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# Your House or Your Credit Card?

For years, the conventional wisdom in the finance industry has been that individuals will continue to pay their mortgage long after they have gone delinquent on other obligations.[1] After all, houses have not only financial and functional value, but also personal value. Nevertheless, evidence from recent research suggests that many individuals make a different choice: they pay credit card bills even at the cost of mortgage delinquencies and foreclosures.[2] That decision pattern has been generating attention during the foreclosure crisis.[3]

The decision is linked to the availability of liquid credit. Less available credit on a credit card makes it more likely people will perceive a need to protect the liquidity they have rather than pay the mortgage. Maintaining credit lines for liquidity purposes can be important if they face difficult financial circumstances. Having a credit card can enable them to pay for groceries, electric bills, gasoline, and other essentials.

A small drop in available credit on credit cards (one standard deviation) has been shown to correlate with an increase in mortgage delinquency of 13.1 percent. Between June 2006 and December 2007, the number of people choosing to pay on their credit cards and become delinquent on mortgages more than doubled—implying that many perceived an increased liquidity need during the run-up to the financial crisis. Clearly, consumer credit is important to people trying to manage economic uncertainty.

Two implications stand out. One, a line of credit on a credit card is a kind of security blanket. It appears ever more likely that individuals will keep credit cards functional to ensure that they can cover regular, nonhousing costs of living in bad times.[4] Two, the increase in foreclosures over the past two years is attributable in part to people's need for access to cash. If that is true, then mortgage-affordability programs will have to address a consumer's full range of liabilities in order to be successful. Many restructuring programs, however, look solely at people's ability to cover mortgage payments out of current income. What may be overlooked is that income could be high enough to pay a mortgage but not high enough to pay both a mortgage and nonhousing debts.[5]

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Thus, among the potential explanations for increased mortgage delinquency, access to cash plays a central and dominant role. Many individuals who default on their mortgage are capable of paying it, but their decision not to do so may be about more than the housing price changes that have received widespread blame as a primary cause of mortgage delinquency. The need for cash is often of greater importance.

This is a concern with serious ramifications. An individual's payment of a credit card bill at the expense of a mortgage payment may lead to foreclosure, causing the value of neighboring houses to decline—ultimately triggering additional delinquencies.

## Stylized Patterns

**Fact 1:** *A large fraction of individuals choose delinquency on mortgages or credit cards, but not both.*

**Fact 2:** *A large fraction of that group choose delinquency on mortgages while continuing payment on credit cards.*

In fact, among mortgage-holding individuals in the dataset studied, a full 74 percent chose to become delinquent on housing but not on their credit cards. That statistic is remarkable partly because a large fraction of consumers facing economic hardship are making choices about which debt to cover. Current economic models of distress (principally bankruptcy) consider that what is most important is overall economic condition or a strategic run-up of unsecured debt prior to bankruptcy. However,

the small scale of the average delinquency (less than $1,000) and the number of individuals in the sample suggest that what we are observing is not prebankruptcy behavior. Average consumers who chose their credit card over their mortgage had a household income of $50,000, a monthly mortgage of about $1,300, and monthly credit card obligations of about $600. They have about $10,000 in remaining balances on their credit cards. Such consumers probably choose to skip the mortgage knowing that, in the long run, they would be unable to support it. On average, once this decision has been made, the borrowers quickly accumulate a large delinquent mortgage balance.

**Fact 3:** *As delinquency rates have risen overall, the proportion of individuals choosing mortgage delinquency over credit cards has risen.*

Between June 2006 and December 2007 alone, delinquency and default rates increased for most groups. A notable change was the difference between credit card and mortgage delinquencies. Individuals who were mortgage delinquent but not credit card delinquent increased 127 percent during the 18-month period. Individuals who were credit card delinquent but not mortgage delinquent rose only 18 percent.

**Fact 4:** *Areas with large housing price declines showed stronger patterns of people trying to protect their credit cards.*

Three states that experienced high housing price increases and then declines—California, Nevada, and Florida—showed a huge increase in mortgage delinquency rates without corresponding increases in credit card delinquency. In fact, mortgage delinquency rates increased by 331 percent during the 18-month time period and credit card delinquencies by 97 percent. That asymmetric increase is consistent with *Wall Street Journal* reports that cardholders in those states—and in the states' distressed construction and finance industries—face increased scrutiny from card issuers.[6]

## Preference for Cash

To isolate the decision to pay credit cards first, the research analysis looked exclusively at individuals who had no delinquencies in June 2006 and either a credit card or mortgage delinquency in December 2007. The thought was that one could then determine factors predicting that choice. The economic analysis found that two factors were dominant. The first, housing price changes, has been well studied. In severely affected states, short-term housing price changes—large drops in the value of homes—were a strong determinant of decisions related to mortgage delinquency. Elsewhere in the country, longer-term housing price changes mattered more.

The second factor is the availability of credit card lines. Individuals with lower lines are more likely to default on their mortgage. Individuals with higher credit availability have less need to protect the credit on their cards and are more willing to allow them to fall into delinquency. The low lines are essential to daily living during economic shocks and have to be protected. The twofold conclusion: the absolute level of available credit to individuals on the economic margin is essential in preventing mortgage defaults; minor changes in credit availability will have disproportionately large effects for such individuals.

Generally, individuals with credit constraints, including the young and those with low credit scores, are more likely than those without such constraints to protect their credit cards, even at the cost of a mortgage delinquency. The strongest effect is seen for those with the least available credit. Indeed, the young, people with low credit scores, low-income individuals, and minorities have the strongest propensity to protect liquidity and forgo housing payments. Given that such groups are those with the greatest need for alternate sources of liquidity, the result is unsurprising.

When liquidity concerns lead to delinquency increases, systemic problems may result. The individual's decision to protect consumer credit instead of housing may have a negative impact on the surrounding community. Policymakers should be encouraged to understand the triage that mortgage holders conduct and investigate ways to reduce risks. Potential approaches might include liquidity insurance that a financial service provider or the government would offer borrowers. For example, a financial institution could offer a credit line bundled with a mortgage at the time of issuance—this could have ameliorated the liquidity crunch that borrowers faced during the recent crisis and also could have reduced foreclosures. Now that foreclosures are occurring, however, loan modifications should at a minimum address mortgage and consumer credit in tandem.

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### Endnotes

[1] See Ethan Cohen-Cole and Jonathan Morse, "Your House or Your Credit Card, Which Would You Choose? Personal Delinquency Tradeoffs and Precautionary Liquidity Motives," Federal Reserve Bank of Boston working paper QAU 09-05, http://www.bos.frb.org/bankinfo/qau/wp/2009/qau0905.htm.

[2] See Luigi Guizo, Paola Sapienza, and Luigi Zingales, "Moral and Social Constraints to Strategic Default on Mortgages," National Bureau of Economic Research working paper 15145. The authors find that 26 percent of all individuals who default on their mortgage are capable of paying it.

[3] Cohen-Cole and Morse find a strong liquidity preference even in areas that had not yet faced housing price declines in December 2007.

[4] Transunion has found that consumers have become "more conscientious in protecting those credit instruments still available to them and are making every effort to pay their credit card bills on time," http://newsroom.transunion.com/index.php?s=43&item=516.

[5] Note that a primary criterion for the Treasury's loan modification program is that payment on a first mortgage be more than 31 percent of gross income. See http://www.makinghomeaffordable.gov/modification_eligibility.html. That amount includes principal, interest, taxes, insurance, and dues, but does not include nonhousing debt.

[6] Robin Sidel, "Card Issuers Get Personal to Check Credit," *The Wall Street Journal*, June 19, 2008.

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