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What Does It Mean to be Upside Down on a Loan?

Dear [--Merge1--],

Navigating Negative Equity: What to Do When You're "Upside Down" on a Loan

Have you ever heard someone say they were "upside down" or "underwater" on a loan? Simply put, negative equity means that the amount you owe on a loan is greater than the current market value of the asset you bought. This situation can happen with major purchases like a home or a car, and understanding it is key to protecting your financial health.

What Does It Mean to be Upside Down on a Loan?



For example, imagine you bought a house for \$400,000 during a peak housing market, and after several years, you still owe \$350,000. If the market has since softened and your home is now only valued at \$300,000, you are underwater by \$50,000. In this scenario, if you were to sell your home, the proceeds would not be enough to pay off your mortgage, and you would still be responsible for the remaining debt. This same principle applies to cars, which can depreciate in value as soon as you drive them off the lot.

Being in a negative equity position can feel overwhelming and can make it difficult to get ahead. However, understanding the causes and knowing your options is the first step

toward getting back on solid financial ground.
Why Do Loans Go "Upside Down"?

While some causes of negative equity are unavoidable, such as an asset being damaged or stolen, many factors can be controlled. Understanding these causes can help you avoid finding yourself in this situation.

Rapid Depreciation

A common cause for car loans to go underwater is rapid depreciation. Many new cars lose a significant portion of their value in the first few years. If your loan term is long or your down payment was small, the amount you owe may decrease slower than the car's market value, putting you underwater.

Market Fluctuations

For real estate, a downturn in the housing market can cause home values to fall. If you bought your home when prices were at their highest, a market correction could easily push your home's value below what you owe.

Small or No Down Payment

Starting with a small or even no down payment can send you upside down fairly quickly. Because you have little to no equity invested in your purchase, you're vulnerable to even minor market shifts or depreciation.

High Interest Rates

A higher interest rate means a larger portion of your monthly payments goes toward interest rather than paying down the loan's principal. This slows your equity growth and increases the risk of being underwater.

Unforeseen Events

Sometimes, unplanned events can put you upside down—for example, your car is stolen or totaled in an accident. Your insurance payout would be based on the car's current market value, which may be less than what you owe on the loan. This can leave you with a debt for an asset you no longer have.

How to Prevent Negative Equity

While some factors are out of your control, there are several proactive steps you can take to make going underwater less likely.

Make a Larger Down Payment

This is the most effective way to prevent negative equity. A substantial down payment reduces the amount you need to borrow and immediately gives you a cushion of equity, protecting you against initial depreciation or market volatility.

Shop for a Shorter Loan Term

Choosing a shorter loan term, like a 3-year car loan instead of a 7-year one, means your payments will be higher, but you will pay down the principal much faster. This helps ensure you build equity more quickly than the asset's value depreciates.

Just be sure to keep your financial realities in mind, and don't opt for a loan payment that's more than you can realistically afford. Since both car and house loans are secured loans, failure to pay them back in a timely manner can have devastating consequences.

Consider Waiting for Better Rates

If interest rates are high and your need for

What to Do If You're Already Underwater

If you find yourself in a negative equity situation, don't despair. You have several options to help you recover.

Make Extra Loan Payments

If you can, make extra payments that go directly toward the principal balance of your loan. Even small, consistent extra payments can make a big difference in how quickly you pay off the loan and get back to a positive equity position.

Refinance Your Loan

If your credit score has improved or if interest rates have dropped since you took out your original loan, you may be able to refinance into a new loan with better terms. A lower interest rate could help you pay down the principal more efficiently.

Stay the Course

For many people, the best option is to simply plan on keeping the asset and continue making your regular payments. Over time, the loan balance will naturally

a new loan isn't urgent, waiting for them to come down can save you a significant amount of money over the life of the loan. A lower interest rate helps you pay down the principal faster and build equity more efficiently, and even a single percentage point can mean the difference of thousands of dollars.

Research Your Asset's Value

Before buying, research the market to understand an asset's typical depreciation or a home's value trends. Avoid overpaying for an asset whenever possible, as this can put you at risk from the very beginning.

decrease, and the value of your asset will eventually catch up, especially for long-term assets like real estate. This is often the most straightforward path to recovering positive equity.



We're Here to Help

Navigating loans and understanding complex financial terms can be challenging. If you have any questions or need guidance on your specific situation, don't hesitate to reach out. We're here to help you get the information you need to make the best financial decisions for your future.

Our *All About Me* program can help you navigate the waters regardless of where you are in life or what your greatest challenges happen to be.

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