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When paying bills can hurt your credit

Settling some old debts can actually harm your credit score. Here's how to do the right thing the right way.

By [Liz Pulliam Weston](#)

Cynthia worked hard to improve her credit scores. She was careful to pay her bills, including an auto loan and a credit card, on time every month. Finally, in December 2004, she decided to pay off the one old debt on her credit reports.

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Her scores promptly plunged by as much as 95 points.

"I spent over \$1,200 in paying off hospital bills from six years ago, thinking this would help," she wrote in an e-mail. "Did this hurt me instead?"

Borrowers who try to pay off old delinquencies, charge-offs and collection accounts often learn the hard way: Sometimes, doing the right thing does the wrong thing to your credit.

Quirky credit scoring system

Thanks to the sometimes bizarre quirks of credit scoring, state statutes of limitations and the federal Fair Credit Reporting Act, consumers can't always assume that paying off old debts will improve their financial situation or make them a better risk in lenders' eyes. Add in the tactics of some unethical collection agencies, and you have a real quagmire.

The one bit of good news, though, is that what happened to Cynthia -- a score plunge because of a new payment on an old debt -- is much less likely to happen today. That's because the company that creates the leading credit score, the FICO, worked with credit bureaus to iron out that particular wrinkle in the formula.

But there are still other problems that can arise:

- Settling accounts for less than you owe can often hurt your credit scores.
- Arranging a payment plan or even inquiring about an old debt can restart the statute of limitations in some states, allowing creditors to sue you.
- Simply contacting a creditor about a past-due account can revive its

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interest in trying to collect, leading to harassment and hardball tactics.

- Unethical collection agencies may promise to upgrade how your debt appears on your credit report in exchange for payment -- then not follow through or make matters worse by making the debt seem more recent than it is.

To understand how these things happen, you need to understand some of the practices of the credit industry, such as:

How delinquencies and charge-offs are handled

A lender will generally write off an account as a bad debt within six months after it becomes delinquent -- in other words, six months after the borrower stops paying. The write-off is reported to the credit bureaus as a "charge-off."

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Some people incorrectly believe that a charge-off means they no longer have to pay their debt. But "charge-off" is basically just an accounting term, notes debt expert Gerri Detweiler, author of "[The Ultimate Credit Handbook](#)." It doesn't relieve you of the legal or ethical obligation to pay the loan, and the lender or a collector can still come after you.

Usually, a lender will turn the charged-off account over to its collections department or a collection agency, and you'll have two entries for the same account on your credit report: one from the original creditor showing the account's status as "charged-off" and another from the collection agency showing the account's status as "in collections."

(If you have more than two entries for the same debt, which sometimes happens when an account is passed from one collection agency to another, you can demand the credit bureaus remove the extra entries.)

How your credit score views old debts

Not paying your bills is a big bad when it comes to your credit. Delinquencies, charge-offs and collections all seriously hurt your score.

But here's something that's really important to know:

When it comes to your FICO credit score, the one most used by lenders, what matters most is what the original creditor says on your credit report. The status and amounts owed shown on that entry will figure more heavily in your credit score than what a collection agency reports.

If the original creditor shows a charge-off with a balance still owed, you might be able to boost your score by paying off the bill and getting the original creditor to reset the balance to zero.

If the balance is already zero -- which credit bureaus say is typical when a collection agency takes over an account -- you can't improve your score by paying up.

"If the trade line balance is showing zero, you're not going to help your FICO score by paying off a collections account," said Craig Watts, spokesman for Fair Isaac Corp., creators of the FICO credit scoring methodology.

'Settling' an old debt can hurt your score

In the past, making any payment on an old, past-due debt could actually make matters worse because the action "updated" the negative mark in the eyes of the credit-scoring formula, making it look more recent than it actually was.

"Recency," or how long it's been since you've had a negative mark, matters a lot to your credit score. The more recent the problem, the more heavily it weighs against you.

In the last couple of years, however, Fair Isaac worked with the credit bureaus to change how new payments on old debts were reported, said Tom Quinn, the company's vice president for scoring. Now, the scoring formula can distinguish between the new payments and actual new delinquencies.

"If you're making a payment (on a past-due account)," Quinn said, "that will not negatively affect your score, in and of itself."

You still can hurt your score, however, by "settling" an account for less than what you owe. Such settlements may get the creditor off your back, but the notation of "settled" on your credit report can sometimes be worse for your

FICO score than just leaving the account open and unpaid, said Barry Paperno, a Fair Isaac manager.

"Settling the account can add a new element to its record at the bureau," Watts said. "Since that element's date would be more recent than the original item, it can end up lowering the score."

Now, this assumes you're still dealing with the original creditor. If you're dealing with a collection agency, a settlement can be more of a wild card: It could help your score, it could hurt your score or it may have no affect.

Lenders may require you to pay old debts

Of course, just leaving the account unpaid might not be an option if you want to buy a house. A mortgage lender may require that you pay off or settle any open collections that show up on your credit report as a condition of getting the loan.

If you're interested in a settlement, credit repair experts suggest that, as part of your negotiations, push to have the creditor or collection agency either stop reporting the account altogether or demand that the account be reported as "paid in full" rather than "settled." Such treatment might not help your score, but it's less likely to hurt it. You'll have more clout if you're able to pay a lump sum than if you have to set up a payment plan.

Credit bureaus really hate it when collection agencies agree to these demands and have even banned companies for failing to properly report transactions. But that doesn't mean you can't try.

How long credit bureaus can report your accounts

Your credit score is based on information in your credit report, and there are limits on how long your bad marks can be used against you. Once a negative item is on your file, it generally can be reported for 7½ years from the time you stopped paying on the account. (Bankruptcies can be reported for up to 10 years.)

So, if you stopped making payments on your Visa bill in January 2004, the lender can report a charge-off the following June. The account can be reported to the credit bureaus until June 2011, when it must be deleted from the bureaus' records.

How letting sleeping dogs lie can affect your credit

You can see why some borrowers choose to just let their old debts "fall off"

their credit report rather than try to repay. Once the bad marks are gone, your credit score probably will improve, and you'll still have the money you would otherwise have sent to your old creditors.

Note the word "probably." In credit scoring, little is certain. Thanks to the way the FICO is designed, sometimes a score actually drops after old, bad accounts disappear.

That's because the FICO formula groups borrowers based on certain characteristics, such as whether they've had a bankruptcy or other credit problem. You could rise to the top of the "had-a-bankruptcy" group but, once your bankruptcy drops off your report, be "transferred" to another group, where you'd rank near the bottom.

"That move (from one group to the next) can sometimes be pretty graceless," Watts concedes. "It's as though you fell off a chair. Your score can change a couple dozen points for no apparent reason."

Fair Isaac attempted to ease this transition with its "next generation" credit-scoring model, known not surprisingly as NextGen. But most lenders still use the classic FICO scoring formula, so a sudden score drop when a negative item disappears is still a possibility.

Know your state's statute of limitations

That's not the end of the complications. Each state limits the amount of time in which a creditor can sue you after an account becomes delinquent. Sometimes the statute is longer than the credit reporting limits, sometimes shorter.

The statutes of limitations for written contracts, for example, range from three years in Delaware to 15 years in Ohio, although the typical limit in most states is five or six years. The

rules vary widely, but, in some states you can inadvertently extend the statute of limitations by entering into a repayment plan with a creditor or even by acknowledging that a debt is yours. Getting dragged into court and having a judgment entered against you could further hurt your credit score and your efforts to rehabilitate your credit.

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Before you contact your creditors, you should know the details of the statute of limitations in your state. (If you've moved, it may be the state you live in now whose law will apply, even if you entered into the credit agreement in another state.) Your best bet may be contacting a consumer law attorney for help; you can get referrals from the [National Association of Consumer Advocates](#).

You might also want to take a look at "[12 tips for negotiating with debt collectors](#)" for some ideas about how to conduct your negotiations. Several Internet sites, including CreditBoards.com, have message boards whose members share advice and tactics.

In the end, you may decide that trying to pay off your old accounts isn't worth the hassle -- or you may decide just the opposite. You may decide the ethical obligation to pay what you owe outweighs any short-term concerns you have about your credit.

"If you can afford to pay, pay," said Steve Rhode, chairman of the credit-crisis counseling firm [MyVesta.org](#). "Too many people live and die by what their credit report says."

Liz Pulliam Weston's column appears every Monday and Thursday, exclusively on MSN Money. She also answers reader questions in the [Your Money message board](#).

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