NEGATIVE NET EQUITY

Negative equity generally occurs when the value of an asset used to secure a loan falls below the outstanding balance on the loan. From a financial analysis perspective, a firm is said to have a negative net equity when the value of its liabilities is greater than that of its assets. In this case, it is also referred to as negative net worth or insolvency. The definition of net equity is however not straightforward. The latter is calculated by taking into account the subscribed capital, share issue, revaluation variance, reserves, net profit or loss, and statutory provisions and eliminating uncalled subscribed capital and intangible fixed assets (Delbreil et al., 2013, 23). Notwithstanding, the main aim of net equity is to “show the ability of a company to remain solvent, without taking account of assets, which at the time of winding up, might not have realizable value.” (23).

Negative equity can also be considered from a real estate point of view. According to Hellebrandt et al. (2009, 110), negative equity occurs when the value of a house is below the outstanding mortgage secured on it. This implies that more is owed in the property than the property is worth (Taff, 2009, 59). From this perspective, negative equity not only exacerbates the financial difficulties experienced by households during periods of economic recession but also has far-reaching consequences in the wider economy. Particularly, it influences monetary policy by affecting the pattern of aggregate demand and supply. Additionally, banks are forced to make write downs in their mortgage books, or incur huge losses on securities associated with the real estate market, which are more often than not substantial enough to distort their capital ratios. Such distortions also have serious implications on the monetary policy. This was evidenced during the financial crisis in 2008.

References

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