

California Enterprise Zone Program

A Refinement of the Net Interest Deduction for Lenders California Small Business and Toxic Mortgages A Key to Economic Recovery

Testimony of

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Introduction:

Good afternoon Chairman Perez, and Members of the California State Assembly Committee on Jobs, Economic Development, and the Economy. Thank you for inviting me to discuss the California Enterprise Zone program.

I would like to **propose a Refinement of the Net Interest Deduction for Lenders** that addresses the main concerns of California's present economic crisis—to stimulate economic recovery, enhance small business survival, **save and create jobs**, and provide small business owners a means for effective **loan modification** which will **prevent foreclosures**.

My name is Samuel D. Bornstein. For the past 33 years, I have been a Professor of Accounting and Taxation, as well as a CPA and Consultant in public practice. **Since 2000, I and my partner Jung I. Song, CPA, of Bornstein and Song CPAs & Consultants**, have conducted research on small business. We discovered a **link** between the Mortgage Crisis and small business owners.

We **found** that small business owners often took out mortgages on their homes to get cash for their newly created or existing businesses, but the main **problem** was that they used **toxic mortgages**. In fact, **small business owners were targeted** by the lending community for these toxic mortgages.

Our research prompted an invitation to testify before **Senator John F. Kerry's U.S. Senate Committee on Small Business and Entrepreneurship** on **April 16, 2008**, in a hearing entitled, "The Impact of the Credit Crunch on Small Business." In my testimony, I presented our research that, during the Subprime Era and Housing Boom, a significant number of small business owners fell prey to these toxic mortgages.

In order to confirm our research, we, **Bornstein & Song**, authored **three Small Business Toxic Mortgage Surveys: U.S. National (November 2008), California (April 2009), and California Hispanic (June 2009)**.

We enclose as an attachment to this testimony the California and California Hispanic surveys. We also enclose a comparison between the three Small Business Toxic Mortgage Surveys.

These surveys provide compelling evidence that a significant number of **California**, and especially **California Hispanic** small-business owners, fell prey to the toxic mortgages, such as Alt-A, Alt-A ARMs, Option ARMs, Interest-Only, and Subprime.

These business owners are at-risk as their **toxic mortgages reset** and **skyrocket** to unexpected and unsustainable amounts. The resulting financial distress **will lead to job loss**. These resets will precipitate the 2nd Tsunami Wave of Foreclosures that will strike in 2009 and will continue to intensify through 2012.

California leads the nation with 58 % of these toxic mortgages and will be hardest hit.

Most **shocking** is that **51.8%** of **California** and **52.6%** of **California Hispanic** small business owners **used toxic mortgages**. These findings clearly indicate that California's small business usage of toxic mortgages **far exceeds** the **National** average of **31.9%**.

The **Bornstein and Song, California Small Business Toxic Mortgage Survey** in April 2009 found that **more than 1.5 million** Californians are **Now** at Immediate Risk of **Job Loss**, and **More than 2.1 million** California Small Business Jobs may be Lost in the **2nd "Tsunami" Wave of Foreclosures in 2009 through 2012.**

It is a tragedy when an individual homeowner defaults on the mortgage and loses the home. The tragedy is **magnified** when the homeowner is also a small business owner employing from 1 to 21+ employees. The **loss of jobs** due to financial distress related to mortgage delinquency and default and the resulting possible business failure will further weaken California's economy.

Today's hearing on California Enterprise Zones, is a natural outgrowth of my testimony before this Committee on **May 5, 2009**, wherein I **sounded an alarm** that among California's homeowners there are a significant number of small business owners who were drawn into these toxic mortgages. They are at-risk of failure, and their employees will lose their jobs.

The economic health of California is at-risk as a result of California's small business involvement in toxic mortgages. The resulting financial distress, mortgage defaults, foreclosures, and job loss will further weaken California's economy.

I would like to suggest a Solution. A **Refined Net Interest Deduction (NID)** provides a **solution** to the toxic mortgage crisis by preventing foreclosures, saving jobs and lowering unemployment, enhancing small business lending, and sustaining California's small businesses.

Background: “Perfect Storm”, Small Business, and Toxic Mortgages

During the housing bubble of 2004 to 2007, many homeowners refinanced their homes to cash-out the equity when housing prices boomed. Loan underwriting standards were often ignored. Even the least credit-worthy borrower had access to this easy money. Loans were made regardless of bad credit histories and low or no documentation of income. This “**perfect storm**”, where both lender and borrower were happy, prompted easy access to cash.

It was too-good-to-be-true. The lending community participated in this frenzy by issuing toxic mortgages, such as Alt-A, Alt-A ARMs, Option ARMs, Interest-Only, and Subprime, etc. Small business owners were especially targeted for these loans which required little or no documentation of income which appealed to many who previously were unable to qualify.

Such lenders as Countrywide, IndyMac, Washington Mutual, GreenPoint Mortgage, Wachovia, World Savings, Bank United, and Downey, etc. were the leaders in Alt-A and Option ARMs mortgages which **originated in California, the Mother of Alt-A and Option ARMs.** These banks have notoriety for the havoc they are causing to our economy by their failure due to these toxic mortgages.

The Alt-A and Option ARMs were the most popular, but there would be a **nasty surprise**, “payment shock”, when these mortgages reset after the initial five years. As these mortgages reset and the monthly mortgage payments skyrocket, homeowners will be at risk of default and foreclosure. These resets will usher-in the second wave of foreclosures in 2009 through 2012, the worst possible time for our economy.

Among these homeowners are a significant number of **small business owners** who were drawn into these toxic mortgages by the ease in which they could refinance and access cash with low teaser rates and little or no proof of income. This appealed to small business owners because their income and collateral was usually too low to otherwise qualify for financing.

For small-business owners, the scheduled resets during 2009 through 2012 and the spike in the monthly mortgage payments will cause additional stress, beyond the stresses of a weakened economy, which may **prompt job loss** for their employees.

Small Business Owners Used Mortgages on their Homes to Get Capital for Their Newly Created or Existing Businesses

The largest asset that small business owners possess is **their home**. In the past, as housing values were increasing, small business owners often cashed-out the equity in their homes to fund their newly created or existing businesses. This practice was most prevalent during the housing bubble when small business owners were provided a unique opportunity for easy access to cash.

Refinancing their homes using **Alt-A and Option ARMs** was the easiest way to meet their **small business cash flow needs**. They chose this option over other traditional sources of financing, such as regular commercial or SBA guaranteed loans, because these toxic mortgages did not require the same level of **cumbersome paperwork**, including financial statements, income documentation, and an established credit history.

In a nationwide study of small business owners conducted by Small Business Research Board and co-sponsored by Business Today Magazine (Jan 17, 2008), 54.2% used their home as collateral. Another study by Middle Tennessee State University found that home equity loans accounted for an average of 43.1% of startup funding. In 1996, bankers estimated that at least 90% of first-time small business owners used their homes as collateral. These statistics are not surprising if you consider that a new business often does not have a track record or sufficient assets to serve as collateral for the entire loan.

During the years 2004-2007, small business owners were specifically targeted by banks and other financial institutions for these toxic mortgages. They were further enticed by the exceptionally low teaser rates which made these mortgages very appealing to the small business owner. According to Amherst Securities and LoanPerformance, California leads the nation with 58% of all Alt-A and Option ARMs mortgages.

Hispanic-owned Small Businesses in Enterprise Zones are the Weakest Link and Most Vulnerable

California is the national leader in Hispanic-owned small businesses and their business formation is three times that of other groups. In 2006, HispanTelligence estimated that there were 744,791 California Hispanic Small Businesses.

In the housing bubble, the **California's Hispanic community was targeted for toxic mortgages by the aggressive mortgage marketing efforts of lenders. In their search for capital to fund their businesses, many California Hispanic small business owners fell prey to these toxic mortgages.**

Considering that many Hispanic small businesses may be located within California Enterprise Zones, this hearing offers a unique opportunity to help Hispanic small business owners who used toxic mortgages to fund their small businesses.

The Bornstein & Song California Hispanic Small Business Toxic Mortgage Survey (June 2009) sheds light on the extent of this crisis:

- **36.9 % got cash from home mortgage for their businesses**
- **52.6 % had toxic mortgages**
- **49.3 % were “very worried” about their monthly mortgage payments at Reset**
- **21.1 % were already delinquent, missed 1 to 3 or more monthly mortgage payments.**

There is the potential for business failure and **job loss** within the Hispanic community. It is essential that we **explore new and innovative programs** that will promote **saving and creating jobs** and address the **survival of these small businesses**, as we seek economic stimulus and recovery for California's economy.

Solution to California Small Business Toxic Mortgage Crisis:

Proposed Refinement of the Net Interest Deduction for Lenders Will Target EZ Small Business Owners with Toxic Mortgages

This Committee has a unique opportunity to **create** a Refined Net Interest Deduction (NID) for Lenders as a valuable tool to **target EZ** small business owners with **toxic mortgages** and **save them** in the next five critical years as these mortgages reset.

The current NID for Lenders should be **extended** to include Lender loans made to small business owners who took out mortgages on their homes and invested the proceeds into their newly created or existing businesses within Enterprise Zones (EZ).

The **current and retroactive tax savings** provided to Lenders should be **mandated** to benefit the small business owners by **lowering their monthly mortgage payments** and by **principal reduction** on their mortgages.

In its present form, the NID allows Lenders making loans **directly** to EZ businesses to effectively receive **tax-free treatment** on the interest income earned on these loans. The apparent incentive is to promote lending to these businesses. For Lenders, this means **tax savings**, thus increasing profitability, reducing interest rates for small business borrowers, and enhancing the ability for EZ businesses to obtain financing.

It is clearly evident that merely applying the Net Interest Deduction (NID) for Lenders to loans made directly to small businesses within EZs does not cover those small business owners who mortgaged their homes to invest the proceeds into their businesses within EZs.

There should be no difference between a loan which was made directly to a business within an EZ, and a loan that was made to a small business owner who got a mortgage on his/her home to provide working capital for his/her business within an EZ. This should apply regardless of whether the small business owner's home is located within or outside of an EZ. In both cases, the Refined NID for Lenders is basically accomplishing the same purpose which is to provide capital for the small business in the EZ.

While the current application will provide **tax savings for Lenders** now and going forward, the **retroactive** application of the Refined NID for Lenders to prior years will provide a **windfall of tax refunds for Lenders** through **amended tax returns** for **4 prior years**.

These 4 prior year's tax refunds and the current and future year's tax savings should be **mandated** to be passed along to the small business owners to reduce the current and future monthly mortgage payments to affordable amounts. The tax refund windfall can also be used for **mortgage principal reduction**.

Since California leads the nation **with in excess of 1.9 million** underwater borrowers, who are in negative equity, this **principal reduction** will mitigate the **negative equity problem for these small business owners**.

This principal reduction **pay-down** of the mortgage balance will provide the Lender with **additional cash and liquidity** which the Lender can use for **small business lending**. Today,

small business loans are limited because Lenders lack liquidity. This additional inflow of cash to the Lenders will stimulate small business loans which are essential for California's economic recovery.

Refined Net Interest Deduction for Lenders:

A Win-Win for Small Business Owners and Lenders

Small business owners will benefit by lower monthly mortgage payments and avoid the expected spike at the resetting of their Alt-A and Option ARMs mortgages. This will benefit all Enterprise Zone small business owners, including those with conventional fixed-rate mortgages, by lowering their monthly mortgage payments. The reduction in financing costs on these mortgages will improve **small business survival** in this economic downturn.

Lenders will benefit by defraying the cost of loan modifications thereby enabling banks and other financial institutions to comply with the Obama Administration's push for loan modifications to prevent foreclosures.

The Lender will benefit in another way. The foreclosure rate in California is among the highest in the U.S. and is expected to continue for years to come. The costs related to foreclosures can be as much as \$50,000 per foreclosure. Lenders will benefit by preventing foreclosures through loan modifications driven by the tax savings for the current year and the tax refund windfall for prior years.

The tax savings will be **mandated** to offset the small business owner's monthly mortgage payment. This loan modification will **not cost the Lender a dime** as other loan modifications require Lenders to lower monthly payments which force them to recognize a loss on the reduced monthly payment.

The Net Cost to California Should Be Zero

Currently, the Obama Administration's foreclosure prevention initiatives have been centered on Treasury's "**Making Home Affordable**" (MHA) program. President Obama has allotted **\$75 Billion** from the TARP for this purpose, but it has fallen short of its goals. MHA was intended to **save 8 to 9 million foreclosures**, but instead about **487,000** are in the trial period, and only a **few thousand have succeeded** in converting their trial modifications into longer term modifications.

The cost of the Refined NID program should **not only** be borne by the State of California alone.

It can be suggested that both the Refined NID and MHA program can be coordinated to enhance loan modifications for foreclosure prevention. The Obama Administration may view the Refined NID as a complementary program. California may be entitled to reimbursement from Washington, on the costs of the Refined NID. Another approach would be to suggest reimbursement under the Federal Government Economic Stimulus program.

Congressional Oversight Panel:

“Making Home Affordable” Foreclosure Prevention is “Inadequate”

The Congressional Oversight Panel (COP) evaluated the “Making Home Affordable” Program in their October 9, 2009 report “An Assessment of Foreclosure Mitigation Efforts after Six Months.” The COP concluded that MHA was “inadequate”.

The COP noted that the MHA program is **failing** to address the most important aspect of the foreclosure crisis, which is the resetting of the Alt-A and Option ARMs mortgages, Principle Reduction, and Negative Equity. MHA’s loan modification efforts **which ignore these toxic mortgages will doom the success of the MHA loan modifications.**

The COP report stressed that the MHA **must be reworked** to address these issues. The resetting of toxic mortgages and negative equity has the greatest impact on California homeowners. Negative equity is of greatest concern for California as it leads the nation with 1.9 homeowners underwater with negative equity. With each passing day, this number increases thereby placing California’s homeowners further underwater and in jeopardy of foreclosure and strategic default.

Strategic default is when a homeowner decides to walk-away, rather continue paying on the home, where the amount owed on the mortgage exceeds the value of the home. The resulting voluntary foreclosure will further depress home values and further threaten a housing recovery.

At December 2008, California had **35% of its homeowners underwater** in negative equity, which can be blamed on the fact that California is at the epicenter of Option ARMs mortgages, such as Interest-Only, which aggravate the negative equity problem for California.

The good news is that the tax savings provided by the Refined NID will mandate Principal Reduction, which is a cure for underwater small business owners with negative equity.

California Small and Medium-sized Banks will Avoid Failure

California banks will also benefit. The Congressional Oversight Panel in its August 2009 report expressed concern that toxic mortgages as “whole loans” are clogging the books of small and medium-sized banks and will cause their failure and limit credit for small business lending. We enclose **Attachment 4**, my article in **American Banker on September 11, 2009**, which addressed this issue.

The Refined Net Interest Deduction (NID) for Lenders program will lower the default risk on these toxic mortgages and save California banks from failure.

Many of California’s small and medium-sized banks hold toxic mortgages such as Alt-A and Option ARMs as “whole loans”. Option ARMs were widely available in the housing boom but have been a disaster in the housing bust. They have been blamed for the demise of Newport Beach's Downey Savings and the near-collapse of mortgage giant Countrywide Financial Corp of Calabasas as well as the country's former fourth-largest bank, Wachovia Corp. First Federal, the second-largest California-based thrift, which is known for its huge volume of Option ARMs

mortgages, is now in danger of failure as a direct result of the high rate of default on these toxic loans.

The Refined Net Interest Deduction (NID) will help reduce the financial distress for small business owners and accomplish economic stimulus and foreclosure prevention. It will address President Obama's agenda to **stimulate the economy, save jobs, and save the housing market.**

Impact on California Small Business Bankruptcy

The Refined Net Interest Deduction (NID) for Lenders will enhance the survival of small businesses in California Enterprise Zones (EZ).

For small business owners with resetting toxic mortgages, the resulting spike in the monthly mortgage payment will lead to financial distress, which will be a contributing factor for **unemployment, mortgage failure, and business bankruptcies.**

These factors may have contributed to the sharp increase in small business bankruptcy filings, delinquencies, notices of default, and foreclosures especially in California where the housing bubble was centered and 58 percent of toxic mortgages such as Alt-A and Option ARMs were issued from 2004 to 2007.

California has the highest rate of business bankruptcies according to an Equifax Report which indicated that small business bankruptcy filings were up 81 percent in June 2009 versus June 2008.

California was the most negatively affected State with 10 Metropolitan Statistical Areas (MSA) among the 15 areas with the most commercial bankruptcy filings during June, 2009. Los Angeles, Riverside/San Bernadino and Sacramento metropolitan areas led the nation in small business bankruptcy filings.

The other MSA's with the most bankruptcy filings were **San Diego**, Carlsbad, Oakland, Fremont, Hayward, Santa Ana, Anaheim, and Irvine California. Small business distress has the potential to exert a devastating impact on the economic health of California.

Summary:

California Enterprise Zones - Key to Economic Recovery

California small businesses in Enterprise Zones (EZ) are facing many challenges. Their success will determine job creation and job retention. Historically, small business has been a reliable source for job creation and played a major role in an economic recovery. After all, small business is the job creation engine of our economy.

But, this time it is different. The toxic mortgages, such as Alt-A, Alt-A ARMs, Option ARMs, Interest-Only, and Subprime, acquired by a significant number of California and California **Hispanic** small business owners to fund their businesses, will be the **Game Changer**.

As California's economy falters and **unemployment is expected to rise** and stay at elevated levels for an extended period of time, these toxic mortgages should prompt a special concern for California's economic recovery.

During the course of our 9 years of research, we, **Bornstein & Song**, discovered a **link** between small business owners who took out mortgages on their homes to fund their businesses, and the toxic mortgages which were prevalent in 2004 to 2007. California's small business owners were especially **targeted** for these mortgages. We authored a separate survey to specifically address California and California Hispanic small business owners.

Our, **Bornstein & Song, Small Business Toxic Mortgage Survey** for the **U.S. National** (November 2008), **California** (April 2009), and **California Hispanic** (June 2009) found that **51.8%** of **California** small business owners and **52.6%** of **California Hispanic** small business owners **used toxic mortgages** which are expected to reset and adjust to double or triple their original monthly mortgage payments. These findings clearly indicate that California's small business usage of toxic mortgages far exceeds the **U.S. National** average of **31.9%**.

These toxic mortgages pose a substantial **threat** to California small business survival and will prolong the agony of California **unemployment** and economic recovery. Our study found that **more than 2.1 million** California small business jobs may be lost **over the next 3 to 4 years**, and **more than 1.5 million** face **immediate risk of job loss** as a result of small business owners who are **currently delinquent** on their toxic mortgages.

The survival of California's economy will be challenged by small business owners' financial distress which will lead to rising unemployment.

Employee layoffs and furloughs now appear to be among the main causes of foreclosures. With rising unemployment leading to higher rates of mortgage defaults, it's hard to tell when the continuing wave of foreclosures will end.

California will be locked-into a Self-Perpetuating Cycle. As the toxic mortgages reset in 2009 through 2012 and spark the 2nd Tsunami Wave of Foreclosures, small business owners will fail, lose their homes to foreclosure, and precipitate employee unemployment which will lead to more foreclosures.

Foreclosures will arise from two sources: Small business owner mortgage failure as well as the resulting employee unemployment. Unemployment will lead to problems in the housing market which will lead the economy to falter, which will lead to even further problems in the housing market. This new wave of foreclosures will put additional pressure on California's economy.

Toxic mortgages are beginning to take their toll on California's economy. On October 10, 2009, H.D. Palmer, the Governor's budget spokesman, announced that there was a **5.3 percent drop in the budgeted income tax receipts** for the three months ended Sept. 30, 2009. He stated that this can be blamed on the drop in Estimated Quarterly Personal Income Tax Payments.

These personal estimated tax payments are made by small business owners to pay their taxes, on a quarterly basis, for their personal income tax returns. This may be a sign that the toxic mortgages, held by small business owners, are taking their toll as these toxic mortgages are beginning to reset in 2009 and will continue to intensify through 2012.

In Conclusion:

Refined Net Interest Deduction for Lenders

The Net Interest Deduction (NID) for Lenders was created to encourage loans to businesses within Enterprise Zones (EZ). California small business owners with businesses in California EZs often took out mortgages, either conventional fixed-rate or toxic mortgages, on their homes to access cash to fund their newly created or existing businesses. These mortgages should be included in the NID for Lenders and the tax savings should benefit these small business owners.

A Refined NID for Lenders can be an effective tool to **target and modify** the toxic mortgages which are expected to cause the 2nd Tsunami Wave of Foreclosures in 2009-2012 as they reset and spike to unaffordable monthly mortgage payments. Our, Bornstein & Song, studies suggest that millions of jobs will be lost during this period due to the financial distress that these mortgages will cause. The result will be rising unemployment and further deterioration of California's housing market.

The tax savings will be passed to the Lenders, such as banks and other financial institutions, but will be **mandated** to be used to lower the small business owner's monthly mortgage payments and provide principal reduction which will mitigate negative equity and thereby help California's underwater small business owners.

The resulting loan modification will enhance economic growth, save and create jobs, and fulfill the objectives of the Obama Administration for economic stimulus and foreclosure prevention.

In Summary, the Proposed Refinement of the NID for Lenders, which applies to small business owners with businesses in California EZs, will address the major concerns for California's economic recovery:

- **Preventing Foreclosures** – Lender tax savings will provide loan modifications for small business owners with toxic or conventional fixed-rate mortgages. Small business owners will avoid foreclosure. The Refined NID will address the three main concerns of mortgage affordability, principal reduction, and negative equity.
- **Saving Jobs and Reducing Unemployment** – By enhancing small business growth and survival, the Refined NID and the resulting tax savings will save and create jobs.
- **Enhancing Small Business Lending** – Lender tax savings, which will be applied to principal reduction pay-down of the mortgage balance, will provide the Lender with additional cash and liquidity which the Lender can then use for small business lending.
- **Saving Small Business** – Lender tax savings will lower the cost of home equity financing and improve small business growth and survival and reduce business bankruptcies.

I and my partner, Jung Song, of Bornstein & Song CPAs & Consultants, would be happy to work with the Committee to develop this Refinement of the Net Interest Deduction for Lenders which will create tax savings that will benefit small businesses in California Enterprise Zones.

Attachment 1

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Bornstein & Song Small Business Toxic Mortgage Surveys

California Hispanic, California, National

	<u>CA Hispanic</u>	<u>California</u>	<u>National</u>
	<u>June 2009</u>	<u>April 2009</u>	<u>Nov. 2008</u>
Homeowners with Mortgages	66.5 %	90.6 %	85.0 %
Mortgages Obtained After 2004	53.3 %	55.4 %	60.1 %
Got Cash from Home Mortgage for Business Expenses	36.9 %	34.3 %	33.9 %
<u>Delinquent</u> : Missed 1 to 3 or More Monthly Payments *	21.1 %	17.9 %	7.9 %
Expecting Resets During 2009 to 2012	44.7 %	34.9 %	22.9 %
<u>“Very Worried”</u> about Monthly Payment at Reset **	49.3 %	29.9 %	18.4 %
Do Not Know Monthly Mortgage Payment at Reset **	33.6 %	28.7 %	19.2 %
Have Fixed Rate Mortgage	13.8 %	48.8 %	68.1 %
Homeowners with Toxic Mortgages	52.6 %	51.8 %	31.9 %

* At Immediate Risk of Default

** At-Risk of “Payment Shock”

Attachment 2

Bornstein & Song Small Business Toxic Mortgage Surveys

Prediction of the 2nd “Tsunami” Wave of Foreclosures & Job Loss

In order to identify the extent of small business owner involvement in these toxic mortgages, we conducted three small business toxic mortgage surveys.

A survey of small business owners was the only way that we could make this determination. While the number and amount of toxic mortgages is known by the mortgage industry, there is no information available to determine how the borrowers used the proceeds of these loans. There is no way to distinguish between whether a borrower used the mortgage proceeds to add a bathroom or invest these proceeds into a new or existing small business.

In November 2008, we authored a **U.S. National Small Business Toxic Mortgage Survey**, which confirmed our research that **a significant number of small business owners did, in fact, acquire these toxic mortgages and were at-risk of payment shock** in the resetting of these mortgages in 2009 and will continue to intensify through 2012. Not only is there a concern for foreclosure, but there is also **a greater concern for the job losses** that would result from the financial distress and possible failure of these small businesses.

Having conducted a National Small Business Toxic Mortgage Survey, it became evident that a California small business toxic mortgage survey was necessary since this State leads the nation in toxic mortgages, mortgage delinquencies and foreclosures, and unemployment.

California Small Business Toxic Mortgage Survey (April 2009)

The Impact of Toxic Mortgages on California Small Business, Foreclosures, and Job Loss.

- **More than 1.5 million Californians, Employed by Small Business Owners who are Delinquent Having Missed 1 to 3 or More Monthly Mortgage Payments. ----Now at Immediate Risk of Job Loss**
- **More than 2.1 million California Small Business Jobs will be Lost in the 2nd “Tsunami” Wave of Foreclosures in 2009 to 2012**

In April 2009, we, **Bornstein & Song**, authored a **California Small Business Toxic Mortgage Survey**, which was the first to provide compelling evidence of California’s small business owner involvement in the toxic mortgage crisis, foreclosures, and job loss. The results of these surveys confirmed our research that expressed concern for the potential damage that the toxic mortgages may impose on **California’s unemployment** and economy.

Attachment 2 (continued)

The survey results provide compelling evidence that a significant number of small-business owners fell prey to these toxic mortgages and were at risk as these mortgages reset. The studies were an outgrowth of small business research which I and my partner Jung I. Song have been conducting for the past **nine years**.

Many fail to realize that a significant number of small business owners, employing from 1 to 21+ employees, were enticed into toxic mortgages to fund their businesses and were at-risk of default and foreclosure as these mortgages reset. Studies showed that these resets will constitute the 2nd “Tsunami” Wave of Foreclosures of toxic mortgages that will dwarf the Subprime Mortgage Crisis and take many homeowners and small business owners.

It is a tragedy when an individual borrower defaults on the mortgage and loses his/her home. The tragedy is magnified when the borrower is a small business owner employing from 1 to 21+ employees. The loss of jobs due to financial distress related to mortgage delinquency and default and the resulting possible business failure will further weaken our economy.

The problem is acute in California, where small businesses employing from 1 to 21 employees account for nearly 90 percent of employment. According to Credit Suisse, **homeowners in California are liable for 58% of all the outstanding Option ARMs mortgages, nationwide.**

So, here we have a major problem. California’s small business owners are at the epicenter of two dangerous forces: the housing bust and the sluggish economy. Not only will they lose their homes, but there will be additional financial distress that may result in business failure. **The resulting job losses are of concern.** Although both Federal and State governments are addressing the issue of job creation ... **Job Retention is as Important as Job Creation.**

The intent of these surveys was to determine the number of small business owners who have toxic mortgages such as Alt-A, Alt-A ARMs, Option ARMs, Interest-Only, and Subprime, etc. These small business owners are at-risk of payment shock and default as their monthly mortgage payments skyrocket during the resets which have already begun in 2009 and will continue through 2012.

The survey results confirm our research and highlight the fact that small business owners hold the key to a solution of this crisis and must be addressed in order to mitigate the nation’s foreclosures and job loss.

The California (April 2009) and the subsequent California Hispanic Small Business Toxic Mortgage (June 2009) surveys determined that a significant number of California and California’s Hispanic small business owners are at-risk of losing their homes to foreclosure and their **businesses to failure**, at the resetting of their toxic mortgages. The resulting job loss will contribute to **California’s spiking unemployment** and cause further financial distress to California’s economy.

Attachment 2 (continued)

Bornstein & Song **California Hispanic Small Business Toxic Mortgage Survey (June 2009)**

Survey Highlights:

- **36.9 % (274,828* At-Risk)** CA Hispanic Small Business Owners used risky or Toxic Mortgages or refinancing **to get cash for business expenses**. These mortgages are at-risk of default at reset.
- **52.6 % (391,760* At-Risk)** CA Hispanic Small Business Owners used risky or Toxic Mortgages or refinancing that are scheduled to Reset during the **2nd “Tsunami” Wave of Foreclosures from 2009 to 2012.**
- **49.3 % (367,182* At-Risk)** CA Hispanic Small Business Owners are **“very worried”** about their monthly mortgage payment due at reset. It may be too high to pay. They are at-risk of **“Payment Shock”**.
- **33.6 % (250,250* At-Risk)** CA Hispanic Small Business Owners are At-Risk of **“Payment Shock”**. They **do not know the monthly mortgage payment** that they will be required to pay at reset.
- **21.1 % (157,151* are at Immediate Risk of Default)** CA Hispanic Small Business Owners are delinquent, **having missed 1 to 3 or more monthly mortgage payments at this date**. More delinquencies are expected in the upcoming resets in 2009 to 2012.

* Based upon 744,791 California Hispanic Small Businesses, according to HispanTelligence® 2006 projections.

Attachment 2 (continued)

Bornstein & Song **California Small Business Toxic Mortgage Survey (April 2009)**

Survey Highlights:

- **34.9 % (1,173,900* At-Risk)** California Small Business Owners used risky or Toxic Mortgages or refinancing **to get cash for business expenses**. These mortgages are at-risk of default at reset.

Schedule of Resets: 2nd “Tsunami” Wave of Foreclosures (2008 to beyond 2011)

Impact on Job Loss: California Small Business Owners employ from 1 to 21+ employees.

	<u>CA Small Business Owners with Mortgages to Reset</u>
2008	47,800
2009	118,100
2010	193,400
2011	87,800
Later than 2011	213,600
Do Not Know	513,200
	<u>1,173,900</u>

- **29.9 % (1,005,700* At-Risk)** California Small Business Owners are “**very worried**” about their monthly mortgage payment due at reset. They are at-risk of “**Payment Shock**”.
- **28.7 % (965,300* At-Risk)** California Small Business Owners are At-Risk of “**Payment Shock**”. They **do not know the monthly mortgage payment** that they will be required to pay at reset.
- **17.9 % (602,100* are at Immediate Risk of Default)** California Small Business Owners are delinquent, having missed 1 to 3 or more monthly mortgage payments at this date. More delinquencies are expected in the upcoming resets in 2009 to 2012.

* Based upon 3,363,476 CA Small Business Owners, according to 2007 report prepared for the Small Business Administration’s office of Advocacy.

Bornstein & Song
Determination of Estimated California Job Loss:

More than 1.5 million Californians, Employed by Small Business Owners who are Delinquent Having Missed 1 to 3 or More Monthly Mortgage Payments. ----Now at Immediate Risk of Job Loss

Estimated Job Loss for CA Small Business Owners Who are Now Delinquent

- Low **1,461,400**
- High **2,582,500+**

The Following Analysis is an Estimate of California Job Loss Based upon Responses to Question No. 6 and No. 7.

6. At this time, have you missed any monthly mortgage payments, and how many have you missed?

			<u>At-Risk for All Respondents (1,339)</u>	
Yes, I have missed one or two payments	101	11.2 %	101	7.5 %
Yes, I have missed three or more payments	87	9.7 %	87	6.5 %
No, I am up-to-date	661	73.4 %	0	0 %
Not Sure *	52	5.7 %	52	3.9 %
Total Homeowners with Mortgages	901	100 %	240	17.9 % !!!

Total Respondents At-Risk	240	17.9 %	!!!
Mortgages Up-to-Date	661	49.4 %	
Homeowners with no mortgages	94	7.0 %	
Homeowners with Foreclosures	35	2.6 %	
Renters	309	23.1 %	

Total Respondents 1,339 100 %

***Determination of Not Sure 52:**

Not applicable	16	
Skipped questions	474	
Total N/A & Skipped	490	
Homeowners with no mortgages	94	
Homeowners with Foreclosures	35	
Renters	309	
No mortgage payments	- 438	
Not Sure Should Be	52	

3,363,476* CA small businesses x 17.9 % = 602,062 Small Business owners who missed 1-3 or more monthly payments

Attachment 2 (continued)

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Determination of Estimated California Job Loss:

7. If you answered "yes" to the previous question, how many employees do you have?

		<u>At-Risk</u>	<u>% At-Risk (of 1,339)</u>	<u>Employers At-Risk</u>	<u>Unemployment</u>	
					<u>Low</u>	<u>High</u>
One employee (including yourself)	102	102	7.62 %	256,297	256,297	256,297
2 to 5 employees	106	106	7.92 %	266,387	532,774	1,331,935
6 to 10 employees	23	23	1.72 %	57,852	347,112	578,520
11 to 20 employees	4	4	0.30 %	10,090	110,990	201,800
21+ employees	4	4	0.30 %	10,090	211,890	211,890+
I answered "no" to previous question	192	0				
Should have answered **	1	1	0.07 %	2,354	2,354	2,354
Skipped question *(908-1)	907	0	0	0	0	0
Total Respondents	1,339				1,461,417	2,582,486+

Total Respondents with Employees At-Risk 240 17.93 % 603,070 (rounding)

3,363,476* small businesses x 17.93 % = 603,071

	<u>Low</u>	<u>High</u>
Range of Estimated Unemployment	1,461,417	2,582,486+

More than 1.5 million Californians are Now at Immediate Risk of Job Loss.

** An underreporting of 1 respondent who should have answered the question. Assume this respondent was self-employed (nonemployer) and should have answered the question as "One employee (including yourself)"

Attachment 2 (continued)

Bornstein & Song

Determination of Estimated California Job Loss:

More than 2.1 million California Small Business Jobs will be Lost in the 2nd “Tsunami” Wave of Foreclosures in 2009 to 2012

Estimated Job Loss for California Small Business Owners who are “Very Worried” (2009 to 2012)

- Low 2,100,500
- High 3,272,300+

The Following Analysis is an Estimate of California Job Loss Based upon Responses to Question No. 11 and No. 12.

11. Will you be able to pay the new higher monthly mortgage payment?

Yes, I am not worried	67	14.7 %
No, I am very worried	400	85.3 %

Homeowners with Mortgages to Reset 467 100 %

Renters	309
Homeowners with Foreclosures	35
Homeowners with no mortgages	94
Fixed-Rate Mortgage	434

Not Subject to Reset 872

Not Subject to Reset	872	65.1 %
Subject to Reset – Not worried about amount at Reset	67	5.0 %
Subject to Reset – Very worried about amount at Reset	400	29.9 % !!!

Total Respondents 1,339 100 %

3,363,476* CA small businesses x 29.9 % = 1,005,679 small business owners are Very worried about amount at Reset

12. If you answered "No. I am very worried", how many employees do you have?

	<u>At-Risk</u>	<u>% At-Risk (of 1,339)</u>	<u>Employers At-Risk</u>	<u>Unemployment</u>	
				<u>Low</u>	<u>High</u>
One employee (including yourself)	84	6.27 %	210,890	210,890	210,890
2 to 5 employees	110	8.22 %	276,478	552,956	1,382,390
6 to 10 employees	25	1.87 %	62,897	377,382	628,970
11 to 20 employees	4	0.30 %	10,090	110,990	201,800
21+ employees	8	0.60 %	20,181	423,801	423,801+
I answered "no" to previous question	20	0 %	0	0	0
Should have answered *	169	12.62 %	424,471	424,471	424,471
Skipped question **	919	0 %	0	0	0
Total Respondents	1,339			2,100,490	3,272,322

Very worried with Employees At-Risk **400** **29.87 %** **1,005,007 (rounding)**

3,363,476 small businesses x 29.87 % = 1,004,670

	<u>Low</u>	<u>High</u>
Range of Estimated Unemployment	2,100,490	3,272,322+

More than 2.1 million California Small Business Jobs will be Lost in the 2nd "Tsunami" Wave of Foreclosures in 2009 to 2012

Subject to Reset – Not worried about amount at Reset 67
Subject to Reset – Very worried about amount at Reset **400**

Total Respondents with Employees At-Risk **467**

*Subject to Reset – Very worried about amount at Reset **400**
 Responses (84+ 110 + 25 + 4 + 8) - 231

Should have answered **169** Understated – assumed one employee

**Skipped question:

Renters	309
Homeowners with Foreclosures	35
Homeowners with no mortgages	94
Fixed-Rate Mortgage	434

Not Subject to Reset **872**
 Not worried about amount at Reset + 47 (of 67 skipped the question)

Skipped question should be **919**

Not Subject to Reset	872
Not worried about amount at Reset	67
I am very worried	400

Total Respondents **1,339**

**According to this calculation, there is an underreporting of 169 respondents who should have answered the question. Assume these respondents were self-employed (nonemployer) and should have answered the question as "One employee (including yourself)" Since "very worried" with Employees At-Risk is 400, the "should have answered" is backed in as 169. Furthermore knowing, "should have answered" is 169, we can then determine the skipped question to be 919.

Attachment 3

California's Foreclosure & Unemployment Nightmare

According to the NY Federal Reserve Bank:

As of January 2009 approximately 31 percent of all outstanding Alt-A loans were issued for properties in California. This is large considering that California accounts for about 10.4 percent of the housing stock in the US. Most striking is 82.9 percent of the Alt-A loans issued in California were low or no documentation loans.

The degree of toxicity within Alt-A loans in California is alarming. As of January 2009, only 67.7 percent of Alt-A loans were current, while nearly 20 percent were delinquent. The remaining loans were either in foreclosure or owned by the banks.

In California, 70 percent of all Alt-A loans were ARMs. This compares unfavorably to the US in which 52.4 percent of Alt-A loans were ARMs. Most shocking, over half of the Alt-A ARMs in California have yet to reset!

According to First American CoreLogic's latest negative-equity report:

California ranked first in the US, with more than 1.9 million borrowers in negative equity (underwater)

California ranked first in the monthly average of new negative-equity borrowers with 40,000 borrowers who slid into negative equity during the fourth quarter of 2008.

California ranked first in the US with 723,000 borrowers in severe negative-equity position, with LTV ratios of 125% or more.

California, the Mother of Alt-A and Option ARMs, leads the nation in Alt-A and Option ARMs mortgages which are the most "toxic". Most are "underwater", as 80% of these borrowers paid the "minimum", while housing prices have dropped more than 50%. They will experience "payment shock" and default at reset.

Credit Suisse, First American CoreLogic, and others predict a 2nd Wave of Foreclosures of these toxic mortgages beginning in 4th quarter 2008 through 2012. Credit Suisse predicts 8.1 million foreclosures in the next 4 years.

California's small businesses (incorporated & unincorporated) in 2007 consisted of 3,363,476 small business owners. According to California Employment Data, 80% of California's employment is provided by these small businesses employing from 0-9 workers.

Unfortunately, the worst is yet to come. California should be taking a proactive approach to address how to help small businesses with toxic mortgages to avoid foreclosure, business failure, and job loss.

Attachment 4

Viewpoint: Small Businesses, Toxic Loans Are a Bad Couple

American Banker | Friday, September 11, 2009

By Samuel D. Bornstein

A Congressional Oversight Panel report on the "continued risk of troubled assets," issued Aug. 11, expressed concern about the solvency of small banks whose balance sheets were clogged with "troubled assets" consisting of toxic mortgages, and about the securities based on them.

The panel may have foreseen the small-bank failures to come as these toxic mortgages default and become non performing assets. In fact, the Alternative-A and Option Adjustable-Rate Mortgages are to begin resetting in 2009 through 2012, and the FDIC "problem list" of banks that run a higher risk of failure grew to 416 in the second quarter, from 305 in the first quarter.

During the housing bubble of 2004 to 2007, many homeowners refinanced their homes when housing prices boomed. The Alt-A and Option Arms were the most popular, but there would be a nasty surprise when these mortgages reset after the initial five years. As these mortgages reset and the monthly payments skyrocket, homeowners will be at risk of default and foreclosure. These resets will usher in the second wave of foreclosures in 2009 through 2012 — the worst possible time for our economy.

Among these homeowners are a significant number of small-business owners who were drawn into these mortgages by the ease with which they could refinance and access cash with low teaser rates and little or no proof of income. Refinancing to cash out the equity in their homes was the easiest way to meet the small businesses' cash-flow needs, instead of the traditional sources of funding provided by the SBA, commercial banks or other financing sources that required cumbersome financial statements, income documentation and credit history.

For small-business owners, the scheduled resets during 2009 through 2012 and the spike in the monthly mortgage payments will cause additional stress, which may prompt job loss for their employees. The loss of jobs related to mortgage default and the resulting financial distress will further weaken our economy and prolong the recession.

My company recently completed surveys on small businesses and toxic mortgages. The results offer compelling evidence that a significant number of small-business owners fell prey to these toxic mortgages and are at risk as these mortgages reset. The studies are an outgrowth of the small-business research I have been conducting with my partner Jung I. Song since 2000.

There were three surveys. The national survey was completed in November 2008, the California survey in April 2009 and the California Hispanic survey in June

We found that among small-business owners:

- More than one-third (33.9%) cashed out the equity in their homes as home values spiked during the 2004-to-2007 housing bubble.
- Respondents have toxic mortgages: U.S. 31.9%; California 51.8%; California Hispanic 52.6%.

- Respondents are expecting resets between 2009 and 2012: U.S. 22.9%; California 34.9%; California Hispanic 44.7%.
- Respondents are "very worried" about their monthly mortgage payment at reset: U.S. 18.4%; California 29.9%; California Hispanic 49.3%.

A significant number of small businesses with these risky mortgages could be at risk of foreclosure.

For small-business owners, the resulting spike in the monthly mortgage payment will lead to financial distress and default and will be a contributing factor for unemployment and mortgage failure. The small-business owner is keenly aware of the importance of a good credit rating. The prospect of default will prompt cost-cutting measures that will mean job loss and closed shops and offices, in turn causing a loss of rental income for commercial real estate owners who have loans originated with small banks.

The link between the financial distress of small-business owners with the resetting toxic mortgages may have contributed to the 81% increase in small-business bankruptcy filings in June 2009 versus June 2008, according to Equifax, and the sharp increase in delinquencies, notices of default, and foreclosures especially in the California, Nevada, Arizona and Florida, where the housing bubble was centered and 75% of these alt-A and option ARMs were issued from 2004 to 2007. Small-business distress and failure has the potential to exert a devastating impact on our economic system by contributing to the surge in bankruptcies, the high level of credit card debt and delinquencies, and bank failures.

The link between small-business failure and small-bank failure may be evidenced by a study of small-bank failures during the last great episode in 1982 to 1989. A September 1990 study commissioned by the Federal Reserve Bank of Cleveland, "Underlying Causes of Commercial Bank Failure in the 1980s," concluded that banks that failed between 1982 and 1989 tended to be in states with higher small-business failure rates than those of the non failed banks. This study shows a correlation between small-business failure and bank failure.

These various findings indicate a link between small-business owners with Alt-A and Option ARMs that are resetting and spiking — to double and triple their initial mortgage payments — and the financial distress and loan defaults precipitating the small-bank failures that the Congressional Oversight Panel warned about.

Samuel D. Bornstein is a professor at Kean University, School of Business in Union, N.J., and a partner at Bornstein & Song, CPAs & Consultants in Oakhurst, N.J.