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What Bills Should You Pay First?

By Ellen Chang

NEW YORK (MainStreet) — Consumers started prioritizing their mortgage payments ahead of their credit card payments as of September 2013, according to a new TransUnion study.

This reverses a trend that began in September 2008 when the mortgage crisis drove consumers to pay their credit cards bills ahead of mortgages. Consumers have placed an emphasis on paying their auto loans before their mortgages and credit card payments by a wide margin - since at least 2003, TransUnion said. The study obtained anonymous consumer information from December 2002 through December 2012, and each monthly sample included about 2.5 million consumers.

"One of the biggest impacts of the Great Recession to the credit system was its influence on consumer payment patterns," said Ezra Becker, co-author of the study and vice president of research and consulting for TransUnion, a Chicago-based credit and information management company. "As unemployment rose and home prices cratered, increasingly more consumers were faced with financial constraints and had to make difficult choices and many chose to value their credit card relationships above their mortgages. This was a measurable result of the economic environment, wherein many consumers were underwater on their mortgages and at the same time needed the liquidity afforded by credit cards to make ends meet."

TransUnion looked at the delinquency spread between mortgages and credit cards over the past decade to determine how much of an impact housing prices had on the rate of payment of credit cards versus mortgages and compared that spread to the Standard and Poor's Case-Shiller 20-City Home Price Index (HPI). For instance, if the 30-day credit card delinquency rate was 1.50% and the 30-day mortgage delinquency rate was 2.25% at a given point in time, then there would be a 0.75% spread between the two variables.

"This was an especially enlightening part of the study because we found that home price appreciation and depreciation can impact mortgage and credit card payment patterns quite differently, depending on whether consumers consider the environment 'normal'," said Toni Guitart, co-author of the study and director of research and consulting in TransUnion's financial services business unit.

Although there was "massive home value appreciation" between 2003 and 2006, the spread between credit card delinquency and mortgage delinquency remained effectively the same, she said. Home value was not a factor in change because it was expected.

When home values experienced major declines in 2007 and 2008, the delinquency spread narrowed to the point where more people were opting to pay their credit cards before their mortgages - something that was unimaginable just a few years prior, Guitart said.

Many consumers were faced with devaluing home prices and chose to preserve their credit line, said David Reiss, professor of law at Brooklyn Law School in New York.

"The underwater mortgage may have seemed like a sinkhole when prices were dropping and putting limited funds into it might have seemed like throwing good money after bad," he said. "When a household's income can't cover all of its expenses, it has to prioritize its payments. If the mortgage is underwater, it may make sense to use those limited funds to protect assets that are integral to daily living and wage earning like an auto or to focus on tools like credit cards that may have some use going forward, if there is still any available credit left."

Homeowners have reversed that logic with the rebound of housing prices, Reiss said.

"If homeowners have equity in their home from those rising prices, prioritizing the mortgage protects that equity and keeps the household in the house to boot," he said. "Not everyone makes such a calculation, but many do."

Major variances were found across the country with cities such as Los Angeles, which was greatly impacted by the mortgage crisis, experiencing much different consumer payment patterns than cities such as Dallas, which had a more stable housing situation, TransUnion said in the report.

"It's been well documented that the Great Recession impacted different areas of the country to varying degrees," said Becker. "While unemployment generally went up throughout most of the country, some areas saw more job losses than others. Markets that experienced extreme housing value increases and declines also saw the biggest shifts in payment dynamics. As unemployment gradually improves and housing prices recover, we expect every major metropolitan city will revert to the traditional payment hierarchy."

When the economic meltdown began and housing prices plunged, people who realized they would ultimately lose their home to foreclosure began putting available money toward servicing their credit card bills, said Gail Cunningham, vice president of public relations of the National Foundation for Credit Counseling.

"Since obtaining new credit would be difficult with a foreclosure on their credit report, their efforts and money focused on protecting existing lines of credit," she said. "Now that things have somewhat stabilized, normalcy is returning."

Since most consumers protect their most valuable investments first, the next most expensive purchase after a home is usually a vehicle, so it makes "perfect sense to service that debt obligation after the mortgage," Cunningham said.

"NFCC member agencies teach people to pay their living expenses first followed by the vehicle payment and then remaining creditors," she said. "Making the vehicle payment before the mortgage should be discouraged. Perhaps they feel that they must have transportation in order to keep their job and without a job, everything falls apart."

Consumers are now feeling more upbeat about the housing market, said Kurt Fillmore, principal of Wealth Trac Financial Group, a Detroit investment adviser.

"If you believe your house will continue to increase in value, you are going to keep paying," he said. "People were so pessimistic, but now there's more optimism."

People who are faced with a myriad of debt should pay off the highest rate, non-deductible debt first and then work their way down the ladder, said Mike Chadwick, CEO of Chadwick Financial in Unionville, Conn.

"People are doing the exact opposite of what they should be doing," he said.

--Written by Ellen Chang for MainStreet