for Chapter 13 after a Chapter 7, you must wait four years. Going from one Chapter 13 to another, two years must elapse.)

And most people can't file for Chapter 7 liquidation if they have significant assets to protect, such as home equity or savings. So these folks who are repeatedly going broke often have little to show for all the money that's leaving their pockets. Instead of building wealth over time, they're losing ground.

Instead, use your bankruptcy as a wake-up call to figure out what's wrong with your finances and fix it.

If your problem was overspending, you'll find plenty of information on this site about creating and sticking to a budget (see "Your 5 minute guide to budgeting").

If you didn't have enough savings to survive a job loss or other setback, get serious about establishing an emergency fund.

If you were sunk by medical bills, seek a job with insurance coverage or check to see if your state offers coverage.

Clean up your credit report

One common problem people emerging from bankruptcy often face is that credit reports frequently show accounts as open and overdue -- when in fact they were closed and the obligations wiped out as part of the bankruptcy.

If you encounter this, you need to contact the credit bureaus and insist that those accounts be properly reported as "included in bankruptcy." It's the only way your credit can recover.

If you have other serious mistakes on your credit report, those need to be corrected as well. Your credit score is based on information in your credit report, so errors on your report can seriously dampen your score.

Get a secured credit card

You need two types of credit to quickly rebuild your credit score:

Installment: auto loans, student loans or mortgages

Revolving: credit cards or home equity lines of credit

Continued: Light credit card use builds credit

Most recent bankrupts have trouble qualifying for a regular, unsecured credit card. So the best solution usually is a secured card, which generally gives you a credit limit that's equal to an amount you deposit at the issuing bank.

Typically, that's $200 to $500, which may seem like a pittance compared with the credit limits you enjoyed before your bankruptcy. But don't make the mistake of using your available credit. *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.

And contrary to what you might have heard, you typically don't need to carry a balance or pay credit card interest to build your score, since the leading credit scoring formula doesn't distinguish between balances that are paid off and balances that are carried month to month. Get in the habit now of not charging more than you can pay off every month; your credit score and your finances will be the better for it.

You also shouldn't grab just any secured card. Look for the following:

No application fee and reasonable annual fee. Some secured cards tack huge upfront and annual charges onto their accounts; you don't need to pay these to build your credit.

Reports to the major credit bureaus. You're not doing your credit score any good unless your payment history is being reported to the three major bureaus: Equifax, Experian and TransUnion. Before you apply for a card, call and ask if the issuer regularly reports to all three.

Converts to an unsecured card after 12-18 months of on-time payments. Good behavior should get you upgraded to a regular credit card within a year or two.

Get an installment loan

If you still have student loans (which typically aren't dischargeable in bankruptcy), you can use them to rebuild your score. Make your payments on time, all the time, and try to pay more than you owe whenever possible. Next to making on-time payments, paying down your existing debt is one of the best ways to improve your credit score.

Ken of Chicago took this to heart, making double or triple the minimum payments required to retire his $23,500 student loan debt within three years of his bankruptcy filing.

"The fact that I had to repay my student loans (rather than having them discharged) might have helped me in the long run," he said.

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.

Just make sure you really can afford a home before you buy one. Many people wind up in bankruptcy court because they stretched too far to buy a house and can't keep up with all the attendant costs of homeownership, said bankruptcy expert Elizabeth Warren of Harvard University. (See "Don't bite off too much house" for more details.)

Video on MSN Money

Video: How's your credit?

Where to go to get free reports -- and how to interpret them when you've got one.

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 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.

Liz Pulliam Weston's latest book, "Easy Money: How to Simplify Your Finances and Get What You Want Out of Life," is now available. Columns by Weston, the Web's most-read personal-finance writer and winner of the 2007 Clarion Award for online journalism, appear every Monday and Thursday, exclusively on MSN Money. She also answers reader questions on the Your Money message board.

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