COMMENTARY – *Bob Knakal*

OCTOBER 14, 2008

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The Banking System Must be Stabilized to Encourage Confidence

The other day, I was asked why my commentaries are generally slanted towards macroeconomics when I am a guy who sells buildings for a living. The reason is that the availability of credit and the cost of that credit are so vitally important to the functionality of our building sales market. It also appears that the credit market's performance has never been quite so profoundly impacted by both domestic and foreign macroeconomic issues. These issues directly affect our ability to sell properties; therefore, I am riveted to them and continually try to connect the dots between what happens in our economy and how that might affect selling a property in New York City. Recently, there has been much to pay attention to.

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 economic news last week was dismal. The Dow ended the worst week in its 112 years history with its most volatile day ever Friday reflected by a 1,018.77 point swing from high to low. Even the 22% market decline over 8 trading days, a movement which normally would have bargain hunters in buy-mode, left investors shell-shocked and unwilling to take new risks. **Paper losses on U.S. stocks now total $8.4 trillion since the market peak one year ago.** Was this surprising given the passing of the Troubled Asset Relief Plan (TARP) by Congress? Not really. There was a short rally before the passage and as the old saying on Wall Street goes, "Buy the rumor and sell the fact." Additionally, **the selling seemed to be fueled by tremendous margin calls which are demands for additional collateral from investors who purchased stocks with borrowed money.** When market value of securities fall, they no longer provide adequate collateral for the loans, and if the investor does not have additional capital to invest, securities must be sold to pay off the loans. Additionally, in recent weeks, **corporate bonds, which are generally considered safer than stocks, have had their largest declines ever.** In fact, the corporate bond market is forecasting the worst recession since The Great Depression according to Moody's Investors Service.

The credit markets have remained essentially frozen even in the aftermath of the passage of the TARP. Many types of debt, including agency mortgage backed securities and corporate rate leveraged loans, tumbled last week as banks, hedge funds and other investors were deleveraging, or unwinding their debt holdings. Banks that provided financing to effectuate hedge funds' asset purchases are asking them to put up more collateral to back their positions or sell the assets which push prices down further.

Perhaps another reason why the markets have not reacted more positively to the TARP is that it is becoming more and more obvious that **purchasing $700 billion of toxic mortgage securities will not be a solution by itself and perhaps should only be a minor component of the plan.** In addition to cleaning up balance sheets in the banking industry, capital must be injected into the system. Bank failures are expected to escalate over the next 6 months as the 117 banks on the FDIC's troubled bank list have combined assets of over $78 billion. **This list is expected to grow as there appear to be massive unrecognized losses ahead of us.** This is one of the reasons the short term interbank lending market is also frozen. **Nearly one-third of banks' net operating revenue has been directed toward loan loss reserves.** It is widely anticipated that the banking industry will see numerous consolidations, restructurings and additional federal regulation. This regulation is expected to affect the "shadow" banking system also which includes investment banks, hedge funds, private equity funds and the over-the-counter market for trading complex financial instruments. Remarkably, this shadow system accounts for 70% of lending in America.

During Mr. Knakal's almost 25-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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There are four Cs in the correction of a market. The first two are Capitulation and Chaos. It appears the capitulation has occurred given the $8.5 billion of value evaporation in the equity market and the $5 billion of value evaporation in the housing market. Chaos is now upon us with economic turmoil going global, lead by equity markets in Russia, Brazil, Argentina, Canada, China and India falling by 61%, 41%, 37%, 34%, 30% and 25% respectively. **The third C is for Catalyst. The TARP is a catalyst but additional catalysts are needed.** Last week the Fed rolled out a $150 billion lending program for banks and created a $330 billion swap line for foreign central banks. The Fed also held a special auction called a term auction facility, or TAF, which made $225 of short term loans available. Two additional TAF sales are scheduled for November totaling $150 billion. Additionally, the Fed is considering injecting equity capital in banks, guaranteeing billions in bank debt and potentially guaranteeing all bank deposits. Around the world, governments are implementing these strategies to varying degrees. **It appears the capital injection in struggling banks may be the most important. If done properly, these mechanisms will lead to the fourth C, Confidence.**

The government has indicated a willingness to pump taxpayer funds into cash-strapped lenders in exchange for ownership interests in the banks. This would most likely be in the form of preferred shares, essentially nationalizing broad segments of the banking industries, reversing a decade long deregulatory trend. **The intention is that this fresh capital will not only improve bank balance sheets but also provide a much needed confidence boost for the financial system.** This would not be the first time this has happened in the U.S. Not surprisingly, in 1932 the Reconstruction Finance Corp. was formed which injected capital into 6,000 financial institutions. Not only did this program assist with the slowdown of the deterioration of the banking system, but it did so without a loss. Using the $700 billion of TARP funds solely for purchasing toxic mortgage securities will be politically impossible given the potential for conflicts of interest so capital infusion seems more realistic. **If this recapitalization of the banking system was implemented and the system was stabilized, confidence would likely follow and credit markets would loosen.** This is an important step in turning things around.

As I have stated several times before, we got into this crisis through the housing market and it is through the housing market that we will emerge from it. The housing market must bottom out in order to know the true value of mortgage backed securities and all of their derivative products. A plan to purchase and restructure troubled mortgages would aid in stabilizing the housing market, as will the loosening of credit. We have been fortunate in the mid-market of building sales in New York because there are many well capitalized banks which continue to pour debt capital into multifamily buildings, retail properties and office buildings. Unfortunately, this debt is available for properties under $50 million in value much more so than for properties with higher values. In order for lending to return to this institutional market, the banking system needs to be cleared out and recapitalized. Let's hope the taxpayer's money is used in the correct ways.

Have a great week,