COMMENTARY – Bob Knakal

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Has American Capitalism Seen Its Last Days? I Don't Think So.

The events of the past week have, without doubt, marked a definitive turn in the evolution of American capitalism. The shocks delivered to us in "Black September" have been the most profound since the Great Depression in the late 1920s and 1930s. This has prompted the Secretary of the Treasury, Henry Paulson and Fed Chairman, Ben Bernanke to propose the most significant government intervention since the Depression. This was all done to avert systemic economic devastation. And the repercussions to our real estate market are numerous. **What will happen to unemployment and capital availability? Unemployment has the most profound affect on our real estate market fundamentals. It affects office occupancy rates, residential occupancy rates and residential for-sale unit volume. The lack of capital availability has stalled the institutional quality building sales market. The problem is that no one really knows where we are headed.**

This article, and all other Commentaries by Bob Knakal, can be found on The Massey Knakal Reel – a blog for breaking sales, listing and neighborhood real estate news – at www.masseyknakal.com/blog

The volatility of the Street has had significant consequences. Gone is the conviction that the free market is the most efficient route to prosperity. The thought that the financial markets should be unleashed to allocate capital, absorb risks, enjoy profits and realize losses has been suppressed. Erased is the thought that when the markets are inefficient they will correct themselves. Also scrapped is the thought that the government's role is to minimize its involvement, limiting itself to protecting small investors and consumers, establishing the rules of the game and stepping in only when necessary to cushion the economy from shocks like the stock market crash of 1987 and the instances where large institutions like Long Term Capital Management collapsed in 1998.

Many politicians today claim that the problem is that the regulation system is antiquated. Indeed it is as many of the parameters were established in the Depression era. But the larger problem is that financial instruments have become so complex that most people who are trading them don't even understand them. Who really knew what the potential risks were if MBS securities went wrong? If anyone really knew the risks, wouldn't at least one of the companies holding these securities sell all of them when they could have to save themselves? They didn't do it because they were not aware of the risks and ramifications. So if you had regulators overseeing what these issuers were doing, would they even know what to look for? I don't think so. Regulation sounds good in theory but the regulators would have to know more about the financial instruments than the creators of the instruments because, clearly, even the creators did not fully understand the ramifications of their innovation. **An inevitable result of this crisis will be an attempt of more control by government of our financial system.**

In the last two weeks, the US government which has been the supporter of the free market system and champion of private enterprise has:

- Nationalized Fannie Mae and Freddie Mac, the two engines of the mortgage industry which required taxpayer dollars to keep them viable.
- Needed to inject an $85 billion loan to American International Group, Inc. and will implement an orderly disposition of all of its assets.
- Allowed the 158 year old Lehman Brothers to crumble as the investment bank could not raise capital needed to stay afloat.
- Extended beyond FDIC insured bank accounts government guarantees of $3.4 trillion of money market mutual funds deposits.
- Banned the short selling of 799 financial stocks. Short selling has been an integral part of our equities market.
- Encouraged the transaction which saw Merrill Lynch sold to Bank of America.

And...

- Asked Congress to ratify a massive and unprecedented plan to have the government acquire hundreds of billions of dollars of toxic illiquid mortgage related assets from financial institutions so they can strengthen their balance sheets, raise capital and resume lending.

During Mr. Knakal's 24-year career, he has sold over 1,000 buildings having an aggregate market value of over $5.8 billion. He was the top salesman, with partner Paul Massey, at Coldwell Banker Commercial (now CB Richard Ellis) in New York in 1986, 1987, and 1988 prior to forming Massey Knakal. In 1990, he was awarded Crain's New York Business "40 Under 40" awarded annually to 40 business people under forty years of age for outstanding achievement in the New York business community. In 2001, Mr. Knakal was named one of "The Top Dealmakers" by Real Estate New York Magazine. He has twice been the recipient of the Robert T. Lawrence Award in the Real Estate Board of New York's Most Ingenious Deal of the Year Contest. First in 2002, for the assemblage of the easterly blockfront of Second Avenue between 54th and 55th Streets. Then again in 2004 for the sale of the historic Gotham Book Mart at 41 West 47th Street.

Please give a call if you have questions about your property or the market in general.

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These are historic times. Nothing like this has ever happened and even if you look at 1933 when numerous banks were shuttered, we haven't seen anything so sweeping. **In the Depression, the government action was taken after the disaster had hit. Here the government has acted preemptively. As bad as things have been, it is surprising that things haven't been worse for our economy and our real estate market.**

In 1991 Congress enacted a law which required banks to increase the amount of capital reserves they were required to hold. This is the primary reason that this crisis hasn't led to a complete disaster. Banks were on stronger footing going into this crisis than banks were in the early '90s which saw 843 banks fail. This time around, only 11 have failed thus far. The problem with the 1991 law is that it did not apply to institutions other than banks. Insurance companies, investment banks and mortgage companies are not subject to these regulations. In fact, investment banks were leveraging capital by a 30 to 1 margin leaving them incapable of meeting capital requirements if things went wrong, which they did based upon rotten mortgage securities. Therefore, regulation of these entities will likely be addressed this time around but regulators must look to the future. They must look at what financial instruments will exist in the future and not only look to regulate what created our problems in the past. They must understand the derivatives market and the risks inherent in these products and how to regulate them. Clearly, almost no one knew how much risk was associated with MBS and their related derivatives. How can you regulate something you do not understand?

There are times when the government has to step in to provide guidance and stability to the markets. What Secretary Paulson and Chairman Bernanke have done, so far, was unavoidable and what they have proposed, while compromising our free market ideology, is necessary to protect taxpayers and minimize our exposure. But the government is always involved in some way in our markets. They need to be there, always have been and always will be. So if you think this government intervention is constraining our capitalistic system, consider this: Do you as a property owner really own your property? Yes, you can make management and strategic decisions, decide when and what to renovate and who to lease space to (provided you do not own rent regulated apartments but that is another conversation for another day) but what happens if you do not pay your real estate taxes? Pay your taxes and capitalism is available to you. Don't pay and the government will own your property. This is contingent capitalism which is the way it always has been and always will be. So don't think that what is happening now flies in the face of capitalism. It does not.

So why all of this talk about banks and the Fed and the Treasury Department and the government? Here's why: Our real estate market needs the banking system to be recapitalized so that the stream of debt into our market is free flowing. Sure underwriting should be more conservative but if our fundamentals stay strong, why shouldn't banks invest in mortgage products? Spreads have exploded and risk has been reduced based upon the low loan to value ratios. If lenders have capital, they should be pouring it into New York City real estate. Net interest income alone can, over time, recapitalize the industry. Lending will come back much stronger than it has been recently and this will provide a shot in the arm to our market. The Fed, the Treasury and the government can, to some degree, enhance this flow of capital and I applaud their attempts to assist in stimulating the necessary liquidity to the banking system which is so desperately needed.

– Bob