Miguel Porlan

The Risk of Using a Home for Extra Cash

By AnnaMaria Andriotis

A growing number of homeowners who are refinancing their mortgages want more than a lower interest rate—they want a little extra cash.

In a cash-out refinance, borrowers can withdraw equity from their homes at the same time as they alter the interest rate on the mortgage. The transaction typically gets more popular when home values rise, as newly confident borrowers look for a way to cover home repairs, reduce debt or pay expenses such as college tuition or travel.

But homeowners should make sure that they aren't digging themselves too deeply into debt, which could haunt them down the road if, for example, home prices fall. And they should consider whether other alternative moves might accomplish the same goal at a lower cost.

Lenders completed 243,847 cash-out refinances in the third quarter, up 32% from the prior quarter and up 6% from a year ago, according to exclusive data from Black Knight Financial Services, a mortgage data and services company. Cash-out refis accounted for 31% of all refinancing activity in the third quarter, compared with 18% a year ago, according to Black Knight. That was the highest share since the fourth quarter of 2008.

The move can be a convenient way to get extra spending money.

Putting the proceeds of a cash-out refi into upgrading your home can increase its value and pay off in the long run, says Stu Feldstein, president at SMR Research, a mortgage-research firm in Hackettstown, N.J.

Banks say some homeowners are also opting for a cash-out refi to pay off a home-equity line of credit, or Heloc.

Payments on Helocs are often interest-only for the first 10 years, before principal payments are also due. The move can make sense if you refinance into a fixed-rate mortgage, because interest rates on Helocs are typically variable, so borrowers could get hit hard if those rates rise.

Other uses for the money can also be tempting. Using the cash to pay off credit-card debt or other debt can lead to savings, because the interest rate on the new mortgage will likely be lower. The average rate on a 30-year fixed-rate mortgage, for example, was 4.1% for the week ended Nov. 14, according to mortgage-information website HSH.com. Credit cards had an average interest rate of 11.82% as of August, according to the latest data from the Federal Reserve.

But be aware of the risks. Borrowers who fall behind on credit-card payments don't risk losing an asset, while borrowers who fall behind on home loans risk foreclosure. Take particular caution before using a cash-out refi to fund a vacation or another big-ticket purchase.

Borrowers should also check their current interest rate. If they took out their current loan in the past few years, they may already be paying less than 4% on a 30-year fixed-rate mortgage and could end up with a higher interest rate and larger monthly payments if they refinance now. They could get a lower rate with an adjustable-rate mortgage, but that rate could rise significantly over the life of the loan.

Don't forget closing costs, which are typically 2% of the loan amount on a refinancing, says Keith Gumbinger, a vice president at HSH.com. Homeowners who refinance into a $400,000 loan, including a cash withdrawal of $40,000, could in effect pay $8,000 for that privilege.

Another factor to consider: Borrowers who are 10 years into paying down a 30-year mortgage and refinance into another one will once again be making the early payments, which mostly go toward interest charges. On a $400,000 30-year mortgage with a fixed interest rate of 4%, borrowers will pay $15,872 in interest charges and just $7,044 in principal in the first year, says Mr. Feldstein of SMR Research.

To pay down principal faster, ask lenders to make the new loan for a shorter term. Many borrowers hesitate to take out a 15-year loan because it often comes with larger monthly payments. But most lenders offer 20- and 25-year options.

Consider taking out a Heloc or a home-equity loan, instead. The interest rates on these loans are typically higher. But because the amount borrowed tends to be smaller, borrowers typically pay less in interest charges than they would on a mortgage, says Mr. Gumbinger.

Also, Heloc borrowers only incur interest charges on the amount they draw down. And closing costs on Helocs can be under $200, and sometimes cost nothing, he says. On home-equity loans, closing costs can be up to about $1,000.