ADMINISTRATIVE AND PROCEDURAL ASPECTS OF THE FEDERAL RESERVE BOARD/DEPARTMENT OF THE TREASURY PROPOSED RULE CONCERNING COMPETITION IN THE REAL ESTATE BROKERAGE AND MANAGEMENT MARKETS

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

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CONTENTS

MAY 16, 2002

OPENING STATEMENT

WITNESSES

LETTERS, STATEMENTS, ETC., SUBMITTED FOR THE HEARING

APPENDIX

ADMINISTRATIVE AND PROCEDURAL ASPECTS OF THE FEDERAL RESERVE BOARD/DEPARTMENT OF THE TREASURY PROPOSED RULE CONCERNING COMPETITION IN THE REAL ESTATE BROKERAGE AND MANAGEMENT MARKETS

THURSDAY, MAY 16, 2002

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to call, at 2:05 p.m., in Room 2141, Rayburn House Office Building, Hon. Bob Barr [Chairman of the Subcommittee] presiding.

Mr. BARR. Good afternoon, ladies and gentlemen.

My name is Bob Barr, Chairman of the Subcommittee on Commercial and Administrative Law, joined with two other very distinguished Members of our Subcommittee, the Ranking minority Member, Mr. Mel Watt from the great State of North Carolina, and Ms. Tammy Baldwin from the great State of Wisconsin. We appreciate them being here today.

We probably will be joined by other Members of the Subcommittee who will be able to come in between other responsibilities.

We will probably have floor votes this afternoon on the welfare reform reauthorization, other Committee hearings that Members have to go to, but we appreciate the witnesses very much being with us here today.

We appreciate members of the audience that are here.

At this time, I will call this hearing to order. This is a Subcommittee oversight hearing on administrative and procedural aspects of the Federal Reserve Board/Department of the Treasury proposed rule concerning competition in the real estate brokerage and management markets.

I am very pleased to convene this hearing on an issue that has aroused considerable interest in the banking and the real estate industry, as evidenced by the attendance at today's hearing.

As many of you know, on January 3, 2001, the Department of the Treasury and the Federal Reserve Board jointly issued a proposed rule that would have the effect of transforming the definition of financial activity to include services theretofore considered commercial in nature.

Specifically, the proposed rule would permit banking entities to enter the real estate brokerage and management markets. This proposed rule was issued pursuant to an interpretation of the then recently passed Gramm-Leach-Bliley Act.

The rule was proposed in response to requests from commercial banking interests received from the Treasury Department within a month of Gramm-Leach-Bliley's enactment into law. Prior to passage of Gramm-Leach-Bliley, Congress had maintained what was termed a firewall between commercial and financial activities.

The proposed rule is extremely controversial, as evidenced by the fact it has occasioned more public comment than any other rule of its type in history. In fact, so many comments were received that the Treasury Department and the Federal Reserve have twice had to delay the effective date of the proposed rule. Late last month, as a matter of fact, Treasury Secretary O'Neill stated the rule would not be finalized until 2003 at the earliest.

The Subcommittee on Commercial and Administrative Law does not exercise jurisdiction over the substantive issues underlying the proposed rule. It is not for us to address the general policy merits of these issues. However, this Subcommittee has both the authority and continuing responsibility to examine the process by which agencies propose and issue rules.

Since 1946, when the Administrative Procedure Act was first signed into law, Congress and the President have labored continuously to craft an administrative process that treats all parties and all perspectives fairly.

While we have striven to obtain the best possible agency rules, another equally important purpose is making the administrative process an open one that informs the American people about the actions of its Government. Today's hearing helps advance this crucial goal.

The proposed rule is clearly a matter of considerable public concern which demands serious congressional attention. We must inquire whether issuing agencies adhered to administrative and procedural requirements in examining whether the particular circumstances surrounding the proposed rule necessitate amendment of the Administrative Procedure Act and other statutes which pertain to agency rulemaking.

Specifically, we will address the following questions:

Did the statute giving rise to the proposed rule provide sufficient congressional authority to transform the definition of financial activity to include real estate brokerage and management?

Was the language sufficiently clear to provide a coherent basis on which the respective agencies could make this determination?

Can—should Congress delegate its authority to regulate interstate commerce without any cognizable constraints on agency discretion?

Did the issuing agencies provide a sufficient factual or legal basis for concluding that real estate brokerage and management are financial activities?

Were the requirements of the Regulatory Flexibility Act, which requires agencies to analyze the effects of a proposed rule on small businesses, including REALTORS®, adequately observed?

How will the agencies consider and act on the public comments it has received?

Given the broad and deep impact finalization of this rule would have, should an alternative method of rulemaking, such as that provided in the Negotiated Rulemaking Act, have been contemplated by the issuing agencies?

How can the experiences of this proposed rulemaking facilitate the more effective promulgation of agency rules consistent with congressional intent?

Before we begin, I would like to emphasize that I am committed to continuing this Subcommittee's regulatory reform agenda and wish to recognize the effort of former Subcommittee Chairman George Gekas to ensure Federal agencies adhere to congressional intent during the administrative rulemaking process.

I am particularly pleased to welcome three very distinguished witnesses today who represent our Government and organizations most closely associated with the proposed rule and its effects. We will receive testimony from the Department of Treasury as well as the National Association of REALTORS® and the American Bankers Association. I wish to thank all three witnesses in advance for their attendance and expert testimony today.

I now am pleased to recognize Mr. Watt, the Ranking Member of this Subcommittee, for his opening remarks.

Mr. WATT. Thank you, Mr. Chairman; and thank you for convening this hearing, I guess. I am not real sure that I wanted to thank you for the second part of that, but to the extent that we deal with the issues within this Subcommittee's jurisdiction, I think it is important to have this hearing.

Let me be pretty direct, as most of the people that I have dealt with in the audience know me to be, though, and say right up front that I understand that there is a tremendous tug of war going on between the real estate interests and the banking interests. If there is anybody here in the audience who believes that that tug of war is going to be resolved by this hearing, they should get up and leave now.

That question, to the extent that it requires a resolution, will be resolved in the Financial Services Committee. It just so happens that both the Chairman of this Subcommittee, Chairman Barr, and the Ranking Member of this Subcommittee, Ranking Member Watt, serve on the Financial Services Committee; and I think we ought to let that Committee handle that tug of war.

Now, it is easy for Congress or Members of Congress or Committees of Congress to write a piece of legislation that has substantial ambiguities in it and have regulatory agencies interpret those ambiguities in one way or another and for Members of Congress to then bash administrative agencies for doing what they think a law authorized them to do. It gives us a sense of deniability, us against them.

But I would submit to you, if there is any ambiguity in the law, we bear the responsibility in Congress to clarify that ambiguity.

So I don't think—and I should say we don't have the jurisdiction in this Committee to clarify that ambiguity. If anybody thinks that we do, I think you should rethink this. I am going to encourage our witnesses to refrain from a fight about this REALTOR® versus banking issue and stick to the matters that are under the jurisdiction of this Committee.

As I understand the purpose of this hearing—and I am reading from what I was given—we are to determine, number one, the efficacy of the Administrative Procedure Act in ensuring that congressional intent is realized in the rulemaking process; and, number two, determine the responsiveness of Federal regulators to Congress and the public.

Now, I didn't write that. I have no idea really—well, I have some idea of what it means. I have my own conceptions of what it means. But my conception does not include a resolution of this conflict between REALTORS® and banking.

If we think the regulators have done something improper and they think that they have done something proper, then I think it is Congress's responsibility to clarify that and not to just beat up on the regulators; and that is regardless of where you stand on the substantive issue here. We can't resolve it in the context of this hearing.

So, that having been said, I am looking forward to hearing the witnesses. I hope they will restrain themselves in the substantive analysis of this REALTOR® versus banking issue and deal with the Administrative Procedure Act issue that this jurisdiction—this Subcommittee has jurisdiction over. If we can bring some light to that, then this hearing will be of benefit. If we can't bring light to that, then I think we have done this Subcommittee, the Judiciary Committee and the Financial Services Committee and Congress and the jurisdictions that each of those bodies have, a disservice.

So I am proceeding with confidence that we will stay on mission today, and I hope everybody will cooperate in that mission.

Thank you very much, Mr. Chairman. I yield back.

Mr. BARR. The gentleman from Arizona, Mr. Flake, the Vice Chairman of the Subcommittee, is recognized.

Mr. FLAKE. I thank the Chairman.

I have no opening statement, but I will yield the remainder of my time to the Chairman.

Mr. BARR. Thank you.

It is a common practice for this Subcommittee to hold hearings of this sort today. This is not a unique hearing. It is not the first one this Subcommittee has ever held. There have been a number of other instances in recent years where rules have been proposed by one Federal agency or another and this Subcommittee has, within the exercise of its jurisdiction to maintain oversight over the regulatory processes of the executive branch, held hearings.

For example, on March 4, 1999, this Subcommittee held a hearing entitled, Know Your Customer Rules: Privacy in the Hands of Federal Regulators. The hearing examined rules that had been noticed by the Federal Reserve Board and Treasury Department under the purported authority of the Bank Secrecy Act.

In May 1999, the Subcommittee held a hearing into novel procedures in FCC license transfer proceedings. That hearing examined the administrative efficacy of license transfer regulations that raised considerable administrative law questions.

In February 1998, the Subcommittee conducted an oversight hearing on administrative taxation to examine the administrative efficacy and constitutionality of the universal service fee.

In 1996, the Subcommittee held a hearing on the role of Congress in monitoring administrative rulemaking.

And there are others. So if there is any confusion on the part of any of the witnesses or audience or Committee Members about the history of this Subcommittee under different leadership to conduct appropriate hearings of this sort, let me set their minds at ease. This is a long-held practice of this Subcommittee, and we again—we welcome the witnesses being here today and look forward to their testimony.

I yield back to the gentleman from Arizona.

Mr. FLAKE. Thanks. I yield back.

Mr. BARR. The gentlelady from Wisconsin is recognized for any opening statement that she may have to make.

Ms. BALDWIN. Thank you, Mr. Chairman. I do not have an opening statement and yield back.

Mr. BARR. Thank you.

The gentlelady from California is recognized for an opening statement she might have.

Ms. WATERS. Thank you very much, Mr. Chairman.

I do have a prepared opening statement, and I think I am not going to read my statement because I think Mr. Watt's comments and your comments are so very interesting.

Let me thank you for holding this hearing to look at the rulemaking process.

Also let me just comment a bit on how this Congress works and what we do in Committees and why it is important for the people who are here today to understand that, despite the fact that Mr. Watt believes that somehow it is extremely important to stick to the subject matter of rulemaking and not to wander off into the so-called tug of war that he so eloquently referred to, since he did call it a tug of war, all is fair in love and war. And let me just say that, despite the fact he gave you this classic description and definition of what we are supposed to do and what we should not be doing, this place doesn't work like that. As a matter of fact, what happens here is he or she who is creative enough, smart enough, visionary enough to concoct something to their advantage, we do that; and we do it day in and day out; and that is not going to stop. I am amazed at the kind of creativity that is used in this place and what benefits come from it.

You are here today and Mr. Barr has been smart enough to organize this hearing to give you an opportunity, number one, just to show yourselves. The fact that you are here and that you are concerned about this, this in itself may get a press story that will serve to influence somebody.

So it is not always about the rules as they are written somewhere, it is about the ability for Members to be their own best advocates and advocates for those that they care about.

Let me just say this. Also, Mr. Barr went so far as to recite chapter and verse all of the other hearings that have been held in an effort to say, see, I am not out of line. I am holding this hearing in this matter, and it has been done before. But that doesn't make any difference either. Whether he had that kind of documentation or not, I am sure he would be holding this hearing because he thinks there is some benefit in doing so.

So let me just welcome you and say to you that I am very pleased that the hearing is being held. The regulators who have the responsibility for this rulemaking, don't worry about getting beaten up on. You have been beaten up on before, and this will not be such a beating that you won't be able to withstand it. You will do just fine.

So, with that, this tug of war includes whatever we do today in the Subcommittee. Let's get on with it. Thank you very much.

Mr. BARR. Mr. Watt.

Mr. WATT. That was classic.

Mr. BARR. I thank the gentlelady from California.

We have been joined by the gentleman from Ohio, Mr. Chabot. Do you have an opening statement, Mr. Chabot?

Mr. CHABOT. No, I don't.

Mr. BARR. At this time, we will proceed then to introduce the witnesses; and then the witnesses will each be allotted approximately 5 minutes for their opening statements. The full written statements and any supplementing material that each one of the witnesses or any of the witnesses might have, we encourage them to submit that for the record; and it will be admitted to the record without objection.

The record will remain open for an additional 7 days for any additional materials that the witnesses may come across or deem appropriate and relevant for the hearing to aid in the deliberations of this Subcommittee.

Our first witness today is Ms. Sheila Bair, Assistant Secretary for Financial Institutions at the United States Department of the Treasury. In this role, Secretary Bair leads the Office of Financial Institutions in coordinating the Department's legislative and regulatory agenda, including legislation affecting Federal agencies that regulate or ensure financial institutions, as well as securities markets legislation and regulation.

Before joining the Treasury Department, Secretary Bair was Senior Vice President for Government Relations at the New York Stock Exchange. She also served as a Commissioner of the Commodity Futures Trading Commission during the Bush and Clinton administrations and was chairperson of the FTC's Financial Products Advisory Committee. Finally, Secretary Bair worked as senior counsel under Senator Bob Dole.

A native of Kansas, Secretary Bair received her bachelor's degree from the University of Kansas and is a graduate of the University of Kansas School of Law.

We are very happy to welcome the Assistant Secretary here today, and appreciate her testimony and answers to the Committee's questions.

Our next witness will be Mr. Martin Edwards, Jr., the president of the National Association of REALTORS®.

The National Association of REALTORS® is America's largest professional association, representing more than 800,000 members involved in all aspects of the residential and commercial real estate industry.

Mr. Edwards has been a REALTOR® for more than 30 years and is a partner in Colliers, Wilkinson & Snowden, Inc, a commercial and industrial real estate firm headquartered in Memphis, Tennessee. He is also a senior instructor for the Commercial Investment and Real Estate Institute, an NEAR affiliate.

Mr. Edwards is no stranger to Congress, having testified on issues ranging from Gramm-Leach-Bliley, brownfields legislation, housing affordability and many other housing and real-estate-related issues. Mr. Edwards has served in a number of positions at NAR including treasurer, chairman of the association's finance committee, regional vice president for the States of Tennessee, South Carolina, North Carolina, and Kentucky and other committees.

He has been active on various NAR committees, including the executive committee and the building advisory committee.

Mr. Edwards is also active at the State and local levels. He serves on numerous State association committees, including the commercial and investment committee. He was named REALTOR® of the Year in 1989.

We are particularly pleased to have you here today, Mr. Edwards. Thank you.

Our third witness on today's panel is Edward Yingling, deputy vice president and executive director for Government Relations at the American Bankers Association. Mr. Yingling is also a board member of the Corporation for American Banking, the American Bankers Association's for-profit subsidiary. He also serves as a director of the American Bankers Professional and Fidelity Insurance Company.

Before joining the American Bankers Association, Mr. Yingling served in private practice, specializing in the representation of banks and other financial institutions.

From 1973 to 1974, Mr. Yingling served as legislative assistant to Senator William J. Fulbright. He is a graduate of Princeton University and the Stanford University Law School.

Mr. Yingling, thank you very much today; and thank you for your service very capably representing America's bankers for so long.

At this time, I am pleased to welcome the three panelists.

Mr. BARR. We will go through each one of the panelists beginning with the Honorable Sheila Bair, Assistant Secretary of the Treasury, who will be recognized for her opening statement. Ms. Bair.

STATEMENT OF SHEILA BAIR, ASSISTANT SECRETARY, UNITED STATES DEPARTMENT OF THE TREASURY

Ms. BAIR. I appreciate the opportunity to appear here today to discuss administrative and procedural aspects of the joint Federal Reserve-Treasury rule proposal on whether to permit financial holding companies and financial subsidiaries of national banks to engage in real estate brokerage and real estate management under the Gramm-Leach-Bliley Act.

The 4-month public comment for this proposal ended May 1st of last year. Based on the substantial number of comment letters that the Treasury and the Federal Reserve Board have received, there clearly is wide public interest in this proposal. The volume of letters demonstrates the sensitivity of this particular determination as well as the difficulty of the task that Congress gave us in implementing the Gramm-Leach-Bliley Act.

On April 22nd, Secretary O'Neill informed Chairman Oxley by letter that, in consultation with Chairman Greenspan, he had decided that the Treasury will not make a final determination on this proposed rule until next year. It is incumbent upon us to carefully review all of the issues in keeping with the statutory criteria and purposes of the Gramm-Leach-Bliley Act and to carefully articulate criteria that can guide our review of future requests. Given other Treasury priorities in the wake of September 11, we do not believe such a deliberative review can be completed until next year.

Because the rulemaking is pending, I will not be able to discuss the Treasury's views on substantive issues involved in making a final decision about the proposed rule. Instead, my prepared remarks will briefly describe the process.

The rulemaking process was initiated under the prior administration after Treasury and the Board received requests from the American Bankers Association, the Financial Services Roundtable and the New York Clearing House Association asking that we determine that real estate brokerage and real estate management activities are financial in nature or incidental to a financial activity. Shortly thereafter, the National Association of REALTORS® sent a letter opposing such a determination.

In March, 2000, the Treasury issued an Interim Final Rule setting forth specific procedures for requesting determinations under the Gramm-Leach-Bliley Act and invited the American Bankers Association and the Financial Services Roundtable to resubmit their request to conform to these procedures. The American Bankers Association did so in July of 2000, and a month later Fremont National Bank submitted a request that referenced the American Bankers Association's request.

After considering the factors specified in the Gramm-Leach-Bliley Act and other relevant information and consulting with the Federal Reserve Board and its staff, in December of 2000 the Treasury agreed with the Board to issue a joint notice of proposed rulemaking with a 60-day comment period. The proposal was published in the Federal Register on January 3, 2001.

Following publication, it soon became apparent that there was a great deal of public interest in the proposal. Given this wide public interest and our desire to give the public sufficient time to consider and comment on the proposal, and in view of letters we received requesting an extension, the Treasury and the Board decided to extend the comment period another 60 days.

As I mentioned, the comment period closed on May 1, 2001. Of the 34,735 comment letters we have received, most have come from real estate brokers. We are giving serious consideration to the views expressed.

In conclusion, Mr. Chairman, we intend to carefully consider the issues raised by all of the commenters. As we move forward next year, the Treasury will work closely with the Federal Reserve to ensure that this and other rulemakings under the financial in nature authority are consistent with the criteria Congress prescribed, the legal process, and the public interest.

Thank you.

Mr. BARR. Thank you, Ms. Bair.

[The prepared statement of Ms. Bair follows:]

PREPARED STATEMENT OF SHEILA C. BAIR

Chairman Barr, Mr. Watt, and Members of the Subcommittee, I appreciate the opportunity to appear here today to discuss administrative and procedural aspects of the joint Federal Reserve-Treasury rule proposal on whether to permit financial holding companies and financial subsidiaries of national banks to engage in real estate brokerage and real estate management under the Gramm-Leach-Bliley Act ("GLBA").

The four-month public comment period for this proposal ended May 1st of last year. Based on the substantial number of comment letters that the Treasury and the Federal Reserve Board ("Board") have received, there clearly is wide public interest in this proposal. The volume of letters demonstrates the sensitivity of this particular determination as well as the difficulty of the task that Congress gave us in promoting competition in financial services.

We also received letters from 160 Members of Congress, some of whom transmitted comments from their constituents and some of whom set forth comments of their own. We are carefully reviewing the issues raised by all the commenters.

On April 22nd, Secretary O'Neill informed Chairman Oxley by letter that, in consultation with Chairman Greenspan, he had decided that the Treasury will not make a final determination on this proposed rule until next year. It is incumbent on us to carefully review all the issues in keeping with the statutory criteria and purposes of the GLBA and to carefully articulate criteria that can guide our review of future requests. Given other Treasury priorities in the wake of September 11, we do not believe such a deliberative review can be completed until next year.

Because the rulemaking is pending, I will not be able to discuss the Treasury's views on substantive issues involved in making a final decision about the proposed rule. Instead, my prepared remarks will briefly describe the process and factors we considered in making the proposal and where it stands today.

By way of background, let me begin by highlighting the key provisions of the GLBA that relate to the rulemaking.

RULEMAKING PROVISIONS OF THE GRAMM-LEACH-BLILEY ACT

At its core, the GLBA stimulates greater competition and innovation in the financial services industry. At the same time, the legislation promotes consumer protection and safety and soundness, and restricts the mixing of banking and commerce.

To accomplish these outcomes, the GLBA amended the Bank Holding Company Act to permit financial holding companies to engage in a broad range of activities specifically listed in GLBA, as well as other activities that the Board determines, in consultation with the Treasury, to be "financial in nature or incidental to a financial activity." According to the Conference Report, the "financial in nature or incidental" standard represents a significant expansion of the "closely related to banking" standard that the Board previously applied in determining the permissibility of activities for bank holding companies.

The GLBA also amended the National Bank Act to allow national banks to control qualifying "financial subsidiaries" that are permitted to engage in most of the same "financial in nature or incidental" activities that the GLBA authorizes for financial holding companies. Activities in which financial subsidiaries may not engage under the GLBA generally include insurance underwriting and merchant banking. GLBA also explicitly prohibits financial subsidiaries from engaging in real estate development and investment.

Just as GLBA requires the Board to consult with Treasury before approving new activities as "financial in nature" or "incidental to a financial activity" for financial holding companies, GLBA also requires Treasury to consult with the Board in determining whether a new activity should be approved as financial in nature or incidental for financial subsidiaries. Under the GLBA's consultation requirement, neither the Treasury nor the Board may determine that an activity is financial in nature or incidental to a financial activity if the other agency disagrees with such a determination in writing. Treasury and the Board have developed procedures for those requesting determinations under the financial activities provisions of GLBA and for coordinating and consulting with each other. Treasury and the Board are working cooperatively in considering these determinations, as the joint proposal on real estate brokerage and management demonstrates.

In making determinations for financial subsidiaries, the GLBA requires Treasury to take into account, among other factors:

- the purposes of GLBA and the National Bank Act,
- changes in the marketplace in which banks compete,
- changes in the technology for delivering financial services, and
- whether the activity is necessary or appropriate to allow a bank and its subsidiaries to compete effectively with any company seeking to provide financial services in the United States.[1]

Let me turn now to a description of the process that the Treasury and the Board are following and where the rulemaking stands currently.

STATUS OF THE RULEMAKING PROCESS

The rulemaking process was initiated after Treasury and the Board received requests from the American Bankers Association, the Financial Services Roundtable, and the New York Clearing House Association asking that we determine that real estate brokerage and real estate management activities are financial in nature or incidental to a financial activity. Shortly thereafter, the National Association of REALTORS® sent a letter opposing such a determination.

In March 2000, the Treasury issued an Interim Final Rule setting forth specific procedures for requesting determinations under the GLBA, and invited the American Bankers Association and the Financial Services Roundtable to resubmit their requests to conform to these procedures. The American Bankers Association did so in July 2000, and a month later Freemont National Bank submitted a request that referenced the American Bankers Association's request.

After considering the factors specified in the GLBA and other relevant information, and consulting with the Federal Reserve Board and its staff, in December of 2000 the Treasury agreed with the Board to issue a joint notice of proposed rulemaking with a 60-day comment period. The proposal was published in the Federal Register on January 3, 2001.

Following publication, it soon became apparent that there was a great deal of public interest in the proposal. Given this wide public interest and our desire to give the public sufficient time to consider and comment on the proposal, and in view of letters we received requesting an extension, the Treasury and the Board decided to extend the comment period another 60 days.

As I mentioned, the comment period closed on May 1, 2001. Of the 34,735 comment letters we have received, most have come from real estate brokers expressing the same or similar views. We are giving serious consideration to the views expressed.

CONCLUSION

In conclusion, Mr. Chairman, we intend to carefully consider the issues raised by all the commenters. As we move forward next year, the Treasury will work closely with the Federal Reserve to ensure that this and other rulemakings under the financial in nature authority are consistent with the criteria Congress prescribed, the legal process, and the public interest.

Thank you. I am happy to respond to any questions.

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[1] Section 5136A(b)(2) of the Revised Statutes (the National Bank Act) provides that:

"In determining whether an activity is financial in nature or incidental to a financial activity, the Secretary shall take into account—

(A) the purposes of this [National Bank] Act and the Gramm-Leach-Bliley Act;

(B) changes or reasonably expected changes in the marketplace in which banks compete;

(C) changes or reasonably expected changes in the technology for delivering financial services; and

(D) whether such activity is necessary or appropriate to allow a bank and the subsidiaries of a bank to—

(i) compete effectively with any company seeking to provide financial services in the United States;

(ii) efficiently deliver information and services that are financial in nature through the use of technological means, including any application necessary to protect the security or efficacy of systems for the transmission of data or financial transactions; and

(iii) offer customers any available or emerging technological means for using financial services or for the document imaging of data."

Mr. BARR. Mr. Edwards, you are now recognized for your opening statement.

STATEMENT OF MARTIN EDWARDS, JR., PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®

Mr. EDWARDS. Thank you, Mr. Chairman.

On behalf of more than 800,000 REALTORS® across this country engaged in all aspects of commercial and residential real estate, I want to thank you and Congressman Watt and the Members of the Subcommittee for the opportunity to testify today.

Like you, we want to know about the process involved in the proposed rulemaking by the Federal Reserve Board and the Treasury Department. Both entities have proposed to let financial holding companies and national bank subsidiaries operate real estate brokerage, leasing and property management companies.

As you know, we adamantly oppose the rule. We firmly believe that redefining real estate brokerage, leasing, and property management as financial in nature is totally acceptable because it mixes banking and commerce. It is our contention that Congress never intended to delegate such authority to the regulators. In fact, given the criteria set by Congress to determine new financial activities under Gramm-Leach-Bliley, we believe this proposed rule would circumvent congressional intent.

The bottom line is that the banks who petitioned the Federal Reserve and Treasury for this proposed rule cannot gain through regulation what they failed to get through legislation.

In 1999, as you pointed out, Congress clearly went out on record in supporting separation of banking and commerce. We believe that congressional intent was clear that section 4(k)(3) of the Bank Holding Act was added to give banks new powers to help with delivery of existing financial products and those that evolved as the financial services industry changed over time. But section 4(k)(3) was not meant to give banks the authority to operate whole new commercial businesses; and there is nothing in the law, the legislative history to infer that such broad legislative powers could be delegated to the regulators.

Let me direct your attention to two charts set up to my left. The first chart shows how the commercial and banking industries compete in the financial services areas. REALTORS® don't take deposits or run ATM machines, and banks don't sell real estate. It is that simple. Otherwise, why shouldn't banks sell automobiles? Both banks and GMAC finance automobile purchases.

The second chart I would like to point out to my left clearly shows that REALTORS® do compete on mortgage originations. Banks clearly are the winner here. REALTOR®-affiliated mortgage lending companies only originate about 1 percent of the mortgages, while banks originate 44 percent.

Clearly, the time to consider granting of real estate powers was during the debate of Gramm-Leach-Bliley and certainly not through regulation now, after the close of that debate.

Even if one believes that Congress intended to delegate the authority, the factors, as spelled out in section 4(k)(3), haven't been met by the regulators. For example, the agencies didn't address all of the necessary factors or explain what determinations they are making. They also failed to offer explanations of why the regulations should apply to the leasing of real estate or to commercial real estate transactions.

There is no indication whether the OMB has reviewed the Treasury's proposed regulation. Generally, any regulatory action deemed significant by an executive branch agency must first be reviewed by OMB.

Mr. Chairman, the National Association of REALTORS® believes that Congress should assert its authority to prevent the regulators from determining if it is in the Nation's best interest to mix banking and commerce. We also believe that letting financial holding companies and national bank subsidiaries enter into the real estate business, brokerage, leasing and property management industry would have wide-ranging adverse market effects, including a decline in competition, consumer choices and quality of service.

That is why we called upon Congress to enact the Community Choice in Real Estate, H.R. 3424, and in the Senate a companion bill. REALTORS® from across this country have sent more than 75,000 letters to congressional representatives urging support of these bills.

We have sent more than 40,000 to the Federal Reserve and to the Treasury expressing our opposition to the proposed regulation; and we have sent more than 50,000 letters, by CD-ROM I might add, to President Bush urging support.

So far, H.R. 3424 in this House has generated a tremendous support. We have today over 231 cosponsors; and, last month, Secretary of Treasury O'Neill postponed a decision of this issue until next year. The ball is clearly back in Congress's court, and you must act now to resolve this issue.

In conclusion, Mr. Chairman, REALTORS® aren't alone in this issue. A diverse group of trade associations and consumer groups stand with us on this issue.

We look forward to today's testimony as well as those questions rising out of this hearing. We hope that they will shed more light on how this whole process by the Federal Reserve and Treasury evolved. Thank you.

Mr. BARR. I would ask the audience to refrain from applause, please.

Mr. Edwards, thank you very much for your testimony.

[The prepared statement of Mr. Edwards follows:]

PREPARED STATEMENT OF MARTIN EDWARDS, JR.

Chairman Barr, Congressman Watt, and members of the Subcommittee. Thank you for inviting me to testify on this important issue. My name is Martin Edwards. I am a REALTOR® and a partner with Colliers, Wilkinson and Snowden, Inc. in Memphis, Tennessee. I am appearing here today as President of the National Association of REALTORS® (NAR) on behalf of over 800,000 REALTORS® engaged in all aspects of the commercial and residential real estate industry.

Mr. Chairman, we are pleased you are holding this hearing today to explore the process involved in the proposed rulemaking by the Federal Reserve Board and Treasury Department that would allow financial holding companies (FHCs) and national bank subsidiaries to operate real estate brokerage, leasing and management companies. As you know, we are opposed to this rule. We believe that redefining real estate brokerage, leasing and property management as a financial activity is an impermissible mixing of banking and commerce that Congress never intended to delegate to the regulators. Moreover, given the criteria Congress established for determining new financial activities under the Gramm-Leach-Bliley Act, we believe that the proposed rule does not conform with the intent of Congress.

The procedure followed by the regulators in proposing this rule raises many questions. It will be enlightening to hear responses to questions that would explain how and why the proposed rule came so soon after the law was enacted.

- What analysis was provided regarding the impact of the rule on the real estate industry?
- What role did the Office of Management and Budget play in reviewing the proposed real estate regulation?
- Congress authorized the Federal Reserve Board and the Treasury Department to jointly agree on new financial activities based on criteria established in Section 4(k)(3) of the Act. Do the Agencies view their authority to designate new financial activities as license to effectively hand entire industries over to FHCs and bank subsidiaries?
- Were all the criteria examined and met before the rule was issued? What weight, if any, was given to each of the enumerated criteria?
- How is it possible that in less than three months after the Act became public law the real estate industry, particularly brokerage, leasing and property management, could have changed so dramatically to merit consideration as a financial activity?
- Congress gave considerable attention to the regulation of insurance activities that are traditionally the purview of state regulators. Real estate is similarly regulated, yet the Act makes no provision to resolve conflicts of regulatory jurisdiction that most certainly will occur should FHCs and national bank subsidiaries engage in real estate brokerage and management as proposed. Have the Federal Reserve and the Treasury Department considered how real estate activities of FHCs and bank subsidiaries would be regulated?
- Was federal preemption of state regulatory and licensing authority contemplated?

In February 2000, barely a month after the Gramm-Leach-Bliley Act became public law, several banking institutions and representatives petitioned the Federal Reserve Board and the Treasury Department to grant financial holding companies and national bank subsidiaries real estate brokerage and management powers. They argued that they were allowed to participate in virtually every aspect of the real estate transaction except for brokerage. What the bankers failed to recognize was that there is a clear difference between these other aspects of the real estate transaction and the brokerage activity—the brokerage service is a commercial one. It is the provision of advice, analysis, and marketing of a tangible piece of property-real estate. It is unlike a financial or fungible product that has some monetary value. It is just like an automobile, boat, jewelry, electronic equipment or groceries. To argue that the use of some financing mechanism grants banks the power to broker the sale of the underlying durable product is to argue for elimination of the separation of banking and commerce. That debate occurred during consideration of the Gramm-Leach-Bliley Act (GLBA) and Congress upheld the continued separation of these activities. The bankers cannot now gain by regulation what they failed to gain by legislation.

We believe that Congressional intent was clear that Section 4(k)(3)[1] was meant to authorize new powers to banks to assist in the delivery of existing *financial* products or those that evolved as the financial services industry changed over time. Such powers might include the authority to operate a new technology to assist in the electronic delivery of financial or investment instruments. Section 4(k)(3) was not meant to grant banks the authority to operate whole new commercial businesses. There is nothing in the law or legislative history to infer that such broad legislative powers

[1] The Gramm-Leach-Bliley Act (GLBA) allows the Federal Reserve Board and the Treasury Department to determine activities that are "financial in nature." In their consideration, the regulators are required to examine several statutory factors. They are (1) the purposes of the Bank Holding Company Act (BHCA) and the GLBA; (2) changes or reasonably expected changes in the marketplace in which financial holding companies compete; (3) changes or reasonably expected changes in the technology for delivering financial services; and (4) whether such activity is necessary or appropriate to allow a financial holding company and the affiliates of a financial holding company to: (i) compete effectively with any company seeking to provide financial services in the U.S.; (ii) efficiently deliver information and services that are financial in nature through the use of technological means, including any application necessary to protect the security or efficacy of systems for the transmission of data or financial transactions; and (iii) offer customers any available or emerging technological means for using financial services or for the document imaging of data. BHCA section 4(k)(3).

were to be delegated to the regulators. The time to consider the granting of real estate powers was during debate on GLBA, not through regulation after the close of that debate.

Even if one were to believe that Congress intended to delegate this authority, the factors enumerated in Section 4(k)(3) have not been met by the regulators.

The agencies did not address all the necessary factors. Although the agencies recite in cursory fashion that they have considered all of these factors, the only one they actually discuss is the first prong of the fourth factor, dealing with competition with other companies seeking to provide financial services. There is no discussion of what weight the other three factors may have been given in the agencies' decision-making process.

Furthermore, even as to the factors the agencies did consider, they undertook no factual investigation of their own. They simply cite, in a footnote, a petition from the American Bankers Association, reporting a review of various companies' websites. They merely repeat the bankers' plea to move into this area. Their analysis fails to consider the most important aspect of the issue—that real estate brokerage is a commercial activity. If anything, the mortgage is incidental to the commercial activity. Just the opposite of what the bankers argue.

Twenty percent of real estate transactions involve no institutional financing at all. They are either cash transactions, or owner financed sales. Here there is absolutely no bank involvement. There is still the commercial real estate brokerage transaction though. Logic dictates that the financing may complement certain real estate transactions, but to argue that the brokerage is incidental to the financing is to put the cart before the horse.

Congress held that commercial businesses and banks would compete in the financial services arena. This "gray area" consists of financial activities that support either a commercial or banking activity. For instance, automobile manufacturers such as General Motors provide financing for their auto purchases. Banks also provide financing for auto purchases. The competition comes in the financing arena—not in the sale of the auto. Likewise for real estate, boats, or jewelry. Congress has granted specific legislative authority to banks to include securities and insurance powers within that gray area. Thus you have both commercial firms and banks offering these products. But they were gained only by a legislative action. Even mortgage lending was granted by specific legislative authority. These examples make clear congressional intent that new industry powers can only be granted by legislation.

Existing mortgage activity in this gray area provides banks with little reason to complain. Commercial banks account for almost half of the mortgage originations in this country. Independent mortgage companies and savings and loans combined account for about the same amount. Credit Unions and real estate firm affiliated mortgage operations account for only about two percent of mortgage loan originations. The banks dominate this market already.[2]

While bankers argue that some 26 states allow their state chartered banks to conduct real estate brokerage and management, further analysis shows that in fact only eighteen state banks in six states were doing any kind of real estate brokerage last year. These banks typically served the smallest communities in those states, with 0.57 percent of the U.S. population.[3] There are even fewer thrifts operating real estate brokerages. There is no evidence to suggest that large national banks would serve smaller communities. Today, many of these communities have seen the local bank replaced by a national bank's ATM machine.

The agencies do not explain what determination they are making. Under the most natural reading of the GLB Act, an activity may be "financial in nature," or it may be "incidental" to some other financial activity. The agencies lump these two concepts together, without explaining which determination they are making. If the agencies are claiming that real estate brokerage and management are "incidental" to some other financial activity, they should explain what that activity is.

The agencies offer no explanation for why the regulations should apply to leasing of real estate. The agencies' rationale for describing real estate brokerage as "financial in nature" rests on the theory that "banks and bank holding companies participate in most aspects of the typical real estate transaction other than brokerage." 66 Fed. Reg. at 309. That may be true as to residential purchases of real estate, for which banks commonly provide mortgages and incidental services like appraisals. But it is not generally true as to leasing of real estate, often a relatively simple transaction that does not require financing, appraisals, settlement services, escrow services, or insurance. Yet the proposed regulations would apply to brokerage for lessors and lessees of real estate, as well as purchasers and sellers. The agencies

[2] See Mortgage Loan Origination chart

[3] See "State Banking and Real Estate Activity" chart

offer no explanation as to why bank affiliates should be permitted to engage in these activities.

The agencies offer no explanation for why the regulations should apply to commercial real estate transactions. The agencies' reasoning also appears to focus primarily on the purchase of residential real estate by individuals. *See* 66 Fed. Reg. at 310. Yet the proposed regulations would apply to both commercial and residential real estate brokerage. Commercial enterprises frequently buy, sell, or lease real estate. The agencies offer no explanation why such transactions should be viewed as "financial" activities, rather than as part of a business's ordinary commercial activities.

There is no indication whether the Treasury Department's proposed regulation have been reviewed by OMB. Under Executive Order No. 12,866 (3 C.F.R. 658 (1994)), any "significant regulatory action" by an Executive Branch agency must generally be reviewed by the Office of Management and Budget ("OMB").

> A "significant regulatory action" includes any action that is likely to result in a rule that may * * * [h]ave an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities.

Id. ' 3(f). Although that requirement does not apply to the Federal Reserve Board (an independent regulatory agency), it does apply to the Treasury Department. There is no indication in the proposed regulations whether Treasury considers them to be a "significant regulatory action," or whether it plans to submit them (or has submitted them) to OMB.

Congress needs to reassert its authority to prevent regulators from usurping the power to determine whether it is in the best interests of our country to mix banking and commerce. This decision should not be left to unelected regulators.

We are calling on Congress to enact The Community Choice in Real Estate Act (H.R. 3424/S. 1839) to clarify congressional intent to prohibit the mixing of banking and commerce. REALTORS® have let members of Congress know where they stand on the issue. More than 75,000 REALTORS® sent letters to their elected representatives urging support for *The Community Choice in Real Estate Act*. Before the legislation was even introduced, the Federal Reserve Board and the Treasury Department received more than 40,000 letters each opposing the proposed regulation that would allow financial holding companies and national bank subsidiaries to broker real estate and manage property. REALTORS® from all over the nation sent over 50,000 letters to President Bush urging his support.

But REALTORS® are not alone on this issue. A number of diverse trade associations and consumer groups stand with the National Association of REALTORS®. Consumers Union testified before the House Financial Institutions Subcommittee and raised significant questions about the diminished consumer choices and quality of service that would likely follow from banks brokering and managing real estate. The National Community Reinvestment Coalition, the National Fair Housing Alliance, and the National Association of Hispanic Real Estate Professionals have formally urged members of Congress to support H.R. 3424 and S.1839.

The issue of banks in real estate cuts across the entire spectrum of real estate and related industries, and the FHCs' aggressive attempts to use regulations to define real estate brokerage and property management as financial activities in order to expand their powers threatens other related industries. Consequently, other trade groups representing both residential and commercial real estate interests have sent comment letters to the Federal Reserve and the Treasury Department opposing the proposed regulation. The National Association of Real Estate Professionals (NAREP), the National Association of Home Builders (NAHB), the National Association of Real Estate Investment Trusts (NAREIT), the Real Estate Roundtable, the Institute for Real Estate Management (IREM), the International Council of Shopping Centers, and the National Apartment Association are all standing with the National Association of REALTORS® in keeping large banks out of real estate brokerage and property management.

We look forward to the testimony and questions at this hearing and hope they will shed further light on how this process unfolded. Our written materials include further information and data from surveys conducted on this issue.

Well over a year ago, the Federal Reserve and the Treasury Department issued a proposed rule that would allow financial holding companies (FHCs) and financial subsidiaries of national banks to engage in real estate brokerage, leasing, and property management activities. The National Association of REALTORS® (NAR) strongly opposed this regulation on the grounds that real estate brokerage and property management are not financial activities, nor are they incidental to finance, and approval of the proposed rule would thus effect a mixing of banking and commerce.

This regulation would not only result in negative market and consumer consequences. An affirmative decision by the Federal Reserve and Treasury on this proposal would also violate Congressional intent, evident in several key banking laws which make it very clear that Congress specifically intended to maintain the separation of banking and commerce.

Congress adopted the Gramm-Leach-Bliley Act in 1999, which established a legal and regulatory framework for financial subsidiaries of banks and financial holding companies to engage in designated financial activities under the new law. The Act created a new entity, the financial holding company that would compete in the financial services area offering services that were prohibited to bank holding companies. By distinguishing the permissible activities of bank holding companies from financial holding companies, the Act also reaffirmed the longstanding national policy that separated banking from commerce because of the unique powers and advantages granted to banking institutions by their federal charters.

NAR-supported legislation was introduced in both the U.S. House of Representatives and the U.S. Senate (H.R. 3424 and S.1839) that will clarify Congressional intent that real estate brokerage and management are not incidental or complimentary to a financial activity. The proposed legislation, *The Community Choice in Real Estate Act*, will maintain the status quo regarding FHCs ability to expand into real estate brokerage and property management activities through regulation. *The Community Choice in Real Estate Act* returns the issue back to its proper forum—the U.S. Congress.

The National Association of REALTORS®-supported legislation and its position on this issue is based primarily on two strong beliefs:

1. The Congress, *not* the Board of Governors of the Federal Reserve or the Secretary of the Treasury, is the proper judge of what is commerce and what is banking or financial services. The 535 elected Congressional representatives, not the seven Federal Reserve Board Governors or the Secretary of the Treasury, should be responsible for any changes in current law that would result in a dramatic restructuring of the real estate industry. Real estate brokerage and property management are clearly *commercial activities*. This view was central throughout the 25-year debate on the Glass-Steagall Act and the passage of the Gramm-Leach-Bliley Act of 1999, and clearly is reflected in historical and present Congressional intent.
2. Permitting financial holding companies and national bank subsidiaries to enter the real estate brokerage and management industry would have wide-ranging, adverse market effects. Industry concentration would increase, competition would decline, and consumer choice would be limited with no real benefits from economies of scale or scope. The unprecedented expansion of banking powers into the real estate brokerage/management industry would clearly expose the financial holding companies' and their banking subsidiaries' inherent conflicts of interest in selling financial services (banking products) rather than serving customers in the brokering of real estate property.

NAR's position was eloquently stated by Congressman Jim Leach of Iowa, the sponsor of the Gramm-Leach-Bliley Act:

> *"The movement to go beyond the integration of financial services and eliminate the traditional legal barriers between commerce and banking is simply a bridge we should not cross. It is a course fraught with risk and devoid of benefit and one for which there is no justification.*
>
> *Such a step would open the door to a vast restructuring of the American economy and an abandonment of the traditional role of banks as impartial providers of credit, while exposing the taxpayer to liabilities on a scale far exceeding the savings and loan bailout. At issue with financial services modernization is increased competition. At issue with mixing commerce and banking is economic conglomeration, the concentration of ownership of corporate America."*

Financial holding companies, their representative associations and other groups, including some large real estate brokerage companies, argue against the National Association of REALTORS® position. They claim that the Association is being "protectionist," and that the entry of banks into real estate would encourage more open competition in the real estate marketplace. On the contrary, the National Association of REALTORS® position promotes open and fair competition. Indeed, its members would welcome FHCs as competitors if FHCs truly competed in a free market without the advantages of their bank subsidiaries' federal charters and without creating the risks outlined by Chairman Leach.

Currently we have a balanced marketplace for commerce, banking and financial services. Real estate brokerage firms do not engage in banking. Financial holding companies do not engage in commercial activities, such as real estate brokerage and property management. Banking and commerce are separate. The arena of financial services allows competition from both financial holding companies and commercial firms. Both real estate brokerages and financial holding companies (banks) have diversified their business lines into financial services that have served as a buffer between commerce and banking activities. This was the intent of Congress throughout its deliberations on financial modernization.

The reality is that the entry of federally chartered banks or financial holding companies into the real estate brokerage business would tilt this balanced marketplace toward the FHCs. It would pit government-subsidized banking companies (putting taxpayer money at risk) against privately funded real estate enterprises. Furthermore, if FHCs are permitted to enter the real estate business, REALTORS® and builders would be placed in the awkward position of having to go to banks which are subsidiaries of FHCs—their direct competitors—for loans and financial services.

WHY REALTORS® SUPPORT *THE COMMUNITY CHOICE IN REAL ESTATE ACT*

The Community Choice in Real Estate Act of 2001 was introduced by Congressmen Ken Calvert of California and Paul Kanjorski of Pennsylvania. The Act, H.R. 3424 was introduced with more than 30 original cosponsors and today has more than 225 co-sponsors. The legislation, along with its companion bill in the Senate, S.1839, is designed to address concerns expressed by both real estate professionals and consumers if financial holding companies and subsidiaries of national banks (FHCs) are permitted to engage in real estate brokerage and property management activities.

In brief, *The Community Choice in Real Estate Act* stipulates that federal regulators prohibit these financial institutions from engaging in real estate brokerage and management activities. More specifically, H.R. 3424 and S.1839 specify that the Federal Reserve Board and the Secretary of the Treasury may not determine that real estate brokerage or real estate management activities are financial in nature, incidental to any financial activity, or complementary to a financial activity.

THE COMMUNITY CHOICE IN REAL ESTATE ACT *RETURNS THE ISSUE TO THE PROPER FORUM—THE U.S. CONGRESS*

The National Association of REALTORS® position on banks entering the real estate business aligns with both historical and current Congressional intent. The legislative history of banking laws demonstrates that real estate brokerage has been consistently interpreted as a commercial, not a financial activity. Although the Gramm-Leach-Bliley Act of 1999 (GLB) made specific reforms in the nation's banking and financial services laws, the separation of banking from commerce remains a tenet of national policy. And while the Federal Reserve and the Secretary of the Treasury are authorized by Gramm-Leach-Bliley to expand the list of financial activities, Congress has clearly indicated its intent to maintain the separation of banking and commerce.

Financial modernization—the term that advocates used to characterize the legal changes that allowed banks, securities firms and insurance companies to enter each other's businesses—has been interpreted by some as removing all barriers to banks entering non-banking businesses. But in its deliberations on the Gramm-Leach-Bliley Act, Congress stopped short of mixing banking and commerce. The GLB Act was quite specific from the outset in describing what a financial activity may be. The current activities of banks and financial holding companies principally relate to financial instruments: loans, checking accounts, mortgages, etc. While these represent value between two parties (usually a bank and a depositor or borrower), they are not tangible goods and rarely take any physical form.

Commercial activities, such as real estate brokerage and property management, offer to consumers something that is tangible—a house, an appliance, a car, for example. Although banks argue that real estate has financial attributes, even the Federal Reserve Board and the Secretary of the Treasury in the proposed real estate regulation observed that bank-ascribed financial attributes might not be enough to treat real estate as a financial asset.[4] And while purchasing tangible assets, such as a car, computer, or a home, may entail the use of financial instruments—usually cash or loans—this does not mean that commerce is "financial in nature" or "incidental to a financial activity." Rather, it can be argued that financial activity *is incidental to the real estate transaction*.

[4] See Federal Register, Vol.66, No.2, Wednesday, January 3, 2001, p.310.

In the GLB Act, Congress enumerated those activities that it deemed to be financial in nature, but specifically omitted real estate brokerage and management. (For specifics, see *12 U.S.C. 1843 (k)(4)*).[5] Congress did make provisions to expand the list of financial activities. It devised specific criteria that such activities must meet, based on new technological developments to deliver financial products to consumers and how the marketplace itself evolved. Congress also authorized the Federal Reserve Board and the Treasury Department to agree on such new financial activities.

However, Congress did not anticipate nor intend for that list of financial activities to include commercial ones. There has been no significant change in the relevant technology, or in the business of real estate brokerage or management, since enactment of the GLB Act in late 1999. The businesses of real estate brokerage and management remain, for all practical intents and purposes, the same today as they were on the date of enactment: the transfer of real property and such commercial activities related to such transactions. The very purpose of the regulation proposed by the Federal Reserve and the Treasury Department is to overturn the long-held understanding that real estate is commerce by re-designating it as a financial activity for purposes of the Gramm-Leach-Bliley Act. The proposal from the Federal Reserve and the Secretary of the Treasury runs counter to Congressional intent.

The proposal to redefine real estate brokerage as a financial activity has met opposition from a full spectrum of consumer and industry groups. In support of that opposition, Congress is reasserting its authority in the arena by introducing *The Community Choice in Real Estate Act*. This bill amends the Bank Holding Company Act to preclude any such action by the Federal Reserve or Treasury, and clarifies Congressional intent by prohibiting banks and financial holding companies from entering real estate brokerage or property management. The bill's intent is to maintain the status quo; it does not seek to preclude any current activities that banks and their affiliated businesses are authorized to do. It reasserts Congressional intent in maintaining the separation of banking and commerce.

Members of Congress overwhelmingly are signaling their support for retaining the commercial distinction of real estate activities and their intention to maintain the separation of banking and commerce. In fewer than five months after *The Community Choice in Real Estate Act* was introduced in Congress, more than 225 members of the House of Representatives and at least 10 members of the Senate signed on as co-sponsors of the bills.

THE ACT SUPPORTS A DIVERSIFIED REAL ESTATE SERVICES MARKETPLACE

During the past two decades, the financial services marketplace has grown substantially due, in part, to the entry of both commercial firms and banking companies. Commercial firms that are involved in the selling and/or brokering of durable goods (such as refrigerators, automobiles and homes) have naturally expanded into financial services to facilitate the transaction by offering consumer financing that is complementary to their primary service—the brokering/selling of a tangible product. Similarly, banking companies that are involved in the selling of banking services (such as consumer loans and commercial and industrial loans) have also expanded into financial services so that they can capture a greater market share by offering their customers financial services that complement their primary service—banking.

However, unlike a commercial firm, which risks its own capital funds, a bank's ability to expand its powers and diversify into financial activities has historically been constrained by Congressional oversight. Because of the "special nature" of banks and the many federal subsidies that flow through a bank (e.g., deposit insurance, privileged access to credit), Congress has continually repeated its intent to separate banking activities from commerce activities in an effort to avoid conflicts of interest, adverse market outcomes and fairness issues that can be caused by a bank's special privileges.

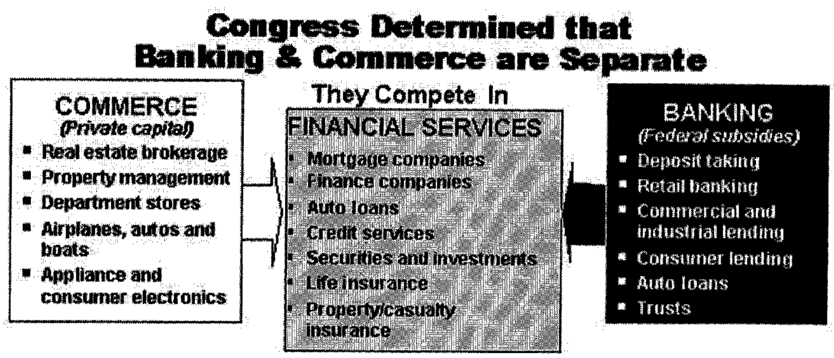
The Gramm-Leach-Bliley Act provided an opportunity for financial holding companies to expand their product/service lines into financial activities and activities that are incidental to finance. It is very clear that the GLB Act set the foundation for a shared competitive playing field for both commercial firms and banks—the financial services marketplace. Commercial firms that have subsidiaries involved in financial activities compete head on with bank-owned financial subsidiaries. This competition was not "created" by the GLB Act; it already existed because bank-affili-

[5] Further evidence of Congressional intent regarding holding company expansion into non-financial areas can be discerned by the vote in the House of Representatives in 1998 in which an effort to permit banks to engage in commerce—up to five percent of their annual net revenue and five percent of their total assets—was defeated by a vote of 229 to 193.

ated mortgage lenders already existed and, in fact, dominated—and still dominate—mortgage originations. (In 1999, commercial banks and subsidiaries of commercial banks accounted for the largest market share—44 percent—of mortgage originations, according to the Home Mortgage Disclosure Act. The top 25 diversified real estate brokerage firms accounted for only 0.8 percent of mortgage originations.) For example, the General Motors Acceptance Corporation (GMAC)—a financial services subsidiary of General Motors competes against Wells Fargo and other banks to sell financing services to customers purchasing a General Motors automobile. Similarly, Circuit City competes directly with Bank America to sell financing services to customers purchasing Circuit City-electronic products.

In the real estate marketplace, companies like John Doe, REALTOR®, compete directly with banks, like BankAmerica, in the financial services marketplace by providing real estate-related financial services—principally mortgage brokering services and title insurance—to customers purchasing a home that was brokered/sold by John Doe, REALTOR®. Both the real estate brokerage company and the bank offer a number of real estate related financial services to homebuyers and sellers.

In the post-GLB Act marketplace, the real estate brokerage company does not offer banking services and banks do not offer commercial services—real estate brokerage and management. The separation of banking and commercial activities is intact. The competition is in the financial services arena where it belongs. Consumers benefit from this arrangement because the direct competition for financial services between commercial companies and banks results in greater consumer choice and customer service. Prohibitions against the encroachment of federally subsidized banks into the world of commerce limit conflicts of interest or unfair competition.



The ability of real estate brokerage companies to diversify their business lines into the financial services marketplace has produced a number of diversified real estate services companies to better serve consumers. Even the smaller and less diversified real estate brokerage companies now look to offer ancillary services to their homebuying and selling clients. Moreover, there are examples where banks and real estate brokerage companies have joint ventured in the financial services marketplace. A prominent example is Prosperity Mortgage, which couples Wells Fargo Bank and Long and Foster, REALTORS®.

Diversified real estate brokerage companies compete directly against the large financial holding companies (banks) in the financial services marketplace each and every day. The competitive dynamics in this marketplace are no different from the competitive nature of the automobile and electronics marketplaces. The beneficiaries in all of these markets are consumers.

THE COMMUNITY CHOICE IN REAL ESTATE ACT WILL BENEFIT CONSUMERS AND THE REAL ESTATE INDUSTRY

The Community Choice in Real Estate Act will help to maintain a competitive, efficient, and balanced real estate marketplace, providing consumer choice at low cost and with no risk to the U.S. taxpayers. The entry of federally insured depository lending institutions into the real estate brokerage business would tilt the competitive playing field by pitting government-subsidized financial holding companies and national bank subsidiaries against privately funded real estate enterprises. Passage of the Act will help preserve a fiercely competitive real estate brokerage marketplace.

The real estate brokerage industry as it exists today has large numbers of independent real estate professionals and brokerages actively competing for prospective buyers and sellers. Competition is fierce, efficiencies are high, and there are relatively few barriers to entry. These characteristics make it highly unlikely that the proposed regulation would benefit either business or consumer interests.

The residential real estate brokerage industry is a competitive marketplace, where more three quarters of a million REALTORS®[6] and tens of thousands of real estate brokerages compete for customers' business each day. The underlying cost structure of the industry and the relative ease of entry into the market serve as checks to the concentration of market power. The large number of industry players ensures homebuyers and sellers access to service providers who best meet consumers' needs at the lowest price possible.

Real estate firms tend to compete actively for business in three different arenas. First, firms compete for the best real estate agents. Second, firms compete for sellers' listings and homebuyers against other real estate firms in their market area. Finally, real estate firms and agents compete against the other homebuying and selling options, including For Sale by Owner (FSBOs). The result of this three-pronged competition revenue and cost pressures that limit profitability for most real estate brokerages. But this competition also results in excellent service provided efficiently by real estate firms and agents for both buyers and sellers. *The Community Choice in Real Estate Act* would preserve this system.

MIXING BANKING AND COMMERCE WILL STIFLE COMPETITION IN THE REAL ESTATE INDUSTRY

Today any commercial firm can enter real estate brokerage, but FHCs have government-imposed barriers to entry. National banks and financial holding companies have long been able to own mortgage companies and engage in joint ventures with real estate firms. They now claim that real estate brokerage and management are financial activities, without acknowledging their current competition in this area through their existing mortgage lending affiliates. Financial holding companies now want to directly own commercial firms in the form of real estate firms and compete with other commercial firms using the federal subsidies available to their banking subsidiaries. This is not the sort of competition that Gramm-Leach-Bliley envisioned.

The expansion of banking powers that would permit FHCs to engage in real estate brokerage activities will have a detrimental effect on the real estate brokerage industry. The federal banking charter provides federal deposit insurance and privileged access to credit—advantages not offered to real estate brokerage firms. Most of the advantages of the bank charter directly add to bank profitability that would flow up to the financial holding company, thus offering FHCs and their real estate brokerage subsidiaries a competitive advantage over commercial firms in the real estate industry.

Allowing FHCs to provide brokerage, funding and investment services for real estate would increase the power of these integrated firms. This power could be used to limit the entry of new real estate firms and thus limit the competition characterizing the market today in two distinct ways.

First, FHCs would have the ability to fund new real estate brokerages with revenues from the banking side of the business, thus tilting the playing field towards FHCs. Financial holding companies would be able to use banking fees or even profits from their mortgage operations both to increase profitability and to subsidize their entry into insurance and other financial services. Few traditional real estate brokerages have access to outside income streams to subsidize the real estate brokerage business. The result could be an increase in industry concentration as real estate brokerages exit the industry unable to respond to their well-financed new competitors. The same dynamic would limit entry of new real estate firms.

Second, FHCs could leverage their privileged access to capital, access to numerous subsidiaries and outside income streams to engage in a sustained period of below-cost pricing designed to eliminate other firms providing the same service. This could damage any real estate brokerage firms that do not have the resources to defend themselves against a well-financed and subsidized FHC. Again, formerly viable real estate brokerages could be forced to dissolve—not because of an inability to provide efficient and quality service to consumers, but because below-cost pricing can un-

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[6] There are approximately two million people who hold real estate licenses. However, not all of those are active practitioners. It should be noted that REALTOR®, REALTORS®, and REALTOR-ASSOCIATE(r) are registered collective membership marks that identify, and may be used only by, real estate professionals who are members of the National Association of REALTORS® and subscribe to is strict Code of Ethics.

fairly eliminate the competition. The result could be a smaller number of firms that are less likely to provide the benefits that competition brings to today's real estate brokerage market.

MIXING BANKING AND COMMERCE HURTS CONSUMERS

The National Association of REALTORS® agrees with the message sent by the U.S. Congress: mixing commerce and banking will adversely affect the real estate industry. If big banks are allowed into the real estate business, the market could soon be dominated by a smattering of large banking conglomerates whose primary goal is to cross-sell various financial products, not to put people in homes and commercial properties. The end result could be fewer choices for consumers, higher fees and less competition.

In the banking industry a few dominant firms control a significant share of the total market. FHCs' entry into the real estate brokerage market would likely increase concentration and introduce unfair competition because of their federal subsidies. There is likely to be a significant decline in the number of firms and the number of small firms that represent a key segment of the industry. The real estate brokerage business could change from a localized, highly competitive industry to one that is dominated by nationwide federally chartered firms.

It is unclear what FHCs could bring to the market that would increase competition. Any additional entry will not necessarily lower costs. FHCs claim that consumer costs will go down, but those lower costs can only be realized by introducing economies of scale or scope, cross-subsidization, or predatory pricing. The latter two reasons are not permanent benefits for consumers. Only the first—economies of scale—enhances consumer welfare. Without an increase in efficiency, there would be no cost savings to pass along to consumers. But there are limited economies of scale in the real estate brokerage industry.

Even if FHCs were able to reduce real estate brokerage fees temporarily, any savings to homebuyers would be offset by higher costs for bank customers. Absent economies of scale, lower real estate brokerage fees can only come via cross-subsidization from other business arenas. The higher banking fees are likely to become permanent features of the banking system, given barriers to entry and concentration of market power, while reductions in real estate brokerage fees could be temporary as firms exit the industry.

The expansion of banking powers that would permit financial holding companies into the real estate brokerage business could also limit consumer choice in the selection of a real estate professional and other real estate-related service providers. FHCs have an inherent conflict of interest in selling financial services (banking products) rather than serving customers in the brokering of real property. The parental relationship between FHCs and their subsidiary real estate brokerage business would likely steer consumers to the FHCs' subsidiaries. Agents working for an FHC-owned real estate brokerage firm would have less incentive to find an outside loan provider or other real estate settlement service vendor that best fits their customers' needs.

There is also the likelihood that FHCs entering the real estate brokerage industry would retain their real estate agents as salary-based employees, rather than as commission-based independent contractors. As FHC employees, these real estate agents would focus on the FHC's profits, cross-selling the holding company's other services. This is contrary to the current real estate market where there is fierce competition among a large number of firms ensuring that consumers receive valuable, *impartial* advice when they most need it.

THE ACT BENEFITS CONSUMERS AND THE REAL ESTATE INDUSTRY

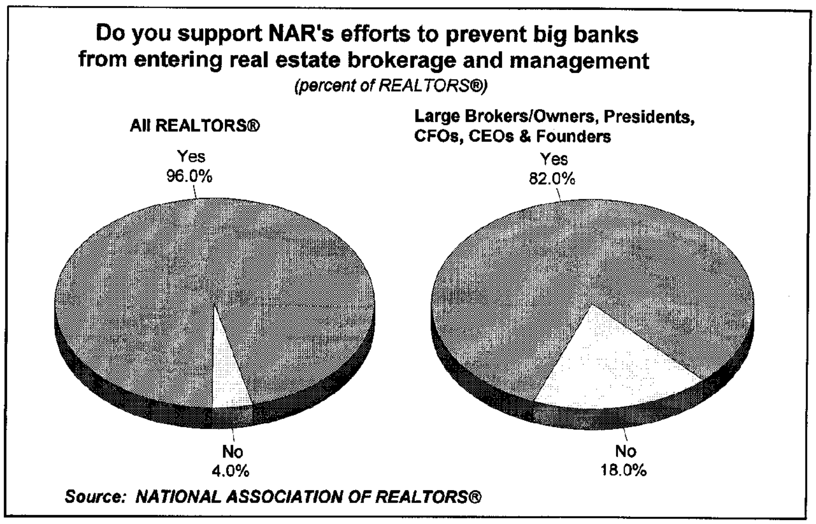
In summary, passage of *The Community Choice in Real Estate Act* will ensure more competition, and thus more consumer choice. More competition will maintain the lowest cost real estate brokerage services as well as lower banking fees. Taxpayers will be protected from risks associated with commercial endeavors underwritten by federally insured depository lending institutions. Consumers will continue to be served by real estate professionals whose interests are aligned with theirs.

The Community Choice in Real Estate Act defines real estate brokerage and management as commercial activities, outside the scope of a federal bank charter. *The Community Choice in Real Estate Act* will limit banking institutions to activities permitted under their current charters, and maintain the current environment that provides for an efficient and competitive real estate brokerage market that benefits both the real estate industry and America's consumers.

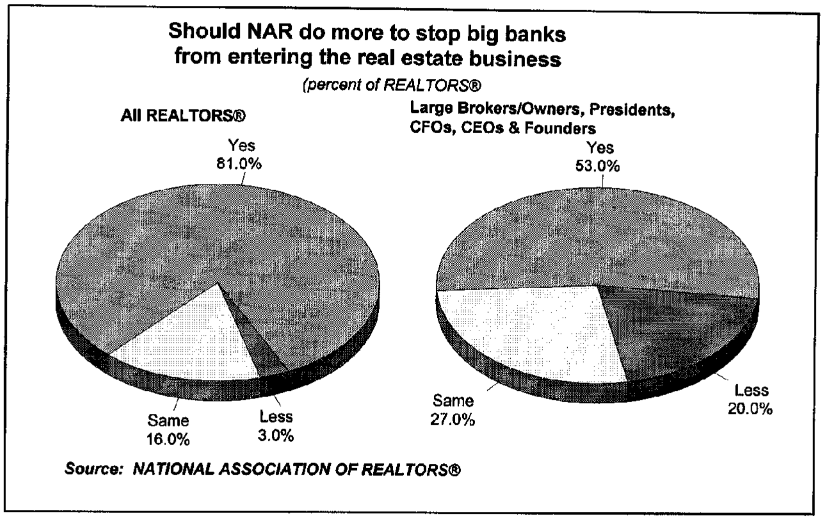
OVERWHELMING INDUSTRY SUPPORT FOR THE NATIONAL ASSOCIATION OF REALTORS® POSITION

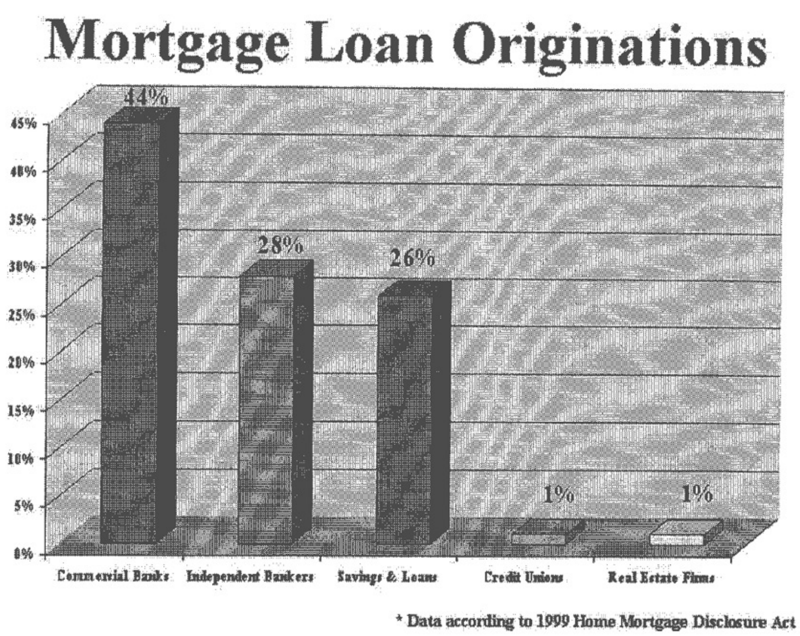
The National Association of REALTORS® represents all of its members and the real estate industry as a whole. In the last 14 months, the Association has spoken for its 800,000 members with one voice, as *The Voice for Real Estate*. A unified voice is crucial in maintaining a competitive and highly efficient real estate industry that serves America's property owners. It is even more vital on the issue of allowing financial holding companies and national bank subsidiaries (FHCs) to engage in real estate brokerage and property management activities.

Recent research indicates that the National Associatino of REALTORS® *does* speak for an overwhelming majority of its members who oppose FHCs' entry into the real estate brokerage and management business. In a recent survey (February 2002), more than nine out of 10 REALTORS® oppose the pending Federal Reserve and Treasury Department rule that would allow big banking conglomerates to enter real estate brokerage and management. Perhaps more importantly, 96 percent support efforts by the National Association of REALTORS® to prevent FHCs from entering real estate brokerage management.



The survey found widespread support among broker-owners as well as sales agents. Some 82 percent of large brokers support NAR's position, according to the survey. The survey also found that 81 percent of REALTORS® want NAR to be even more aggressive in its efforts, and majority of large brokers also want NAR to do more to stop FHCs from entering the real estate business.


Should NAR do more to stop big banks
from entering the real estate business
(percent of REALTORS®
All REALTORS®
Yes
81.0%
Same
16.0%
Less
3.0%
Large Brokers/Owners, Presidents,
CFOs, CEOs & Founders
Yes
53.0%
Same
27.0%
Less
20.0%
Source: NATIONAL ASSOCIATION OF REALTORS®


Mortgage Loan Originations
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
44%
28%
26%
1%
1%
Commercial Banks
Independent Bankers
Savings & Loans
Credit Unions
Real Estate Firms
* Data according to 1999 Home Mortgage Disclosure Act

State Banking and Real Estate Activity

Few state-chartered banks engage in real estate brokerage

- Only 6 states have banks with residential real estate brokerage operations
- Only 18 banks in these states have residential real estate brokerage operation
- These banks represent 0.2 percent of all banks and serve areas with 0.57 percent of U.S. population.

State	Bank Name	City	County	County Pop
1 Iowa	Tama State Bank	Marshalltown	Marshall	39,311
2	Northwest Federal Savings Bank	Storm Lake	Buena Vista	20,411
3	Sac City State Bank Real Estate	Sac City	Sac	11,529
4	Mercantile Bank-Rock Rapids	Rock Rapids	Lyon	11,763
5	United Bank of Iowa	Odebolt	Sac	11,529
6	First Central Bank	Dewitt	Clinton	50,149
7	Maquoketa State Bank	Maquoketa	Jackson	20,296
8	Hardin County Savings Bank	Eldor	Hardin	18,812
9	St. Angar State Bank	St. Angar	Mitchell	10,874
10	First Federal Bank	Sioux City	Woodburry	103,877
11	Tranor State Bank	Tranor	Pottawattami	87,704
12 Georgia	Community Bank	Cornelia	Habersham	35,902
			Jackson	41,589
			Stephens	25,435
13 Wisconsin	Bank of Alma	Alma	Buffalo	13,804
14	Anchor Bank	Madison	Dane	426,526
15	Union State Bank	Kewaunee	Kewaunee	20,187
			Brown	226,778
16 Michigan	First Bank	Excanaba	Delta	38,520
17 North Carolina	People's Bank	Newton	Catawaba	141,685
18 Nebraska	Security First	Lincoln	Lancaster	250,291
			TOTAL POP	1,606,972

Source: Research conducted by the NATIONAL ASSOCIATION OF REALTORS® July 2001. Information collected through telephone calls with state banking and real estate regulators and state REALTOR associations.

Mr. BARR. Mr. Yingling, you are now recognized for a 5-minute opening statement, sir.

STATEMENT OF EDWARD L. YINGLING, EXECUTIVE DIRECTOR, AMERICAN BANKERS ASSOCIATION, UNITED STATES PUBLIC INTEREST GROUP

Mr. YINGLING. Thank you, Mr. Chairman and thank you for inviting the ABA to testify this afternoon.

We believe that it is clear that the Fed and the Treasury are correctly following the process established in the Gramm-Leach-Bliley Act and under established principles of administrative law.

The provision of law under which the real estate issue has been raised is really the heart and soul of the Gramm-Leach-Bliley Act.

In more than 15 years of debate leading up to the act, Congress often found itself in the middle of arguments between financial services sectors about who should do what. The result was gridlock and an out-of-date financial system that did not reflect changes in consumer needs or in the use of technology.

Now, unfortunately, the Congress is being asked to ignore the primary purpose of Gramm-Leach-Bliley and to once again become a referee deciding who should do what.

In enacting Gramm-Leach-Bliley Congress created a flexible yet conservative process. For a new activity to be approved, not one agency but two must approve it. The Fed and the Treasury were chosen for their obvious expertise in financial services and on the economy.

Under the statute, the Fed and the Treasury determine whether a new activity is, "financial in nature or incidental to a financial activity." The regulators must consider, among other factors, changes in the marketplace and technology and whether the activity would enable a bank to compete with any company providing financial services.

The marketplace and technology are rapidly changing. Moreover, combining real estate brokerage and banking services is not a new or unusual activity. Real estate firms combine banking services and real estate brokerage. Insurance companies do it, securities firms do it, and well over half of the federally insured depository institutions in this country today have the authority to do it. The ABA believes that all banks should have the same opportunity to provide services to meet the needs of our customers.

Despite comments to the contrary, anyone who paid attention during the years of debate that led up to the Gramm-Leach-Bliley Act should not have been surprised to see the current proposal.

I can add from personal experience that over 10 years ago I negotiated at length with my counterpart at the National Association of REALTORS® the rules under which banks could provide real estate brokerage services. This negotiation was in the context of a previous version of Gramm-Leach-Bliley, which was actually more restrictive than the one that was enacted in 1999.

Thus, over 10 years ago, the National Association of REALTORS® recognized that a more restrictive version of financial modernization could be interpreted as permitting banks to offer real estate brokerage. Furthermore, in 1995, the National Association of REALTORS® testified on another forerunner of Gramm-Leach-Bliley before the House Banking Committee and stated unequivocally that the language must be amended to exclude brokerage and management.

It was not amended then, nor was it amended in 1999; and, of course, the marketplace has changed dramatically in the 10 years since I first negotiated with the REALTORS®. Just look at the ads attached to my testimony to see what is really going on today.

No one has been able to point to any specific language in the legislative history that supports the argument that Congress intended to exclude real estate brokerage.

Congress, on the other hand, did specifically exclude one aspect of real estate in Gramm-Leach-Bliley, and that aspect was real estate development. Certainly the real estate brokerage issue would have been raised in that context if it was going to be raised.

Finally, I would point out that the language in question is in the form of amendments to section 4 of the Bank Holding Company Act, which has been in existence since 1956; and section 4 has a long history of regulatory action and court review, including numerous Supreme Court reviews, particularly since 1970. So there is a long history with regard to this process. We strongly believe that the Fed and the Treasury have correctly followed the letter and intent of the law.

More importantly, increased competition clearly benefits consumers and the economy. It is a catalyst for innovation, more customer choice, better service and competitive prices.

Thank you, Mr. Chairman.

Mr. BARR. Thank you very much, Mr. Yingling, for your testimony.

[The prepared statement of Mr. Yingling follows:]

PREPARED STATEMENT OF EDWARD L. YINGLING

Mr. Chairman, thank you for inviting the American Bankers Association (ABA) to testify this afternoon. My name is Edward L. Yingling, and I am the Executive Director of Government Relations at the ABA. The American Bankers Association brings together all categories of banking institutions to best represent the interests of a rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

Mr. Chairman, in addition to my role in government relations at the ABA, I am also an attorney with over 25 years of experience in the banking field. Both in private practice and at the ABA, I have been directly involved for well over two decades in the Congressional and legal debates that led eventually, after so many years, to the enactment of the financial modernization legislation known as the Gramm-Leach-Bliley Act (GLBA). Hopefully, with this background, I can provide some useful insight to the Subcommittee with respect to the administrative process, as requested in your letter of invitation.

In my testimony today I would like to make the following points:

In enacting GLBA, Congress created a flexible, yet conservative regulatory process to allow banks to offer new services—a process that the Federal Reserve Board and the Treasury Department have correctly followed.

We have grave concerns about the broader effects of the current controversy and whether it sets a precedent that could hinder future approvals of new services under GLBA. The Act was designed to keep our financial system up-to-date by delegating those decisions to the FRB and the Treasury. This goal is being frustrated by efforts to take the case for determining what is financial in nature back to Congress, placing Congress in the very role that it delegated in GLBA to the agencies with the greatest level of expertise.

The request by the American Bankers Association and others to have real estate brokerage and management approved fully meets the statutory standard contained within GLBA.

I. OVERVIEW

We believe it is quite evident that the Federal Reserve Board (FRB) and the Department of the Treasury are following the process laid down in GLBA, as well as the normal process under established principles of administrative law. Of course, we do not know, nor does anyone know at this point, what the result of this regulatory process will be, although we believe there is a strong case that real estate brokerage and management activities should be approved under the standards of GLBA.

While much of the public discussion during consideration of GLBA was on securities and insurance activities, which had been the focus of the most controversy over a number of years, it is quite clear that GLBA had a more general and broader purpose. In fact, the provision of GLBA under which the real estate issue has been raised is really the heart and soul of that Act. The primary purpose of GLBA was to create a mechanism to bring our financial services laws up-to-date both at the time of its enactment, and also going forward. It was widely believed that the contentiousness, turf wars, and delays that preceded GLBA were harmful to our financial system, our economy, and the consumers of financial services. Therefore, Congress provided a mechanism to keep our financial system up-to-date going forward, and, importantly in this context, to remove the need to have Congress referee between industries every time any change to our financial system was proposed. It is ironic, but really very sad, that on the first issue of modernization raised under this new regulatory process, the Congress is being asked to ignore this primary purpose of GLBA, and to once again become a referee, deciding whether or not a specific industry should be exempt from the criteria Congress set up less than three years ago.

In enacting GLBA, Congress created a flexible, yet conservative, process. In order for a new activity to be approved, not one agency, but two, must approve it. The two agencies chosen were, not surprisingly, the FRB and the Treasury. These are the two agencies that have the most expertise with respect to the entire financial services industry, as well as the economy. They are also two conservative agencies. It is worth noting, since the National Association of REALTORS®® (NAR) has raised the specter of banking and commerce, that the FRB has, for many years, been the primary opponent of breaching the wall between banking and commerce. Based on this record, one would certainly expect the FRB to look very closely at any question relating to commercial activities.

It is important, of course, to look at the specific language in the statute. Under the statute, the FRB and the Treasury determine whether or not a potential new activity is "financial in nature or incidental to a financial activity." In making that determination, GLBA directs the regulators to consider a variety of factors. Those factors include: 1) the purposes of the GLBA; 2) changes, or reasonably expected changes, in the marketplace in which financial holding companies compete; 3) changes, or reasonably expected changes, in the technology for delivering financial services; and 4) whether the proposed activity is necessary or appropriate to allow a financial holding company to compete effectively with any company seeking to provide financial services in the United States.

As discussed more fully below, we believe that real estate brokerage and property management, in the context of the changes taking place in the marketplace for these services, clearly meet the criteria of the statute. However, that is something for the regulators ultimately to determine. One thing is for certain—it is quite clear that a strong case can be made that these criteria are met.

While many of the issues are discussed further below, at this stage it is worth emphasizing a couple of points. First, while the purchase of a home has many aspects, it is clearly the most important financial transaction for the great majority of people. It is not only the largest monetary transaction in which most people engage, but also the mechanism through which they accumulate a great portion of their wealth over time. Second, the criteria in the statute specifically refer to competing with companies providing financial services in the United States. It is a fact that a significant majority of insured depository institutions can already offer real estate brokerage services under the laws of many states and under federal statutes. More importantly, as demonstrated by the advertisements attached to this testimony, many real estate brokerage firms are actively engaged in providing financial services in direct competition with banks.

The NAR has tried to make a simplistic argument that the proposal involves "commerce" and is, therefore, beyond the scope of GLBA. However, the issue is not at all that simple. GLBA does not prohibit commercial activities; rather it sets out specific criteria to determine permissible activities. The authors of GLBA clearly recognized that there was no exact or permanent line to define financial services. That is why they set up a mechanism to have the FRB and Treasury make determinations going forward, and why they developed the specific criteria that are in the statute.

Despite comments to the contrary, anyone who paid attention to the debate over the many years that led up to GLBA would not have been surprised to see the current proposal. I can add from personal experience that over ten years ago I negotiated, at length, with my counterpart at the NAR, the rules under which banks would enter the real estate brokerage business. This negotiation took place with respect to criteria in a previous version of GLBA which was, in fact, much more restrictive than the criteria enacted in 1999. Thus, over ten years ago, the NAR recognized that even a more restrictive version of financial modernization could be interpreted as permitting banking companies to offer real estate brokerage. Furthermore, in 1995, NAR testified on another forerunner of GLBA before the House Banking Committee. In that testimony, NAR stated unequivocally that the language must be clarified to exclude brokerage and management. It was not clarified then, nor was it in GLBA. That bill, the "Financial Services Competitiveness Act of 1995," contained similar, but less broad, language to that ultimately enacted in GLBA.

The NAR has conducted an extensive lobbying and public relations campaign on this issue. Yet, it has been unable to point to any specific language in the legislative history that supports its argument that Congress intended to exclude real estate brokerage. In fact, Congress did specifically exclude one aspect of real estate—real estate development and investment—in GLBA. Certainly the real estate brokerage issue would have been raised in that context, if it were going to be raised.

The FRB and Treasury have correctly followed the letter and intent of GLBA, as well as all administrative law requirements, in this matter. Their approach is precisely what Congress intended. It is NAR's efforts to have Congress serve as referee that is a prime example of what Congress was seeking to avoid in enacting GLBA.

II. LEGAL ANALYSIS

The Regulatory Process

The FRB and Treasury began the regulatory process over two years ago, on March 17, 2000, when the agencies published an interim rule in the *Federal Register* enumerating those activities determined specifically under the statute to be "financial in nature or incidental to such financial activity, "as well as proposing a process by which any party could seek to have additional activities included in the list. This process was approved by the FRB and Treasury without amendment and republished in the *Federal Register* on January 13, 2001.

The regulatory process adopted by the FRB and Treasury requires the petitioner to do the following: 1) identify and define the activity for which the determination is sought; 2) provide specific information about what the activity would involve and how it would be conducted; and 3) explain in detail why the activity should be considered financial in nature or incidental to a financial activity and provide information that is sufficient to support a finding that the activity is financial.

On July 25, 2000, the ABA petitioned the FRB and Treasury under the interim rule for a determination that real estate brokerage and real estate management activities were permissible activities for financial holding companies and financial subsidiaries under GLBA.

On January 3, 2001, the FRB and Treasury published a request for comments as to whether the agencies should determine that real estate brokerage and management were activities that were "financial in nature or incidental to a financial activity." On April 30, 2001, ABA responded to the request, stating that real estate brokerage and management activities fall squarely within the language of GLBA. Authorizing these activities, we believe, would increase competition in the real estate markets and provide consumers with innovation, more choices and lower prices. The proposal raises no new consumer protection or safety and soundness concerns and will enable banks to compete with integrated real estate firms that currently provide brokerage and mortgage lending activities.

While I will outline the compelling market and technological factors in a moment, the point that existing federal and state laws protect consumers from the potentially adverse effects of combining banking and real estate brokerage is also an important one. The simple fact is the same potential for abuse the NAR alleges will occur if banks offer real estate brokerage services exists any time one of the many real estate firms engaged in financial services deals with a customer. However, while these firms, along with some insured depository institutions, have been selling real estate and funding mortgages for years, there has been no outcry about these conflicts of interest. Why?—Because the Real Estate Settlement Procedures Act (RESPA)[1] requires realtors affiliated with lenders to disclose that fact to customers before the purchase occurs.

The RESPA disclosure,[2] which must be on a separate piece of paper, must state the relationship between the real estate agent and the lender and provide the estimated charges or range of charges by the lender. It must also notify the customer that he or she is *not* required to use the lender and is free to shop around for a better deal. If the real estate agent requires the use of its affiliated lender, that agent violates the kickback and unearned fee provisions of Section 8 of RESPA. The customer is expected to sign an acknowledgement of the disclosure.

Bank involvement in real estate brokerage and management services is also consistent with safe and sound banking. First, providing these services will help to diversify the income stream of these institutions and help to improve their financial

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[1] 12 U.S.C. § 2601 *et seq*

[2] The requirement for affiliated business disclosures is part of the regulations of the Department of Housing and Urban Development that implement RESPA. 24 C.F.R. § 3500.15.

base. Real estate brokerage and management services are activities where a bank acts only as an agent for a third party, *but does not take an ownership position in the property.* By their very nature, agency activities pose very little risk to the safety and soundness of depository institutions.

Second, under GLBA, the bank regulators must deem a bank to be well-capitalized and well-managed before a banking organization can participate in any of the expanded financial activities permitted under the GLB Act, including real estate brokerage and property management. Thus, only financially strong institutions would be authorized to engage in these activities.

Third, banking organizations are also subject to Sections 23A and 23B of the Federal Reserve Act, which limit the amount of credit and other forms of support a bank could provide to a real estate brokerage affiliate or subsidiary. Such limits ensure the safety and soundness of the bank will not be negatively impacted by its subsidiaries or affiliates.

Fourth, many banking organizations already have years of experience in providing real estate activities. In fact, the purchase, sale and management of real estate are frequently significant aspects of fiduciary asset management in many bank trust departments. Because banks currently have trust personnel who provide real estate brokerage and management services on a daily basis to trust customers, providing the service outside of the trust department would not be a new activity in which banking organizations lack expertise. Thus, no new safety and soundness issues would be raised.

Finally, a precedent already exists for bank involvement in real estate activities. In over half of the states, state banking regulators have the authority (either explicitly, through regulatory interpretations, and through wildcard and parity statutes) to allow state-chartered banking organizations to engage in real estate activities. (See the attached state-by-state listing developed by the Conference of State Bank Supervisors.) Moreover, savings institutions and credit unions already have brokerage authority. Thus well over a majority of federally insured depository institutions already have this authority. Allowing all banks the same rights and privileges should enhance the competition for real estate services.

In July, it will be two years since the filing of the original petition requesting a determination that real estate brokerage and management be deemed financial in nature. It is now certain that this determination will not be made until 2003. As you are aware, in a letter to Congressman Michael G. Oxley, dated April 22, 2002, Treasury Secretary Paul H. O'Neill indicated, in consultation with the FRB, the Treasury will not make a final decision on this proposed rule until next year.

A fundamental purpose of GLBA was to enable banking institutions to compete with other financial services providers, and ABA has amply demonstrated that the competition is touting the advantages of one-stop homebuying services. While we as an industry have always looked at real estate brokerage and management as providing us with more options to compete in the long term, with each passing day, real estate firms become more deeply involved in financial services such as mortgage and insurance. And with each passing day, the case for allowing banks to offer real estate services only gets stronger.

As an industry we have grave concerns about the broader effects of this controversy and whether it sets a precedent that could hinder future approvals of new powers under GLB. The Act was designed to keep our financial system up-to-date by delegating those decisions to the FRB and Treasury. This goal is being frustrated by efforts to take the case for determining what is appropriate back to Congress, placing Congress in the very role that it delegated to the agencies with the greatest level of expertise to make these decisions based on specific statutory criteria.

H.R. 3424 not only frustrates the GLBA process, it reduces consumer choice. Consumers would have fewer choices of whom to do business with; agents would have fewer choices of whom to work for; and businesses would have fewer choices for joint marketing, fewer potential merger partners, and fewer potential buyers. We believe a competitive market is the best way to provide quality real estate brokerage and management services.

The Statutory Standard

Congress did not give the FRB and the Treasury unfettered discretion to make the determination that an activity is appropriate for approval. GLBA specifically sets forth certain traditional banking activities that Congress knew were clearly financial in nature.

In addition to these currently-recognized activities, the Act authorizes activities that the FRB and Treasury determine, by regulation or order, to be "financial in nature or incidental to such financial activity." This authority to permit new financial activities is considerably broader than the FRB's comparable authority before

GLBA was enacted, which had only extended to a new activity that was "so closely related to banking as to be a proper incident thereto."

One specific aspect of this new authority is that the FRB is directed to define the extent to which three types of activities are "financial in nature:" 1) lending, exchanging, and engaging in certain other transactions with financial assets other than money or securities; 2) providing any device or instrumentality for transferring money or other financial assets; or 3) arranging, effecting, or facilitating financial transactions for the account of third parties.

ABA believes the proposed real estate activities qualify under the first and third statutory categories. For example, real estate brokerage is generally the business of negotiating a contract for the purchase, sale, exchange, lease, or rental of real estate—which we believe is a financial asset—for others.

The FRB and Treasury, in their request for public comment, note that many of the essential aspects of real estate brokerage are already permissible under national bank "finder" authority. The regulators already authorize financial holding companies, as well as national banks and their subsidiaries, to act as finders in bringing together buyers and sellers for financial or nonfinancial transactions. Permissible finder activities include "identifying potential parties, making inquiries as to interest, introducing or arranging meetings of interested parties, and otherwise bringing parties together for a transaction . . ."[3] This description of finders authority is the essence of every real estate transaction.

Apart from their authority with respect to these three specified activities, the FRB and Treasury have broad discretion to determine that other types of activities are "financial in nature or incidental to such activity." In making such a determination, the regulators are directed to consider a number of factors. Among the specific factors to be considered are:

- Changes or reasonably expected changes in the marketplace in which financial holding companies compete or the technology for delivering financial services; and
- Whether the proposed activity is necessary or appropriate to allow a financial holding company to -
  - Compete effectively with any company seeking to provide financial services;
  - Efficiently deliver information and services that are financial in nature through the use of technology, including applications involving systems for data transmission or financial transactions; and
  - Offer customers any available or emerging technological means for using financial services or for the document imaging of data.

The GLBA standard is a significant expansion of the FRB and Treasury's capacity to consider the competitive realities of our nation's financial marketplace when determining permissible activities for financial holding companies and financial subsidiaries. It is our contention that the marketplace, and the technology associated with it, in the case of real estate brokerage and property management, have already changed and will continue to change dramatically in ways that significantly impact the ability of banks to effectively compete with other companies that provide financial services.

Finally, in addition to the newly-authorized financial activities described above, the Act authorizes financial holding companies to engage in certain nonfinancial activities. Specifically, a financial holding company may engage in a nonfinancial activity, or acquire a company engaged in a nonfinancial activity, if the FRB and Treasury determine by regulation or order that the activity: 1) is complementary to a financial activity; and 2) does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

III. THE MARKETPLACE AND TECHNOLOGY

Clearly, combining real estate brokerage and banking services is not a new or unusual activity. Real estate firms do it. Insurance companies do it. Securities firms do it. And well over half the federally insured depository institutions in this country, including many of the largest banks and savings institutions, can do it. The ABA believes that *all* banks should have the same opportunity to provide services that meet the needs of our customers.

In 1990 there were 150,000 residential real estate firms. Today there are about half that many. In this new, competitive environment, bankers and real estate pro-

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[3] 12 CFR 7.1002.

fessionals have much to offer to each other—and to consumers. Banks could provide needed capital and cross-marketing opportunities to support the growth of local real estate firms. Real estate professionals could provide the personalized services and experience that is their strength. Many real estate brokers have told the ABA that they would welcome approval of the proposal because it would provide a potential local partner to help them compete with the large national chains that are increasingly dominating the real estate market.

The benefits of competition are well known. In a free market, businesses choose to offer new products if they believe they can provide better services at competitive prices. Obviously, not all banking organizations will choose to offer real estate services, but those that do will enter the market because they believe they can meet or beat the competition. Increasing the number of providers raises the bar for all the participants, forcing improvements in efficiency, pricing and service levels—*all to the benefit of homebuyers*.

If banks were allowed to offer real estate brokerage and management services there would be more choices for everyone.

- *More Choices for Consumers*
  More players in the real estate business mean more and better products for consumers. In any competitive market, new participants bring new, creative ideas to the market—all designed to provide better service and greater convenience, at reasonable prices. In fact, businesses can only be successful in new markets by providing services that meet the needs of customers. Free competition among a wide variety of providers is the cornerstone of our economic system.
- *More Choices for Real Estate Agents*
  Real estate agents pride themselves on being independent contractors, choosing the best companies to work for. If there are more companies to choose from, agents' employment opportunities will be much broader. Banks will only be able to attract good agents by offering competitive commissions and other incentive-based compensation packages. And because the real estate business requires expertise, licensing, and other requirements, banks would look to hire experienced real estate agents. Banks know that converting tellers to real estate agents would be a poor business strategy.
- *More Choices for Real Estate Companies*
  Forward-looking businesses are always looking for opportunities to improve their franchise value—strengthening, expanding, merging, or even selling their business. Allowing banks to engage in real estate brokerage and management services gives real estate companies more options for bringing additional capital and technology to the table, through joint ventures, for example. Banks also represent potential buyers if agencies choose to sell their businesses. Indeed, in some communities, partnering with the local bank may be the only way for the local real estate brokerage to compete with the growing national chains. This is one reason why many real estate firms also oppose H.R. 3424 and S. 1839. It is interesting to note that many insurance agencies thought that bank involvement was going to hurt their business—until they realized that it provided many more options than they had before.

The Marketplace is Changing—Real Estate and Banking Services Combined

Ironically, the NAR is now objecting to the very combinations that their members have undertaken—offering brokerage, mortgage banking, and, often, insurance under one roof. As I previously noted, securities firms, insurance companies, credit unions, savings associations and state-chartered banks in half the states can offer end-to-end services.[4]

Take, for example, two of the biggest real estate companies in the Washington D.C. area—Weichert and Long & Foster. Both offer the full range of financial services. Weichert calls it "One Stop Gold" and Long & Foster calls it "Real-Edge Services." These packages provide cost, convenience and service options for customers. They may not be right for every consumer, but they give those consumers choices. These examples show the importance companies—and their customers—place on having the option to combine real estate brokerage, mortgage and insurance services. I've included as an attachment several pages of examples—in their own words—of real estate companies that offer both banking and brokerage services.

All banks should have the same options. In fact, according to NAR's own survey in 1999 and a recent 2002 survey by Murray Consulting, not only is one-stop shop-

[4] For example, recently several credit unions in Wisconsin jointly purchased a majority interest in one of the state's larger real estate brokerage firms.

ping viewed very positively by homebuyers, but banks, mortgage companies and real estate companies are all viewed *equally* as appropriate providers of these services.

Restricting some banking organizations from offering the same end-to-end combination of real estate services and mortgage lending as others will place those banks at a tremendous competitive disadvantage—losing not just an opportunity in the brokerage field, but also the opportunity to interact with the customer in the first place and to offer one of the most traditional of banking products—the mortgage loan.

Simply put, if real estate services and other financial products are already combined by real estate firms, securities firms, insurance companies, credit unions, savings associations and state-chartered banks in half the states, there is no reason why all banks should not be accorded the same opportunities to provide these products to their customers.

Many Real Estate Agents Support Open Competition and Oppose H.R. 3424

Many agents and real estate companies are not concerned by the prospect of banking organizations offering real estate services. Many look forward to the opportunity to partner with a local bank. Independent agents who provide good service today know that they will be competitive with anyone, whether the competitor is another independent agent or one affiliated with a bank. Here are a few examples of comments filed by real estate agents with the regulators on this proposal:

- A real estate broker in North Carolina writes: "I am a 38-year veteran of the real estate industry and do not agree with our National Association of [REALTORS®] . . . There are several reasons I feel this way, primarily because our small family-owned business has always faced stiff competition from large real estate firms, yet we have been able to earn a good, honest living. I believe that competition is the American way and if you're good at what you do, you can survive whether large or small."
- A real estate broker in Wisconsin writes: "I don't recall the NAR concerning themselves with real estate brokers having access to on-line companies therefore cutting the independent mortgage banker and local lender out of the transaction."
- Another real estate agent notes: "I would welcome the hopefully more professional business management that banks would likely bring to this business. With most real estate being part-time people with limited training, the real estate business is full of misinformation, poor service, etc., a situation that could be improved with bank involvement. Furthermore, the American consumer deserves more true competition in this business. Bank owned real estate agencies may be able to lower transactions costs to consumers through aggregation of services benefiting the public as a whole."
- A broker from California writes: "Additional competition will be healthy for the industry. Banks and other financial institutions have learned how to meet the needs of consumers and to handle their financial matters. One's home is the biggest financial asset most consumers will ever deal with. If agents are so special for consumers, then they have nothing to fear. Maybe we could see commissions come down!"
- Another real estate agent writes: "NAR [National Association of REALTORS®®] predicted the doom and gloom many, many years ago when franchise brokerage was in its formative stages. ERA, RE/MAX, Coldwell Banker et al were all predicted to end 'mom and pop' real estate firms. These franchises have come, many have gone or merged with others. And yet still, 'mom & pop' brokerage firms continue to survive because of the personal attention. I welcome the competition, and I will continue to survive."

Many Real Estate Companies Also Support Open Competition and Many Oppose H.R. 3424

For example, Paul Harrington, president of DeWolfe New England, which is one of the largest real estate firms in the Northeast, was quoted in the Boston Globe as saying: "We believe that banks ought to be able to compete with us as long as there are safeguards to insure that deposits are not being improperly invested. It would be hypocritical for us to say otherwise because we promote the fact that we offer customers convenience through one-stop shopping."[5]

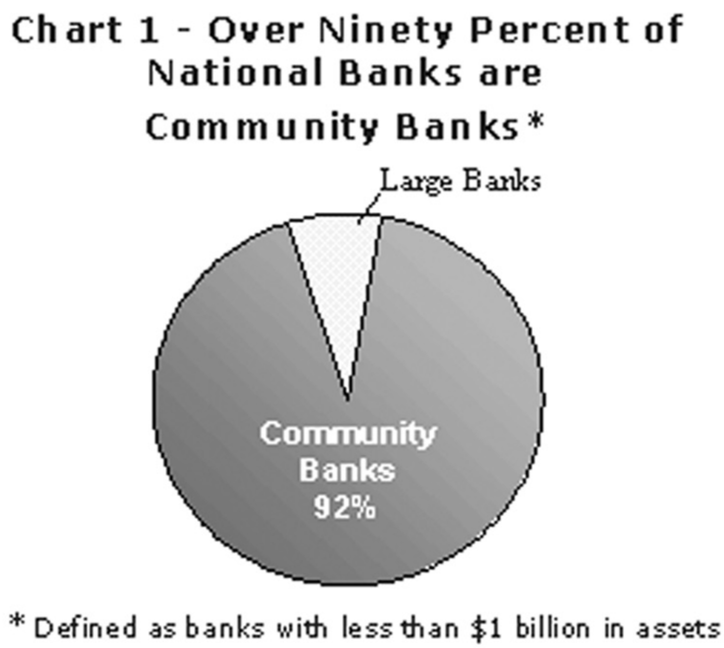
The Realty Alliance—comprised of many of the nation's largest and most successful independent real estate companies with a total of 62,000 agents—went on record

[5] *The Boston Globe, February 25, 2001*

in February in opposition to NAR's position. In its letter to NAR, the Realty Alliance stated: "Our members favor and support a fair, free-market environment unbound by legislative restrictions. We find it hypocritical and fundamentally wrong to ask that national bank subsidiaries be barred from real estate brokerage activity, while real estate brokerages operate mortgage banking, insurance and title insurance businesses. . . . We believe, in fact, that consumers would benefit from the influx of capital that may result from nationally chartered banks entering this arena. We also believe that increased competition from companies of size would benefit consumers by making all of us sharpen our skills and improve the services we provide. In our view, the role of government is not to limit competition, as your legislation would do, but rather to foster a business environment in which consumers benefit from competition. The members of The Realty Alliance look forward to working, and prospering, in such an environment."

This is an Issue for All Banks*, Not Just Large Banks*

Despite the rhetoric about "big" banks, small banking organizations have a deep interest in this issue. *It is also a misconception that all national banks are large.* More than 40 percent of all banks—over 4,000 institutions—have fewer than 25 employees. As Chart 1 demonstrates, over ninety percent of national banks are community banks. These are truly small businesses that would like the option to broaden the financial products they can offer their customers and to compete with real estate firms offering loans and homeowners insurance.



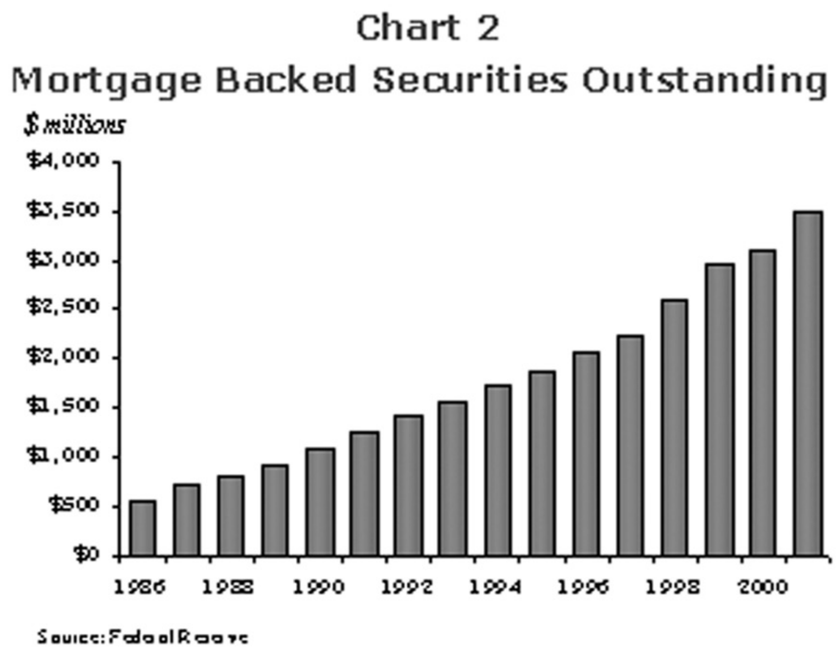
In fact, the ability to offer real estate brokerage may be more important for smaller institutions. Rural communities may lack real estate agents or are served only by branches of brokers in other towns because there is insufficient business to warrant a local brokerage office. In such small communities, the bank is perceived as the place that will have the greatest amount of information on what properties are for sale, including farmland acreage in agricultural communities.

As such, in communities where there are no real estate firms, community banks would typically contemplate establishing a subsidiary and hiring real estate brokers (fully subject, of course, to state real estate licensing provisions). In other instances, small banks are likely to partner with existing real estate brokers to provide these services.

Moreover, of the ten largest banking companies, four already have depository institutions which have authority to engage in real estate activities. There certainly has been no market disruption from the fact that well over half of the depository institutions in this country have the ability to offer real estate brokerage and management services today.

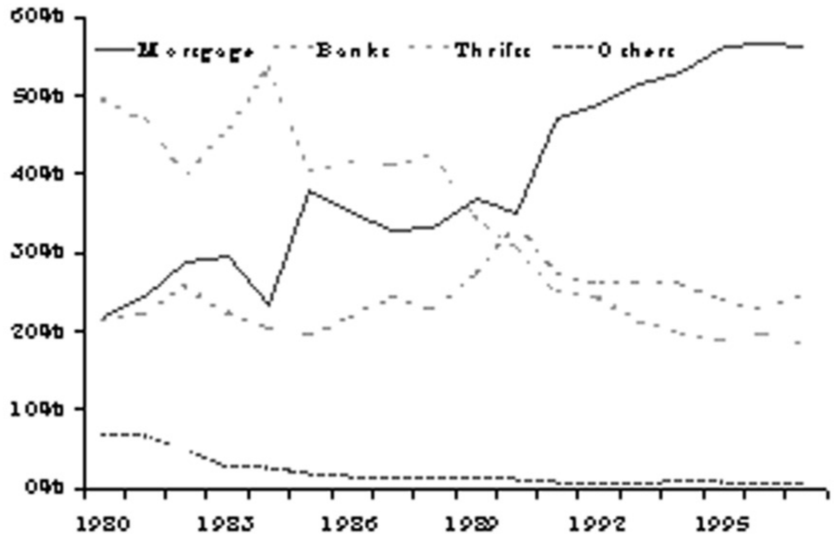
The GLB Act Was Designed to Allow Flexibility to Adjust to the Marketplace

Technological innovations have also had a dramatic impact on real estate markets. Perhaps the biggest change is the development of the secondary market for mortgage loans and the efficient process that bundles individual home loans into highly liquid, globally-traded securities (see Chart 2).



The increasing importance of the secondary market has facilitated the rapid growth of mortgage lending outside traditional banking and savings institutions (see Chart 3). In fact, securitization has significantly changed the very nature of mortgage funding, enabling real estate firms to establish their own mortgage companies and to offer end-to-end real estate transactions—helping a buyer find a home, finance it, and insure it. The result is that traditional deposit-based lenders—banks and thrifts—are often bypassed completely. These are exactly the kinds of technological changes the GLB Act authorized the Treasury and the Fed to address.

Chart 3 - Mortgage Originations



Source: MBA

The dominance of the secondary market is clear evidence that this form of funding for plain vanilla mortgage loans is generally superior in terms of costs to funding with bank deposits. If banks somehow enjoyed some special benefit from deposits, or deposit insurance (which banks pay for through premiums and extensive regulatory costs), banks would not be selling into the secondary market, and the secondary market would not control an ever-increasing share of the marketplace. More importantly, access to this secondary market source of funding is available equally to mortgage and banking organizations, and is clearly why real estate companies increasingly are affiliating with mortgage banking companies.

CONCLUSION

Mr. Chairman, increased competition clearly benefits consumers and the economy. It is a catalyst for innovation, more customer choice, better service, and competitive prices.

In fact, promoting competition in financial markets was the primary motivation for passage of the GLB Act. Congress also recognized the need for regulatory flexibility in an environment where the bright lines between financial activities and between financial providers has all but disappeared. Providing real estate brokerage and property management is no exception to this rule. We strongly believe that both real estate brokerage and property management meet the criteria set forth by Congress in enacting the GLB Act.

Not only would consumers benefit from bank involvement in real estate services, but also bank involvement is consistent with safe and sound banking. All consumer protections that apply to independent realtors would apply to bank-affiliated real estate agents—plus bank-affiliated agents would be subject to additional anti-tying regulations. And because brokerage and management are agency activities, they pose no financial risk to the safety and soundness of the banking organization.

I thank you, Mr. Chairman, for this opportunity to present the views of the American Bankers Association.

Real Estate Brokerage

State	Available	Subsidiary Required	Authorization	Citation
Alabama	Yes	No	Statute	5-5A-18
Alaska	No	No	Statute	AS 06.05.272(d)
Arizona	Yes	Yes	Statute	ARS 6-184(A)(7)
Arkansas	No	No	Not Authorized	NA
California	Yes	No	Statute	Cal. Corps. C. Sec. 206 and Cal. Fin. C. Sec. 751.3
Colorado	No	No	Not Authorized	N/A
Connecticut	Yes[1]	Yes[1]	See Footnote[1]	See Footnote[1]
Delaware	Yes	Yes	Statute	Title Five, Delaware Code § 761(a)(3)
DC	Yes[2]	NR	NR	NR
Florida	Yes	Yes	Statute	658.67(6), F.S.
Georgia	Yes	No	Statute & Regulation	7-1-261, operational powers of banks; Regulation 80-5-5
Guam				
Hawaii	No[3]	No	Wildcard	NR
Idaho	Yes	No	Wildcard	NR
Illinois	No	No	Not Authorized	N/A – Express prohibition exists within IL wildcard statute that grants parity with federal thrifts, among other entities
Indiana	Yes	No	Statute	I.C. 28-1-3.1
Iowa	Yes	No	Statute	Section 524.802
Kansas	No	No	Not Authorized	N/A
Kentucky	No	No	Not Authorized	N/A
Louisiana	No	No	Not Authorized	N/A
Maine	Yes[4]	No	Regulation	Maine 9B Section 131(6-A); 9B Section 446-A; Regulation #7
Maryland	No	No	Not Authorized	N/A
Massachusetts	Yes	Yes	Statute	G.L.c.167F §2 p. 25
Michigan	Yes	No	Statute	MCL 487.14104(1)
Minnesota	No	No	Statute is Silent	N/A
Mississippi	No	No	Not Authorized	N/A
Missouri	No[5]	No	Not Authorized	N/A
Montana	No	No	Not Authorized	N/A
Nebraska	Yes	No	Incidental Powers Regulation	Department Statement of Policy #9
Nevada	No	No	Not Authorized	N/A
New Hampshire	Yes[6]	No	Regulation & Wildcard	Ban 525, Federal Savings Associations Powers
New Jersey	Yes	No	Regulation	NJAC 3:11-11.5(a)(4)

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Real Estate Brokerage

State	Available		Subsidiary Required		Authorization	Citation
New Mexico	Yes		No		Wildcard	58-1-54
New York	No		No		Not Authorized	N/A
North Carolina	Yes		Yes		Statute	NCGS 53-47c(3)
North Dakota	No		No		Not Authorized	N/A
Ohio	No		No		Not Authorized	N/A
Oklahoma	No		No		Not Authorized	N/A
Oregon	No		No		Not Authorized	N/A
Pennsylvania	Yes		No		Parity Statute	7P.S. §201
Puerto Rico	No		No		Not Authorized	N/A
Rhode Island	No		No		Not Authorized	N/A
South Dakota	Yes		No		Interpretation	51-A-2-14(3)
Tennessee	Yes		No		Statute, Regulation & Wildcard	T.C.A. § 45-2-607(d); Regulation Chpt. 0180-19; 45-14-105
Texas	Yes		No- Preferred		Statute	Texas Real Estate License Act
Utah	No		No		Not Authorized	N/A
Vermont	No		No		Not Authorized	N/A
Virginia	No		No		Not Authorized	N/A
Washington	Yes[7]		No		Wildcard Authority	RCW 30.04.127
West Virginia	No		No		Not Authorized	N/A
Wisconsin	Yes		No		Statute & Regulation	221.0322 & DFI -Bkg#16
Wyoming	Yes		No		Statute	W.S.13-2-101(a)(xiii) & W.S.13-2-101(a)(xii)
SUMMARY	Yes	No	Yes	No		
	26	25	6	45		

NR: Not Reported.
N/A: Not Applicable.
[1] The activity is permissible through a subsidiary. It may also be conducted directly under the authority provided by the "closely related activities" statute [Sect 36a-250(a)(40) of CT General Statutes] or "wild card" statute [Sect. 36a-250(a)(41) of the CT General Statutes]. To date, The Department has not formally acted on any request to conduct the activity.
[2] The DC Office of Banking & Financial Institutions is presently modernizing its bank, mortgage banking, trusts, savings and loan, and credit union statutes, regulations and chartering requirements.
[3] Real estate brokerage is expressly prohibited by state law, unless otherwise allowed through wildcard authority because the activity is permissible for national banks.
[4] The Department would review on a case-by-case basis and refer to Sections 416 and 419-A of the Maine Banking Statute, together with Regulation 7.
[5] Depository Trust Companies have real estate brokerage powers under 362.105

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[6] Effective March 16, 2001, Ban 525 allows commercial banks, trust institutions and savings banks to engage in activities and make any investment in the same manner and to the same extent that the activity is permissible for federal savings associations.
[7] See also the following: Pursuant to RCW 30.04.215(3), 32.08.140(16) and 32.08.146, banks can perform the same activities federal banks can, provided that the activities are approved by the Director of the Department of Financial Institutions.

NOTE: The data included in this table is provided for information purposes only. It should not be construed to be legal guidance.

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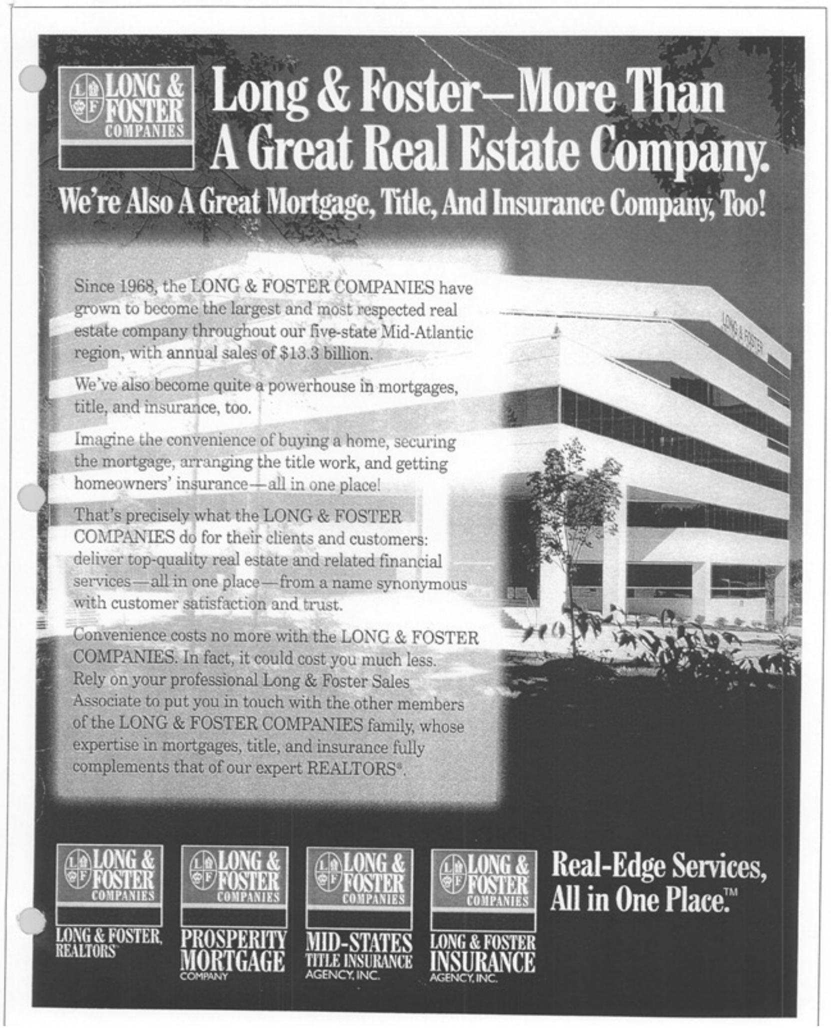
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Long & Foster—More Than A Great Real Estate Company.
We're Also A Great Mortgage, Title, And Insurance Company, Too!
Since 1968, the LONG & FOSTER COMPANIES have grown to become the largest and most respected real estate company throughout our five-state Mid-Atlantic region, with annual sales of $13.3 billion.
We've also become quite a powerhouse in mortgages, title, and insurance, too.
Imagine the convenience of buying a home, securing the mortgage, arranging the title work, and getting homeowners' insurance—all in one place!
That's precisely what the LONG & FOSTER COMPANIES do for their clients and customers: deliver top-quality real estate and related financial services—all in one place—from a name synonymous with customer satisfaction and trust.
Convenience costs no more with the LONG & FOSTER COMPANIES. In fact, it could cost you much less. Rely on your professional Long & Foster Sales Associate to put you in touch with the other members of the LONG & FOSTER COMPANIES family, whose expertise in mortgages, title, and insurance fully complements that of our expert REALTORS®.
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BAIRD&WARNER

The largest independent real estate broker in Illinois, with more than $4 billion in annual sales.

The nation's oldest real estate company actually started in the financial arena nearly 150 years ago, when Baird & Warner began making loans on downtown Chicago properties. We continue to play a dominant role today, with Key Mortgage Services and its subsidiary, North Shore Mortgage, closing more than $500 million per year in residential mortgage loans — ranking among the top five mortgage companies in Illinois. Baird & Warner is once again leading the field, offering the convenience of "one-stop shopping" for a wide variety of real estate-related services.

Emphasis added
Source: http://www.bairdwarner.com/about/default.asp

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The nation's largest individually owned real estate company, with over 370 loan products to choose from, including Conventional, FHA, and VA loans.

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*To participate, the buyer must elect to use Weichert Financial Services to obtain a mortgage, Weichert Insurance Agency to obtain homeowners insurance and Weichert Title Agency or Weichert Closing Services to obtain title insurance.

Emphasis added
Source: http://www.weichert.com/

Mr. BARR. As I mentioned earlier, the entire testimony—the entire written testimony of all of the witnesses will be submitted as part of the record; and, again, any additional testimony or information you all wish to make a part of the record, please feel free to do so for up to 7 days following this hearing during which time the record will remain open.

I would like to recognize—we have been joined by a couple of other Members of the Subcommittee, including our distinguished former Chairman, the gentleman from the Commonwealth of Pennsylvania, Mr. Gekas. Did you have an opening statement, Mr. Gekas?

Mr. GEKAS. I will waive that, Mr. Chairman, and await the question period.

Mr. BARR. Very good.

There being no other Members that have not had an opportunity for an opening statement——

Ms. WATERS. Mr. Chairman, I would like unanimous consent to submit my real opening statement for the record.

Mr. BARR. Without objection, so ordered.

[The prepared statement of Ms. Waters follows:]

PREPARED STATEMENT OF THE HONORABLE MAXINE WATERS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Thank you, Chairman Barr, for holding this hearing to look at the Rulemaking Process used in making the Proposed Rule Concerning Competition in the Real Estate Brokerage and Management Markets. It is important that we focus our attention on that process to be sure that it is done in an appropriate and legal manner. I look forward to hearing the testimony of the witnesses.

I especially am concerned that the process used to develop this particular rule was done properly, because the Rule could potentially have a devastating impact on consumers. Under this Proposed Rule, banks would be allowed to enter into the real estate business. This would constitute a true breach of the division between banking and commerce. That separation has been a hallmark of U.S. banking law since the Great Depression, and is critical to ensuring that this country does not end up following the Japanese system model. There, the indiscriminate mixing of banking and commerce arguably has had disastrous consequences for the banking system and the economy as a whole. During consideration of financial modernization, we looked at this issue and Congress decided to maintain our tradition of separating banking and commerce.

Some parties have advocated in favor of permitting banks to engage in real estate activities. I am very concerned that we would be embarking on a slippery slope if real estate brokerage activity is considered a financial activity. Where would it end? Would appliances, cars and anything purchased with a credit card be deemed "financial in nature?"

As a result of these concerns, I became an original cosponsor of H.R. 3424, the "Community Choice in Real Estate Act." HR 3424 will make it clear that banking and commerce should not be mixed and will prevent financial institutions from engaging in real estate management and brokerage. These activities are not "financial in nature" and should not be conducted by financial institutions. HR 3424 will prohibit federal regulators from issuing regulations that would permit banks to engage in real estate activities.

This legislation will protect consumers and small businesses operating in our communities. If big banks were allowed to enter the real estate business, it would lead to industry consolidation, higher costs and fewer choices for consumers, and conflicts of interest for the lenders and brokers. HR 3424 will ensure that consumers maintain choices and control in their real estate transactions.

I understand that the comments received by the Federal Reserve and the Treasury have been overwhelmingly negative. In 1971, a similar Proposed Rule was not made final in part because of a substantial amount of negative public comment. It is my hope that this Proposed Rule will follow a similar course.

Mr. BARR. We will now proceed with questions in 5-minute increments, and the Chair recognizes himself for 5 minutes.

Ms. Bair, with regard to the various different laws and executive orders that have to be taken or that must be taken into account by an executive agency prior to issuing a proposed rule, as you know, Executive Order 12866 requires agencies to submit rules that would constitute a significant regulatory action to the Office of Management and Budget. Would this proposed rule have an annual effect on the economy of more than $100 million?

Ms. BAIR. The previous leadership of the Treasury Department, which issued this rule jointly with the Federal Reserve Board, determined that this was not a significant regulatory action, thus did not do a cost-benefit analysis. If and when we proceed with this rule, we will have to revisit that determination.

Mr. BARR. Thank you.

Do you know whether the proposed rule was submitted to the Office of Management and Budget for a cost-benefit analysis under Executive Order 12866?

Ms. BAIR. It was. They did not exercise their authority to review it.

Mr. BARR. Thank you.

The Regulatory Flexibility Act requires agencies to consider the small business impact of proposed rules when they are noticed for public comment. Are most real estate brokers considered small business, Ms. Bair?

Ms. BAIR. Again, I have no record basis on which to answer that question. Because when this rule was issued under the prior administration, a determination was made that it would not have a significant economic impact on a substantial number of small businesses. Again, we will be required to revisit that determination, make it—look at it again if and when we go to a final rule on this.

Mr. BARR. Thank you.

Mr. Edwards, being at least tangentially familiar with the real estate business yourself, could you provide some enlightenment to the Subcommittee with regard to the nature of most REALTORS® in terms of the number that might be affected by this proposed rule if it does go into effect and the nature of those REALTORS®, their size, and would they be considered small businesses?

Mr. EDWARDS. Thank you, Mr. Chairman.

First of all, most REALTORS® are independent agents or independent contractors. So if you really want to go to the heart of the issue, each one of them is a small business. They are not—by great margin, they are not employees. They are free—they are independent contractors. So they are, by your definition, a small business onto themselves.

Also, from a firm size, the individual firm size, about 80 percent of our firms across the country are less than 10 or 12 members, something like that. So it is, for sure, a very significant small-business business.

So if you want to just say it one way, you know, every agent that is an independent contractor is a small businessperson, but then the firms themselves which hire independent contractors are small businesses, the great preponderance of them.

Your second question? I am sorry.

Mr. BARR. I was wondering if the National Association of REALTORS®, have they made an analysis with regard to the overall impact on the economy of the proposed rule? As you know, we mentioned in my question to Ms. Bair the hundred million dollar threshold. Have you all done an analysis to determine whether that would be a—whether that threshold would be met if this proposed rule goes into effect?

Mr. EDWARDS. That is a question that I do not have an answer to. I will tell you that over the last several years, and this is a direct—this is a result of the marketplace as much as anything else, we have—over the last 8 years we have added 11 million new homeowners. We have—home ownership is up, has increased to about 68 percent. There has been about a 44 percent increase in minority ownership.

But for me to be able to tell you how it would be affected, I do not have that answer. It would be a pretty good-sized undertaking, I am sure, to do that, because you have to figure out how many of those independent contractors would be removed from business.

Mr. BARR. It might be a worthwhile exercise to go through that.

Mr. EDWARDS. It would be a big exercise, but I think it would be a very worthwhile exercise.

Mr. BARR. Ms. Bair, there is, of course, the many other different laws that are applicable or might be applicable to the rulemaking procedures. Is the Negotiated Rulemaking Act—is this something that the Federal Reserve Board or, in the case of your expertise and jurisdiction, the Department of Treasury would consider utilizing when looking at this proposed rule in an effort to try and bring the parties together and see if there is a consensus that could be reached?

Ms. BAIR. Yes. Anticipating that, I consulted with the career staff who were involved in the preparation of the original proposed rule for publications. To our knowledge, that issue was not considered at the time it was proposed. I would have to consult with our general counsel to determine whether that is a process, given the current state of the rulemaking, that we could utilize. But it is a fair question. I will be happy to consult with them and get back to you in writing.

Mr. BARR. Thank you. We appreciate that.

Recognize the distinguished Ranking Member, the gentleman from North Carolina, for 5 minutes.

Mr. WATT. Mr. Chairman, I think that I do not have any questions. I am happy to yield back. Or if the Chairman has a series of questions that he wants to ask, I am happy to yield him my time. Either way is fine with me.

Mr. BARR. I appreciate very much the gentleman's eloquence. What we will do is proceed. If myself or any other Members have additional questions, we will have a second round. So if there are some other things you think of, Mr. Watt, certainly just jot them down, and you will have more time.

Mr. WATT. I yield back.

Mr. BARR. The gentleman from Arizona, Mr. Flake, is recognized for 5 minutes.

Mr. FLAKE. Thank you, Mr. Chairman.

Mr. Edwards, one of the arguments that is raised against this is that if banks get involved in the real estate business they default, taxpayers are on the hook. Do you want to—because of FDIC. Do you want to elaborate on that?

Mr. EDWARDS. Mr. Flake, I would be happy to.

I happen to have been in the business, as I said, 30 years; and I went through the savings and loan issue in the late 1980's. The real estate business is not in—my firm is not insured by any Federal agency. And when we in our business—our capital comes from at-risk capital. So if we make a mistake, we don't do something correctly or we get—we expand our business, we are in the commercial business too far, we pay for it.

We went through a series of years in the late 1980's and early 1990's where we did have an industry—and, as a matter of fact, it was a very significant industry for the real estate industry—in the financial world called the savings and loans. There are a few left. But I felt at that point in time that some of those expanded powers that were given to savings and loans got them in a position where there was a lot of default.

Certainly, there were other areas that caused that huge bailout, as we will call it, that has been probably totalled at $500 or $600 billion. Our concern is that the banking industry——

And let me just say this. I started off as a bank. You know it is an insured—that capital comes from insured deposits. My capital comes from borrowing from those banks. So it would be hard for me to say that I don't fear—I fear that mixing banking and commerce is something that I don't think this country is wanting to do or willing to do, and I would question what is broke that we are trying to fix.

Mr. YINGLING. Can I comment?

Mr. FLAKE. Yes. You mentioned that half of those who can already engage in real estate are federally insured. Do you want to expand on that? Or several organizations or institutions?

Mr. YINGLING. Right. Thank you.

First, with respect to deposit insurance, this is an agency activity. It is not a principal activity. And, as the Members of the former Banking Committee, now Financial Services Committee, could tell you, there is a big difference with respect to agency versus principal activity. That is because you don't make big investments.

We are not talking about owning any homes here. We are not talking about real estate development. In fact, it is interesting that the Congress specifically said, there is one thing you cannot do, and only one thing in this law we are talking about; that was real estate development.

Second, under this proposal, the bank can't do it. It has to be done in either a subsidiary of the holding company or a subsidiary of the bank. Under banking rules, those subsidiaries are walled off. They are not subject to the use of deposit insurance, and they are protected from the bank. So there is series of protections to wall them off.

Now, with respect to the rights of others to do it today with respect to insured depository institutions, not under this rule but under current law in 25 States, State-chartered banks have this authority, as do all Federal savings institutions. You would not know whether it was a commercial bank or a savings institution if you walked in the door. They can all do it. All Federal credit unions can do it, and a lot of State-chartered savings institutions and credit unions can do it. The only group that really can't do it are national banks and those State-chartered banks in the States which have not yet given them that authority.

Mr. FLAKE. Thank you, Mr. Chairman. I yield back.

Mr. BARR. Thank the gentleman from Arizona.

The gentlelady from California is recognized for 5 minutes for any questions.

Ms. WATERS. Thank you very much, Mr. Chairman.

Some of this may have been answered, but I think it is very important for me to delve into it a little bit more.

As I understand it, the act is silent on this particular question; is that correct?

Mr. YINGLING. It is correct that the act nowhere uses the word real estate brokerage, correct.

Ms. WATERS. At no time, no place does it use that word. And it seems to me that the fact that we are now trying to determine whether or not real estate brokerage and management activities are financial in nature kind of bypasses the work of Congress in some way. It seems to me that this is not simply a gray area to be decided through rulemaking. It seems to me this is a question for the Congress of the United States in the same process that passed the act in the first place to come back if it has to be revisited and go through the Congress of the United States.

How, in fact, did we get to the point where we are asking the Board of Governors of the Federal Reserve and the Secretary of the Treasury to get involved in this? How? Would you explain, please, Ms. Bair?

Ms. BAIR. The Gramm-Leach-Bliley Act delegated fairly broad authority to the Treasury Department and the Federal Reserve Board to determine what activities are financial in nature or incidental to a financial activity. There are some factors that are listed that the Treasury and the Federal Reserve are required to consider in making that determination. But the delegation of authority is fairly broad.

Ms. WATERS. Have you ever had a question put before you that you refused to deal with and say we think that this question does not fall within our jurisdiction, that you are asking us to decide on something that really should be decided by Congress? This is not——

Ms. BAIR. Under Gramm-Leach-Bliley or in general?

Ms. WATERS. In general.

Ms. BAIR. I would like to consult with our attorneys.

Ms. WATERS. Have you ever turned one down because you didn't think it was within your authority?

Ms. BAIR. I can't cite you any specific examples. I mean, clearly if we were petitioned to promulgate a rulemaking that we felt outside of our congressionally-delegated authority we would decline to do so. We can't off the top of our heads think of any specific examples where that has happened, but they may have.

Ms. WATERS. Well, then, could you specifically tell me why you think this is within your authority?

Ms. BAIR. Because—well, again, I think one of the issues we will have to decide as we proceed with this rule, a lot of the comment letters, most of them in opposition, raised the issue whether we were mixing financial banking and commerce, which would be, if that is what in fact the rule entailed, that would be exceeding the delegation of authority. But Congress is fairly clear about wanting to maintain that separation. However, the devil is in the details, and definitely not a lot of guidance is provided.

Again, on the face of it, the grant of authority to us and the Fed to determine what is financial in nature as opposed to a commercial activity is fairly broad. But I think that is exactly a key issue that we will have to decide if and when we go final with this rule.

Ms. WATERS. Let me suggest something to you. Let me suggest to you this would be an economical, financial, structural change in the way we do business in this country. This is big. This is not simply a gray area where a decision by regulatory agency would decide a structural change.

I would suggest to you that this could have such a huge economic impact that the Congress of the United States is the only body that should be in the business of deciding whether or not we want to make this structural change.

I would suggest to you that it is absolutely reasonable to take a look at this and the regulatory agencies turn it back and say, this is too big. This is out of our authority. We should not be involved in this. If you people over there want to do this, then you had better come out with a law that spells it out, but don't throw this in our laps. I think you would do yourselves a big favor, and you would do all of us a big favor.

Because I really do believe that it is not specifically addressed in the act. You don't see it anywhere. And I think that for those who are trying to make this change, they shouldn't be able to hide behind the act and say, somehow you have the right to determine whether or not this is financial activity.

Wash your hands of it. Get rid of it. Put it back over here. We will take care of it.

Mr. YINGLING. Ms. Waters, I don't want to take your time. On your question about kind of the history of it, again, this provision amends section 4 of the Bank Holding Company Act. There is a long history to that. It was under the Fed's jurisdiction totally. Now, this new procedure, you have to have two approve it, the Fed and the Treasury.

Now, during that history there was something called the closely related to banking test that I am sure you are familiar with. And from time to time the Fed approves things, and from time to time they turn down approvals. And there are instances where they first turned them down, then as the market changed they approved them.

Now, in the House Banking Committee, as the report said in 1999 when they did Gramm-Leach-Bliley, they indicated they were building on that history. And what they said about this section is, "it greatly expands permissible activities for bank holding companies from the current requirements in section 4 that affiliations be closely related to banking to those that are financial in nature."

So it is clear, at least to me, that what the Congress was saying is, we are going to build on that. We cannot decide in advance, just like we couldn't in 1970 when we enacted this, what is appropriate. And when we try to do that we get gridlocked. So we are going to delegate that to these two agencies, which is more conservative than one, and have this new test.

But there is a precedent under which they approve it. They sometimes turn it down. And that is what the Committee, I believe, was building on and what the legislative history would show.

Ms. WATERS. Reclaiming my time. I suppose that is a fair interpretation, you know, based on your point of view. But again, I don't think so. I don't agree with that at all. Again, even if the act refers to expanded authority and to two agencies in order to ensure the kind of review that you may be alluding to, again, this is a structural change in the economic business of this country.

This is big. This is not simply something that we say, oh, we think that falls within. No. It has got to be clearly legislated by the Congress of the United States, in my opinion, in order to take a whole industry and literally undermine it and open up opportunities for others who will be in an advantaged position. If I got a bank and I can sell real estate, I am in a very good position to be able to grab all of the business. Because the REALTORS® don't own banks for the most part. They are shopping. They are helping their clients to connect.

And that is another thing. I am hoping—as I have seen real estate agents who can help their clients find the best financial services for them to be able to shop around. If I am stuck with a bank, I don't know, you may be a predatory lender, you may be giving me interest rates that I could do better if I didn't have—I was not your captive coming to your bank. I may can pay a lot less in charges, in fees and on and on and on. I don't know if I want you to have that much power.

I think it is very important to have this kind of separation by way of distant industries so that that real estate person out there who is the advocate for the buyer remains in position to be able to not only assist the buyer but to help that buyer make good decisions about the financing and to get them the best buy. So this is not a little gray area where you think that perhaps that is what we intended.

I think that it is a good thing that we are having this hearing today, because it gives us an opportunity, having been able to see some of this, to talk about how we grab this back, Mr. Chairman. As Members of the Financial Services Committee in this House, we need to take it out of this arena altogether.

Thank you for the extended time.

Mr. BARR. I thank the gentlelady from California.

The Chair now recognizes the distinguished former Chairman of the Subcommittee, the gentleman from Pennsylvania, Mr. Gekas.

Mr. GEKAS. Yes, I thank the Chair.

I recall in the former life of this Subcommittee that we engaged, back in 1996, in reauthorizing the rulemaking—how did we phrase that—the Negotiated Rulemaking Law, which was, I thought, intended to try, at least at the outset, to deal with these kinds of problems. And, Ms. Bair, did that ever come into play at all? Did anyone suggest that, in this issue, that the negotiated rulemaking process should come into play?

Ms. BAIR. Again, this rule was proposed under the previous administration. I was not there when the rule was proposed. My consultations with the career staff that were involved have suggested to me that, no, that was not considered. And I can't—since I wasn't there, I really don't know. I can't tell you much more.

Mr. GEKAS. Since you took office, you don't remember any one proposing this or falling back to a negotiated rulemaking posture before future action should be taken?

Ms. BAIR. In response to Chairman Barr's expression of interest, we are going to take a look at whether at this stage in the process that is something that can be utilized, but we will have to get back to you in writing.

Mr. GEKAS. Then maybe we can add your comments to this hearing book later on.

Mr. GEKAS. One thing that fascinated me, Mr. Yingling, when you were describing how the separation of entities within banking places a firewall, some separation between the banking portion and that which would take up real estate in the future under this rule, in other words, you would be—you are saying that, in effect, it is an arm's-length transaction with another entity created in different ways. That is really not the bank itself. Is that what you were trying to imply?

Mr. YINGLING. Well, there are two aspects. You may be raising both of them.

I was responding to the question about, really, safety and soundness; and there are a whole series of rules which are used to segregate activities in affiliates and subsidiaries from the bank. The whole purpose of those rules is to protect the deposit insurance fund. For example, there are very strict limits on the ability of a bank to lend to any of its affiliates. And there are rules about how much you can lend and what interest rates have to be. In other words, they have to be arms-length, as you say. There also are a series of rules that relate to the ability to cross-market and that type of thing.

Now there is one set, the Real Estate Settlement Procedures Act, which actually applies to all real estate transactions and would apply to a bank with a real estate affiliate. It also applies, for example, to Long & Foster here in this area, which has a mortgage bank and has an insurance company. They are also subject to those rules that protect consumers. For example, nobody can tell a consumer, if you are going to use me as the REALTOR®, you have to use my mortgage company. Long & Foster couldn't do it. A bank couldn't do it.

Now, in banking, there actually is another rule, a specific anti-tie-in rule which applies only to banks, which basically says, I can't tell—I, the bank, can't tell you, the customer, that if you are going to get a loan from me, you have to use this service. I can't tie those services.

Mr. GEKAS. But the fact remains that you are trying, in the way you described it, to demonstrate that banking as the principal would not be engaged in all of the necessary functions of the real estate portion under a subsidiary. Is that correct?

Mr. YINGLING. Well, the bank itself couldn't. This would have to be a separate company that would be a regulated like any other real estate firm.

Mr. GEKAS. What you have described, sir, it seems to me, is what the situation is today. That is, banking and real estate, and that the wall that you are talking about to allow this separation of activities and protection for consumers and all of that exists under the current market system in which real estate people and the bank are separated by a wall of noncompetition, as it were.

So I want to analyze—and I haven't really thought it through fully—how the holding company, the separation you are talking about and so forth really benefits banking anyway, if they are going to be talking about separate entities and separate bottom lines and separate rules and separate corporate officers and all of that. Maybe we should leave it as it is, because that is what the situation is now.

Mr. YINGLING. If I might comment. I don't want to use up all of your time. Let me just give you an example of what we hear from a community bank, and that is that in a small town in Pennsylvania it could be that——

Mr. GEKAS. Why did you say Pennsylvania?

Mr. YINGLING. It seemed like a good State in my hypothetical—that what may have happened is there may be four or five independent real estate firms a few years ago that are doing quite well. Then one of them has been bought by Century 21. One of them has been bought by Prudential. There is a tremendous amount of consolidation. So what is happening to the local bank is that, as the customer—it may be a new person that moved to town or it may be an existing bank customer—goes to buy a home, they go to the REALTOR® first. The REALTOR® now is affiliated with somebody that has a mortgage arm, an insurance arm. The bank never sees the customer. The customer goes and buys the house. The bank never has a chance to make the loan, never has a chance to sell the insurance.

So what they may want to do is in some fashion go to one of the remaining independent REALTORS®. That remaining independent REALTOR® may be saying, I am having a little trouble because I have got these deep-pocket companies now that can market like crazy; and the two of them might want to get together. They could become affiliated. The bank could make an investment in the real estate firm. Quite frankly, what they want to be able to do is say to each other, I have got a customer here who wants to buy a house. You would have a chance to make the loan. You would have a chance to sell the insurance. So that's what they want to be able to do, basically, is not lose the entire customer.

Mr. GEKAS. Do you endorse the concept of an independent REALTOR®?

Mr. YINGLING. Sure.

Mr. GEKAS. And, therefore, the structure that you described to me, which I have to delve into farther, maybe, with your help, results—if this rule were to become effective, results in a bank with a wall, with a subsidiary, that deals as an independent REALTOR®, in effect; is that correct?

Mr. YINGLING. That is largely correct. We would be subject to all of the State rules. But we would own—we would have an investment—the bank, if I am the bank, has an investment in the REALTOR®, or the realty firm could have an investment in the bank, or the bank could own the realty firm. But they would be subject to all of these kind of firewalls and consumer protections that I am talking about.

Mr. GEKAS. Well, I think we are talking about the same thing in different terms.

I yield back the balance of my time.

Ms. WATERS. Will the gentleman yield?

Mr. BARR. We will have another round of questions. Will that be sufficient? We will have a second round of questions, and I will recognize myself for 5 minutes.

One of the matters that we sort of touched on a little bit—I think it comes into play certainly in my mind with the last questions between Mr. Yingling and Mr. Gekas—are privacy concerns with this legislation. Of course, one of the—Mr. Yingling, there has been pressure to revisit the privacy aspects of Gramm-Leach-Bliley; and a number of us have resisted that as being premature, preferring to let a couple of years go by, during which time all of the different provisions of Gramm-Leach-Bliley could be, you know, allowed to sort of run their course and we will see how they work before going back in and tinkering, upsetting the apple cart as it were, by retinkering with the privacy provisions of the bill. And the banking industry has been supportive of that approach.

Given the fact that, I think, any way you look at it, this is—as Ms. Waters said, this is a very significant proposal before the American people now. And already, because I think of the complexities of it and the issues raised and the amount of public comment, the Treasury and the Fed are taking a considerable amount of time, as I think that they should, to look at it, make sure the process operated properly, make sure that substantially it is good or bad to proceed.

What will be wrong to take the same consistent approach with regard to this that the banking industry has taken with regard to privacy? Let's see how the provisions of Gramm-Leach-Bliley operate for a few years before we immediately go back in and try and reconfigure it and tinker with it. Will there be a great harm in allowing the procedures as are already implemented through the passage of the bill and the signing into law operate for a while before we address this very important issue?

Mr. YINGLING. Well, first of all, that is one possible response of the agencies. I referred in my discussion with Ms. Waters to the history of the Bank Holding Company Act and the Fed; and there are instances wherein the Fed said, we will delay starting for a while or we will start small. If you look at the history, for example, of bank holding company entry into the securities area, that was done.

One of our big concerns here, though, is that this section of Gramm-Leach-Bliley is, in our opinion, the heart and soul of it. And the purpose, we believe, of Gramm-Leach-Bliley was to set up a process to permanently keep our——

Mr. BARR. Excuse me. Do you mean to say that allowing banks to involve themselves directly in real estate brokerage and management is the heart and soul of Gramm-Leach-Bliley?

Mr. YINGLING. The general provision that we are talking about under the statute, the financial and incidental to financial section. Because it is the provision under which we will be able, for the foreseeable future, to go back and look at what happened in Glass-Steigel, that future turned out to be about 60 years long.

Mr. BARR. But my point was, is there any harm that would ensue? In other words, the banking industry, I think correctly, has told those who want to go in and tinker with Gramm-Leach-Bliley even a year or a year and a half ago on privacy issues that the position of the banking community was, hold on, let's not tinker with this thing. Let's see how this law plays itself out. Correctly, I think, arguing that there would be harm if, you know, somebody went in and did the opposite.

What harm would befall the banking industry if this rule—this proposed rule, you know, did not go into effect immediately but we have a couple of years at least to see how the provisions of the bill—as you say, if the heart and soul of it, let's assume, is the breaking down of the barriers between financial and commercial, at least to some extent, let's see how that operates first.

Mr. YINGLING. Well, first, I want to add, we appreciate what you do in the area of privacy. But first there is a distinction there. We are talking about the Congress coming back and legislating. Here we are talking about the regulators implementing a part of the law.

Mr. BARR. We have already seen—you might be pushing Congress to come in and legislate. There are a number of ways that that might happen. Of course, the legislation currently before the House. In addition, the Congressional Review Act, which could come into play if, in fact, the Administration makes a final determination to move forward with the proposed rule and finalizes it. The Congressional Review Act could come into play, as it did about a year and a half ago with regard to the ergonomics rule.

So there are a number of areas where I am not sure that you—I certainly can't tell you what to do, but you are almost pushing Congress into acting in an area, whereas maybe it would be better to just wait a little while to see how the bill plays itself out.

Mr. YINGLING. One of our big concerns is the precedent here. This is the first attempt to implement what this section which we are arguing is the heart and soul——

Mr. BARR. It is a big one.

Mr. YINGLING. It is a big one. But if Congress enacts something that says we intend for the regulators to have a process for modernizing the system and we don't want to be in the position of referring that every time there is a new proposal and the first one out of the box gets basically beat back, how are we going to ever test it? Because the next one out of the box——

Mr. BARR. You might take a small step first, instead of a giant leap for mankind.

Mr. YINGLING. It is taking us—it is taking a long time, I would point out. And just—since we are allowed to get into it, Ms. Waters, maybe the alternative—maybe the equal of that is, if real estate firms would stop getting into the mortgage business and the insurance business during that period, maybe there is a deal there.

Mr. BARR. You heard it here first. There is room for a deal.

Mr. YINGLING. I said maybe.

Mr. BARR. We do hope—that is one reason why several of us have mentioned the Negotiated Rulemaking Act, which was a mechanism that was passed a dozen or so years ago and reauthorized, which would seem, at least on the surface, to have been a mechanism that might lend itself more to this.

But, anyway, I have a few more questions, but I don't want to monopolize the time.

The gentleman from North Carolina is recognized.

Mr. WATT. Is the Chairman trying to finish and avoid coming back, or are you planning to come back anyway?

Mr. BARR. I am informed that we do have a vote. What we might try and do is, we have maybe just 5 or 7 more minutes, and then, you know because I don't want to keep the witnesses—and, you know, I also want to recognize we do have many REALTORS® in town. We very much appreciate you all being here and participating in this public process. My admonition before not to applaud had nothing to do with all of us being very pleased with you all being here. It is just normal protocol in our Committee hearings. But we do very much appreciate you all being here in town and coming by today.

Mr. WATT. Are you planning to come back?

Mr. BARR. No. What I would like to do is finish up.

Mr. WATT. Okay. All right. Let me just ask Mr. Edwards and Mr. Yingling a question which I think they probably will not have the information readily available to answer. But I would ask you to submit the information just so we will have a complete picture here.

I think this mortgage loan origination chart indicates that there is 1 percent real estate firms currently doing banking or lending origination activities. It would be interesting for me to know how unprecedented what is being proposed here is, to have the reverse of that, which would be the number or percentage of real estate transactions that are currently being originated by non-national banks and other financial institutions.

Mr. Yingling testified that there were a number of State-regulated banks, non-Federal financial stations that are authorized now to do real estate. Just for the completeness of the record, it seems to me we—it would be good to have a chart that basically tells how much banking is now doing real estate, as opposed to how much real estate is now doing banking, just for completeness.

Mr. EDWARDS. Mr. Watt, I think we have that information. We would be glad to supply it to you.

Mr. WATT. If you all could—then we could compare you-alls two charts, and hopefully they would correspond—but might not necessarily.

Mr. YINGLING. While we are at it, we would like to take an opportunity to maybe do our own chart. Because that 1 percent really puzzles us. Because, for example, Cendant is one of the largest mortgage lenders in the country.

Mr. WATT. I would invite you to do that, too. If there is a counter chart that you want to originate. That would be helpful.

Other than that, Mr. Chairman, I would just ask unanimous consent to insert for the record a statement which has been submitted by the Financial Services Roundtable, so we will have that in the record, and a copy of a news article from Inman News Features dated February 22, 2002, about, apparently, some real estate—REALTORS® who may be on the opposite side of this issue, so we will have that on the public record, also.

Mr. BARR. Without objection, so ordered.

[The information referred to follows:]

ARTICLE FROM INMAN NEWS FEATURES, DATED FEBRUARY 22, 2002

Bring on the banks!

The Realty Alliance opposes Realtors association effort to bar banks from brokerage

Friday, February 22, 2002

By Marcie Geffner
Inman News Features

The Realty Alliance, an organization that represents many of the nation's biggest names among independent residential real estate brokerage companies, has taken a stand against legislation pending in Congress that would bar banking institutions from getting into the real estate brokerage business. The group's position reveals a stunning level of dissention within the National Association of Realtors' membership on the issue of whether the business should be opened to new competition from the financial sector.

Realty Alliance Chairman Richard Christopher, CEO of Patterson-Schwartz Real Estate in Hockessin, Del., on Feb. 8 sent a letter by overnight mail to NAR 2002 President Martin Edwards Jr., along with a copy of a white paper, "Why the Real Estate Industry Should Allow Banks to Enter the Business."

The letter calls NAR's position "hypocritical," "fundamentally wrong" and "objectionable" because it would bar banks from real estate brokerage activity even though brokerages operate mortgage banking, insurance and title insurance businesses and certain state-chartered banks and subsidiaries of the Federal Savings & Loan Association are permitted to engage in real estate brokerage.

The letter also warns that NAR's legislation—if it proves successful—could trigger "retaliatory" legislation from the banking industry. "If federal banks were indeed prohibited from engaging in real estate brokerage, how long would it be before the powerful banking lobby took steps to prevent real estate brokerages from participating in the mortgage banking, insurance and title insurance business?" the letter asks.

The letter also argues that allowing nationally chartered banks into real estate brokerage would increase competition, attract more capital to the industry and benefit consumers. "Increased competition from companies of size would benefit consumers by making all of us sharpen our skills and improve the services we provide," the letter said.

The letter closes with a not-so-subtle warning that NAR's failure to reconsider its position could result in "a breakdown of the relationship between The Realty Alliance and NAR."

Charles McKee, CEO of The Realty Alliance, said the group hasn't received a reply from the Realtors' association.

McKee also said alliance members are taking their message directly to members of Congress and that the white paper already has found its way to the hands of some influential representatives.

The Realty Alliance is comprised of 44 companies with 62,000 sales associates who closed more than 800,000 home sale transactions last year, according to the group. The membership roster includes Arvida Realty Services in Clearwater, Fla., The DeWolfe Cos. in Lexington, Mass., Ebby Halliday Realtors in Dallas, Texas, Edina Realty in Edina, Minn., F.C. Tucker in Indianapolis, Ind., First Team Real Estate in Costa Mesa, Calif., Fonville Morisey Realty in Raleigh, N.C., Frank

Howard Allen in Novato, Calif., Howard Hanna Real Estate in Pittsburgh, Pa., John L. Scott Real Estate in Bellevue, Wash., The Keyes Co. in Miami, Fla., Latter & Blum Cos., in New Orleans, La., Long & Foster Real Estate in Fairfax, Va., Michael Saunders & Co. in Sarasota, Fla., Prudential Fox & Roach in Devon, Pa., Real Living (formerly HER Realtors) in Columbus, Ohio, Royal LePage in Canada, William Raveis Home-Link in Southport, Conn., and Windermere Real Estate in Seattle, Wash.

McKee said 37 of the Alliance's 44 member companies agreed with the decision to oppose the legislation. He declined to name which of the companies took no position or supported NAR's position on the matter.

The NAR-supported legislation—H.R. 324 and S. 1839—would block a proposal by the Federal Reserve and U.S. Treasury that would define real estate brokerage as a financial activity, opening that business to banking institutions under the Gramm-Leach-Bliley Act of 1999. The regulatory proposal has been on the table and the subject of intense debate in both industries since early last year.

NAR has waged an all-out effort to "stop the big grab" by the banks. The latest tactic is a newspaper advertising campaign that's intended to spark a consumer movement in favor of NAR's position. The print ads urge consumers to contact their Congressional representatives and ask them to co-sponsor the legislation.

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PREPARED STATEMENT OF THE FINANCIAL SERVICES ROUNDTABLE
(WITH ATTACHMENTS)

The Financial Services Roundtable ("Roundtable") appreciates the opportunity to submit testimony on the proposal by the Federal Reserve Board ("Board") and Treasury to allow greater competition in the real estate brokerage industry by permitting financial holding companies and national bank subsidiaries to enter the business. The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO.

Roundtable member companies provide fuel for America's economic engine, accounting directly for $12.4 trillion in managed assets, $561 billion in revenue, and 1.8 million jobs

The Roundtable strongly opposes the "Community Choice in Real Estate Act" (H.R. 3424 and S. 1839). Despite its name, the Act would limit the ability of consumers to choose the real estate agent or broker of their choice, and would artificially restrain competition in the brokerage industry. As a result, the Act would harm both consumers and the financial services industry.

The "Community Choice in Real Estate Act" would prohibit the Board and the Treasury from completing the administrative rulemaking process required by the Gramm-Leach-Bliley Act (the "GLB Act") and from ruling – if the statutory factors are met – that real estate brokerage and real estate management are "financial in nature" and therefore permissible for financial holding companies and national bank subsidiaries.

The Roundtable believes that the Board and the Treasury should be allowed to complete the rulemaking process. In addition, the Roundtable believes that the Board and Treasury should ultimately rule that real estate brokerage is a permissible activity, for several reasons. First, permitting financial holding companies to enter the real estate brokerage business is good for consumers. Second, it is good for the financial services industry. Third, real estate brokerage is a financial activity consistent with the Gramm-Leach-Bliley Act.

Consumers Will Benefit From the Proposed Rule.

The Roundtable strongly believes that consumers will be the real winners if the proposed regulation is adopted. Adoption of the rule will increase competition in the brokerage industry. More competition means more consumer choice, lower prices, and better customer service.

Adoption of the regulation is necessary to meet the demands of consumers for one-stop shopping for all their home buying needs. In 1999, a study of recent home buyers was conducted on behalf of the National Association of Realtors ("NAR"). *(See Attachment A).* According to this NAR study, 76 percent of home buyers said that getting all or some of their home buying services handled through one company was appealing. Eighty-one percent supported the idea of one-stop shopping for all of their home buying services and were evenly split on whether the best provider of such services would be a bank, a realtor, or a mortgage company, although a slight majority stated they would prefer a bank as the one-stop shopping provider. The NAR study concluded that 77 percent would consider using a bank for those one-stop shopping services in future transactions.

If the proposed regulation is adopted, consumers will be able to receive in one location all the services necessary to buy a home: pre-approval for a mortgage loan; assistance in finding a home; a mortgage loan after a contract to purchase a home has been signed; and insurance for the property (including title insurance, property insurance, and private mortgage insurance) prior to closing. The consumer's life will be simplified and services will be expedited. Many traditional real estate brokers already have responded to consumer demand for one-stop shopping and are offering mortgage and insurance services in addition to real estate brokerage services.

Proponents of the "Community Choice in Real Estate Act" oppose letting financial holding companies compete in the real estate brokerage business. They argue that consumers are worried about their privacy when purchasing a home, and that letting financial holding companies compete would hurt consumer privacy. Concluding that brokerage is a financial activity in fact greatly *enhances* consumer privacy. While customers of financial holding companies and national banks are entitled to the GLB Act's far-reaching privacy protections, customers of real estate brokers currently have *no* federal privacy protections.

If adopted, the Board/Treasury regulation will afford brokerage customers the same federal privacy protections now afforded to bank customers: real estate brokers will have to disclose their privacy policies to home buyers and will be prohibited from sharing certain nonpublic information about the home buyer with any nonaffiliated third parties unless the home buyer has been given notice and the opportunity to opt out of such information sharing. Ironically, enactment of H.R. 3424 would in effect harm consumers by depriving them of the federal privacy protections currently afforded the consumers in other sensitive financial transactions.

Proponents of the Act also argue that allowing financial holding companies to offer real estate brokerage services could result in harmful tying and other coercive practices. This argument is easily refuted by the fact that many brokerages are already affiliated with mortgage lenders, insurers, thrifts, credit unions, and state banks, and there is no evidence of these harmful practices occurring. Moreover, existing banking laws are more than adequate to preclude these types of practices within a financial holding company. Sections 23A and 23B of the Federal Reserve Act prohibit a bank from making below-market loans to any affiliates or subsidiaries, including those that would be engaged in real estate brokerage, and severely restrict a bank's ability to provide equity contributions and other support to the real estate brokerage affiliate.[1] Furthermore,

[1] See 12 U.S.C. §§ 371c, 371c-1 and 1828(j).

Section 8 of the Real Estate Settlement Procedures Act[2] and the anti-tying provisions of Section 106 of the Bank Holding Company Act Amendments of 1970[3] preclude any coercive practices against the bank's (or brokerage's) customers. In fact, a customer dealing with a brokerage affiliated with a bank will enjoy far *greater* consumer protection than if he or she were dealing with a real estate brokerage firm not affiliated with a bank.

The Financial Services Industry Will Benefit From the Proposed Rule.

Adoption of the regulation is prudent for the financial services industry. Traditional real estate brokers are now actively competing with banks and financial holding companies by offering financial services – in particular, loans and insurance. Of the ten leading real estate brokers cited by *Realtor* magazine, nine provide financial services and compete with financial holding companies by offering loans or insurance. According to the "1999 National Association of Realtors Profile of Real Estate Firms," 56 percent of its residential real estate brokerage firms with more than 50 agents are involved in mortgage lending. *(See Attachment B).*

Additionally, federal thrifts[4] and credit unions[5], as well as state-chartered banks in 26 states, are permitted to act as real estate brokers. *(See Attachment C for data on the states).* In fact, the only financial institutions that uniformly cannot engage in real estate brokerage are financial holding companies and national banks. The Roundtable asks only that more competition be allowed by permitting financial holding companies and national bank subsidiaries to offer these services as well.

NAR argues that permitting financial holding companies to engage in real estate brokerage would create an unlevel playing field due to alleged "federally chartered advantages." NAR contends, without support, that federal deposit insurance and access to the Federal Reserve system, for example, creates "federal subsidies" enjoyed by

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[2] 12 U.S.C. § 2607.
[3] 12 U.S.C. § 1971, *et seq.*
[4] See 12 C.F.R. §§ 559.4(e)(3) (thrift service corporations), 584.2-1(b)(8) (thrift affiliates).
[5] See 12 C.F.R. § 712.5(g) and (p).

depository institutions which give banks an unfair advantage. NAR further alleges that the proposed regulation would result in an unsafe and unsound banking system.

Brokerage poses very little risk to the banking system. A real estate brokerage company does not act "as principal," but rather acts in an "agency" capacity by being an intermediary in a transaction between a buyer and a seller. Banks have historically been permitted to conduct "agency" activities either directly or through affiliates. Financial holding companies are currently permitted to provide their customers with a wide array of agency services, including travel, securities, commodities, and insurance brokerage.

Any federal subsidy is far outweighed by the heightened regulatory burden and cost of supervision borne by depository institutions. The proposed regulation would permit real estate brokerage only in nonbank affiliates and financial subsidiaries – entities which, by law, are firewalled away from their affiliated depository institutions and therefore cannot enjoy any such alleged "federal subsidy." In any event, NAR's contention that the proposal would result in an unsafe and unsound banking system has not been evidenced in the 26 states that currently permit real estate brokerage by banks, or by the thrift or credit union industries.

There is no evidence that consumers have been hurt in any way by the current involvement of these depository institutions in the real estate brokerage industry, and there is no evidence that depository institutions in these markets dominate the brokerage industry or enjoy significant market power. Prohibiting real estate brokers from affiliating with financial holding companies seems to be out of step with the current marketplace.

The most vocal proponent of the Act – NAR – does not speak for the entire real estate industry. The Realty Alliance, a real estate brokerage trade organization with over 62,000 members (most of whom are also members of NAR), publicly opposes NAR's efforts. *(See Attachment D for a copy of a White Paper delivered by The Realty Alliance* *to the NAR).* The Realty Alliance, like the financial services industry, welcomes increased competition and recognizes the potential benefits to consumers that the regulation could bring.

Real Estate Brokerage is a Financial Transaction Consistent with the Gramm-Leach-Bliley Act.

Finally, the Roundtable believes that the proposed regulation is entirely consistent with the GLB Act, which was designed to modernize and expand the financial services marketplace. The specific purpose of financial modernization, as stated in the preamble to the GLB Act, was to "*enhance competition in the financial services industry* by providing a prudent framework for the affiliation of banks, securities firms, insurance companies and *other financial service providers*, and for other purposes." [emphasis added]

Title I of the GLB Act created the "financial holding company" structure and permitted financial holding companies to conduct a much broader range of financial activities than was historically permissible for bank holding companies. The GLB Act permits financial holding companies to engage in all activities that have been determined by the Federal Reserve Board to be "financial in nature," or incidental or complementary to a financial activity.[6] Given the historical experience of the Glass-Steagall Act and the practical limitations of creating a rigid regulatory structure, the GLB Act established a flexible framework that allows regulators to respond to changes in technology, the marketplace, and consumer demand. The GLB Act provides the Board, in consultation with Treasury, the authority to expand the statutory list of financial activities.[7]

Consistent with Congress' directive and following the request of the American Bankers Association, the Roundtable, and others, the Board and Treasury issued a joint notice of proposed rulemaking in December 2000 to determine that real estate brokerage

[6] See Bank Holding Company Act § 4(k)(1)(A), (B) (12 U.S.C. § 1843(k)(1)(A), (B)).
[7] See Bank Holding Company Act § 4(k) (12 U.S.C. § 1843(k)).

and real estate management activities are "financial in nature" or "incidental to a financial activity" and, consequently, permissible for financial holding companies and national bank subsidiaries. By issuing this proposal, the agencies were simply fulfilling their obligation under the GLB Act to ensure that financial holding companies and national banks have the ability to compete with other financial service providers. In doing so, the Board and Treasury have followed the objective rulemaking process contemplated by the GLB Act and have sought public comments on the rule. We ask that the Board and Treasury be allowed to continue their deliberative process.

The broader scope of the "financial in nature" standard for non-bank activities of financial holding companies is reflected in both the legislative history of the GLB Act and the diverse range of activities that financial holding companies are currently permitted to conduct. First, the Conference Report to the GLB Act states that "[p]ermitting banks to affiliate with firms engaged in financial activities represents a significant expansion from the current requirement that bank affiliates may engage only in activities that are closely related to banking."[8] Second, financial holding companies are currently permitted to conduct a broad range of activities that bank holding companies are prohibited from conducting, such as unrestricted securities underwriting, merchant banking, unrestricted insurance underwriting, unrestricted insurance agency, travel agency, and acting as finder.[9] The financial services marketplace has changed dramatically in the past 30 years, and what may have been inappropriate for bank holding companies in the early 1970s may be entirely appropriate for the diversified financial holding companies of the early 21st century.

With respect to the permissibility of real estate brokerage under the GLB Act, the GLB Act permits the Board to define certain activities as "financial in nature," including "transferring ... for others financial assets other than money or securities." The Roundtable believes that real estate brokerage is exactly that type of activity. Real estate

[8] H.R. Conf. Rep. No. 106-434, at 153 (Nov. 2, 1999).
[9] See BHCA § 4(k)(4) (12 U.S.C. § 1843(k)(4)); 12 C.F.R. § 225.86(d)(1) (finder activities).

is the largest financial asset owned by most consumers and is the most widely used source of collateral for consumers seeking credit. The purchase of real estate is the largest financial transaction for most consumers. For many, real estate is the largest source of individual wealth; the decision to purchase, sell, and finance real estate plays a significant part in retirement planning. Real estate is conferred special status under federal and state tax laws, distinguishing real estate from other large-ticket items. For these reasons, we believe that real estate is a "financial asset" and that brokerage is "financial in nature."

In addition, the GLB Act defines as "financial in nature" all activities that involve "arranging, effecting, or facilitating financial transactions" for others.[10] Real estate brokerage is part of the overall financial activity of helping a consumer receive pre-approval for a mortgage loan, find a home, appraise the property, receive final approval for the mortgage loan, close the transaction, and insure the home with property insurance, title insurance, and, in certain cases, private mortgage insurance. Each of the services and products offered as part of the overall financial transaction are integrated with one another. Such integration is reflected in several ways. First, consumers frequently enlist the services of a real estate broker at the same time that they seek the products of a mortgage lender and an insurance agency. Second, consumers generally pay the loan fees, the realtor's commission, and the initial insurance premiums together at the closing. Third, the documents that consumers sign with respect to the mortgage loan, real estate brokerage, and the insurance generally cross-reference and are conditioned upon each other.

In determining whether an activity is "financial in nature," the GLB Act also requires the Fed to consider "changes in the marketplace in which financial holding companies compete" and whether such activity is "necessary or appropriate" to allow a financial holding company or its affiliates to "compete effectively with any company

[10] See Bank Holding Company Act § 4(k)(5)(B)(iii) (12 U.S.C. § 1843(k)(5)(B)(iii)).

seeking to provide financial services in the United States."[11] As highlighted earlier, approval of the regulation is both necessary and appropriate to allow financial holding companies to compete effectively with real estate brokerage companies, as well as with federal thrifts, credit unions, and state banks in 26 states.

As a result, the Roundtable firmly believes that real estate brokerage is "financial in nature," consistent with the GLB Act. At the very least, the Board and Treasury should find that it is "incidental to a financial activity." Banks and financial holding companies are involved in virtually every other aspect of residential and commercial real estate transactions, ranging from rendering advice; acting as a finder; appraising the property; issuing abstracts of title and performing title searches; selling and underwriting hazard, title, and mortgage guaranty insurance; arranging or providing financing; providing loan closing, settlement, and escrow services; and securitizing mortgage loans or underwriting and selling mortgage backed securities. Clearly, acting as a real estate broker is incidental to the performance of these other real estate related services that are already considered to be "closely related to banking" or "financial in nature."

In sum, assertions that the Board and Treasury may not rule on real estate brokerage are without basis under the GLB Act. Such an interpretation of the GLB Act would chill future proposals for activities to be considered "financial in nature" and would effectively turn the clock back on financial modernization.

Conclusion

In conclusion, the Roundtable strongly supports the proposed regulation and believes that its adoption would be a win-win proposition for consumers and the financial services industry. The regulation would allow financial services companies to build alliances with real estate brokerages, creating tremendous benefits for consumers, including one-stop shopping, lower prices, more choice, and increased competition.

[11] Section 103(a), new Bank Holding Company Act ("BHCA") section 4(k)(3)(A)&(D)(i).

The "Community Choice in Real Estate Act" is nothing but an attempt to derail the deliberative rulemaking process – thereby preserving artificial barriers to entry in the brokerage market for the purpose of preserving market share and reducing threatened competition. While NAR wants to compete in the financial services markets by making loans and selling insurance, NAR wants Congress to protect them from competition in their own back yard.

For the foregoing reasons, the Roundtable opposes H.R. 3424 and supports the rulemaking process commenced by the Board and the Treasury in December 2000. This rulemaking process is an appropriate delegation of authority to the regulators, who have expertise and experience in this area and are fully equipped to consider all the substantive issues and make an objective ruling in the best interests of both the consumers and the industry.

Thank you for the opportunity to submit our views.

ATTACHMENT A

Back to homepage

Appendix I

MEMORANDUM

TO: National Association of REALTORS®

FROM: Hart-Riehle-Hartwig Research

DATE: August 23, 1999

SUBJECT: Findings of a Survey among Recent Home Buyers

From July 25 to 30, 1999, Hart-Riehle-Hartwig Research interviewed a representative cross section of 801 home buyers nationwide who purchased their homes within the past two years. This report presents the key findings of this research, for the internal strategic purposes of the National Association of REALTORS.

Key Findings

1. Most people find the concept of one-stop shopping to be appealing. The intensity of support for the idea, however, is not as strong as it was in 1997.

- **Three in four recent homebuyers (76%) say that getting all or some of their home-buying services handled through one company is appealing.**
- **Only one in three (31%), however, find this idea to be very appealing.**

The shift in the recent-home-buyer audience may explain the decline in intense support. In 1997, the market was comprised largely of core homebuyers, who were willing to buy even in a poor housing market and who were service- and hassle-conscious. In 1999, recent homebuyers represent an expanded pool that includes many non-traditional homebuyers, for whom the home purchase is a financial stretch, and who are, therefore, more price-conscious when it comes to services.

2. Recent home buyers may have been satisfied with the process that led them to a successful home purchase, but they still see the need for many improvements in that process. One would expect these people to be strong defenders of the status quo, but they endorse changes that would make the home-buying process quicker, cheaper -- particularly regarding upfront costs -- more convenient, and more objective. Changes that would allow companies (specifically real-estate companies) to receive referral fees for homebuyers' using services that they recommend, however, are not seen as measures that would significantly improve the home-buying process.

- **Two in three (65%) recent home buyers feel that a change in current rules in order to give companies a financial incentive to put together a one-stop shopping package for home buyers would be an improvement in the home-buying process** -- 33% feel that it would be a big improvement.
- **Two in three (68%) recent home buyers say that banning the practice of mortgage lenders' requiring a large, upfront payment from mortgage applicants would be an improvement** -- 48% say that it would be a big improvement.
- **Two in three recent home buyers (67%) believe that increasing the use of Internet applications to reduce the time it takes for a home buyer to get full mortgage approval would be an improvement** -- 39% believe that this would be a big improvement.
- **And nearly two in three (62%) recent home buyers say that increasing the use of computer credit scoring to make mortgage approval decisions more objective would be an improvement** -- 33% say that this would be a big improvement.

Support for one-stop shopping is on par with support for such popular changes as eliminating upfront mortgage application

costs. Clearly, however, fewer new homebuyers endorse one-stop shopping when it is described from the point of view of real-estate companies or companies in general. The one-stop shopping idea works much better when described in terms of what is in it for the home buyer -- price reduction and a quicker, more objective process.

3. The current pool of recent home buyers is highly cost-conscious. Because of the past few years' strong housing market, more non-traditional homebuyers are in the market, and these buyers often are stretching their family finances in order to buy a home. When asked to evaluate several reasons for supporting the idea of one-stop shopping, home buyers today put saving money, along with making the process easier, at the top of their list. Neither brand-name service nor speed of process prove as compelling as *lower cost* and *simpler process* in framing the concept of one-stop shopping for home-buying services.

- **Today's home buyers are much more likely than they were in 1997 to say that the idea of saving money through discount-priced one-stop services has a great deal of merit.** In fact, four in five (81%) recent home buyers believe that this idea has at least some merit, including 50% who say that the idea has a great deal of merit -- representing a 17-point increase since 1997, when 33% said that the idea had a great deal of merit.
- **Home buyers are as likely now as they were two years ago to support the concept of one-stop shopping if it means dealing with only one person in order to achieve a more simplified home-buying process.** Four in five (81%) recent home buyers say that there is merit in this idea, including 50% who say that the idea has a great deal of merit -- nearly the same proportion as in 1997 (52%).
- **Many homebuyers see merit in the idea of one-stop shopping if it would speed up the home-buying process.** More than three in four (78%) recent home buyers believe that this idea has merit, including 44% who believe that it has a great deal of merit.
- **Receiving a standard level of service does not prove as important as other reasons for having one-stop shopping.** Although two in three (63%) new home buyers believe that the idea of brand-name service has merit, only one in four (23%) say that it has a great deal of merit.
- **Repeat buyers are more loyal to the status quo.** First-time home buyers range from six to 10 percentage points more likely than repeat buyers to endorse each change as having a great deal of merit.
- **Core home buyers -- the kind of people who buy a home even in a bad housing market -- are perhaps the best targets for one-stop shopping.** Today, in a hot market that attracts many non-traditional buyers, nearly half (49%) of all recent homebuyers say that if they had to go through the whole process again, they would use a company that offers one-stop shopping. In 1997, however, when the housing market was much less vibrant than it is today, two in three (66%) new homebuyers said that they would use a company that provides one-stop shopping.

That nearly half of today's home buyers would consider using a company that offers one-stop shopping may be due to core home buyers' interest in relieving the hassles of home buying, although it also may reflect non-traditional home buyers' cost-consciousness.

4. When recent home buyers consider where to go for one-stop shopping, only realtors, banks, and mortgage companies make sense to them. About two in three recent homebuyers say that they would consider each of these types of companies for one-stop shopping, with about one in four strongly considering each one. Companies that are not given widespread consideration include insurance firms (39% strongly/ somewhat consider), religious or fraternal organizations (36%), stock and mutual fund brokerage firms (33%), Internet Web sites (28%), tax preparation companies (24%), shopping clubs or price clubs (15%), and credit card companies (10%). About half (51%) of recent homebuyers would consider using a professional organization of which they are a member to provide one-stop shopping for home-buying services. **In the one-stop shopping world, realtors are royalty.**

5. A majority (58%) of new home buyers say that they would consider using a company that offers a simplified, one-stop shopping process of referrals or recommendations for service providers. Only one in three recent homebuyers express serious concern about referral fees. Fewer than one in five (18%) homebuyers, however, say that they would strongly consider using such a service. And as further evidence of the tenuous support of such a service, only one in five (20%) recent home buyers indicate that they would be willing to pay more for one-stop shopping through a real estate company, down from one in three (32%) home buyers willing to do so two years ago.
Recent homebuyers have several concerns about the one-stop shopping concept. Their biggest worries include the idea that this would give one company a financial incentive to recommend only home-buying service providers who pay them a commission or referral fee -- a majority (54%) of home buyers say that this would give them a great deal of concern -- and the expectation that home buyers would pay a higher price for the convenience of handling the services through one company

(53%, up from 37% in 1997). Another major concern among recent homebuyers is that one-stop shopping would give one company too much control over the home-buying process – half (49%) say that this is a great concern to them. **These findings suggest that the new, non-traditional homebuyers have pocketbook concerns – namely, whether they are getting the best price for each service.**

6. Overall, half (49%) of all recent home buyers would prefer to use a one-stop shopping company if they could go through the home-buying process again. Certain demographic groups are more likely than others to prefer using a one-stop shopping company rather than shopping around for each service.

- **Recent homebuyers who live in large cities are more likely to prefer a one-stop shopping company (55%) than are those who live in the suburbs (45%) or in a medium/small city (49%).**
- **Recent homebuyers in the traditional homebuyer market (those under age 50) are much more likely to prefer one-stop shopping (52%) than are their older counterparts (41%).**
- **White new home buyers (50%) are more likely than are blacks (43%) to say that they prefer one-stop shopping for home-buying services.**
- **Recent home buyers with less than a college degree (52%) are more likely than their neighbors who have at least a bachelor's degree (46%) to prefer one-stop shopping.**

7. A majority (55%) of recent home buyers report that the home-buying process was either excellent or very good. Slightly less than half (44%) say that the process was either just okay (32%), not very good (7%), or poor (5%).

- **Among the groups most satisfied with their recent home-buying process are 18- to 29-year-olds (68% excellent/very good), new home buyers age 50 and over (61%), those with an annual income less than $65,000 (60%), and those who live in a suburb (58%) or a medium/small city (57%).**
- **Among those least satisfied with their home-buying process are 30- to 49-year-olds (48% just okay, not very good, poor), those with an annual income less than $65,000 (47%), and residents of large cities (49%).**

That nearly half of all recent homebuyers say that they were not happy with their home-buying experience shows that there is room for improvement and change.

8. Most home buyers are not adverse, per se, to using service providers recommended by real estate agents. In fact, in most cases in which the real estate agent recommended a service provider (with the exception of homeowners insurance providers), home buyers were at least two-and-a-half times more likely to use the provider recommended than not.

- **Recent home buyers were four times more likely to use a home inspector recommended by a real estate agent (43%) than to use a home inspector other than the one recommended by the agent (10%).**
- **Recent home buyers were four times more likely to use a title insurance company recommended by a real estate agent (42%) than to use one other than was recommended (10%).**
- **Recent homebuyers were four times more likely to use an appraiser recommended by a real estate agent (37%) than to use a different appraiser (9%).**
- **Recent home buyers were more than two times more likely to use a mortgage company recommended by a real estate agent (35%) than to use another mortgage company (14%).**
- **Recent home buyers were five times more likely to use a termite inspector recommended by a real estate agent (34%) than to use one other than was recommended (7%).**
- **Recent homebuyers were four times more likely to use a settlement attorney recommended by a real estate agent (25%) than to use a different one (6%).**

Hart-Riehle-Hartwig Research FINAL
1724 Connecticut Avenue, NW Interviews: 801 recent homebuyers
Washington, DC 20009 Dates: July 25-30, 1999
(202) 234-5570

Study #5522 N.A.R. July 1999

Please note: all results are shown as percentages unless otherwise stated.

1a. Which of the following phrases best describes your involvement in the home-buying process?

You were the sole decisionmaker	20		[139]
You were one of the primary decisionmakers	78	**CONTINUE**	
You played a major role in researching and recommending, but the decision was made by somebody else	2		
You played little or no role in the decision, and the decision was made by someone else	-	**TERMINATE**	
Refused	-		
Not sure	-		

1b. Is this the first home you have purchased? (IF "NO", ASK:) How many homes in total have you bought in your life, including the one you just bought?

Yes, this is the first home purchased	34	[140]
No, two homes, including current purchase	26	
No, three homes	19	
No, four homes	9	
No, five or more homes	12	
Not sure/refused	-	

1c. Did you get a mortgage loan to purchase your home?

Yes, got mortgage loan	90	[141]
No, did not get mortgage loan	10	
Not sure/refused	-	

2a. You have just been through the home-buying process. From a homebuyer's point of view, how would you rate the process overall--is the overall home-buying process for homebuyers excellent, very good, just okay, not very good, or poor?

Excellent	13	[142]
Very good	42	
Just okay	32	
Not very good	7	
Poor	5	
Not sure	1	

2b. Thinking about the real estate agent who was the most involved with you in your recent home purchase, would you rate the job that the real estate agent did for you as excellent, very good, just okay, not very good, or poor?

	7/99	5/97	
Excellent	31	43	[143]
Very good	30	25	
Just okay	15	15	
Not very good	4	2	
Poor	4	5	
Not sure	16	10	

(READ ITEM) -- did the real estate agent who helped you buy your home recommend a list of possible service providers or assist you in finding someone to provide this service? **(IF "YES," ASK:)** Did you use someone recommended by the real estate agent, or did you use someone other than the ones recommended by the agent?

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY THEY USED SOMEONE THE AG RECOMMENDED

	Agent Recommended			
	Used Someone Agent Recommended	Used Someone Other Than Ones Agent Recommended	Agent Did NOT Offer Recommendation Or Assistance In Finding This Service	Not Sure
Home inspector	43	10	37	10
Title insurance company	42	10	36	12
Appraiser	37	9	41	13
Mortgage company	35	14	44	7
Termite inspector	34	7	46	13
Settlement attorney	25	6	54	15
Homeowners insurance	16	15	60	9

As you have just been through the traditional home-buying process, let me describe a new home-buying process that is being discussed. Under current law, it is illegal for anyone, based on a recommendation or endorsement, to receive a commission, a finder's fee, or a referral fee when a home buyer chooses to use one of the services we just mentioned, such as a settlement attorney, home inspector, mortgage, or insurance company. As a result, there is no financial incentive for any company to offer a one-stop shopping program for home buyers that includes referrals to other companies that might provide these services. Under this new law, referral fees could be paid if a homebuyer used the recommended service provider, and those referral fees or commissions would have to be disclosed to the homebuyer in advance. The home buyer would be under no obligation to use any of the services recommended and could shop for their own services if they wanted to, just as they can now.

3a. Suppose you were buying a home. If a company offered to set up a simplified, one-stop shopping process for you, in which they would offer referrals or recommendations for service providers that the home buyer could use, is that something you would consider strongly, consider somewhat, consider a little, or would you not consider using it at all?

Consider strongly	18	**[151]**
Consider somewhat	40	
Consider a little	17	
Would not consider at all	22	
Not sure	3	

3b. Many different kinds of companies might offer this kind of one-stop shopping for homebuyers. For each one I name, tell me whether you would consider using THAT KIND OF COMPANY for one-stop shopping for a home.

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY CONSIDER STRONGLY OR SOMEWHAT

	Consider Strongly	Consider Somewhat	Consider A Little	Would Not Consider At All	Not Sure	
A mortgage lender or mortgage provider.....	22	44	14	19	1	[158]
A bank or credit union.....	26	38	13	22	1	[157]
A real estate company.....	23	40	14	22	1	[162]
A professional organization that you are a member of.....	18	33	13	34	2	[155]
An insurance company.....	9	30	18	42	1	[161]
A religious or fraternal organization that you are a member of.....	11	25	11	51	2	[156]
A stock and mutual fund brokerage firm.....	6	27	16	49	2	[154]
An internet Web site.....	7	21	17	52	3	[160]
A tax-preparation company, such as H&R Block.....	4	20	13	62	1	[152]
A shopping club or price club.....	3	12	14	70	1	[159]
A credit card company.....	2	8	10	79	1	[153]

3c. Let me read you a list of changes that some people have suggested could be made in the home-buying process. For each item, tell me whether you feel that it would be a big improvement, a small improvement, or whether it would not make any difference to you as a homebuyer.

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY BIG IMPROVEMENT

	Improvement				
	Big	Small	Would Make No Difference	Would Make Things Worse (VOL)	Not Sure
Ban the current practice of mortgage lenders requiring a large, upfront payment from mortgage applicants, to cover the cost of credit checks, and requiring the mortgage company to pay for checking an applicant's credit.....	48	20	24	4	4
Increase the use of Internet applications to reduce the time that it takes for a home buyer to get full mortgage approval.....	39	28	27	4	2
Change current rules in order to give companies a financial incentive to put together a one-stop shopping package for home buyers, including inspections, title insurance, and mortgage approval.....	33	32	25	7	3
Increase the use of computer credit scoring to make mortgage approval decisions more objective and less subject to human bias....	33	29	26	7	5
Allow companies to receive a referral fee for home buyers who use home-buying services from partners they recommend, in order to encourage closer cooperation between companies involved in the home-buying process.....	13	30	39	11	7
Change current rules in order to allow real estate companies to accept referral fees from their partners when they offer home buyers a brand-name inspection, title insurance, or mortgage services.....	10	29	42	13	6

3d. Suppose you could do it all over again, but this time you had the choice of handling some or all of the steps involved in buying a home--from real estate listings, to the mortgage application, inspections, appraisals, title insurance, legal work, and settlement attorney--directly through one company. If you had that choice, which would you personally prefer?

Option A: Shopping around for each settlement service yourself, OR

Option B: Using a company that offers many settlement services or "one-stop shopping."

	7/99
Option A: Shopping around for each settlement service yourself	40
Option B: Using a company that offers many settlement services or "one-stop shopping"	49
Neither (VOL)	1
Depends/both (VOL)	7
Not sure	3

4a. Overall, how appealing would it be to have the choice of getting some, or all, of your home-buying services handled through one company, instead of individually hiring all of them yourself--very appealing, somewhat appealing, not very appealing, or not appealing at all?

	7/99	5/97		
Very appealing	31	42	CONTINUE	[170]
Somewhat appealing	45	36		
Not very appealing	9	8		
Not appealing at all	13	11	Skip to Q.5a	
Not sure	2	3		

(ASK ONLY OF RESPONDENTS WHO SAY IT WOULD BE "VERY" OR "SOMEWHAT" APPEALING IN Q.4a.)

4b. Would you have been willing to pay more for these services for the convenience of having some or all of the services handled through the real estate company?

	7/99	5/97	
Willing to pay more	20	32	[171]
Not willing to pay more	49	37	
Not sure	7	9	
Not Very/Not Appealing At All/Not Sure (Q.4a)	24	22	

5a. I'd like to read you various reasons why some homebuyers say that they would like to handle some or all of their home-buying services through one company. For each one I read, please tell me how much merit you feel that reason has.

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY A GREAT DEAL OF MERIT

	A Great Deal Of Merit	Some Merit	Only A Little Merit	No Merit At All	Not Sure	
It would mean just one person to contact, making the process easier to manage for the buyer						[173]
July 1999	50	31	9	9	1	
May 1997	52	30	8	9	1	
The home buyer could save money if companies offer these services at discount prices						[175]
July 1999	50	31	8	9	2	
May 1997[1]	33	41	11	14	1	
It would speed up the home-buying process						[172]
July 1999	44	34	8	13	1	
It means getting one standard level of brand-name service from all the individual home-buying service providers						[174]
July 1999	23	40	17	18	2	

[1] In May 1997, the question was phrased "The home buyer could save money if real estate companies..."

5b. Now I'd like to read you some concerns that people have about getting some or all of their home-buying services througl one company. For each one I read, please tell me how much that would concern you.

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY A GREAT DEAL OF CONCERN

	A Great Deal Of Concern	Some Concern	Only A Little Concern	No Concern At All	Not Sure	
It gives the one company a financial incentive to recommend only those home-buying service providers that pay them a commission or referral fee						[178]
July 1999	54	31	8	6	1	
It would mean that the home buyer pays a higher price for the convenience of handling the services through one company						[176]
July 1999	53	30	9	7	1	
May 1997[1]	37	43	12	7	1	
It would give one company too much control over the home-buying process						[177]
July 1999	49	31	9	10	1	
May 1997[1]	38	34	14	13	1	
It would mean that a company would get referral fees or commissions when home buyers use services that the company recommends						[179]
July 1999	33	34	15	17	1	

[1] In May 1997, the phrasing "real estate company" was used in place of "one company".

6. Suppose you could use this kind of one-stop home-buying process to identify some or all of the individual home-buying services you might use, with the recommended companies cooperating with each other to simplify the home-buying process. Thinking about it again, how appealing would it be to have the choice of getting some or all of your home-buying services handled through one company, instead of individually hiring all of them yourself–very appealing, somewhat appealing, not very appealing, or not appealing at all?

Very appealing	27	[180]
Somewhat appealing	48	
Not very appealing	8	
Not appealing at all	14	
Not sure	3	

7. If you were dissatisfied with one of the services provided, who would you hold most accountable–the one-stop shopping company you used, or the individual service provider recommended by that company?

The one-stop shopping service	51	[208]
The individual service provider	32	
Both equally (VOL)	12	
Not sure	5	

8. Suppose a real estate company offered you one-stop shopping for home-buying services and a law required that company to give you complete disclosure on the amount of any referral fee it would receive if you used a service recommended by them. In that case, how much confidence would you have about handling some or all of those services through that real estate company, instead of hiring each one yourself–a great deal of confidence, quite a bit of confidence, only some confidence, or very little confidence?

Great deal of confidence	16	[209]
Quite a bit of confidence	29	
Only some confidence	35	
Very little confidence	18	
Not sure	2	

9. Finally, thinking about all the issues we have discussed, do you feel that the government should make it easier for any kind of company to offer one-stop shopping services, should it leave the rules as they are now, or should the government put more restrictions on companies' ability to offer one-stop shopping services?

	7/99	5/97[1]	
Make it easier	34	46	[210]
Leave rules the same	41	30	
More restrictions	13	12	
None of them (VOL)	5	4	
Not sure	7	8	

[1] In May 1997, the phrasing "real estate company" was used in place of "any kind of company".

FACTUALS: Now I have some questions for statistical purposes only.

F1. In what age groups are you?

18-24	2	[211-212]
25-29	12	
30-34	16	
35-39	21	
40-44	13	
45-49	11	
50-54	9	
55-59	5	
60-64	3	
65 and over	6	
Refused	2	

F2. Are you currently employed?

(IF CURRENTLY EMPLOYED:) What type of work do you do?

(IF NOT CURRENTLY EMPLOYED:) Are you a student, a homemaker, retired, or unemployed and looking for work?

Currently Employed		
Professional/ manager	38	[213-214]
White collar worker	21	
Blue collar worker	18	
Farmer, rancher	-	
Not Currently Employed		
Student	-	
Homemaker	10	
Retired	10	
Unemployed, looking for work	1	
Other	-	
Not sure	2	

F3. What is the last grade you completed in school?

Eighth grade or less	-	[221-222]
Some high school	2	
High school graduate	19	
Some college, no degree	15	
Technical degree	3	
2-year college graduate	11	
4-year college graduate	27	
Postgraduate work, master's degree.	19	
Doctoral/law degree	2	
Not sure/refused	2	

F4. Are you currently single, married, separated, widowed, or divorced?

Less than a month ago	3	[228]
1 to 3 months ago	8	
4 to 6 months ago	1	
7 months to 1 year ago	18	
1 to 2 years ago	65	
2 to 3 years ago	4	
More than 3 years ago	-	
Not sure	1	

F9. Is the amount of your mortgage above or below $150,000?

(IF BELOW $150,000, ASK:) Is it above or below $125,000? **(IF BELOW $125,000, ASK:)** Is it above or below $100,000?

(IF ABOVE $150,000, ASK:) Is it above or below $200,000? **(IF ABOVE $200,000, ASK:)** Is it above or below $250,000?

Below $100.000	30	[229]
$100.000 to $125.000	18	
$125.000 to $150.000	13	
$150.000 to $200.000	15	
$200.000 to $250.000	6	
Above $250.000	4	
Refused	14	

F10. Was the purchase price of your home when you bought it above or below $150,000?

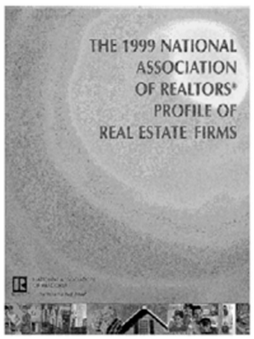
(IF BELOW $150,000, ASK:) Was it above or below $125,000? **(IF BELOW $125,000, ASK:)** Was it above or below $100,000?

(IF ABOVE $150,000, ASK:) Was it above or below $200,000? **(IF ABOVE $200,000, ASK:)** Was it above or below $250,000?

Below $100.000	24	[230]
$100.000 to $125.000	16	
$125.000 to $150.000	14	
$150.000 to $200.000	17	
$200.000 to $250.000	8	
Above $250.000	9	
Refused	12	

ATTACHMENT B

THE 1999 NATIONAL ASSOCIATION OF REALTORS® PROFILE OF REAL ESTATE FIRMS



Questions about the report? Email topresearch@realtors.org

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Prepared by: THE NATIONAL ASSOCIATION OF REALTORS®
Economic Research Group
700 11th Street, NW
Washington, DC 20001

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Table I-13
Secondary Real Estate Activity: Mortgage Finance
(Percentage Distribution of Firms)

		Residential Firms			
			number of salespeople		
	All Firms	All	10 or Less	11 - 50	More than 50
Engaged in Activity Within Firm	7%	6%	4%	8%	25%
Engaged in Activity Through Ownership in Another Firm	5	6	3	8	31
Not Engaged in this Activity	80	78	85	72	32
Not Engaged but Planning to Provide	9	10	9	12	12

* Less than one percent

Back to Tables and Figures Back to Text

Back to Home Page

Preface

Changes in the real estate industry have had significant impact on the operation of real estate firms. In response to those changes, real estate firms are adapting their organizations to meet the industry's challenges. What are some of those challenges?

- How do technology and other recent developments in real estate practices affect firm structure?
- What services do firms use to attract top salespeople and successfully compete in an ever-changing marketplace?
- What relationships with non-real estate firms are being developed to generate new business for the real estate organization?
- How have the trends in franchising impacted the number and size of real estate firms?

To answer these questions, and to provide a clearer understanding of the size and structure of firms represented by its members, the NATIONAL ASSOCIATION OF REALTORS® regularly surveys its membership about various characteristics of real estate firms, including size of firm, type of organization, structure, primary real estate activity and affinity relationships. Results of the survey allow the Association to fashion a Profile of Real Estate Firms. The Profile provides NAR Leadership, State and Local REALTOR® Association executives, and firm owners and managers with information they can use to benchmark their own operations and in planning for future operations.

NOTES TO THE 1999 FIRM PROFILE

During the spring of 1999, the Economic Research Group of the NATIONAL ASSOCIATION OF REALTORS® mailed a six-page questionnaire to 30,000 designated REALTORS® nationwide. A total of 2,624 usable surveys were returned. All information presented in this report is characteristic of 1999. (see methodology)

A note of caution regarding the expressions "all real estate firms" and "typical real estate firm" is called for here. It is hard to define the typical real estate firm. Firm size varies dramatically. There are large firms with hundreds—even thousands—of sales agents, while there are numerous firms with a sales force of just one or two agents. In addition, while the majority of firms specialize in residential brokerage, others deal with commercial brokerage, appraisals, or property management. Consequently, reporting one figure as representative of the entire industry would be inaccurate and misleading. Instead, most results in this 1999 Firm Profile are presented with several cross-tabulations to represent different firm types. Along with the survey results for all real estate firms, there are additional cross tabulations for all residential firms (those firms that derive at least 50 percent of their revenue from residential brokerage), smaller residential firms (ten or less agents), medium-sized residential firms (11 to 50 sales agents), and larger residential firms (more than 50 agents).

In addition, we are in the process of improving the survey methodology. In the past, there has been concern that a greater number of smaller firms respond to the firm survey questionnaire than do larger firms, and so the results of the survey are biased in favor of smaller firms and thus may misrepresent the true "profile" of the industry. In a perfect world, we could correct for this bias by oversampling larger firms and then weighting the responses by the "true" size distribution of real estate firms. Unfortunately, no database—private or government—currently exists that contains information that enables us to derive the true distribution of real estate firms. The NATIONAL ASSOCIATION OF REALTORS® is in the process of developing a membership database. This National REALTOR® Database System (NRDS) will, among other things, allow for oversampling of traditional poor respondents and for the proper weighting of responses.

This report consists of five chapters, each of which focuses on specific practices, structural characteristics, or business arrangements of real estate firms.

REPORT HIGHLIGHTS

It is difficult to define what is the typical real estate firm. A real estate firm may be a single office operation with a sales force of one agent, or a firm with hundreds of offices and thousands of sales agents and brokers. A firm may specialize in residential brokerage or in one of a dozen or so specialties. A brokerage may participate in affinity arrangements, have a relocation department, and have a huge presence on the Internet or they may just offer a narrow menu of services.

With this caveat, the typical real estate firm:

- Is a single-office operation, operating in 1,250 square feet of office space.
- Specializes in residential brokerage.
- Has been in business for 13 years.
- Has a sales force of four agents who are independent contractors.
- Is not affiliated with a franchise organization, and operates as a corporation.
- Provides in-house training and/or educational programs for their sales associates.
- Is a member of at least one multiple listing service (MLS) system.
- Uses cellular phones and pagers to communicate with agents and clients.
- Uses scanners and digital cameras to make sophisticated marketing materials.
- Operates a Web page to attract customers.
- Posts its listings on REALTOR.COM™ and its Web site.
- Generates at least one percent of its business from on-line services such as the Internet and E-mail.

The diversity of real estate firms is most apparent by firm size:

- Eighty-two percent of residential brokerages have a single office, while five percent of firms have more than three offices.
- Fifty-one percent of residential brokerages have a sales force of five agents or less; five percent have a sales force larger than 50.

- Larger residential brokerages—those with more than 50 salespeople—have been in the real estate business twice as long as smaller firms (those with ten or fewer agents).
- Fifty-six percent of larger residential firms and seven percent of smaller residential firms are involved in mortgage activities.
- More than half of firms with more than ten agents have a franchise agreement, compared to just 14 percent of firms with ten or less agents who are affiliated with a franchise organization.

Compared to smaller residential firms, larger brokerages are more likely to:

- Use part-time sales agents.
- Lease at least part of their office space.
- Offer health benefits to their sales force (although they tend not to contribute to the premiums).
- Offer in-house educational training and/or educational programs.
- Use outside sources for educational training.
- Use personal assistants.
- Be a member of a referral or relocation company.
- Participate in affinity arrangements.
- Have a Web site on the Internet.
- Place their listings with on-line services, such as REALTOR.COM™, their firm's Web site, and other sites.
- Generate business from on-line services.

Back to top of Page

Chapter 1: Structural Characteristics of Real Estate Firms

What does today's real estate firm look like?

The number of offices a firm operates, the size of its workforce, its experience in the industry, the business specialties practiced, and franchise affiliation are all indicative of a firm's strategy to increase business and its earnings.

The typical real estate firm is, even in this age of industry consolidation, a single-office operation. It has four sales agents, specializes in residential brokerage (that is, generates at least 50 percent of their revenue from residential brokerage), and has been in the business for 13 years.

Larger real estate firms (that is, firms with a sales forces larger than 50) represent a small portion of the number of firms, but represent a sizeable portion of the industry's sales force.

Number of offices

In spite of the continuing trend of consolidation in the real estate industry, the typical real estate firm has remained a single-office operation (See Figure I-1). Eighty-three percent of real estate firms are one-office operations, just a small drop compared to 20 years ago. Ten percent of firms have two offices, while two percent of real estate brokerages have three offices. Four percent of firms have at least four offices—a result consistent with figures in past Firm Profiles.

Residential firms are more likely to be a single-office operation than are firms that specialize in other real estate related activities. Eighty-two percent of residential real estate firms have just one office; 12 percent have two offices. Only five percent of residential firms have more than three offices (See Figure I-2).

A strong real estate market and the continued consolidation of the real estate industry have led to firms adding offices to their operations. Consistent with the trends noted in the 1996 Firm Profile, 12 percent of all real estate firms opened at least one office during 1998; only three percent closed at least one during the same period. Thirteen percent of residential firms opened an office last year, while three percent closed at least one office during the same period (See Table I-1).

Size of Sales Force

The typical real estate firm has four sales agents. In 1999, three out of five real estate firms have five or less sales agents, while just four percent of real estate firms have more than 50 sales agents. Residential brokerages have slightly more agents than do those real estate firms primarily involved in nonresidential activities. Fifty-one percent of residential firms have five or less agents, while five percent have more than fifty sales agents (See Figure I-3 and Table I-2) .

Even though most real estate firms are small, REALTORS® tend to represent larger real estate firms. As found in the 1999 NATIONAL ASSOCIATION OF REALTORS® Member Profile, the majority of REALTORS® are affiliated with a firm of at least 20 sales agents. Those firms with a sales force of more than 50 sales agents represent 38 percent of REALTORS®.

Minority Ownership and Sales Force

Nine percent of real estate firms are at least partly owned by a member of a racial or ethnic minority. There appears to be little difference in the degree of minority ownership among real estate firms.

Nearly a third of real estate firms have sales agents and/or brokers who are members of a racial or ethnic minority (See Table I-3 and Figure I-4). Not surprisingly, nine out of ten larger residential real estate brokerages—which have large sales staffs—have sales associates who are members of a minority. Blacks are the most widely cited minority reported as a part of a firm's sales force.

Years in the business

Today's real estate firms have been in the business longer than brokerage firms have in the past (See Table I-4 and Table I-5). A typical firm in the real estate industry today has been in the business for 13 years (See Figure I-5). In 1983, that figure was nine years. Thirty percent of all real estate firms, including 28 percent of residential real estate firms, have been in business for more than 20 years. Twelve percent of all real estate firms, including 12 percent of residential brokerages, have been in business for two years or less.

As would be expected, larger firms tend to have been in the industry for longer periods of time. Residential brokerages with more than 50 agents have been in business for twice as long as firms with ten or fewer agents.

Primary Real Estate Specialty

Residential brokerage is the dominant specialization of real estate firms (See Figure I-6). More than three-quarters of real estate firms generate at least 50 percent of their revenues from residential brokerage. This proportion of real estate firms primarily focused on residential real estate is consistent with that found in earlier surveys (See Table I-6).

Nearly ten percent of real estate firms generate the majority of their revenues from other forms of real estate activities. These activities include commercial/ industrial brokerage and farm/land brokerage. The remaining 14 percent of firms are involved in some sort of non-brokerage activity. These non-brokerage activities include property management, appraisal, building/development, and mortgage finance.

Firms that specialize in residential brokerage tend to be larger than firms involved in other specialties. The typical residential brokerage has five sales agents, while other real estate brokerages and firms that are not brokerages (such as firms interested in mortgage services, property management, etc.) have a median of two sales agents.

Other Business Activities

A relatively small group of real estate firms conduct non-real estate related activities that complement the firms' primary business focus (See Table I-7). The most widely cited business activity is business brokerage (17 percent) (See Table I-8), where real estate firms are not only involved in selling real estate but also in selling businesses. Other frequently cited other business activities include insurance brokerage , mortgage operations, and escrow services (See Table I-9, Table I-10, Table I-11, Table I-12, Table I-13, Table I-14 and Table I-15).

The larger the firm, the more likely that it will be involved in other business activities. For example, 56 percent of residential firms with more than 50 agents are involved in mortgage activities, compared to just seven percent of residential firms with ten agents or less.

Firms may either offer these services from within the firm or are engaged in the activity through ownership in another firm. Half of residential firms that offer mortgage services do so through in-house operations, while the other half offer such services through ownership in another firm.

Franchises

Through the 1980s and early 1990s, an increasing number of real estate firms became affiliated with franchises (See Table I-16 and Figure I-7). However, through the mid- to late 1990s, the growth of franchise affiliation has stopped. In 1999, 22 percent of real estate firms are affiliated with either a national or regional/local franchise. Twenty-seven percent of residential firms are affiliated with a franchise. Larger firms are more likely to be affiliated with franchises. More than half of residential firms with at least 11 agents are affiliated with franchises compared to just 11 percent of firms with ten or less agents.

Thirty-eight percent of the nation's sales force is affiliated with franchised firms in 1999. In 1983, the proportion was 30 percent. Given that larger firms tend to be franchised, the higher proportion of sales agents representing franchised firms relative to the number of firms is not surprising.

The typical franchised firm has been affiliated with its franchiser for eight years (See Table I-17). For the typical franchised residential firm, the length of the affiliation rises to nine years. Nearly two out of five franchised firms have been with their present franchiser for more than ten years. On the flip side, 27 percent of franchised firms have been affiliated with their franchiser for three years or less.

Franchised firms have been in the real estate business slightly longer than non-franchised firms. The typical franchised firm has been in business for 15 years, compared to 13 years for non-franchised firms.

Firms decide to affiliate with a franchise for a variety of reasons (See Table I-18). They may be attracted by a franchiser's ability to offer better advertising exposure, offer better training, and assist in recruiting sales agents. Most franchised firms report that franchisers are successful in meeting these goals. For example, nearly three quarters of franchised firms feel that the franchise affiliation improved their name recognition considerably, while half feel that the franchise has considerably improved the ability to generate listings.

As with many other business decisions, the ultimate goal for joining a franchise operation is to improve profitability (See Table I-19 , Table I-20 and Figure I-8). Seventy-two percent of franchised real estate brokerages feel that their franchise affiliation has improved their profitability. Larger firms are more likely than are smaller firms to report that their franchise affiliation has led to higher profits.

Back to top of Page

Chapter 2: Organizational Characteristics of Real Estate Firms

Real estate firms have several organizational characteristics that affect the way in which they operate. These features include a firm's legal organization, the relationship a firm has with its sales force, and the amount of office space used by the company. This chapter presents the most recent information on these organizational characteristics.

Some of the most dominant organizational traits of real estate firms include the following:

- Fifty seven percent of real estate firms are corporations.
- Most have a sales force comprised of independent contractors.
- An almost equal proportion of firms own their office space as lease their office space.

Legal Organization

A real estate firm can be a corporation, a partnership, or a proprietorship. The key difference in these three types of organizational structures is the income tax treatment of the firm.

Under a corporate arrangement, companies expense salary and bonuses of the owners to reduce the taxable income of corporations. Therefore, the real estate (or other) firm pays taxes on its income at a corporate rate and the owners pay taxes on their salary at their personal rates.

In contrast, owners of a proprietorship or partnership pay taxes at the owner's personal income tax rate. Historically, corporations have been popular among real estate firms because of the limited liability and exposure to personal assets, in addition to the tax treatment of profits.

In 1999, 57 percent of real estate firms operate as a corporation, while 38 percent operate as a proprietorship (See Figure II-1 and Table II-1). Five percent are partnerships. The larger the firm, the more likely the firm operates as a corporation. Nine out of ten residential real estate firms that have more than 50 sales agents operate as corporations.

Working Relationship of the Sales Force

Most real estate firms have an independent contractor sales force. Eighty-five percent of real estate firms report that their sales force comprises independent contractors. Three percent of firms report that their sales force are employees, and five percent of real estate brokerages have a mix of employees and independent contractors as their sales force (See Figure II-2).

With their sales agents and brokers as independent contractors, these firms are not bound by the Fair Employment Act and do not contribute half of the Social Security taxes (FICA) normally paid by most employers. As demonstrated in the next chapter, independent contractors tend to receive few, if any, benefits in the forms of health or life insurance, etc., from the firm they represent.

Residential firms, particularly the medium-sized and larger ones, are more likely to have sales forces that consist of independent contractors (See Table II-2). Ninety-six percent of medium sized residential firms and 93 percent of larger size residential firms classify their sales forces as independent contractors. "Only" 61 percent of non-brokerage firms have sales forces that are comprised of independent contractors.

Part-time Sales Force

Just over a half of real estate firms use part-time agents as a part of their sales force (See Table II-3). The use of part-time sales agents is more prevalent among medium and larger size residential firms.

Sales Force Turnover

In 1998, real estate firms lost an average of 15 percent of their sales force, down from 18 percent in 1990. On the flip side, real estate firms gained an average of 19 percent of their sales forces, leaving a net gain of four percent per firm. This net gain is consistent with that found in other Firm Profiles in the 1990s (See Table II-4 and Figure II-3).

While brokerage firms experienced a net increase in their sales forces during 1998, non-brokerage firms had no net change in their sales force. Franchise firms experienced greater volatility in their sales forces, yet also gained more sales agents compared to non-franchise firms. Finally, smaller residential firms had a net gain in their sales force of four percent, compared to a ten percent increase that larger residential firms sustained.

Office Space Occupancy

In 1999, 54 percent of the total office space occupied by real estate firms is leased (See Figure II-4). Smaller firms are more likely to own their office space, while larger residential firms lease relatively more space.

Forty-seven percent of all real estate firms lease all of their office space (See Figure II-5). Forty-six percent of firms own all of their space, while seven percent of firms have both leased and owned office space. Smaller residential firms are more likely to own all of their office space than are larger residential firms.

Size of Office Space

The typical real estate firm has 1,250 square feet of office space, up slightly from the 1996 Firm Profile. Of course, firms with larger sales forces tend to have larger offices. For example, residential firms, which tend to be larger than other real estate firms, have a median office space of 1,400 square feet.

On average, firms have 7.4 sales people per office, similar to that found in surveys in the mid-1980s. Larger firms tend to have more sales staff in each of their offices. For example, firms with just one office have 6.6 sales people per office, compared to 14.2 sales people per office in firms with four or more offices. (See Table II-5)

Back to top of Page

Chapter 3: Firm Practices and Services

Insurance and retirement benefits, in-house training, use of personal assistants, agency, and participation in outside community organizations are all services that real estate firms use to attract top salespeople and customers.

Typically, real estate firms do NOT provide employer-paid benefits to its sales force. This is because most salespeople in real estate companies operate as independent contractors. But thirty-two percent of firms with salaried licensees offer some sort of health benefits to those agents. On the other hand, real estate firms do tend to contribute towards Errors and Omissions (E&O) insurance premiums for their sales force.

By attracting and keeping a productive sales force and building a reputation from satisfied clients, firms can successfully compete with each other in the ever-changing real estate industry.

Insurance and Retirement Programs

Some real estate firms offer benefits as a part of their compensation package. Health insurance, group term life insurance, profit sharing, and pension plans are all benefit programs real estate companies may offer to their sales force or employees. However, real estate companies do not typically provide employer-paid benefits because most firms use independent contractors (See Table III-1).

Eighteen percent of firms with an independent contractor sales force offer health benefits to those sales agents. Thirty-two percent of firms with salaried licensees offer some sort of health benefits to those sales agents, while 30 percent of real estate firms offer health benefits to their administrative staff.

Residential brokerages offer health benefits less frequently than non-residential brokerages. Larger firms are more likely to offer such benefits than are their smaller brethren (See Table III-2).

Of those firms that do offer health benefits, most will pay at least a part of the premium for health coverage for their administrative staff and their salaried licensees. In contrast, independent contractors are generally responsible for paying all of their premiums. Even so, independent contractors who pay for all of their premiums still gain the advantages of buying into a group policy that may offer better benefits at a lower price compared to what they could purchase on their own. (Also, many REALTORS® who are not offered benefits from their real estate firm rely on benefits from other sources such as their spouse's employment benefit package.)

Real estate firms may offer other benefits such as group term life insurance, pension, and disability insurance. As is the case with health insurance, residential brokerages, especially the smaller ones, are less likely to offer such benefits than are other real estate firms (See Table III-3).

Errors and Omissions Insurance

The increasing complexities of real estate transactions and the rising use of litigation in today's society have prompted the need for errors and omissions (E&O) insurance programs to protect sales associates and the real estate firm they represent against potential lawsuits. These policies cover disputes between real estate professionals and their clients. E&O insurance may also provide protection against judgements for actual (not punitive) damages.

Sixty-nine percent of firms with independent contractor licensees offer E&O coverage, while 43 percent of firms with salaried licenses offer such coverage (See Table III-4). Three quarters of residential brokerages offer E&O insurance, with larger brokerages having a greater probability of carrying coverage compared to smaller firms (See Table III-5).

Unlike other benefits offered, real estate firms do tend to contribute towards E&O insurance premiums. Nearly 60 percent of firms pay for at least part of the premiums associated with E&O insurance . Residential brokerages, especially the larger brokerages, are slightly less likely to pay for at least part of the premiums compared to other real estate firms.

There are a variety of reasons why real estate firms decide to cease offering E&O insurance or choose to never offer such insurance (See Table III-6, Table III-7 and Figure III-1). Of those firms that cancel the E&O programs, 24 percent feel the insurance is too expensive, 22 percent believe that it is not necessary, and 17 percent feel it is the salesperson's responsibility to secure such insurance. Similarly, of those firms that have never provided E&O insurance, 26 percent feel the insurance is not necessary, 22 percent believe the insurance is too expensive, and 19 percent feel that E&O insurance is the responsibility of the agents.

Mediation

Mediation offers real estate firms the ability to settle disputes with other agents, clients, and customers without the time and expense associated with court trials. Half of all real estate firms use mediation services to settle disputes (See Table III-8). Residential firms, especially the larger ones, are more likely to use these services with 64 percent of larger residential firms reporting their use of mediation services. For 71 percent of these firms, the use of mediation services is firm policy. Twenty-nine percent of firms use mediation services because of state mandates.

Property Disclosure Forms

Most state laws require real estate firms to use property disclosure forms that list known defects of the houses in their transactions and most firms report their use of such forms. The use of property disclosure forms can protect REALTORS® and real estate firms from liability that can result from defects in the properties. Most firms use the form that is developed either by themselves or by their local or state REALTOR® association (See Figure III-2, Table III-9, Figure III-3, and Table III-10).

In-house Training and Education

Education is a very important component of a real estate professional's career. Not only do brokers and salespeople take required courses to maintain their license, but REALTORS® acquire additional training to successfully compete in the today's marketplace.

More than half of real estate firms provide in-house educational training and/or educational programs for sales associates (See Figure III-4). Larger residential firms offer such classes more frequently. Most of these firms provide this training to all of their staff, as opposed to just new sales associates (See Table III-11). Furthermore, this training tends to take the form of informal sessions, as opposed to regularly scheduled formal training classes (See Table III-12).
The typical real estate firm requires 11 to 20 hours of training for its new sales associates, compared to one to ten hours of training for its experienced sales associates (See Table III-13 and Table III-14).
In additional to in-house training, many firms enlist the services of outside educators/trainers for educational training . Brokers or owners are most likely to choose the outside training sources for their firms (See Figure III-5 and Table III-15). Eighty percent of real estate firms use colleges, private education providers, motivational speakers, and other outside sources to supplement or replace in-house training. Larger residential firms are more likely to use outside sources compared to other real estate firms. Firms are more likely to reimburse agents—at least partially—for real estate sales training than to reimburse agents for college degree programs (See Table III-16, Table III-17 and Table III-18).

Personal Assistants

A third of real estate firms (or their brokers or sales associates) employ personal assistants (See Figure III-6). Personal assistants are more prevalent in residential brokerages and in larger brokerages. More than half of firms with personal assistants have set policies on their use.
Use of licensed and unlicensed personal assistants is split relatively evenly (See Figure III-7). Thirty-one percent of firms with personal assistants use only licensed personal assistants. Twenty-nine percent of firms use only unlicensed personal assistants, and 40 percent use both licensed and unlicensed personal assistants.

Community Organization Participation of Real Estate Firms

Community organization participation is a great way for real estate firms to promote their commitment to their surrounding neighborhoods. It is also one way many firms "give back" to their community.
Three quarters of real estate firms report participating in community associations (See Table III-19 andTable III-20) . Six percent report participating in the local civil rights organization, while 12 percent participate in the local fair housing group.

Firm Profitability

The strong housing market in 1998 translated in increased firm profitability (See Table III-21). Fifty-nine percent of real estate firms report that their profitability rose in 1998 compared to 1997. Sixty-one percent of residential brokerages experienced higher profitability in 1998, while 14 percent of residential brokerages indicate that their profitability diminished.

Firms in the Northeast are more likely to indicate that their profitability rose in 1998 (See Table III-22). While all firm types report stronger profitability, larger firms tend to respond that they are experiencing increased profitability. Eighty percent of larger residential brokerages report higher profitability, compared to 56 percent of smaller residential brokerages.

Back to top of Page

Chapter 4: Real Estate Networks

Real estate networks enhance the way real estate professionals gather data on potential customers. Networks are also used to improve the flow of information enabling REALTORS® to do their job more effectively. The multiple listing service, referral networks, and relocation companies are ways REALTORS® obtain information regarding future clients.

This chapter presents the latest information regarding REALTOR® firms' association with these networks. Eighty-seven percent of firms are affiliated with at least one multiple listing service, and the typical firm with an affiliation has had an agreement with that MLS service for seven years. More than half of larger residential firms participates in affinity arrangements. The typical firm participating in affinity relationships has three affinity partners.

Multiple Listing Services

The multiple listing service (MLS) system allows real estate firms to share information on properties. This information has a major role in the ability of real estate firms to serve their customers and clients effectively with additional marketing power. A listing placed on the MLS is available to numerous other firms in the market, thereby increasing the exposure of the listing to numerous other REALTORS® and potential homebuyers.

Eighty-seven percent of real estate firms are affiliates of at least one multiple listing service (See Figure IV-1,Table IV-1 and Table IV-2). Sixteen percent of residential brokerages are members of more than one MLS. Larger firms, which tend to serve larger geographic regions, have more MLS memberships compared to smaller firms.

Most MLS affiliated firms access the MLS from office terminals. However, technology has enabled other means of access. For example, there has been an increase in access from agents' residences and via cellular phones. By making access to the MLS more flexible, real estate firms give their sales force an additional tool to find the best house for their buying customers and a better marketing tool to their listing clients.

Referral/Relocation Firms

All real estate firms look for ways to generate business. One source of business is through referrals from national referral firms and relocation firms. Other broker-to-broker referrals arise from networking activity at state and local meetings.

Twenty-eight percent of real estate firms are members of a national referral and/or relocation company (See Figure IV-2). Another 22 percent of firms are not members of such a group, but do occasionally receive business from the referral/relocation company. The larger the firm, the greater the likelihood that it will be a member of a referral or relocation company. For example, 84 percent of larger residential firms are members of these groups, compared to "just" 21 percent of smaller residential firms.
Larger real estate firms tend to maintain affiliations with referral and/or relocations networks for longer periods of time than do smaller firms (See Table IV-3). The typical firm with an affiliation has had this relationship for seven years, while affiliated larger residential firms have held such agreements for a median of ten years.

Because of reduced commission rates associated with referrals, some sales agents and brokers are turning down referrals. More than forty percent of firms report that they had brokers and/or agents who refused a referral because of the size of the commission (See Table IV-4). Residential firms with more agents are more likely to refuse referrals compared to smaller firms.

Twenty-six percent of real estate firms have a relocation department (See Figure IV-3). Nearly eighty percent of larger residential firms have a relocation department compared to 17 percent of smaller residential firms.

Affinity Relationships

Many firms are entering into arrangements with groups or corporations, in which the real estate firm will provide discounted services or additional services to the customers or members of such groups or corporations. For example, members of a fraternal group may be able to receive commission rebates from a local real estate firm. Given that it is generally the customer who receives the benefits, these "affinity" relationships are a different form of referral.

The vast majority of firms do not participate in affinity arrangements (See Table IV-5). Fourteen percent of real estate firms participate in an affinity relationship with at least one outside group or corporation. Three percent of firms do not participate because company policy prohibits such participation, while another five percent of firms operate in states that do not permit these programs.

Participation in affinity arrangements tends to be more common among larger residential firms. A third of medium sized residential firms and more than half of larger residential firms participate in affinity arrangements.

The typical firm participating in affinity relationships has such arrangements with three groups and/or corporations (See Table IV-6). The smallest affiliated firms have arrangements with a median of two groups/corporations while the largest affiliated firms have arrangements with a median of four groups/corporations.

Corporations (such as airlines, insurance companies, and membership warehouses) tend to be the most popular groups with which real estate firms establish affinity relationships (See Table IV-7). Professional associations, employers, special interests are other widely cited affinity groups.

The types of benefits in these affinity arrangements vary greatly from discounted services to access to ancillary services (See Table IV-8). Popular benefits offered to those eligible include special mortgage packages, "getting to know you" packages, a reduction in sales commission, and/or "other" goods and services.

Back to top of Page

Chapter 5: The Role of Technology in Real Estate Firms

Technology, including the Internet, is playing an increasing role in the way real estate firms compete for and conduct business. Cellular phones and pagers have made it easier for sales agents and brokers to communicate with their clients while out of the office. Because computer usage by real estate firms is nearly 100 percent, this survey did not ask firms whether they owned/leased computers.

But as we enter the 21st century, the Internet has begun to impact the industry. Some REALTORS® see the Internet as a threat to business, while others see it as an opportunity to better attract and serve customers. In either case, this new communication technology is having profound impacts on real estate firms.

Office Technology

Communication technologies, such as cellular phones and pagers, are popular tools among real estate firms. Ninety-six percent of real estate firms use cellular phones and pagers in their business operations (See Table V-1).

Nearly a third of real estate firms or their sales forces use personal digital assistants to organize both their contact information and schedules. The penetration rates of scanners and digital cameras, both of which significantly improve a real estate firm's marketing capabilities, are at 71 percent and 59 percent of real estate firms, respectively. Penetration rates for all tools rise as firm size increases (See Table V-2).

Software Packages

Computer software contributes to the efficiency and productivity of real estate firms and allows these firms to better serve their clients. MLS, comparative market analysis, and document preparation software are the most widely cited software packages used by real estate firms.

Some software packages are geared towards special fields of the real estate industry. For example, just 47 percent of real estate firms use property management software, while 90 percent of firms that specialize in property management use such software (See Table V-3 and Table V-4).

Internet

The Internet represents a new marketing opportunity for real estate firms. A 1999 NAR study, "REALTORS® and the Internet," found that 23 percent of home searchers used the Internet in their home search. As a result, real estate firms feel that they need a presence on the World Wide Web to be competitive in today's market.

Fifty-seven percent of real estate firms have a site on the World Wide Web (See Figure V-1). Residential firms are more likely to have a Web site, with larger residential firms having a greater presence on the Internet compared to their smaller brethren .

A presence on the Internet leads to business. More than seven out of ten real estate firms report that they generate at least one percent of their business from on-line services (See Figure V-2). Larger firms are more likely to generate business from the Internet compared to smaller firms (See Table V-5).

Real estate firms also are turning to the Internet as a place to market their listings (See Figure V-3 and Table V-6). REALTOR.COM™ is the most popular site on the Internet for real estate firms to place their listings. Sixty-four percent of residential real estate firms have their listings on REALTOR.COM™. The second most popular site for on-line listings is the firm's own Web site, followed by local real estate magazine Web sites and local newspaper Web sites.

Nearly all of the larger residential firms have their listings on REALTOR®.COM™ and 80 percent of them put their listings on their company's Web site. Other third party providers, such as HomeAdvisor.com and HomeSeekers.com, lag far behind.

Back to top of Page

Conclusion

Real estate firms take many forms and sizes. There are small firms with a sales force of one competing with firms with thousands of agents. Whereas most firms are small, REALTORS® tend to represent larger brokerages. Most real estate firms specialize in residential brokerage, other firms specialize in commercial brokerage, land sales, appraisal, or some other important facet of the real estate industry. Some firms offer a wide menu of services to their customers, while others just offer a service or two. Simply said, there is not just one type of successful real estate firm.

As there are different types of real estate firms, there are different predictions about the future of the real estate industry. Some industry "experts" predict that only larger real estate firms that offer a wide menu of services will thrive in the future, leaving no room for those firms that remain. Others feel that smaller firms will continue to prosper as long as they serve a niche market that does not interest the big conglomerates. Yet another group of experts challenges the notion that super-sized firms will compete profitably in real estate. Only a clairvoyant truly knows which scenario will happen.

Looming behind this discussion is the burgeoning role of technology, especially the Internet and the impact it is having on the real estate industry. Will the Internet enable other parties to displace the role of REALTORS® and real estate firms in the transaction? Will the Internet open new opportunities for real estate firms to compete in the future? How will the Internet change the way real estate firms conduct business and how will it impact the menu of services offered? The answers to these questions will greatly impact the type of real estate firms and their role in the future.

However, those answers are not yet obvious, and so it is important to continue tracking trends in the size of real estate firms types and their business practices. Ongoing data collection and analysis will enable firm owners and managers, and others in the real estate industry, to make informed decisions on how to successfully manage their operations in the new millennium.

Back to top of Page

ATTACHMENT C

Real Estate Brokerage

State	Available	Subsidiary Required	Authorization	Citation
Alabama	Yes	No	Statute	5-5A-18
Alaska	No	No	Statute	AS 06.05.272(d)
Arizona	Yes	Yes	Statute	ARS 6-184(A)(7)
Arkansas	No	No	Not Authorized	NA
California	Yes	No	Statute	Cal. Corps. C. Sec. 206 and Cal. Fin. C. Sec. 751.3
Colorado	No	No	Not Authorized	N/A
Connecticut	Yes[1]	Yes[1]	See Footnote[1]	See Footnote[1]
Delaware	Yes	Yes	Statute	Title Five, Delaware Code § 761(a)(3)
DC	Yes[2]	NR	NR	NR
Florida	Yes	Yes	Statute	658.67(6), F.S.
Georgia	Yes	No	Statute & Regulation	7-1-261, operational powers of banks; Regulation 80-5-5
Guam				
Hawaii	No[3]	No	Wildcard	NR
Idaho	Yes	No	Wildcard	NR
Illinois	No	No	Not Authorized	N/A -- Express prohibition exists within IL wildcard statute that grants parity with federal thrifts, among other entities
Indiana	Yes	No	Statute	I.C. 28-1-3-1
Iowa	Yes	No	Statute	Section 524.802
Kansas	No	No	Not Authorized	N/A
Kentucky	No	No	Not Authorized	N/A
Louisiana	No	No	Not Authorized	N/A
Maine	Yes[4]	No	Regulation	Maine 9B Section 131(6-A); 9B Section 446-A; Regulation #7
Maryland	No	No	Not Authorized	N/A
Massachusetts	Yes	Yes	Statute	G.L.c.167F §2 p. 25
Michigan	Yes	No	Statute	MCL 487.14104(1)
Minnesota	No	No	Statute is Silent	N/A
Mississippi	No	No	Not Authorized	N/A
Missouri	No[5]	No	Not Authorized	N/A
Montana	No	No	Not Authorized	N/A
Nebraska	Yes	No	Incidental Powers Regulation	Department Statement of Policy #9
Nevada	No	No	Not Authorized	N/A
New Hampshire	Yes[6]	No	Regulation & Wildcard	Ban 525, Federal Savings Associations Powers
New Jersey	Yes	No	Regulation	NJAC 3:11-11.5(a)(4)

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Real Estate Brokerage

State	Available		Subsidiary Required		Authorization	Citation
New Mexico	Yes		No		Wildcard	58-1-54
New York	No		No		Not Authorized	N/A
North Carolina	Yes		Yes		Statute	NCGS 53-47c(3)
North Dakota	No		No		Not Authorized	N/A
Ohio	No		No		Not Authorized	N/A
Oklahoma	No		No		Not Authorized	N/A
Oregon	No		No		Not Authorized	N/A
Pennsylvania	Yes		No		Parity Statute	7P.S. §201
Puerto Rico	No		No		Not Authorized	N/A
Rhode Island	No		No		Not Authorized	N/A
South Dakota	Yes		No		Interpretation	51-A-2-14(3)
Tennessee	Yes		No		Statute, Regulation & Wildcard	T.C.A. §45-2-607(d); Regulation Chpt. 0180-19; 45-14-105
Texas	Yes		No- Preferred		Statute	Texas Real Estate License Act
Utah	No		No		Not Authorized	N/A
Vermont	No		No		Not Authorized	N/A
Virginia	No		No		Not Authorized	N/A
Washington	Yes[7]		No		Wildcard Authority	RCW 30.04.127
West Virginia	No		No		Not Authorized	N/A
Wisconsin	Yes		No		Statute & Regulation	221.0322 & DFI -Bkg#16
Wyoming	Yes		No		Statute	W.S.13-2-101(a)(xiii) & W.S.13-2-101(a)(xii)
SUMMARY	Yes	No	Yes	No		
	26	25	6	45		

NR: Not Reported.

N/A: Not Applicable.

[1] The activity is permissible through a subsidiary. It may also be conducted directly under the authority provided by the "closely related activities" statute [Sect 36a-250(a)(40) of CT General Statutes] or "wild card" statute [Sect. 36a-250(a)(41) of the CT General Statutes]. To date, The Department has not formally acted on any request to conduct the activity.

[2] The DC Office of Banking & Financial Institutions is presently modernizing its bank, mortgage banking, trusts, savings and loan, and credit union statutes, regulations and chartering requirements.

[3] Real estate brokerage is expressly prohibited by state law, unless otherwise allowed through wildcard authority because the activity is permissible for national banks.

[4] The Department would review on a case-by-case basis and refer to Sections 416 and 419-A of the Maine Banking Statute, together with Regulation 7.

[5] Depository Trust Companies have real estate brokerage powers under 362.105

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[6] Effective March 16, 2001, Ban 525 allows commercial banks, trust institutions and savings banks to engage in activities and make any investment in the same manner and to the same extent that the activity is permissible for federal savings associations.

[7] See also the following: Pursuant to RCW 30.04.215(3), 32.08.140(16) and 32.08.146, banks can perform the same activities federal banks can, provided that the activities are approved by the Director of the Department of Financial Institutions.

NOTE: The data included in this table is provided for information purposes only. It should not be construed to be legal guidance.

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ATTACHMENT D

AGENCY LAW QUARTERLY
REAL ESTATE INTELLIGENCE REPORT

To return to the home page, click here.

Realty Alliance letter to NAR

February 8, 2002

Martin Edwards, Jr., President
National Association of Realtors
430 North Michigan Avenue
Chicago, IL 60611-4087

Dear Mr. Edwards:

I am writing to you on behalf of The Realty Alliance to respectfully express our disagreement with NAR on the subject of allowing banks to participate in the real estate business. NAR has chosen to introduce bills into both the House of Representatives (HR324) and the Senate (S1839), which would prohibit banks from owning companies that sell or manage residential real estate in the United States. This legislation is opposed by over 80% of the members of The Realty Alliance, whose membership is comprised of many of the nation's largest and most successful independent real estate companies. The 45 member firms of The Realty Alliance sold over $150 billion worth of real estate in 2001, involving 62,000 sales associates. This represents more than 800,000 transactions.

Our members favor and support a fair, free-market environment unbound by legislative restrictions. We find it hypocritical and fundamentally wrong to ask that national bank subsidiaries be barred from real estate brokerage activity, while real estate brokerages operate mortgage banking, insurance and title insurance businesses. This is all the more objectionable in light of the fact that state chartered banks in 24 states, plus the District of Columbia, are permitted to engage in real estate brokerage as are certain subsidiaries of the Federal Savings & Loan Association.

Further, the members of The Realty Alliance are loath to invite the sort of retaliatory legislation that we would expect the banking industry to introduce should your proposed legislation become law. If federal banks were indeed prohibited from engaging in real estate brokerage, how long would it be before the powerful banking lobby took steps to prevent real estate brokerages from participating in the mortgage banking, insurance and title insurance business?

We believe, in fact, that consumers would benefit from the influx of capital that may result from nationally chartered banks entering this arena. We also believe that increased competition from companies of size would benefit consumers by making all of us sharpen our skills and improve the services we provide. In our view, the role of government is not to limit competition, as your legislation would do, but rather to foster a business environment in which consumers benefit from competition. The members of The Realty Alliance look forward to working, and prospering, in such an environment. We strongly urge you to reconsider your current position on this issue to avoid a breakdown of the relationship between The Realty Alliance and NAR.

Sincerely,

Richard Christopher, Chairman
(Patterson-Schwartz Real Estate, Hockessi, Del.)
The Realty Alliance

Here is the white paper developed by the *Realty Alliance* concerning banks in brokerage:

Members of the Realty Alliance are:

Realty One
Cleveland

Baird & Warner
Chicago

Frank Howard Allen
Novato, Calif.

Ebby Halliday
Dallas

Royal LePage
Ontario, Canada

Patterson-Schwartz
Hockessi, Del.

Champion Realty
Severna Park, Md.

Arvida Realty
Clearwater, Fl.

Crye-Leike
Memphis

Paul Semonin
Louisville, Ky.

DeWolfe Companies
Lexington, Mass.

Real Estate One
Farmington Hills, Mich.

Pru Fox & Roach
Devon, Pa.

Long & Foster
Fairfax, Va.

Prudential Gardner
Metairie, La.

Howard Hanna
Pittsburgh, Pa.

Why The Real Estate Industry Should Allow Banks To Enter The Business

Last April at the Realty Alliance meeting in Dallas we debated, voted, and ultimately took no position on Banks entering the real estate business. While there were strong concerns on both sides, the issue seemed distant and mostly academic. While we debated the impact of a new competitor on our business, none of us believed these events could have a significant impact on our abilities to offer diversified service to our customers.

The situation has changed. NAR has recently introduced Legislation in the House and in the Senate that will directly prohibit Banks from engaging in the real estate business. While on the surface this would seem to be a positive development the ramifications for each of our companies are significant and profound.

The ABA (American Bankers Association) is a strong organization and lobby. There now exists a significant fear that if banks are prohibited from entering real estate, they could turn around and prohibit us from being in the mortgage, title, insurance, etc businesses. (See Real Trend Dec 14th, 2001). Since a great majority of us have built our companies by diversifying into other businesses, our inability to continue in these businesses would be a huge blow, both financially as well as strategically.

While we were concerned by NAR's position last April, we didn't think it was that important either way. Today our membership has a huge concern that this debate may cripple our ability to build our companies currently and in the future.

The following is a brief summary of why we believe Banks should be allowed to enter our business. There are two other good discussions of the debate. They are " Dear Mr. Greenspan", by Steve Murray, Real Trend, February 2001, and "Real Estate confronts the Banks" by Stefan Swanepoel.

Open Competition is the American Way

As the real estate industry has changed, brokerage companies have looked to diversify and enter new businesses (mortgage, title, insurance, etc). Just as we should be able to compete in these businesses, so should any other industry be able to enter and compete with us. Open competition is the American way. Today, more than at any time in history, it should be apparent that open, free markets are superior to closed, controlled, or regulated markets. Real estate brokerage should be treated no differently that any other industry.

There are certain areas of our business that could use a greater level of competition. With large financial institutions entering the business, there would be more competition for the largest entities. Today Cendant, Prudential, and GMAC have little true competition. Large Banks could only create more competition at this level, which would certainly benefit the industry as a whole.

Capital is Good for Our Business

Residential real estate has always been a capital-short industry, and we should encourage efforts to bring more capital to our business. We have struggled for many years to find enough capital to expand our businesses, to innovate, to do research and development, and to grow our companies. Many of us have been faced with the inability to raise capital or borrow money to finance our growth plans. With an open market, capital would most certainly be more available.

Furthermore, capital provides liquidity for those owners who are interested in selling. Many large, significant capital players have entered our industry over

Shorewest Realtors
Brookfield, Wis.

Hunt Real Estate
Williamsville, N.Y.

Windemere Real Estate
Seattle, Wash.

F.C. Tucker Real Estate
Indianapolis

Lyon & Associate
Sacramento, Calif.

Smythe, Cramer
Cleveland

First Team Real Estate
Costa Mesa, Calif.

Fonville Morisey
Raleigh, N.C.

Harry Norman
Atlanta

The Keyes Company
Miami

Edina Realty
Edina, Minn.

Greenridge Realty
Grand Rapids, Mich.

William Raveis Home-Link
Shelton, Conn.

J.D. Reece Realtors
Overland Park, Ks.

RealtySouth
Birmingham, Ala.

Insignia Douglas Elliman
New York

HER Realtors
Columbus, Ohio

Michael Saunders & Co.
Sarasota, Fla.

John L. Scott

the years – Sears, Merrill Lynch, Prudential, and Cendant, to name a few. They certainly have not destroyed or taken over our business. They have competed with us shoulder to shoulder with varying levels of success. Some would even argue that they have had a positive impact on the industry as a whole.

Many owners of real estate brokerages who sold their companies in prior years would argue that these large capital sources provided them excellent exit strategies. Banks and financial institutions are a new source of capital and, therefore, a potential buyer. Their entry into the industry would mean that all companies are worth more. A rising tide raises all boats. Who would not like their company to be worth more?

Capital can enter our business in many ways. The ability to joint venture or create partnerships to grow our businesses or expand into new businesses has been a successful strategy for many real estate companies. By having new capital resources available combined with our entrepreneurial abilities, the future possibilities are endless. In other industries (insurance, and securities) banks have typically partnered with existing companies more often than employing any other strategy.

Competition Will Make Us Better

Competition makes us all better. The argument that banks would be "anti-consumer" makes no sense. How could real estate brokerage be less competitive and anti-consumer if there are more companies offering new and different services? Some argue that the banks' only interest is to sell other financial products. If this were true, it would only emphasize the positive services that we, as realtors, provide to our customers.

Even though they are working hard at relationship management, banks are not known for their customer service. When they entered the insurance business, their performance lagged significantly behind existing insurance brokerages. The negative reaction to raising ATM fees in California and in other states is another example. Our owners would much rather compete with a large financial institution than a small, local, entrepreneurial brokerage that is smart, aggressive and competitive. And if the banks improve their customer service, it raises the bar for all of us.

It Will Affect the Prospects for RESPA Reform

Most importantly, our industry will be facing RESPA reform in the near future. RESPA reform will have a significant impact on how we practice our business and on our ability to build and grow our companies. How can we go to Washington and ask for the things that we feel are appropriate in RESPA reform and at the same time proclaim that banks and financial institutions cannot be allowed in our business? Not only would our credibility be questioned, but also our ability to lobby on future issues would be significantly compromised.

This is the area of the greatest danger. The ABA could easily attempt to limit our abilities to be in other businesses if they are not allowed to be in real estate. Fair is fair. If banks cannot be in real estate then real estate companies should not be in mortgage, title, insurance, etc. This is a powerful argument.

We Should Welcome New Players

Our industry has succeeded for many years by maintaining an open, competitive marketplace where all players can compete on an even footing, and we should welcome new entrants whomever they may be. When we erect regulatory boundaries or prohibit others from joining our business, it hurts us in the long run. Over the years many companies have come into our industry with new

Bellevue, Wash.

Sibcy Cline
Cincinnati

Latter & Blum Co.
New Orleans

Allen Tate Company
Charlotte, N.C.

CBS Real Estate Co.
Omaha, Neb.

The Vaughn Company
Albuquerque, N.M.

Watson Realty Corp.
Jacksonville, Fla.

Prudential Northwest
Beaverton, Ore.

Northwood GMAC
Pittsburgh, Pa.

John R. Wood Realty
Naples, Fla.

ideas and new ways of doing things. Meanwhile, we have changed and prospered. The challenges only make us stronger and better

They Will be There Anyway

In the long term it is highly unlikely that banks will not be in the real estate business. They can always find a way if they think there is enough opportunity. According to the Conference of State Bank Supervisors, the Association of State Bank Regulators, the following states and the District of Columbia, permit their state chartered banks to engage in real estate brokerage either directly or through a subsidiary. Those states are as follows: AL, AZ, CA, CT, DE, DC, FL, GA, ID, IN, IA, MA, MI, NE, NJ, NM, NC, PA, SD, TN, TX, WA, WI, WY. Also, Federal Savings Associations are authorized through service corporation subsidiaries to engage in real estate brokerage activities. The Federal/Treasury Proposal cites the authority in their proposed rule at 12CFR559.4(e)(4) and OTS letter dated July 16, 1997 (1997 OTS Lexis 3). This would mean that Federal Savings Associations such as Washington Mutual, for example, could get into the real estate business today.

We already compete with large financial players (Cendant, Prudential, GMAC) and we see no difference between them and a large bank or a Federal Savings Bank. Why should we waste political capital and risk our current way of doing business, if they are going to enter the business anyway?

Let's not let the National Association of Realtors® speak for us and ruin our business. NAR does not represent us on this issue. We need to stand up as a united force and be counted. Please contact your congressman and/or senator and explain your view to them as soon as possible.

Mr. WATT. I yield back any time that I have.

Mr. BARR. The gentlelady from California, did she have some final?

Ms. WATERS. I don't think I am going to—I was going to engage on the walls of separation that have been alluded to and what the holding company cannot do in relationship to the subsidiary. I didn't want us to leave here thinking that there was no connection that somehow the banks wanted to get into this business, but they are not interested in what their subsidiary, the real estate subsidiary would be doing.

It seems to me, we all know that we get those little notices that say, tell us whether or not you will allow us to market your name to our subsidiaries or to others. Well, I mean, that is what it is all about. It is about having a captive audience. It is about all of those people who don't read this and get to be on the list that can get marketed to—over in the subsidiary from the bank to say, hey, we got a great product here for you.

So it is okay. That is the American way. We understand that it is okay to try and market and to do business in ways that will enhance the bottom line of the company. But I just didn't want us to kind of think that somehow the separation was such that one would not in any way be touching the other, because that is not true. Thank you.

Mr. YINGLING. You are correct.

Mr. BARR. I would like to ask unanimous consent that the statement by the Building Owners and Managers Association be incorporated in the record.

Without objection, so ordered.

Mr. BARR. I think this has been a very, very worthwhile hearing. I hope that we met the burden laid down to us by Mr. Watt at the beginning and that we did essentially stick to the issues within the jurisdiction of this Subcommittee, namely the procedures and processes whereby this proposal has come before the American people.

We have raised a number of very interesting questions, and we appreciate the testimony. Especially appreciate the Treasury Department being here and indicating a willingness to look at various aspects of this process. I think that is a fair recognition of the complexities involved in this and the very long-term, significant consequences of it.

And we appreciate very much the REALTORS® being here and especially taking some time during your very busy trip to Washington this year. We very much appreciate the banks involvement. They are an important part of any consideration of matters that affect our economy and businesses in this country. They are one of the true backbones or underpinnings of our financial structure. We certainly appreciate that.

There are a number of areas that we certainly will be looking into, such as the Congressional Review Act and others, as well certainly the legislation that we all know is pending. But we appreciate you all being here today, and we appreciate very much any additional material that you wish to submit for the record for the consideration of this Subcommittee as we deliberate this very important rulemaking aspect.

With that, I declare this hearing closed.

[Whereupon, at 3:30 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

Responses to Chairman Bob Barr, Subcommittee on Commercial and Administrative Law

1. What procedural and administrative law problems does this proposed rule raise?

Overall Framework

Under § 706 of the Administrative Procedure Act, an agency may not act in an arbitrary and capricious manner. Its decision must be "rational, based on consideration of relevant factors, and within the scope of the authority delegated to the agency by the statute." Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 20, 42 (1983). Furthermore, the agency must comply with procedures required by law.

Specific Points

1. *The agencies did not address all the necessary factors.* Congress set forth four factors that the Board and the Secretary must use in determining whether an activity is "financial in nature" or "incidental to a financial activity" under 12 U.S.C. §§ 24a, 1843(k). They are:

- The purposes of the Bank Holding Company Act and the GLB Act;
- Changes or reasonably expected changes in the marketplace in which FHCs and/or banks compete;
- Changes or reasonably expected changes in the technology for delivering financial services; and
- Whether the activity is necessary or appropriate to allow an FHC or its affiliates or a bank and its financial subsidiaries to:

(i) compete effectively with other companies seeking to provide financial services in the United States;

(ii) efficiently deliver information and services that are financial in nature through technological means; and

(iii) offer customers any available or emerging technological means for using financial services or for the document imaging of data.

Although the agencies recite in cursory fashion that they have considered all of these factors, the only one they actually discuss is the first prong of the fourth factor, dealing with competition with other companies seeking to provide financial services. There is no discussion of what weight the other three factors may have been given in the agencies' decisionmaking process.

Furthermore, even as to the factors the agencies did consider, they undertook no factual investigation of their own. They simply cite, in a footnote, a petition from the American Bankers Association, reporting a review of various companies' websites.

2. *The agencies do not explain what determination they are making.* Under the most natural reading of the GLB Act, an activity may be "financial in nature," or it may be "incidental" to some other financial activity. The agencies lump these two concepts together, without explaining which determination they are making. If the agencies are claiming that real estate brokerage and management are "incidental" to some other financial activity, they should explain what that activity is.

3. *The agencies offer no explanation for why the regulations should apply to leasing of real estate.* The agencies' rationale for describing real estate brokerage as "financial in nature" rests on the theory that "banks and bank holding companies participate in most aspects of the typical real estate transaction other than brokerage." See 66 Fed. Reg. at 309. That may be true as to residential purchases of real estate,

for which banks commonly provide mortgages and incidental services like appraisals. But it is not generally true as to leasing of real estate, often a relatively simple transaction that does not require financing, appraisals, settlement services, escrow services, or insurance. Yet the proposed regulations would apply to brokerage for lessors and lessees of real estate, as well as purchasers and sellers. The agencies offer no explanation as to why bank affiliates should be permitted to engage in these activities.

4. *The agencies offer no explanation for why the regulations should apply to commercial real estate transactions.* The agencies' reasoning also appears to focus primarily on the purchase of residential real estate by individuals. See 66 Fed. Reg. at 310. Yet the proposed regulations would apply to both commercial and residential real estate brokerage. Commercial enterprises frequently buy, sell, or lease real estate. The agencies offer no explanation why such transactions should be viewed as "financial" activities, rather than as part of a business's ordinary commercial activities.

5. *There is no indication whether the Treasury Department's proposed regulations have been reviewed by OMB.* Under Executive Order No. 12,866 (3 C.F.R. 658 (1994)), any "significant regulatory action" by an Executive Branch agency must generally be reviewed by the Office of Management and Budget ("OMB"). A "significant regulatory action" includes any action

> that is likely to result in a rule that may * * * [h]ave an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities.

Although that requirement does not apply to the Federal Reserve Board (an independent regulatory agency), it does apply to the Treasury Department. There is no indication in the proposed regulations whether Treasury considers them to be a "significant regulatory action," or whether it plans to submit them (or has submitted them) to OMB.

2. Please explain the rationale for Congress' long-term policy prohibition against merging "commercial" and "financial" activities.

Congress has continued to separate banking and commerce to prevent inherent conflicts of interest. An example of this conflict can be explained by the following example that could occur if the proposed real estate regs were finalized: If a real estate broker needed operating capital and had to go to a bank who is now a competitor, would that broker get the best rates on this needed loan? Congress voted against combining commercial and financial activities during debate on the Gramm-Leach-Bliley Act. In the House, an amendment was passed to not only prevent this mix, but to require any entity created under the act that had a commercial affiliation to divest that operation within ten years of enactment. In the Senate, an amendment to close the "unitary thrift loophole" that allowed a mix of banking and commerce was successful. It is interesting to note that the American Bankers' Association priority for Senate action was to close this loophole. Banks are now seeking for themselves, through regulation, powers they successfully removed from their thrift competitors during GLB.

3. Are most realtors small businesses? If so, why did the Treasury Department and Federal Reserve fail to consider the impact of the proposed rule on small businesses as is required by the Regulatory Flexibility Act?

Most REALTORS® are small businesses. Seventy-seven percent of all residential firms consist of a single office. Ninety-two percent of all REALTORS® are independent contractors, who typically earn a gross personal income of $34,100. Eighty-four percent of all residential firms are independent, not affiliated with a franchise. Even the vast majority of franchise real estate operations are independently owned and operated. According to the most recent Economic Census, over 375,000 small women and minority owned real estate businesses operate in this country. As the Treasury witness testified during your hearing, they didn't consider the Regulatory Flexibility Act. NAR would assert that this should have been considered. Our only assumption can be that the regulators only looked to the effect on their regulated industry-banks. How the real estate industry, with many minority and women owned small businesses would be effected was not considered.

4. The proposed rule defines "real estate management and brokerage" as "financial" in nature. Please explain why these two activities are more properly viewed as "commercial" activities? What is the difference between "commercial" and "financial" activities?

Real estate brokerage, leasing and property management are commercial activities. Selling and leasing real estate, although much more complicated, is much like selling any other durable goods such as automobiles, appliances, groceries, jewelry or boats. The business of brokering, leasing, or managing real estate does not involve lending. It is financing of the mortgage that facilitates the transfer of real property that involves lending. More than twenty percent of residential home purchases involve no lender financing whatsoever. See page twelve in NAR testimony where banking, commercial, and financial activities are charted. Congress added insurance and securities brokerage to the gray area of financial activity that both banks and commercial entities compete in. There are several other financial activities such as auto or appliance financing that are offered by both banks and commercial entities. But real estate brokerage is not one of those activities. Real estate brokers do not offer banking services, like check cashing and deposit taking, and banks don't offer real estate brokerage. It is just that simple.

5. Do all purchases of real estate involve lending activities by banks? Why is this important?

As stated in the previous question, twenty percent of residential real estate sales involve no lender financing whatsoever. They may be cash transfers, or owner financed sales. In addition, commercial real estate sales often are financed in far different methods than bank financing. There may be development bonds sold or other more complex financing schemes. Certainly, property leasing and management involve no bank financing.

6. Some have suggested that the National Association of REALTORS® stands alone against this proposed rule. Is this an accurate statement?

This statement is inaccurate. The Federal Reserve and Treasury Department received over 50,000 comment letters opposed to the rule from many different sources other than REALTORS® . As of the date we are drafting these responses, 240 Members of the House and 15 Senators have cosponsored the Community Choice in Real Estate Act, H.R. 3424. We have been joined by over a dozen business and consumer groups in calling for passage of this legislation that would prevent the Federal Reserve and Treasury from granting real estate brokerage, leasing and property management authority to financial holding company and national bank subsidiaries. They include the American Auctioneers Association, American Association of Small Property Owners, Building Owners and Managers Association, CCIM Institute, Consumers Union, International Council of Shopping Centers, Institute for Real Estate Management, the National Association of Home Builders, the National Community Reinvestment Coalition, National Fair Housing Alliance, National Association of Hispanic Real Estate Professionals, National Association of Industrial and Office Properties, National Association of Real Estate Brokers, Real Estate Roundtable, Society of Industrial and Office REALTORS®.

NAR conducted a survey of our membership of over 800,000 members and found that ninety-six percent of REALTORS® support our efforts to prevent this proposed rule. Eighty-two percent of large broker/owners support this effort, and over eighty percent of all REALTORS® said NAR should do more to stop this action.

7. You explain in your testimony a loan to procure real estate is "incident" to a commercial activity. Please explain why it is important we understand what you mean by this statement.

The GLBA required the federal regulators to examine if new powers for banks would be incidental or complementary to banking. Only those powers so defined could be authorized by the regulators. It is important to understand that all real estate transactions involve a transfer of real property and most involve a real estate agent's assistance. But as explained in previous answers, not all real estate transactions involve financing. Thus the loan is incidental to the commercial real estate transfer. The transfer itself is a purely commercial transaction involving a contract between two parties. It may or may not involve financing. Thus the financing or loan is incidental to the real estate transaction. Using that logic, it might better be said that a real estate broker should be able to own a bank, as the loan is incidental to the real estate transaction. This is a huge difference and a major reason why NAR believes that the regulators are exceeding Congressional intent with this proposed rule.

8. Why is it important Congress retain the "firewall" separating banking from commerce?

It is important to retain the separation of banking and commerce due to the inherent risks that would be created. Congress took explicit action during GLB to avoid creating that mixture. Great debate was held on whether the United States should move to a "universal banking" system like that employed by Japan. Even Fed Chairman Alan Greenspan made a critical point during hearings on Gramm-Leach-Bliley: Firewalls leak and in today's closely integrated financial institutions they leak quickly. Chairman Greenspan had the "Asian contagion" fear in mind when making these comments. Given the failure of the Japanese universal banking system these comments were well founded. The whole point in banks getting these additional authorities is to cross sell their proprietary products. Banks call this "one-stop" shopping. We call it "one-bank" shopping. Banks do not have an agency relationship with their customers. Banks necessarily will promote their bank and financial products to the exclusion of any competitive products. That's the nature of banking. The business of banking requires capturing customers for proprietary product and service sales. Real estate brokers and agents have a completely different relationship with their clients based on an agency relationship and the unique nature of selling and marketing real estate. Their only goal is to assist in the marketing or purchase of their client's real estate. Although they may recommend ancillary services, their only compensation comes from the completion of that transaction. Thus their motivations are completely different from a banker's. A real estate agent's sole obligation is to their client.

307

Proposed Rules

Federal Register
Vol. 66, No. 2
Wednesday, January 3, 2001

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-1091]

Bank Holding Companies and Change in Bank Control

DEPARTMENT OF THE TREASURY

Office of the Under Secretary for Domestic Finance

12 CFR Part 1501

RIN 1505-AA84

Financial Subsidiaries

AGENCIES: Board of Governors of the Federal Reserve System and Department of the Treasury.

ACTION: Joint proposed rule with request for public comments.

SUMMARY: The Board of Governors of the Federal Reserve System and the Secretary of the Treasury jointly propose to seek comment on whether to determine by rule that real estate brokerage is an activity that is financial in nature or incidental to a financial activity and therefore permissible for financial holding companies and financial subsidiaries of national banks. The Board and the Secretary also jointly propose to solicit comment on whether real estate management activities could be considered financial in nature or incidental to a financial activity. The Board's proposed rule would amend subpart I of the Board's Regulation Y to add real estate brokerage and real estate management to the list of activities permissible for financial holding companies. The Secretary's proposed rule would amend its financial subsidiary regulations to add real estate brokerage and real estate management to the activities permissible for financial subsidiaries of national banks. The Board and the Secretary solicit comment on all aspects of the proposal.

DATES: Comments must be received by March 2, 2001.

ADDRESSES: Comments should refer to docket number R-1091 and should be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551 (or mailed electronically to *regs.comments@federalreserve.gov*) and to Real Estate Brokerage and Management Regulation, Office of Financial Institution Policy, U.S. Department of the Treasury, 1500 Pennsylvania Avenue, NW., Room SC 37, Washington, DC 20220 (or mailed electronically to *financial.institutions@do.treas.gov*). Comments addressed to Ms. Johnson also may be delivered to the Board's mailroom between 8:45 a.m. and 5:15 p.m. and, outside those hours, to the Board's security control room. Both the mailroom and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street between Constitution Avenue and C Street, N.W. Members of the public may inspect comments in room MP-500 of the Martin Building between 9 a.m. and 5 p.m. on weekdays. Comments addressed to the Treasury Department may also be delivered to the Treasury Department mail room between the hours of 8:45 a.m. and 5:15 p.m. at the 15th Street entrance to the Treasury Building.

FOR FURTHER INFORMATION CONTACT:

Board of Governors: Scott G. Alvarez, Associate General Counsel (202/452-3583), or Mark E. Van Der Weide, Counsel (202/452-2263), Legal Division; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. For users of Telecommunications Device for the Deaf ("TDD") only, contact Janice Simms at 202/872-4984.

Department of the Treasury: Gerry Hughes, Senior Financial Analyst (202/622-2740); Roberta K. McInerney, Assistant General Counsel (Banking and Finance) (202/622-0480); or Gary W. Sutton, Senior Banking Counsel (202/622-0480).

SUPPLEMENTARY INFORMATION:

Background

The Gramm-Leach-Bliley Act (Pub. L. 106-102, 113 Stat. 1338 (1999)) ("GLB Act") amended the Bank Holding Company Act (12 U.S.C. 1841 *et seq.*) ("BHC Act") to allow a bank holding company or foreign bank that qualifies as a financial holding company ("FHC") to engage in a broad range of activities that are defined by the GLB Act to be financial in nature. The GLB Act also permits FHCs to engage in other activities that the Board determines, by regulation or order and in consultation with the Secretary of the Treasury ("Secretary"), to be financial in nature or incidental to a financial activity.

The GLB Act also amended the National Bank Act (12 U.S.C. 1 *et seq.*) to allow a national bank to invest in financial subsidiaries. Financial subsidiaries may engage, with certain exceptions, in the same broad range of activities that are defined by the GLB Act to be financial in nature and, therefore, permissible for FHCs.[1] In addition, the GLB Act permits financial subsidiaries to engage in other activities that the Secretary determines, in consultation with the Board, to be financial in nature or incidental to a financial activity.

The American Bankers Association ("ABA") and Fremont National Bank & Trust Company, Fremont, Nebraska, have asked the Board and the Secretary (collectively, the "Agencies") to determine that real estate brokerage and management activities are financial in nature. Two additional trade associations, the Financial Services Roundtable and the New York Clearing House Association, have requested that the Board permit FHCs to engage in real estate brokerage activities.[2] The National Association of Realtors ("NAR") has urged the Agencies not to determine that real estate brokerage activities are financial in nature or incidental to a financial activity.

The GLB Act directs the Board to consider a variety of factors when considering a request for a determination that an activity is financial in nature or incidental to a financial activity, including (i) the purposes of the BHC Act and the GLB

[1] The exceptions are engaging as principal in certain insurance underwriting activities, real estate investment and development (unless otherwise expressly authorized by law), and merchant banking activities permitted in 12 U.S.C. 1843(k)(4)(H) or (I). 12 U.S.C. 24a(a)(2)(B).

[2] The New York Clearing House Association submitted its request on behalf of The Bank of New York Company, Inc.; Chase Manhattan Corporation; Citigroup, Inc.; J.P. Morgan, Inc.; Bankers Trust Company; Fleet Boston, Inc.; HSBC; Bank One Corporation; First Union Corporation; and Wells Fargo & Company.

Act; (ii) the changes or reasonably expected changes in the marketplace in which FHCs compete; (iii) the changes or reasonably expected changes in the technology for delivering financial services; and (iv) whether the proposed activity is necessary or appropriate to allow a FHC to compete effectively with any company seeking to provide financial services in the United States, efficiently deliver financial information and services through the use of technological means, or offer customers any available or emerging technological means for using financial services or for the document imaging of data.[3] The Secretary must consider a virtually identical set of factors in determining whether an activity is permissible for financial subsidiaries.[4] The Agencies also may consider other factors and information that they consider relevant to their determination.

The Agencies believe that the GLB Act's "financial in nature or incidental" standard represents a significant expansion of the "closely related to banking" standard that the Board previously applied in determining the permissibility of activities for bank holding companies.[5] In considering whether an activity was closely related to banking, the Board and the courts looked to whether banks generally (i) conduct the proposed activity, (ii) provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed services, or (iii) provide services that are so integrally related to the proposed services as to require their provision in a specialized form.[6] Because the new "financial in nature or incidental" test appears to be substantially broader than the old "closely related to banking" test, the Agencies believe that they should consider an activity to be financial in nature or incidental to a financial activity to the extent that it meets the old standard.

After considering the factors listed above and other relevant information, the Agencies propose to seek public comment on whether to adopt rules that would define real estate brokerage and real estate management as activities that are financial in nature or incidental to a financial activity. The Board's proposed rule would amend § 225.86 of the Board's Regulation Y to add these two new activities to the list of activities permissible for FHCs. Bank holding companies and foreign banks that qualify as FHCs would be permitted to engage in real estate brokerage and real estate management by using the post-consummation notice procedure described in § 225.87 of Regulation Y. Bank holding companies and foreign banks that do not qualify as FHCs may engage only in those nonbanking activities that were permissible for bank holding companies prior to the enactment of the GLB Act and, thus, could not provide real estate brokerage or management services under the proposed rule. The Secretary's proposed rule would amend its regulations regarding financial subsidiaries to add real estate brokerage and real estate management to the activities permissible for financial subsidiaries. Qualifying national banks would be permitted to engage in these activities through financial subsidiaries by providing the Office of the Comptroller of the Currency ("OCC") with a notice under the OCC's rules.

The GLB Act requires that the Board and the Secretary consult with each other concerning any request, proposal, or application for a determination that an activity is financial in nature or incidental to a financial activity. The Agencies have consulted with each other concerning the proposed rules, and each Agency supports the other's determination to seek public comment on the proposed rules.[7]

Proposed Rules

A. Real Estate Brokerage

Real estate brokerage is the business of bringing together parties interested in consummating a real estate purchase, sale, exchange, lease, or rental transaction and negotiating on behalf of such parties a contract relating to the transaction. The activity of real estate brokerage would include acting as agent for a party to a real estate transaction; listing and advertising real estate; locating buyers, sellers, lessors, and lessees interested in engaging in real estate transactions among themselves; conveying information between the parties to a potential real estate transaction; providing advice in connection with a real estate transaction; negotiating price and other terms on behalf of parties to a real estate transaction; and administering the closing to a real estate transaction. Real estate brokerage generally does not involve purchasing or selling real estate as principal. The business of real estate brokerage may only be conducted pursuant to state licensing laws and regulations.

As noted, prior to the passage of the GLB Act, bank holding companies were permitted to engage only in activities that the Board determined were closely related to banking under section 4(c)(8) of the BHC Act. In 1972, the Board determined that real estate brokerage was not closely related to banking for purposes of the BHC Act.[8] Although the GLB Act does not explicitly authorize FHCs to act as real estate brokers, the statute permits FHCs to engage in any activity that the Board, in consultation with the Secretary, has determined to be financial in nature or incidental to a financial activity. As noted, the GLB Act's "financial in nature or incidental" test is broader than the former "closely related to banking" test.

Similarly, the OCC has not permitted national banks to engage in general real estate brokerage.[9] Although the GLB Act does not explicitly authorize financial subsidiaries to act as real estate brokers, the statute permits financial subsidiaries to engage in any activity that the Secretary, in consultation with the Board, has determined to be financial in nature or incidental to a financial activity. For the reasons discussed below, the Agencies believe that they should seek public comment on whether real estate brokerage activities are financial in nature or incidental to a financial activity within the meaning of section 4(k)(1)(A) of the BHC Act and section 5136A(a)(2)(A)(i) of the Revised Statutes.

1. General "Financial in Nature or Incidental" Analysis

Some depository institutions already engage in real estate brokerage. Although, as noted, the OCC has not permitted national banks to provide

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[3] *See* 12 U.S.C. 1843(k)(3).

[4] *See* 12 U.S.C. 24a(b)(2).

[5] *See* H.R. Conf. Rep. No. 106–434, at 153 (1999) ("permitting banks to affiliate with firms engaged in financial activities represents a significant expansion from the current requirement that bank affiliates may only be engaged in activities that are closely related to banking").

[6] *See National Courier Association* v. *Board of Governors of the Federal Reserve System*, 516 F.2d 1229, 1237 (D.C. Cir. 1975).

[7] Under the GLB Act, neither Agency may determine that an activity is financial in nature or incidental to a financial activity if the other Agency indicates in writing that it believes that the activity is not financial in nature, incidental to a financial activity, or otherwise permissible. 12 U.S.C. 1843(k)(2)(A)(ii), 24a(b)(1)(B)(i)(II).

[8] 12 CFR 225.126(c); *Boatmen's Bancshares, Inc.*, 58 Federal Reserve Bulletin 427, 428 (1972). In 1987, as part of a proposal to authorize bank holding companies to engage in real estate investment (the "1987 Proposal"), the Board proposed permitting a bank holding company to provide real estate brokerage services in connection with real estate in which the bank holding company had an interest. *See* 52 FR 543 (Nov. 4, 1987); *see also* 50 FR 4519 (Jan. 31, 1985). The Board never adopted this proposed rule in final form.

[9] *See* OCC Interpretive Letter No. 84, *reprinted in* [1978–1979 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,159 (Apr. 3, 1979).

general real estate brokerage services, several states currently permit their state-chartered banks to act as a general real estate broker.[10] The Office of Thrift Supervision ("OTS") also has permitted the service corporation subsidiaries of federal savings associations to provide general real estate brokerage services.[11] In addition, national and state bank trust departments have long been involved as agent in the purchase and sale of real estate assets that are part of trust estates.

Although bank holding companies and financial subsidiaries do not have authority to provide real estate brokerage services, banks and bank holding companies engage in a wide variety of other real-estate related activities, including (i) holding bank premises and acquiring real estate in a fiduciary capacity or in full or partial satisfaction of a debt previously contracted; (ii) making real estate investments that have as their primary purpose community development (subject to certain limits); (iii) providing real estate appraisal services; (iv) arranging commercial real estate equity financing; (v) real estate lending; (vi) real estate leasing; (vii) providing real estate settlement and escrow services; and (viii) providing real estate investment advisory services.[12] Since the passage of the GLB Act, FHCs and financial subsidiaries also have been able to provide title insurance, private mortgage insurance, and any other type of insurance to the parties to a real estate transaction.[13] As a result, banks and bank holding companies participate in most aspects of the typical real estate transaction other than brokerage.

In addition, banks and bank holding companies currently engage in a variety of activities that are functionally and operationally similar to real estate brokerage. Banking organizations have provided their customers with various agency transactional services, including securities brokerage services, private placement services, futures commission merchant services, agency transactional services relating to swaps and other derivative instruments, and insurance agency services.[14] Although these agency services are provided by banking organizations in connection with an underlying financial transaction (the purchase of securities, derivatives, or insurance), the agency services provided by a real estate broker are similar in nature to those provided by a securities, derivatives, or insurance broker.

Although the full range of real estate brokerage services would not fit within the scope of national bank or FHC finder authority,[15] many of the essential aspects of real estate brokerage are already permissible finder activities. The OCC's regulations provide that "a national bank may act as a finder in bringing together a buyer and a seller" for a financial or nonfinancial transaction and further provide that permissible finder activities include "identifying potential parties, making inquiries as to interest, introducing or arranging meetings of interested parties, and otherwise bringing parties together for a transaction that the parties themselves negotiate and consummate." [16] Pursuant to the finder and financial counseling authorities, the OCC has permitted national banks to locate, analyze, and make recommendations regarding the purchase or sale of real estate; and to place real estate investment properties by contacting a limited number of qualified investors, identifying and engaging real estate brokers, advising investors regarding the terms of a real estate sale, and administering a real estate closing.[17] A final rule issued by the Board on December 13, 2000, authorized FHCs to act as a finder.[18]

In addition, the authority of national banks and bank holding companies to assist third parties in obtaining commercial real estate equity financing includes an important subset, although not the full panoply, of services provided by the typical real estate broker.[19] In this regard, the Board has allowed bank holding companies to act as an intermediary for the financing of commercial or industrial income-producing real estate by arranging for the transfer of the title, control, and risk of such a real estate project to one or more investors. Bank holding companies may only arrange commercial real estate equity financing with respect to real estate projects that are not sponsored by or invested in by the holding company. The OCC similarly has authorized national banks to arrange for the placement of equity interests in commercial and investment real estate.[20]

In determining whether an activity is financial in nature or incidental to a financial activity, the GLB Act specifically instructs the Board and the Secretary to consider whether the activity is necessary or appropriate to allow a FHC or a bank, respectively, to compete effectively with other financial services companies operating in the United States.[21] Before the passage of the GLB Act, in determining whether an activity was "closely related to banking," the law directed the Board to consider whether banks engaged in the activity, but did not explicitly authorize the Board to consider whether other financial service providers engaged in the activity.[22] This change in law represents a significant expansion of the

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[10] *See, e.g.*, Iowa Code § 524.802 ("A state bank shall have * * * the power to * * * engage in the brokerage of insurance and real estate subject to the prior approval of the superintendent."); N.J. Admin. Code tit. 3, § 11–11.5(a)(4) (permitting a subsidiary of a New Jersey state-chartered bank to provide real estate brokerage services); 1979 Ky. AG LEXIS 224 ("A state bank, through its authorized trust department, and state trust companies may act as real estate brokers or salesmen in the general real estate business, regardless of whether it involves the institution's fiducial business or not.").

[11] *See* 12 CFR 559.4(e)(4) and OTS Letter, July 16, 1997 (1997 OTS LEXIS 3).

[12] With respect to bank holding companies, see, *e.g.*, 12 CFR 225.22(d)(1) and (3) and 225.28(b)(2), (3), and (12). With respect to national banks, see, *e.g.*, 12 U.S.C. 29 (holding bank premises and acquiring real estate DPC); 12 U.S.C. 92a (general fiduciary authority); OCC Interpretive Letter No. 467, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,691 (Jan. 24, 1989) (providing real estate appraisal services); OCC Interpretive Letter No. 387, *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,611 (June 22, 1987) (arranging commercial real estate equity financing); 12 U.S.C. 371 (real estate lending); 12 CFR 5.34(e)(5)(v) (providing real estate settlement and escrow services and real estate investment advisory services).

[13] *See* 12 U.S.C. 1843(k)(4)(B), 24a(b)(1)(A)(i). The authority of a financial subsidiary to underwrite certain types of insurance is, however, limited. *See* 12 U.S.C. 24a(a)(2)(B)(i).

[14] With respect to bank holding companies, see, *e.g.*, 12 CFR 225.28(b)(7) and 12 U.S.C. 1843(k)(4)(B). With respect to national banks, *see, e.g.*, 12 U.S.C. 24(7) (securities brokerage services); OCC Interpretive Letter No. 329, *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,499 (Mar. 4, 1985) (private placement services); 12 CFR 5.34(e)(5)(v) (futures commission merchant services and agency transactional services relating to swaps and derivatives); and 12 U.S.C. 92 (insurance agency services).

[15] Real estate brokerage would not fit within the finder activities permitted to national banks because real estate brokerage essentially involves the real estate broker in negotiation of the real estate transaction—a role specifically forbidden to national bank finders. *See* 12 CFR 7.1002(b). Real estate brokerage would not fit within the finder activities authorized for FHCs because the Board's finder rule prohibits a finder from becoming involved in negotiation and specifically excludes any activity that would require the FHC to register or obtain a license as a real estate agent or broker. *See* Board press release (December 13, 2000).

[16] 12 CFR 7.1002.

[17] *See* OCC Interpretive Letter No. 238, *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,402 (Feb. 9, 1982). The OCC also has allowed national banks to participate in the structuring and negotiation of certain real estate exchange transactions. *See* OCC Interpretive Letter No. 880, *reprinted in* [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,373 (Dec. 6, 1999).

[18] *See* Board press release (December 13, 2000).

[19] *See, e.g.*, 12 CFR 225.28(b)(2)(ii).

[20] *See* OCC Interpretive Letter No. 271, *reprinted in* [1983–1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,435 (Sept. 21, 1983).

[21] 12 U.S.C. 1843(k)(3)(D)(i), 24a(b)(2)(D)(i).

[22] *See National Courier Association* v. *Board of Governors of the Federal Reserve System*, 516 F.2d 1229, 1237 (D.C. Cir. 1975).

Board's capacity to consider the competitive realities of the U.S. financial marketplace in determining the permissibility of activities for FHCs.

As the financial marketplace continues to evolve, it appears that many financial companies are adding real estate brokerage to their menu of services. In this regard, the ABA has provided evidence that several diversified financial companies provide real estate brokerage services in addition to their more traditional banking, securities, and insurance services.[23] The ABA also has asserted that buyers and sellers of real estate are increasingly looking to a single company to provide all of their real estate-related needs. Purchasers of real estate seem especially interested in obtaining real estate brokerage and mortgage finance from a single provider. The ABA argues that permitting FHCs and financial subsidiaries to engage in real estate brokerage activities would permit FHCs and banks to compete effectively with other financial service providers in the United States. The Agencies solicit comment on the extent to which U.S. financial services companies provide real estate brokerage services.

Existing federal and state laws should operate to mitigate the potential adverse effects of combining banking and real estate brokerage. The antitying rules should help prevent banks from using any market power they possess to assist an affiliated financial subsidiary or FHC in monopolizing or competing unfairly in the real estate brokerage business. The antitying rules would prohibit a subsidiary bank of a FHC engaged in real estate brokerage or the parent bank of a financial subsidiary engaged in real estate brokerage from extending credit, furnishing any service, or varying the consideration for any loan or service on the condition that the customer obtain real estate brokerage services from the bank or any affiliate (including a financial subsidiary) of the bank.[24] Sections 23A and 23B of the Federal Reserve Act would limit the amount of credit and certain other forms of support that a bank could provide to a real estate brokerage affiliate (including a financial subsidiary).[25] In addition, section 23B would require mortgage loans by a bank to a customer who obtains real estate brokerage services from a bank affiliate (including a financial subsidiary) to be on market terms.[26] Furthermore, federal and state consumer protection laws, including the Real Estate Settlement Procedures Act,[27] would help protect customers of banks and affiliated real estate brokers. The Agencies solicit comment on the potential adverse effects of allowing FHCs or financial subsidiaries to act as a real estate broker and whether special restrictions on transactions or relationships between a real estate broker and its affiliated depository institutions are necessary to mitigate those adverse effects.[28]

Permitting FHCs and financial subsidiaries to engage in real estate brokerage does not appear to present significant risks to those organizations or their depository institution affiliates. The proposed rules would ensure that the authorized real estate brokerage services are agency services only and that FHCs and financial subsidiaries take no principal risk in connection with real estate transactions that they broker. As a consequence, FHCs and financial subsidiaries engaging in real estate brokerage would not be subject to either the liquidity risk or market risk associated with real estate investment and development. Real estate brokerage involves operational and legal risks, but these risks appear similar in nature and extent to those posed by other agency activities conducted by FHCs and financial subsidiaries.

2. Real Estate Brokerage as a Statutorily Listed Financial Activity

The ABA has argued that real estate is a financial asset and that, accordingly, the Agencies should find real estate brokerage to be part of the statutorily listed financial activity of "[l]ending, exchanging, transferring, investing for others or safeguarding financial assets other than money or securities."[29] According to the ABA, real estate is a financial asset because (i) the home is the largest asset for many individuals; (ii) real estate serves as the underpinning for hundreds of billions of dollars of mortgage-backed securities; and (iii) real estate serves as a means of wealth creation by increasing in value over time and providing tax benefits.

The Agencies are not convinced that real estate should be deemed a financial asset because it is a comparatively large asset on most individuals' personal balance sheet or because it often is used as collateral for financial instruments. Airplanes, boats, and automobiles are large assets that are often used as collateral for financial instruments (loans and leases in particular), yet these assets are generally considered to be nonfinancial. The Agencies recognize, however, that real estate does have certain important attributes of a financial asset; namely, that individuals often purchase real estate, at least in part, for investment purposes and with a view toward the financial benefits of the transaction.

These financial attributes of real estate may, however, not be enough to justify treating real estate as a financial asset. Although real estate often is purchased, in part, for investment purposes, the same can be said of many nonfinancial assets such as fine art, rare stamps, and antique cars. Moreover, whereas loans, securities, and most other financial assets are held for investment purposes only, most purchasers and renters of real estate also use the property as a residence or in the operation of a business. Finally, financial assets are generally thought to include money, loans, securities, and other similar intangible properties. Real estate, on the other hand, is a tangible, physical asset.

The ABA also has argued that the purchase, sale, or lease of real estate is a financial transaction and that, accordingly, the Agencies should find that real estate brokerage is part of the listed financial activity of "[a]rranging, effecting, or facilitating financial transactions for the account of third parties."[30] The ABA contends that the purchase, sale, or lease of real estate is a financial transaction because it is the most important, complex, and financially difficult transaction that

[23] For example, General Motors Acceptance Corporation operates a thrift, makes mortgage loans, and provides real estate brokerage services; Prudential Insurance Company provides insurance and securities products and real estate brokerage services; Cendant Corporation provides insurance, mortgage loans, and real estate brokerage services; and Long & Foster provides mortgage loans, insurance products, and real estate brokerage services.

[24] 12 U.S.C. 1972(1)(B).

[25] 12 U.S.C. 371c and 371c–1.

[26] 12 U.S.C. 371c–1(a)(2)(D). Section 23A also would cover mortgage loans by a bank to a customer to the extent that the customer uses part of the loan proceeds to pay the brokerage commission of a real estate brokerage affiliate of the bank.

[27] 12 U.S.C. 2601 *et seq.*

[28] Under section 114 of the GLB Act, the Board has authority to impose restrictions or requirements on transactions or relationships between a depository institution subsidiary of a bank holding company and any affiliate of such depository institution, if the Board finds that such action would be (i) consistent with the purposes of applicable Federal law and (ii) appropriate, among other things, to avoid adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. GLB Act Section 114(b). Section 114 provides the OCC with similar authority to impose restrictions or requirements on transactions or relationships between a national bank and its subsidiaries. GLB Act Section 114(a).

[29] 12 U.S.C. 1843(k)(5)(B)(i), 24a(b)(3)(A). The GLB Act requires the Agencies jointly to define this activity and two other listed activities as "financial in nature" and to determine "the extent to which such activities are financial in nature or incidental to a financial activity." 12 U.S.C. 1843(k)(5)(A), 24a(b)(3).

[30] 12 U.S.C. 1843(k)(5)(B)(iii), 24a(b)(3)(C).

most individuals undertake. The Agencies are not convinced that the importance, complexity, or size of a transaction should affect a determination as to whether the transaction is financial in nature. On the other hand, real estate transactions often are entered into, at least in part, for investment purposes. To that extent, real estate transactions do have some aspects of a financial transaction. The Agencies seek comment on the above issues.

3. Arguments of the NAR

As noted, the NAR has asked that the Agencies not authorize real estate brokerage activities. The NAR makes four principal contentions in support of its position. First, the NAR notes that the GLB Act does not specifically authorize FHCs to engage in real estate brokerage. Although this contention is true, the GLB Act also authorizes each Agency to supplement the statutory activities list with additional activities that it determines, in consultation with the other Agency, to be financial in nature or incidental to a financial activity. The NAR points out that the GLB Act specifically prohibits financial subsidiaries from engaging in real estate investment and development activities, but this prohibition by its terms does not apply to FHCs or to real estate brokerage activities.

Second, the NAR suggests that it would be inappropriate for the Board now to permit FHCs to provide real estate brokerage services because the Board prohibited bank holding companies from acting as a real estate broker in 1972. As noted above, the Board's 1972 decision on real estate brokerage was made pursuant to the former "closely related to banking" standard; the GLB Act now authorizes the Board to approve any activity that is "financial in nature" or "incidental to a financial activity." The plain meaning of and legislative history behind the "financial" and "incidental to financial" standards suggest that Congress intended the new standards to be significantly broader than the old "closely related to banking" test. Furthermore, the financial services environment has changed significantly in the past 30 years, and what may have been an inappropriate activity for bank holding companies in the early 1970s may be appropriate for the diversified FHCs of the early 21st century.

Third, the NAR claims that real estate brokerage is a commercial activity and not a financial activity. Finally, the NAR argues that the Agencies should delay finding real estate brokerage to be a permissible activity until such time as FHCs gain experience in conducting the various other new activities authorized by the GLB Act.

The Agencies seek comment on whether real estate brokerage is an activity that is financial in nature or incidental to a financial activity. In addition, the Agencies seek comment on the particular arguments advanced by the NAR.

B. Real Estate Management Services

Real estate management is the business of providing for others day-to-day management of real estate. Day-to-day management of real estate could include procuring tenants; negotiating leases; maintaining security deposits; billing and collecting rent payments; providing periodic accountings for such payments; making principal, interest, insurance, tax, and utilities payments; and generally overseeing inspection, maintenance, and upkeep of real property. Real estate management generally does not involve purchasing, selling, or owning real estate as principal. Although some states do not subject real estate managers to special licensing laws or regulations, real estate managers in other states are subject to the same state licensing laws and regulations that apply to real estate brokers.

The Board first proposed allowing bank holding companies to provide property management services in 1971.[31] For a variety of reasons, however, including the substantial volume of negative public comment received on the proposal, the Board determined in 1972 that property management was not closely related to banking for purposes of the BHC Act.[32] Similarly, the OCC has not permitted national banks to engage in general real estate management.[33]

The Agencies have some doubts as to whether all aspects of real estate management are financial in nature or incidental to a financial activity. The Agencies also are concerned that certain forms of real estate management appear to resemble more closely day-to-day operation of a commercial enterprise than serving as the intermediary between the owners and users of real estate. Nevertheless, for the reasons discussed below, the Agencies believe that they should seek public comment on (i) what activities are included within real estate management and (ii) which of these activities, if any, are financial in nature or incidental to a financial activity within the meaning of section 4(k)(1)(A) of the BHC Act and section 5136A(a)(2)(A)(i) of the Revised Statutes.

1. General "Financial in Nature or Incidental" Analysis

Neither the OCC nor state banking departments, to the Agencies' knowledge, have permitted banks to provide general real estate management services. Thrift holding companies (including non-unitary thrift holding companies) and thrift service corporation subsidiaries, however, have been permitted to maintain and manage real estate.[34] In addition, as noted above, banking organizations have long been engaged in a variety of real estate-related activities. Moreover, some (though not all) real estate management activities appear to be functionally and operationally similar to various other activities that banks and bank holding companies currently engage in. For example, collecting rental payments; maintaining security deposits; making principal, interest, taxes, and insurance payments; and providing periodic accountings are functionally similar to collecting loan or lease payments, disbursing escrow payments, and performing related accountings. In addition, banks and bank holding companies have a long history of managing real estate assets that are part of trust estates, that are used by the banking organization in its own operations, or that are acquired as a result of foreclosure.[35]

As noted above, in determining whether an activity is financial in nature or incidental to a financial activity, the GLB Act instructs the Board and the Secretary to consider whether the activity is necessary or appropriate to allow FHCs or banks, respectively, to compete effectively with other financial services companies operating in the United States. The ABA has contended that competitive considerations support a determination to allow FHCs and financial subsidiaries to provide real estate management services. The Agencies solicit comment on the extent to which financial services companies

[31] *See* 36 FR 18427 (Sept. 7, 1971).

[32] 12 CFR 225.126(g); 58 Federal Reserve Bulletin 652 (1972). As part of the 1987 Proposal, the Board proposed authorizing a bank holding company to provide real estate management services in connection with real estate in which the bank holding company had an interest. *See* 52 FR 543 (Nov. 4, 1987); *see also* 50 FR 4519 (Jan. 31, 1985). As noted above, the Board never finalized this proposed rule.

[33] *See* OCC Interpretive Letter No. 238, *supra.*

[34] *See* 12 CFR 559.4(e)(3), 584.2–1(b)(8).

[35] *See, e.g.*, OCC Interpretive Letter No. 238, *supra;* OCC Interpretive Letter No. 355, *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85.525 (Dec. 10, 1985); *Bancorp Hawaii, Inc.*, 71 Federal Reserve Bulletin 168, 168 n.2 (1985); *United Missouri Bancshares, Inc.*, 64 Federal Reserve Bulletin 415, 417 (1978).

provide real estate management services in the United States and on whether permitting FHCs and financial subsidiaries to provide real estate management services would help ensure competitive equity between FHCs and financial subsidiaries and other financial firms.

The same laws that would operate to mitigate potential adverse effects in the real estate brokerage context also would help to alleviate adverse effects in the provision of real estate management services. The Agencies solicit comment on the potential adverse effects of allowing FHCs and financial subsidiaries to act as a real estate manager and whether special restrictions are necessary to mitigate those adverse effects.

Permitting FHCs and financial subsidiaries to engage in real estate management activities does not appear to present significant risks to those organizations or their depository institution affiliates. The proposed rules would ensure that the authorized real estate management services are agency services only and that FHCs and financial subsidiaries take no principal risk in connection with real estate that they manage. The Agencies recognize, however, that engaging in property management may increase the operational, legal, and reputational risks faced by a FHC or financial subsidiary. Accordingly, the Agencies seek comment on the nature and extent of these risks.

2. Real Estate Management as a Statutorily Listed Financial Activity

The ABA has argued that the Agencies should find that real estate management is part of the listed financial activity of "[l]ending, exchanging, transferring, investing for others or safeguarding financial assets other than money or securities."[36] If the Agencies were to conclude that real estate is a financial asset, this argument would have some textual appeal. Real estate management could be viewed, in part, as a form of safeguarding real estate.

The ABA also has argued that the Agencies should find that real estate management services are part of the listed financial activity of "[a]rranging, effecting, or facilitating financial transactions for the account of third parties."[37] Part of the role of a property manager does involve the facilitation of financial transactions: For example, maintenance of security deposits, collection of rent payments, and distribution of principal, interest, insurance, tax, and utility payments. Property management also, however, appears to have components that go beyond the facilitation of financial transactions. The Agencies seek comment on the above issues.

C. Description of the Proposed Rules

1. Real Estate Brokerage

The proposed rules authorize FHCs and financial subsidiaries to provide real estate brokerage services and include examples of the sorts of activities that the Agencies consider to be included within real estate brokerage. The Agencies seek comment on whether any final rules should provide further guidance regarding the scope of activities that are included within real estate brokerage.

Importantly, the proposed rules also contain restrictions designed to ensure that a FHC or financial subsidiary, when acting as a real estate broker, serves only as an intermediary between buyers and sellers (or lessees and lessors) and does not otherwise become impermissibly involved in the underlying real estate transaction. In particular, the proposed rules make clear that they do not authorize a FHC or financial subsidiary to (i) invest in or develop real estate; or (ii) take title to, acquire, or hold an ownership interest in any real estate that is the subject of the company's real estate brokerage services.

The Agencies understand that many real estate brokers offer employee relocation services to their corporate clients. Certain fundamental employee relocation services—assisting a client's transferred employees to sell their existing homes, buy homes in their destination locations, and obtain mortgage financing for their new home purchases—appear to be forms of real estate brokerage or currently permissible financial activities.

Other employee relocation activities seem less obviously a part of real estate brokerage or otherwise financial in nature. For example, a real estate broker providing employee relocation services often commits to purchase any home owned by one of its client's transferred employees at a fixed price if the broker fails to sell the home within a certain time period. The Agencies believe that such services may be incidental to real estate brokerage if the homes purchased by the broker are sold within a short time period, the broker's total holdings of unsold real estate do not exceed some threshold amount, and the broker only purchases unsold real estate in connection with providing bona fide employee relocation services to customers (not for the purpose of speculating on the price of real estate). The Agencies also understand that employee relocation services often include assisting transferred employees to move household goods to their destination locations and assisting the spouses of transferred employees to find employment in their destination locations.

The Agencies request information on the kinds of employee relocation services that real estate brokers currently provide. The Agencies also seek comment on whether to permit FHCs or financial subsidiaries: (i) To provide employee relocation services as part of real estate brokerage or otherwise; (ii) to purchase residential real estate in connection with providing employee relocation services and, if so, what conditions or limits should apply to such real estate purchases; and (iii) to assist transferred employees to move their household goods and to assist the spouses of transferred employees to find employment in connection with providing employee relocation services.

2. Real Estate Management

The proposed rules authorize FHCs and financial subsidiaries to provide real estate management services and include examples of the sorts of activities that the Agencies consider to be included within real estate management.

The ABA has suggested that the Agencies' definition of real estate management should include any activities that may be defined as "real estate management" under any state law. The Agencies generally are reluctant to delegate to state legislatures any determinations regarding the scope of permissible activities for federally regulated banking organizations. Nevertheless, the Agencies specifically solicit comment on whether real estate management activities should be defined explicitly to include any activities that are defined as "real estate management" under state law. The Agencies also request comment more generally on whether any final rules should contain further guidance regarding the scope of activities that are included within real estate management.

The proposed rules contain restrictions designed to ensure that a FHC or financial subsidiary, when providing real estate management services, acts only in an agency capacity as an intermediary between the owners and users of real estate. In particular, the proposed rules make clear that real estate management does not include (i) investing in or developing real estate; or

[36] 12 U.S.C. 1843(k)(5)(B)(i), 24a(b)(3)(A).

[37] 12 U.S.C. 1843(k)(5)(B)(iii), 24a(b)(3)(C).

(ii) taking title to, acquiring, or holding an ownership interest in any real estate that the FHC or financial subsidiary manages. In light of these exclusions, the Agencies request comment on whether real estate managers receive compensation in the form of an equity or equity-like interest in the managed real estate and, if so, whether the Agencies should prevent FHCs that engage in real estate management from receiving compensation in this form.

The proposed rules also prevent a FHC or financial subsidiary that provides real estate management services from itself repairing or maintaining the managed real estate. The Agencies have doubts as to whether repair and maintenance of real estate are activities that are financial in nature or incidental to a financial activity. The proposed rules allow a FHC or financial subsidiary, however, to arrange for a third party to provide these services. The Agencies request comment on whether FHCs and financial subsidiaries should be limited in their authority to engage in any other aspects of real estate management.

The Agencies also seek comment on whether they should draw any distinctions between the management of single-family housing, multi-family housing, office buildings, institutional buildings (hotels, hospitals, etc.), commercial and industrial properties, and farms. In addition, the Agencies solicit comment on whether real estate management should include management of the air rights above and the oil and mineral rights beneath particular parcels of land. As noted above, the Agencies are concerned that certain forms of real estate management may more closely resemble day-to-day operation of a commercial enterprise than serving as the intermediary between the owners and users of real estate.

Plain Language

Section 722 of the GLB Act requires the Board to use "plain language" in all proposed and final rules published after January 1, 2000. In light of this requirement, the Board has sought to present its proposed rule in a simple and straightforward manner and has included in the rule examples of activities that would be permissible under the proposed rule. The Board invites comments on whether there are additional steps the Board could take to make the proposed rule easier to understand.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, the Agencies certify that the proposed rules would not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). The proposed rules would remove regulatory restrictions on financial holding companies and financial subsidiaries of national banks by permitting them to engage in real estate brokerage and real estate management activities. The proposed rules would apply to all financial holding companies and national bank financial subsidiaries, regardless of their size. The proposed rules should enhance the ability of financial holding companies and financial subsidiaries, including small financial holding companies and financial subsidiaries, to compete with other providers of financial services in the United States and to respond to technological and other changes in the marketplace in which they compete. Accordingly, a regulatory flexibility analysis is not required.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR part 1320 Appendix A.1), the Board has reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget. No collections of information pursuant to the Paperwork Reduction Act are contained in the proposed rule.

List of Subjects

12 CFR Part 225

Administrative practice and procedures, Banks, Banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 1501

Administrative practice and procedure, National Banks, Reporting and recordkeeping requirements.

Federal Reserve System

12 CFR Chapter II

Authority and Issuance

For the reasons set forth in the joint preamble, part 225 of chapter II, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p-1, 1843(c)(8), 1843(k), 1844(b), 1972(l), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. Section 225.86(d), published at 65 FR 80740, December 22, 2000, is amended by adding new paragraphs (d)(2) and (d)(3) to read as follows:

§ 225.86 What activities are permissible for financial holding companies?

* * * * *

(d) * * *

(2) *Real estate brokerage.*

(i) Providing real estate brokerage services, including, among other things, acting as an agent for a buyer, seller, lessor, or lessee of real estate; listing and advertising real estate; providing advice in connection with a real estate purchase, sale, exchange, lease, or rental transaction; bringing together parties interested in consummating such a real estate transaction; and negotiating on behalf of such parties a contract relating to such a real estate transaction.

(ii) In providing real estate brokerage services, a financial holding company may not:

(A) Invest in or develop real estate as principal; or

(B) Take title to, acquire, or hold any ownership interest in real estate brokered by the company.

(3) *Real estate management.*

(i) Providing real estate management services, including, among other things, procuring tenants; negotiating leases; maintaining security deposits; billing and collecting rent payments; providing periodic accountings for such payments; making principal, interest, insurance, tax, and utility payments; and generally overseeing the inspection, maintenance, and upkeep of real estate.

(ii) In providing real estate management services, a financial holding company may not:

(A) Invest in or develop real estate as principal;

(B) Take title to, acquire, or hold any ownership interest in real estate managed by the company; or

(C) Directly or indirectly maintain or repair real estate managed by the company (but may arrange for a third party to provide these services).

By order of the Board of Governors of the Federal Reserve System, December 26, 2000.

Jennifer J. Johnson,

Secretary of the Board.

Department of the Treasury

12 CFR Chapter XV

Authority and Issuance

For the reasons set forth in the joint preamble, part 1501 of chapter XV, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 1501—FINANCIAL SUBSIDIARIES

1. The authority citation for part 1501 continues to read as follows:

Authority: 12 U.S.C. 24a.

2. Section 1501.2, published in an interim rule in this issue of the **Federal Register**, is amended by adding new paragraphs (b) and (c) to read as follows:

1501.2 What activities has the Secretary determined to be financial in nature or incidental to a financial activity?

(a) * * *

(b) *Real estate brokerage.*

(1) Providing real estate brokerage services, including, among other things, acting as an agent for a buyer, seller, lessor, or lessee of real estate; listing and advertising real estate; providing advice in connection with a real estate purchase, sale, exchange, lease, or rental transaction; bringing together parties interested in consummating such a real estate transaction; and negotiating on behalf of such parties a contract relating to such a real estate transaction.

(2) In providing real estate brokerage services, a financial subsidiary may not:

(i) Invest in or develop real estate as principal; or

(ii) Take title to, acquire, or hold any ownership interest in real estate brokered by the financial subsidiary.

(c) *Real estate management.*

(1) Providing real estate management services, including, among other things, procuring tenants; negotiating leases; maintaining security deposits; billing and collecting rent payments; providing periodic accountings for such payments; making principal, interest, insurance, tax, and utility payments; and generally overseeing the inspection, maintenance, and upkeep of real estate.

(2) In providing real estate management services, a financial subsidiary may not:

(i) Invest in or develop real estate as principal;

(ii) Take title to, acquire, or hold any ownership interest in real estate managed by the financial subsidiary; or

(iii) Directly or indirectly maintain or repair real estate managed by the financial subsidiary (but may arrange for a third party to provide these services).

Dated: December 26, 2000.

Gregory A. Baer,

Assistant Secretary for Financial Institutions, Department of the Treasury.

[FR Doc. 01–43 Filed 1–2–01; 8:45 am]

BILLING CODE 4810–25–P

RAILROAD RETIREMENT BOARD

20 CFR Part 369

RIN 3220–AB49

Use of the Seal of the Railroad Retirement Board

AGENCY: Railroad Retirement Board.

ACTION: Proposed rule.

SUMMARY: The Railroad Retirement Board (Board) proposes to amend its regulations to add a part explaining when use of the Board's seal is permitted. Federal law prohibits the use of an agency seal except as authorized by regulation. The Board currently has no such regulation.

DATE: Comments should be submitted on or before March 5, 2001.

ADDRESSES: Any comments should be submitted to the Secretary to the Board, Railroad Retirement Board, 844 North Rush Street, Chicago, IL 60611.

FOR FURTHER INFORMATION CONTACT: Marguerite P. Dabado, Assistant General Counsel, Railroad Retirement Board, (312) 751–4945, TDD (312) 751–4701.

SUPPLEMENTARY INFORMATION: The Railroad Retirement Board is an independent agency in the executive branch of the United States Government which is charged with the administration of the Railroad Retirement Act (45 U.S.C. 231 *et seq.*) and the Railroad Unemployment Insurance Act (45 U.S.C. 351 *et seq.*). Use of agency seals is governed by 18 U.S.C. 701 which prohibits the use of agency seals except as authorized under regulations made pursuant to law. This proscription is intended to protect the public against the use of a recognizable assertion of authority with intent to deceive (*U.S.* v. *Goeltz*, 513 F.2d 193 (C.A. Utah 1975), *cert. den.* 423 U.S. 830). The regulations of the Railroad Retirement Board do not include provisions for the authorization of use of the Agency's seal. The Board proposes to add Part 369 to its regulations to explain when use of the Board's seal is permitted.

In order to comply with the President's June 1, 1998, memorandum directing the use of plain language for all proposed and final rulemaking, the regulatory paragraphs introduced by the above rule changes have been written in plain language.

This rule concerns agency management and is not a regulation as defined in Executive Order 12866. Therefore, no regulatory impact analysis is required. There are no information collections associated with this rule.

List of Subjects in 20 CFR Part 369

Railroad retirement, Seals and insignia.

For the reasons set out in the preamble, the Railroad Retirement Board proposes to add part 369 to title 20, chapter II of the Code of the Federal Regulations to read as follows:

PART 369—USE OF THE SEAL OF THE RAILROAD RETIREMENT BOARD

Sec.

Authority: 18 U.S.C. 701; 45 U.S.C. 231f.

§ 369.1 Unofficial use of the seal of the Railroad Retirement Board.

Use of the seal of the Railroad Retirement Board for non-agency business is prohibited unless permission for use of the seal has been obtained in accordance with this part.

§ 369.2 Authority to grant written permission for use of the seal.

The Board hereby delegates authority to grant written permission for the use of the seal of the Railroad Retirement Board to the Director of Administration.

§ 369.3 Procedures for obtaining permission to use the seal.

Requests for written permission to use the seal of the Railroad Retirement Board shall be in writing and shall be directed to the Director of Administration of the Railroad Retirement Board. The request should, at a minimum, contain the following information:

(a) Name and address of the requester.

(b) A description of the type of activity in which the requester is engaged or proposes to engage.

(c) A statement of whether the requester considers the proposed use or imitation to be commercial or non-commercial, and why.

(d) A brief description and illustration or sample of the proposed use, as well as a description of the product or service in connection with which it will be used. This description will provide sufficient detail to enable the Director of Administration to determine whether the intended use of the seal is consistent with the interests of the government.

(e) In the case of a non-commercial use, a description of the requesting organization's function and purpose shall be provided.

NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

REALTOR®

700 11th Street, NW
Washington DC 20001

Martin Edwards, Jr. CCIM
President

Terrence M. McDermott
EVP/CEO

GOVERNMENT AFFAIRS
Jerry Giovaniello, Senior Vice President
Walt J. Witek, Vice President

202.383.1194 Fax 202.383.7568
www.realtors.org/federalissues

June 5, 2002

The Honorable Bob Barr
Chairman, Subcommittee on
Commercial and Administrative Law
B353 RHOB
Washington, DC 20515

Dear Chairman Barr:

Thank you for allowing me to testify at your hearing on the administrative procedure ramifications of the Fed/Treasury proposed rule on allowing banks into the real estate brokerage, leasing, and property management business. Our 800,000 REALTOR® members appreciate your leadership on this issue, and we look forward to continuing to work with you to prevent this over-reaching regulatory action.

We agree with your questioning of the regulators on their application of the Administrative Procedures Act and the Regulatory Flexibility Act. We think their proposal fails to account for many of the requirements of these laws, and we applaud your efforts to provide congressional oversight on the issue.

In reviewing the proposed rule in preparation for your hearing, we were struck that the regulators only looked to the effect the rule would have on the financial holding companies. The Regulatory Flexibility Act requires an analysis of all entities that would fall under the proposed rule. There was no analysis done on the effect of this rule on the hundreds of thousands of small businesses operating real estate brokerages today. Many of these businesses are minority and women-owned and consist of only a single office. In fact, 77% of all residential firms consist of a single office. Certainly, any consideration of this proposed rule should take into account the possible consequences to these businesses.

In response to one of your questions to me regarding the economic impact of the proposed rule and whether it should be treated as a major rule, I have attached a brief analysis that shows the rule could impact our industry well over the $100 million annually that would make it a major rule.

This statement shows the economic impact on the residential housing market should banks broker real estate. The estimated impact is based on where housing and real estate fit in the

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EQUAL HOUSING OPPORTUNITY

nation's economy. The assumption is that an economic impact analysis would consider, among other things, market share and the banks' estimate of their market share targets. We can only speak to the brokerage question associated with economic impact. We aren't privy to the petitioners plans regarding real estate brokerage, leasing and management as they pressured the Federal Reserve and Treasury to issue the real estate regulation.

Left unaddressed are analyses of economic impact on real estate leasing and management, which to be thorough would require coordination with other commercial and investment real estate groups.
In addition to the economic analysis, I would like to place two white papers in the record of this hearing. They present strong evidence of the potential negative effects the proposed rule would have on consumers, small businesses and competition.

Again, thank you for holding this important hearing. I hope it is a step toward congressional action on the Community Choice in Real Estate Act, HR 3424. This important bill would clarify congressional intent that real estate brokerage and management are commercial activities that only Congress can grant to financial holding companies and national bank subsidiaries.

Sincerely,

Martin Edwards, Jr. CCIM
President
Partner, Colliers Wilkinson & Snowden Inc., Memphis, TN.

ATTACHMENT

THE ECONOMIC IMPACT OF REGULATIONS ON RESIDENTIAL REAL ESTATE

The residential real estate sector of the U.S. economy is large and fulfills an important role in maintaining economic stability in our economy. The size of the housing market is immense: there are 115.9 million housing units in the United States according to the 2000 Census. In 2001, 5.3 million existing homes were sold across the country. With the median price of an existing home in 2001 at $147,800, the economic value of homes sold is $783 billion.

The housing sector has an impact on the U.S. economy that goes beyond mere size. During the 2001 recession, housing has carried the economy through the recession. While profits declined and payrolls fell off, consumers had confidence in housing and bought homes in record numbers. Indeed from the fourth quarter of 2000 to the fourth quarter of 2001, the GDP grew only 0.48 percent and the housing sector contributed 0.3 percent of that amount: 61 percent.

With the economy teetering on the edge of a recovery, now is not the time to disrupt the housing markets with policy changes that have not been carefully considered. Housing and homeownership play a role beyond the current home sales. The national homeownership rate is over 68 percent, but just as underrepresented groups are beginning to enter these markets, changing the rules could disrupt these gains. Confidence in the system used to buy and sell homes is critical to maintaining an efficient market that allows homebuyers to obtain a home at the best price.

Given the size and importance of the real estate sector, it is vitally important that a thorough analysis be conducted of the impact of the rule proposed by the Board of Governors of the Federal Reserve adding real estate brokerage and property management to the list of activities permissible for financial holding companies. Consideration of the rule in advance of this analysis is short-sighted.

June 7, 2002

Real Estate Brokerage and Property Management Activities

The Consequences of Mixing Banking and Commerce

in response to

**The Board of Governors of the
Federal Reserve System
and
The Secretary of the Treasury**

concerning the proposed addition of real estate brokerage and management activities to the list of activities permissible for financial holding companies

prepared by

**Economic Research
The National Association of REALTORS®**
May 2001

APPENDIX A

The Advantages of the Federal Bank Charter

APPENDIX B

An Estimate of Consumer Costs If Financial Holding Companies Enter the Real Estate Brokerage Industry

ATTACHMENTS

"An Economic Analysis of the Proposal to Allow National Banks to Compete in the Real Estate Brokerage Market," Consultant Study, Capital Economics, Washington, DC, April 2001

Bernard Shull, "Real Estate Brokerage and Management Services As Permissible Activities for Banking Organizations: An Evaluation of the Agencies' Proposal of December 2000," Consultant Study, April 2001

Leonard Zumpano, "The Possible Consequences of Allowing Banks Into the Real Estate Brokerage Industry," Consultant Study, April 2001

EXECUTIVE SUMMARY

The history of banking legislation and regulation in the U.S. has maintained the separation of banking and commerce. Both Congress and the Federal Reserve have consistently interpreted real estate brokerage and property management activities to be commercial in nature. For nearly two decades, the financial services industry has lobbied Congress for the right to engage in real estate and other non-financial activities. A provision of the Gramm-Leach-Bliley Act of 1999 allows for the Federal Reserve Board and the Department of the Treasury—acting in accord—to expand the list of permitted financial activities if they determine the activities are financial in nature or incidental to a financial activity. The Federal Reserve and Treasury have issued a joint proposal which would effectively remove the barrier between commerce and finance, by permitting financial holding companies and federally

chartered banks to operate real estate brokerage firms and engage in property management. The National Association of REALTORS® strongly opposes this proposal on the grounds that real estate brokerage and property management is not a financial activity, nor is it incidental to finance, and that the implementation of such a proposal would lead to negative market and consumer consequences.

THE SEPARATION OF BANKING AND COMMERCE

The strict separation between banking and commercial sectors of the economy has been codified in several key banking laws, including the Glass-Steagall Act (1933), the Bank Holding Company Act of 1956, and the Gramm-Leach-Bliley Act of 1999. These laws prohibit commercial firms from engaging in banking and prohibit banks from engaging in commercial activities.

The most recent legislation on bank powers—the Gramm-Leach-Bliley Act—delineates which activities are financial. It does not include real estate brokerage and property management among them. Indeed, the Act maintains the long-standing principle that even though banking organizations may be allowed to expand into non-banking financial activities, they ought not be permitted to engaged in commercial ones.

Real Estate Brokerage is not a financial activity, nor is it incidental to finance.

Financial activities involve financial instruments—loans, deposit accounts, etc. Real property is not a financial instrument. Ninety three percent of homebuyers purchase their home not as an investment, but rather for a place to live.

The assertion that real estate brokerage is incidental to finance is erroneous; rather, it is the financial activity that is incidental to real estate brokerage. Obtaining a loan is not a requirement for a home purchase any more than getting a loan is necessary to buy cars, boats or fine jewelry. Those are consumer durables that frequently are purchased with multi-year financing. While most households use some kind of financing to purchase their homes, a significant portion do not. The American Housing Survey reports that up to 20 percent of homebuyers purchase their homes without a mortgage.

THE RESIDENTIAL REAL ESTATE BROKERAGE BUSINESS

The residential real estate brokerage industry as it exists today has large numbers of independent real estate professionals and brokerages actively competing for prospective buyers and sellers. Competition is fierce, efficiencies are high, and there are relatively few barriers to entry. These characteristics make it highly unlikely that the entry of financial holding companies and subsidiaries of national banks into the commercial real estate marketplace would benefit either business or consumer interests.

There are approximately two million real estate licensees, of whom more than 760,000 are members of the National Association of REALTORS®, and over 60,000 real estate firms that serve nearly 12 million American homebuyers and sellers every year. Most real estate firms are small businesses with five real estate salespeople or less who are independent contractors. These real estate professionals are generally compensated through a commission. Even franchise brokerages operate as independent firms; the franchiser does not make policy or price decisions for the firm, and cannot influence the price of real estate services through wholesale pricing of the goods sold.

In general, the real estate brokerage business is a local activity. Most real estate professionals serve one town or city, and as such they are well versed in information about schools, neighborhoods, and other quality of life issues.

There is little concentration in the real estate brokerage industry. It is relatively easy and inexpensive to enter the real estate business. There are always new entrants in the industry, increasing competition and expanding consumer choice. Competition among agents and firms is also high. A firm's—and real estate professional's—success depends on the level of service they provide to homebuyers and sellers.

There are limited economies of scale in the real estate brokerage business. Permitting financial holding companies to engage in real estate activities would not make real estate brokerage more efficient or cost less.

THE RISKS OF COMBINING REAL ESTATE AND BANKING

We conclude that the unprecedented expansion of banking powers into the real estate brokerage industry would have little, if any positive effects for either the banking or real estate brokerage industries. FHCs bring with them inherent advantages through the potential upstreaming of the advantages held by their federally insured bank subsidiary. These advantages could be used to undercut real estate brokerage firms and have the potential of making the government a player in the real estate brokerage market.

Expansion of Banking Powers

In contrast to the real estate brokerage industry, banking is a highly concentrated industry dominated by a few powerful firms. This concentration has been driven by mergers and acquisitions that have yet to produce positive outcomes for either the industry or consumers.

Bank entry into non-banking activities has neither improved bank profitability and performance nor decreased risk through diversification. Allowing banks to engage in real estate brokerage activities would not yield better results, as profitability for real estate companies is low in comparison to banks, cross selling opportunities are few, and there are limited economies of scale to exploit.

Banks do not need to enter the real estate brokerage business in order to compete in the mortgage market. Bank and mortgage company subsidiaries of banks already dominate both mortgage origination and mortgage servicing markets. Even those thrift institutions that currently engage in real estate brokerage activities account for less than five percent of mortgage originations.

Real estate brokerage firms with mortgage banking subsidiaries also pose no competitive threat to FHCs. In 1999 the top 75 real estate firms that had mortgage banking affiliates originated only 1.1 percent of mortgages. In comparison, the top 25 financial holding companies alone accounted for 39.2 percent.

Impact on the Real Estate Brokerage Industry

Bank entrance into real estate brokerage could actually threaten the safety and soundness of the nation's banking system. FHC bank subsidiaries have important benefits from their federal charter, including a lower cost-of-funds and access to the Federal Reserve's discount window. The federal "safety net" would likely be extended to other FHC affiliated businesses when they are in distress, thus exposing the nation's payment and monetary systems to losses.

Bank entrance into the real estate brokerage business would increase market concentration. As banks increase their role in real estate brokerage, the real estate industry would change from a localized, highly competitive industry to one dominated by large, national firms. This increased concentration would not improve efficiency of the real estate industry.

Impact on Consumers

Combining real estate and banking services will impose significant costs to consumers. The costs will come in the form of higher prices and fees paid by consumers, reduced level of real estate brokerage services, limited consumer choice, and discomforting intrusion into consumer privacy. Rather than seeing consumer costs go down, as claimed by the FHCs, the cost, even in the best scenario, will likely increase.

Contrary to FHC claims, allowing banks to enter the real estate brokerage industry will not lead to lower costs for consumers. Any temporary reduction in FHC-real estate services fees would be offset by higher costs for bank customers.

Combining real estate and banking services would limit consumer choice. Increased concentration is likely to reduce the number of independent, local real estate brokerage firms that offer services and expertise currently tailored to local real estate needs. It would also eliminate the incentives for FHC-employed real estate professionals to get the "best deal" for their customers, especially in terms of mortgages and other settlement services.

Research studies have found that while consumers take advantage of real estate professional recommendations on lenders and other real estate related service providers, they still want choice. Seventy three percent of real estate professionals recommend two or more mortgage lenders to their clients. This is the type of one-stop stopping consumers value—not the type where they get their mortgage from the same place as they purchase their home.

The entry of banks into real estate also poses concerns about consumer privacy. Under the Gramm-Leach-Bliley Act, financial institutions are permitted to share information with their FHCs and other subsidiaries. If FHCs are permitted to engage in real estate brokerage activities, consumer information currently kept private to real estate brokerages would be exposed to a much larger entity, and shared among affiliated third parties under the provisions of the GLB Act without the prior consent of the consumer.

IMPLICATIONS FOR HOMEOWNERSHIP

Expanding bank powers to allow FHCs to engage in real estate related activities could prove detrimental to homeownership. Banks would find it more profitable to foreclose on delinquent mortgages. Homeowners who experienced foreclosure would lose their homes and be marked as poor credit risks, and thus be unable to finance another home purchase.

Since mortgage origination fees and cross-selling opportunities would be greater for higher income households, incentives for serving those households would increase and those for serving lower-income households would decrease. This would directly impact first-time homebuyers because they generally have lower incomes than repeat buyers.

SUMMARY

This research paper clearly demonstrates that real estate brokerage is not a financial activity, nor is it incidental to finance. Quite the contrary, finance is incidental to real estate brokerage activities. The expansion of bank powers that would permit financial holding companies and subsidiaries of national banks to engage in real estate activities would contravene the long history of banking legislation that specifically precludes the mixing of banking and commerce. Furthermore, financial holding companies would bring with them unfair federally chartered advantages, unleveling the playing field in an already competitive marketplace.

Even if such expansion were allowable under Federal law, it would not be justified because of negative consequences it could impose on both the real estate brokerage business and on consumers. The real estate brokerage industry today is a highly competitive, efficient market with few economies of scale. It is dominated by large numbers of local firms actively competing for market share. Allowing financial holding companies to enter the real estate brokerage business would lead to an increase in market concentration with no appreciable economies of scale or scope. Large financial institutions would gain market share at the expense of small, local businesses. American consumers would suffer from higher real estate and banking fees, limited choice, privacy threats, and a reduced ability to own a home.

INTRODUCTION

The U.S. Congress has consistently mandated the separation of banking and commerce throughout the past two centuries, beginning with the National Bank Act of 1864 and extending through the Bank Holding Company Act of 1956 and the recently adopted Gramm-Leach-Bliley Act of 1999. The Board of Governors of the Federal Reserve has maintained this view throughout the Federal Reserve's history. However, in a dramatic shift in view, the Federal Reserve and the Department of the Treasury are now considering an unprecedented expansion of banking powers. They have jointly issued a proposed rule that would enable financial holding companies (FHCs) and financial subsidiaries of national banks to engage in real estate brokerage and property management activities.

To effect such a sweeping change in banking powers, the Federal Reserve and the Treasury Department must first determine if real estate brokerage and property management activities are "financial in nature" or "incidental to a financial activity." If these real estate activities fail to meet this test—as we believe to be the case—current federal law would clearly prohibit the proposed regulatory change. In addition, regulatory precedence requires that the agencies also consider the market consequences of such a change. If allowing FHCs and banks to engage in real estate brokerage and property management activities would result in reduced competition and fewer options for consumers—as we also believe to be the case—the proposed regulation should be rejected.

In considering the market consequences of the proposed regulatory change, it is important to recognize the size and scope of the real estate industry and its importance to American consumers and the national economy. According to NAR calculations, real estate-related activities (both direct and indirect) account for at least 20 percent of total GDP. Real estate brokerage and management are at the core of these activities, affecting every single community, both large and small. For example, the real estate brokerage industry—one of the largest and most competitive industries in the nation—serves about 12 million homebuyers and sellers in a typical year, generating over $1 trillion in annual sales.

Any regulatory change that affects such a large and vital sector of the American economy should be viewed with considerable caution. As documented in this report, allowing FHCs and banks to enter the real estate brokerage and management business would lead to fundamental changes in the structure of the real estate industry. These changes, in turn, would affect the millions of ordinary American citizens who buy or sell properties in any year. Because of the proposal's far-reaching consequences, both consumer and industry interests need to be considered in any discussion of the proposed regulatory change.

This paper examines the role of banks and real estate firms in the real estate brokerage and home buying process. It also looks at the market consequences of permitting financial holding companies to engage in real estate brokerage and property management activities. The first four chapters focus on the residential real estate brokerage business and the role of banks in real estate. Chapter five focuses on commercial real estate brokerage and real estate property management.

- Chapter 1, *The Separation of Banking and Commerce*, addresses the key issue of whether real estate brokerage activities are financial in nature or incidental to a financial activity. The analysis begins with a historical perspective of Congressional intent, including a discussion of the Bank Holding Company Act of 1956 and the Gramm-Leach-Bliley Act of 1999. It then describes the critical differences between a financial activity and an activity involving the brokering of real property. The discussion suggests that Congress clearly indicated its intent to maintain the separation of banking and commerce. The analysis also indicates that real estate brokerage is not a financial activity or incidental to finance.
- Chapter 2, *The Residential Real Estate Brokerage Business*, describes the real estate brokerage industry as it exists today, including its size and scope, its competitive environment, its market efficiencies, and its ease of entry. The analysis demonstrates that the real estate brokerage industry, as currently structured, is a highly competitive and efficient market, with few opportunities for economies of scale.
- Chapter 3, *The Risks of Combining Real Estate Brokerage and Banking*, assesses the market consequences of allowing financial holding companies and banks to engage in real estate brokerage activities. Market effects are explored from three different perspectives: the impact on banks; the impact on the real estate brokerage industry; and the impact on consumers. The analysis concludes that the proposed regulation would reduce competition within the real estate brokerage industry and limit consumer choice without significantly improving the profitability of the nation's banks.
- Chapter 4, *Implications for Homeownership*, looks at how the mixing of real estate brokerage and banking could increase the number of foreclosures and affect the availability of credit to low-income homeowners. This would have a major impact on the U.S. homeownership rate.
- Chapter 5, *Real Estate Property Management*, addresses the question of whether financial holding companies should engage in the real estate property management business. The issues examined in Chapter 5 are similar to the ones considered for real estate brokerage, and include: whether real estate management is financial in nature or incidental to a financial activity; the current size and structure of the market; the existing level of competition; and the inherent risks of combining real estate property management and banking.

The analysis presented in this report supports two broad conclusions. The first is that real estate brokerage and management activities are neither financial in nature nor incidental to finance. If any thing, the opposite appears to be true; obtaining financing for a real estate transaction is incidental to real estate brokerage and management activities. The second, more important conclusion is that allowing banks to enter the real estate brokerage and management industry could have wide-ranging, adverse market effects. Industry concentration would increase, competition would decline, and consumer choice would be limited with no real benefits from economies of scale or scope. Thus, even if such activities were allowable under existing banking laws, the market risks involved would clearly justify rejecting the proposed regulatory change.

CHAPTER 1

THE SEPARATION OF BANKING AND COMMERCE

What is the nature of the real estate brokerage process—is it a commercial activity or is it incidental to finance? This question is at the core of the debate on expanding bank powers to allow financial holding companies and subsidiaries of national banks to operate real estate brokerage companies or participate in real estate property management. While the purchase of a home (or any other property) is almost always a major financial undertaking, the actual property transaction has been consistently maintained in law and regulation as a commercial one. Indeed, the financial portion of the transaction is a relatively small part of the homebuying process. A review of the legislative history of banking laws as they pertain to real estate-related activities and an examination of both the real estate brokerage and homebuying process demonstrate that real estate brokerage is a commercial activity not financial, nor is it incidental to finance. In fact, the opposite seems to be true: finance is incidental to the real estate brokerage.

A LEGISLATIVE HISTORY

Throughout the history of the U.S. banking system, a central tenet of national policy has been to maintain a strict separation between banking and the various commercial sectors of the economy—i.e., industrial, commercial, and agricultural activities. This structural division between banking and commerce has been codified in several key banking laws including the Bank Act of 1933 (Glass-Steagall), the Bank Holding Company Act of 1956, and the Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act). Collectively, these laws prohibit commercial firms from acquiring or operating banks and, conversely, prohibit banks from engaging in commercial activities.

The separation of banking and commerce dates back to the inception of the nation's banking system in 1864,[1] and the federal laws regulating banking consistently have maintained this policy. The concern among policy makers was, and is, that permitting a single business enterprise to engage simultaneously in both banking and commercial activities would result in the misallocation of credit and extensive anti-competitive practices. In addition, the federal safety net established for the banking system (e.g., the Federal Deposit Insurance Corporation [FDIC]) could be exposed to risks from commercial sectors of the economy. Other concerns posed by the mixing of banking and commerce include violation of consumer and customer privacy interests, and reduction of credit availability in local communities.

The Glass-Steagall Act

The Banking Act of 1933, also called the Glass-Steagall Act, was passed in response to political charges that the Great Depression had been caused by widespread bank speculation in securities.[2] The Act included four sections, which generally required the separation of commercial banking and investment banking.[3] Under the provisions of Glass-Steagall, securities firms were prohibited from engaging in deposit-taking activities, and from being affiliated with entities so engaged. Commercial banks also could not participate in or be affiliated with securities firms that dealt in and underwrote securities.[4]

The Bank Holding Company Act

The Bank Holding Company Act of 1956 (BHCA) was enacted to address concerns about bank holding companies and the type of assets those companies controlled. Underlying the Act's provisions was the Congressional intent that bank holding companies should confine their activities to bank management, and not manage or control activities that had no relationship to banking. The legislative history of the BHCA shows that Congress intended to continue the separation of banking and commerce.[5]

The BHCA prohibited bank holding companies from acquiring commercial interests. It also required those bank holding companies owning interests in companies engaged in non-banking activities—i.e., ownership or control of any company which is not a bank or related to banking—to divest themselves of those interests. The Act also stated that a bank holding company could not engage in a business other than banking or managing or controlling banks or "furnishing or performing services for any bank for which it owns or controls 25 percent or more of the voting shares."[6] The BHCA severely limited the non-banking activities of bank holding companies that owned or controlled two or more banks.

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[1] Thomas E. Wilson, *Separation Between Banking and Commerce Under the Bank Holding Company Act—A Statutory Objective under Attack*, 33 Cath.U.L. Rev. 163 (Fall 1983) (hereinafter "Wilson") (citing the National Bank Act, ch. 106, § 8, 13 Stat.99, 101(1864)(codified as amended at 12 U.S.C. § 38)).

[2] Jonathan R. Macy and Jeffery P. Miller, Banking Law and Regulations, 22 (2nd ed. 1997).

[3] Edward L. Symons, Jr. and James J. White, Banking Law; Teaching Materials 36 (2nd ed. 1984).

[4] *Ibid.*

[5] S. Rep. No.1095, at 1 (1956), reprinted in 1956 U.S.C.C.A.N. 2482.

[6] S.Rep. No. 1095, at 12 (1956), reprinted in 1956 U.S.C.C.A.N. 2482, 2493.

One impetus for this legislation was the case of Transamerica.[7] At the time the BHCA was being debated Transamerica—a holding company for what would later become Bank of America—held an ownership interest in many banking and non-banking activities.[8] The non-banking activities included real estate, insurance, and commercial fishing.[9] After the passage of the BHCA, Transamerica chose to divest itself of its banking activities.[10]

In 1970, the BHCA's prohibitions against the mixing of banking and commerce were extended to one-bank holding companies.[11] Through its enactment of the 1970 amendments to the BHCA, Congress acted both to *reinforce and expand* the federal policy of separating banking and commerce.[12]

The BHCA made all bank holding companies subject to regulation by the Board of Governors of the Federal Reserve System. The principal regulatory powers of the Board of Governors concerning bank holding companies were set forth in Sections 3 and 4 of the BHCA.[13] Section 3 requires prior Board approval of any proposed acquisition by a bank holding company of ownership or control of a bank, while Section 4 codifies provisions regulating the separation between banking and commerce.

Section 4 specifies that a bank holding company may not retain direct or indirect ownership or control of any voting shares of any company which is not a bank or bank holding company.[14] It provides that a bank holding company may not engage in any activities other than (a) those of banking or of managing and controlling banks, and (b) those permitted under Section 4(c)(8) of the BHCA.[15] This section of the Act states that the prohibition against non-banking activities contained in Section 4 (a) shall not bar ownership by a bank holding company of "Shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."[16]

Over the years the Board of Governors of the Federal Reserve has issued a variety of rulings under Section 4 (c)(8) of the BHCA, allowing that some non-banking activities are permissible for bank holding companies, while others are not. But at the same time, the Board of Governors has consistently interpreted real estate brokerage and management activities to be among the proscribed commercial activities for bank holding companies. In 1972, the Board of Governors held that real estate brokerage "is not an activity that the Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."[17] In the same year, the Board of Governors also ruled that it did not consider property management to be a permissible activity for bank holding companies under Section 4 (c)(8) of the Bank Holding Company Act.[18]

The Gramm-Leach-Bliley Act

After many years of deliberation on financial services modernization, Congress adopted landmark legislation that removed the constraints on banks, securities firms, and insurance companies affiliating and entering each other's business. The Gramm-Leach-Bliley Act of 1999 (GLB Act)—as it became known—further amended the BHCA.[19] The GLB Act delineated which activities are financial in nature. The Act does not include real estate brokerage and property management among those activities it deemed to be financial in nature. In addition, real estate development and investment were specifically *excluded* from the new activities allowed for banks and bank holding companies.

The GLB Act dramatically increased the ability of banking organizations to affiliate with insurance, securities and other financial firms, and insured depository institutions by repealing prohibitions against Federal Reserve member banks affiliating with securities firms and insurance companies. The GLB Act also allowed for the creation of new "financial holding companies" (FHCs) with broader powers

[7] John Krainer, *The Separation of Banking and Commerce*, Federal Reserve Bank of San Francisco Economic Review 2000.
[8] *Ibid.*
[9] *Ibid.*
[10] Transamerica Web site, http://www.Transamerica.com.
[11] Pub. L. No. 91–607, Tit. 1, § 101, 84 Stat. 1760 (1970).
[12] "The committee agrees that it is desirable to continue our long standing policy of separating banking from commerce." S. Rep. No. 91–1084, at 4 (1970), reprinted in 1970 U.S.C.C.A.N. 5519, 5522.
[13] 12 U.S.C. §§ 1842 &1843.
[14] 12 U.S.C. § 1843 (a)(2).
[15] *Ibid.*
[16] 12 U.S.C. § 1843(c)(8).
[17] *Boatmen's Bancshares, Inc.*, 58 Fed. Res. Bull. 427, 428 (1972).
[18] 58 Fed. Res. Bull. 652 (1972).
[19] Pub. L. No. 106–102

than traditional bank holding companies to engage in a wide range of financial services and activities, *but not in commercial activities*.

The GLB Act also permitted financial holding companies to engage in any activity determined by the Federal Reserve, after consultation with the Treasury Secretary, to be financial in nature, or *incidental to financial activities*, without posing a substantial risk to the nation's banking system or the U.S. Treasury. An application procedure was established for determining new financial activities. New activities would be determined on a case-by-case basis consistent with the purposes of the BHCA.

When Congress considered the GLB Act, the Board of Governors urged Congress to proceed cautiously in taking any action that could impair the historical barrier between banking and commerce. In testimony before the House Committee on Banking and Financial Services on February 11, 1999, Chairman Greenspan stated:

> *As technology increasingly blurs the distinction among various financial products, it is already beginning to blur the distinctions between predominately commercial and banking firms. But how the underlying subsidies of deposit insurance, discount window access, and guaranteed final settlement through fed wire are folded into a commercial firm, should the latter purchase a bank, is crucially important to the systematic stability of our financial system.*
>
> *It seems to us wise to move first toward the integration of banking, insurance, and securities . . . and employ the lessons we learn from that important step before we consider whether and under what conditions it would be desirable to move to the second stage of full integration of commerce and banking. The Asian Crises last year highlighted some of the risks that can arise if relationships between banks and commercial firms are too close . . . The Federal Reserve Board continues to support elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured depository institution.*

No reasonable observer would suggest that there has been any significant change in the relevant technology, or in the business of real estate brokerage or management, since passage of the GLB Act in November 1999. The businesses of real estate brokerage and management remain the same today as they were on the date of enactment.

The separation of banking and commerce was part of the Congressional debate about the scope of activities to be authorized by the GLB Act. During the debate, the Clinton Administration also urged the Congress to maintain that separation, expressing concerns about mixing banking and commercial activity under any circumstance. The Administration, too, cited concerns raised by the then recent financial crises in other countries (e.g., Thailand and Japan).[20]

The GLB Act effectively repudiates any policy authorizing the mixing of banking and commerce.[21] As with the Bank Holding Company Act of 1956, the legislative history of the GLB Act indicates that Congress intended to maintain the separation between banking and commerce. And while the GLB Act does expand the range of non-banking financial activities permitted to FHCs, it maintains the distinction between banking and commercial activities. The Act maintains the long-standing principle that even though organizations engaged in banking may be permitted to expand into non-banking financial activities, they ought not to be permitted to engage in commercial activities.

A strict statutory separation between banking and commerce has been maintained in federal law, almost without interruption, since the advent of the national banking system. Congress has acted on several occasions to reinforce that separation, most recently in the GLB Act. With the GLB Act Congress determined, yet again, that the separation between banking and commerce is essential to a sound banking system and a fair, competitive, and productive national economy.

THE NATURE OF REAL ESTATE BROKERAGE

The separation of banking and commerce, and so the exclusion of real estate brokerage as a financial activity under historical and current banking legislation, is based on the difference in the brokered assets of the real estate and banking industries. All the current activities of financial holding companies relate to financial instruments: loans, checking accounts, mortgages, etc. While these represent value between two parties (usually a bank and a depositor or borrower), they are not tangible goods. Indeed, they rarely take any physical form.

[20] Cong. Rec. S4626 (1999).

[21] *Congressional Record*, H11,529–H11,530 (1999).

The business of brokerage is industry neutral. The key to distinguishing between financial activities and commercial activities is the nature of the asset. Commercial activities—such as real estate brokerage—relate to transactions of tangible assets. And while purchasing tangible assets, such as a car, computer, or a home, may entail the use of financial instruments—cash, loans, etc.—this does not mean that commerce is "financial in nature" or "incidental to a financial activity." In fact, it can be argued that the financial activity involved in real estate brokerage *is incidental to the real estate transaction.*

Characteristics of the Asset

The characteristics of the underlying real estate asset distinguish real estate brokerage from the brokerage and sale of financial instruments. Real estate is tangible, has a fixed location and is heterogeneous. Even similar structures—houses in a planned community that have a similar look and floor-plan—are unique in some way. One house may face south, another west. One house has a garage; the one next door merely a driveway. A property that has had extensive remodeling may be priced differently than the same model across the street.

Financial instruments, on the other hand, are intangible assets. Unlike houses (or cars, or computers), securities and insurance are not tangible. Deposit accounts, savings accounts, credit cards, mortgages, car loans, are not tangible, either. These instruments represent value between two parties. A mortgage represents the promise to pay an amount that is owed to the bank. The amount is amortized through a schedule of principal and interest payments. Stock and bonds represent, respectively, share of ownership in a corporation and the promise to repay a debt from a corporation or a government.

Bank products often exist as electronic entries on a report. They rarely take any physical form. A checkbook is not the deposit account. The deposit account is the promise of the bank to pay the depositor and the guarantee by the U.S. government that it will pay if the bank does not.

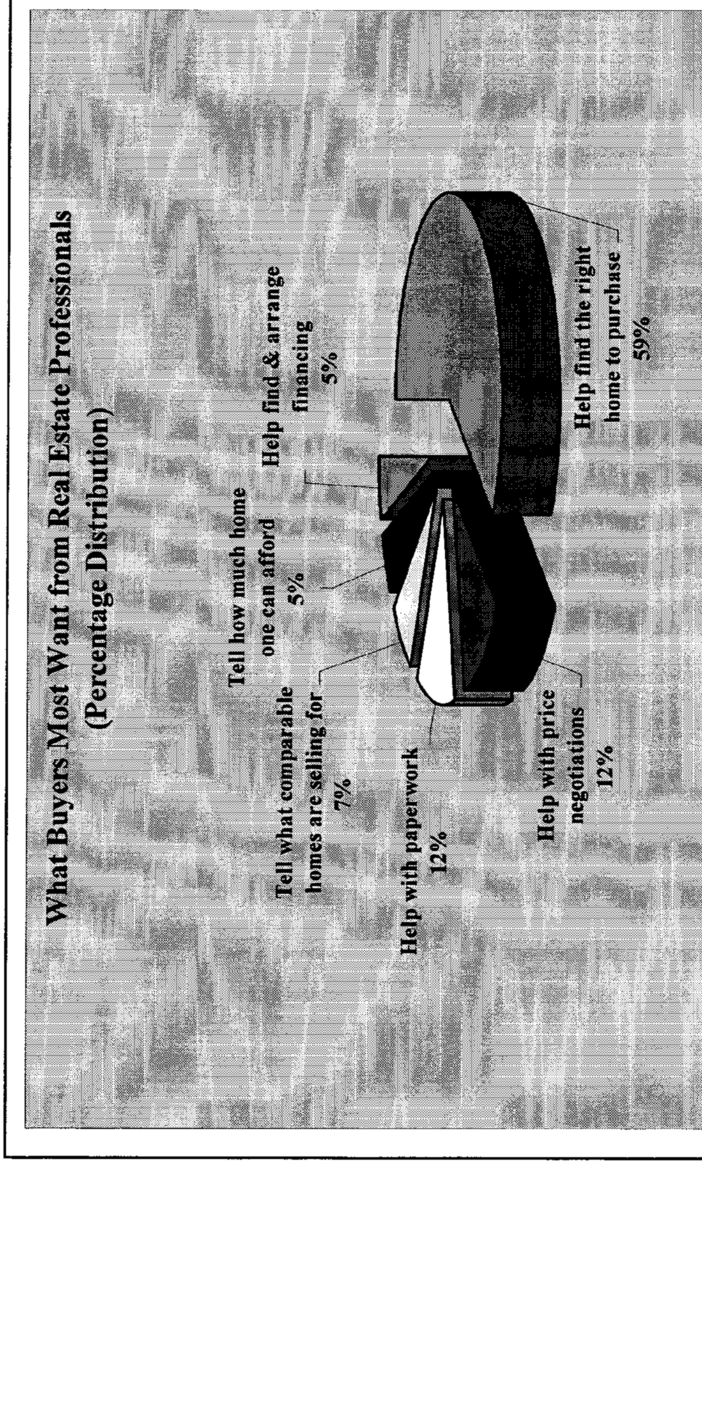
Finally, bank products are not differentiated in any way. Whether a consumer purchases IBM stock from one bank or another, they purchase the same share of ownership in the same company. A key feature of the underlying financial instruments is their liquidity, a feature derived from their homogeneity. Financial instruments are easily traded and moved to locations across the country and around the world through electronic transactions. These instruments are not differentiated through location or any other characteristic.

Those traits that characterize real property also distinguish real estate brokerage activities from financial activities. The heterogeneity of real estate properties make the real estate brokerage process distinct from markets for financial services where products are homogeneous. The multiple listing services developed by real estate agents contain over 70 data elements that briefly describe the important features of a property. However, even the MLS is not sufficient to capture many of the qualitative characteristics of properties. Because each property is different in some way, evaluating properties and educating consumers about them means that the extensive one-on-one contact between buyers and sellers and their real estate professionals is a vital part of the brokerage process.

The Homebuying Process

Most households that purchase homes use financing of some sort. But securing a loan is only a very small part of the homebuying process. The heterogeneous nature of housing and the diversity of households result in a complex matching process between buyers and sellers. This is where real estate professionals play their vital role. Homebuyers turn to real estate professionals for one main reason: to find them the home that best suits their resources and needs. According to the *2000 National Association of REALTORS®* Profile of Home Buyers and Sellers, what buyers most want from real estate professionals is help in finding the "right" home.

The real estate professional also educates potential buyers about housing market conditions, re-sale value and the relative value of location versus amenities. Based on the potential buyer's demand characteristics, the real estate professional advises on affordability. In addition, the professional begins to guide the potential buyer through the homebuying process. The typical homeowning American may purchase and sell a home only three or four times during his or her life. These transactions often occur years apart. Consequently, very few homebuyers and sellers are experienced in the many steps for these complicated transactions. Even repeat homebuyers are relative novices with housing transactions.



Source: ***The 2000 National Association of REALTORS® Profile of Home Buyers and Sellers***

While buyers represent current and potential housing demand, current homeowners and builders are the source of the housing supply. Real estate professionals match the supply to the demand. After selecting a real estate professional, the seller and the agent negotiate a listing agreement. The agent works with the seller to develop a marketing strategy. The agent's recommendations consider the current market conditions, the characteristics of the property, and the sellers' timing requirements. Traditionally, a real estate professional represents the seller of a property, and it is the seller who pays the commission when the sale is complete.[22]

The process of bringing together a buyer and seller to exchange a high-cost, unique, immovable property is both art and science. The real estate professional works with the buyer to draft the offer, discussing the proposed sales price and any conditions on the offer such as home inspections and financing. When ready, the buyer makes a written offer through the real estate professional to the seller. (In many states, the offer becomes the contract for the sale and thus includes many details such as what items will remain with the property such as washing machines and draperies.) The seller may accept the offer, reject the offer or may counteroffer. (The real estate professional also advises the seller on any other offers to buy the property as well as current market conditions.) If the negotiations fail, the process begins again.

Once the contract is signed, the buyer and seller must arrange to fulfill the conditions of the contract. If the offer is contingent on a home inspection or financing, then the buyer is not obligated to complete the transaction if either condition fails. The seller may have to make some repairs to the property and, if necessary the buyer must arrange financing. Financing is but a small piece of the entire homebuying process. The closing itself is conducted by lawyers or other representatives of the title company, the buyer, the buyer's real estate professional, the seller and the seller's real estate agent.

Finance is Incidental to Real Estate Brokerage

While it is true that homes may become a primary source for building household wealth, real estate is not a financial instrument, nor are homes purchased primarily for investment or even tax advantages. The primary reason for purchasing a home is as a place to live. In fact, nearly 93 percent of homebuyers purchase a home for this reason. Selection of a home is a choice of basic shelter as well as a climate, a political jurisdiction and a neighborhood.

PRIMARY REASON FOR PURCHASING A HOME

(percentage)

Desired owning a home of my own	34%
Desire more space	18
Corporate relocation or new job in another area	12
Larger home: investment/tax deduction/upscale neighborhood	7
Desired to be closer to job, school, relatives, mass transit	6
Needed less space (children left, divorce)	4
Decline of previous neighborhood	3
Wanted a newly constructed home	2
Retirement	2
Desired a change of climate	2
Health/age (too much yards/stairs, allergies)	2
Desired second home	1
Other	9

*Source: **The 2000 National Association of REALTORS® Profile of Home Buyers and Sellers.***

Obtaining a loan is not required for purchasing a home. However, because property is often purchased through financing, there is an erroneous perception that the

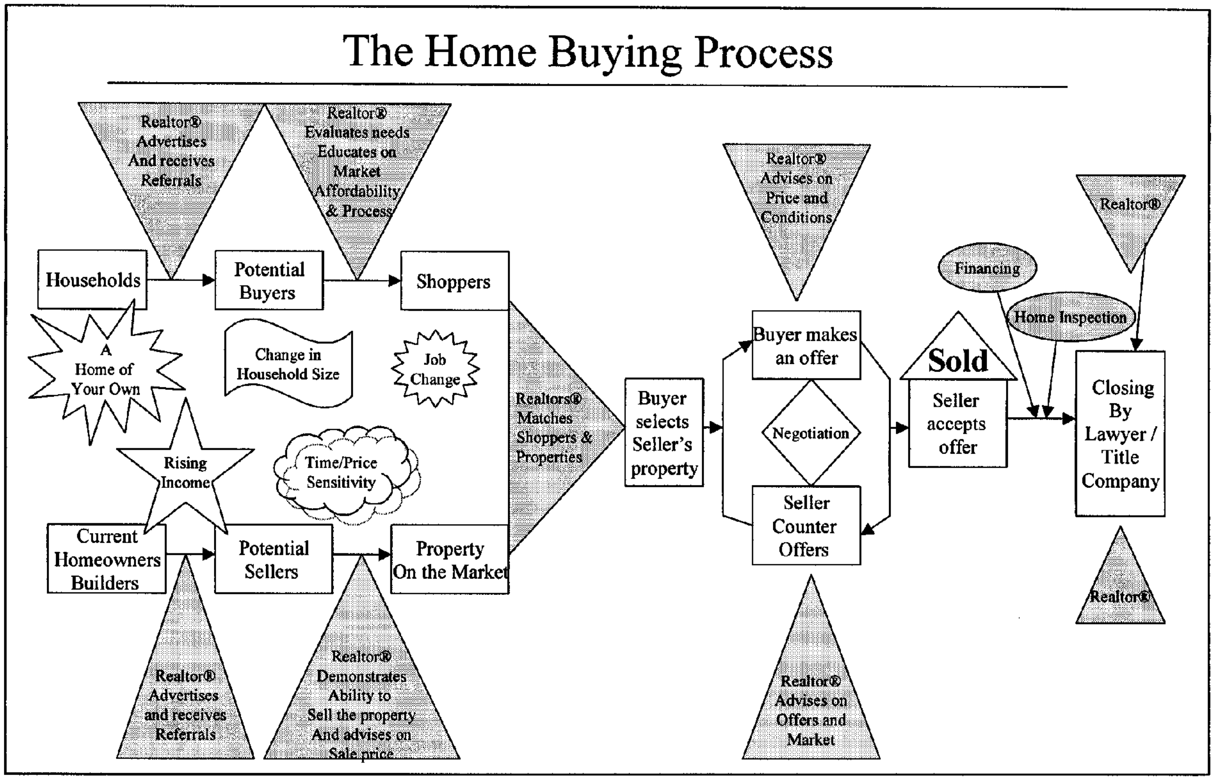
[22] In some cases, homebuyers sign agreements with real estate professionals in which the agent agrees to represent only the buyer. According to *The 2000 National Association of REALTORS®* Profile of Home Buyers and Sellers, nearly half of all homebuyers in 1999 who used the services of a real estate professional signed a "buyer's representative" agreement with their agent.

transaction to secure these goods is financial in nature. While it is true that many consumers may engage in a financial activity—obtaining a loan—in order to buy a home, a car, or a refrigerator, the actual purchase is a commercial activity. The financial portion of the transaction (obtaining a loan) *is incidental* to the primary activity (buying a house). In the homebuying process, financing is but one small part of the entire transaction.*(See flow chart of homebuying process.)* In fact, in a significant portion of home sales, financial activity is not even incidental. According to the *1999 American Housing Survey for the United States* conducted by the U.S. Department of Housing and Urban Development (HUD) and the U.S. Census Bureau, up to 20 percent of all home sales require no financing at all.

In addition, real estate brokerage does not just consist of homebuying. Approximately six million home sales transactions occur in a typical year. Each of those sales transactions involves a buyer and a seller—the two "sides" of a real estate transaction. That totals 12 million homebuyers and sellers. Sellers have no need obtain financing for a home they are selling. That side of the homebuying transaction involves no financing or banking products of any kind.

SUMMARY

Congress has clearly indicated its intent to maintain the separation of commerce and banking. The legislative history of banking laws demonstrates that real estate brokerage has been consistently interpreted as a commercial, not financial activity. Real estate brokerage is not a financial activity nor is it incidental to finance. Real property is a unique asset. It is tangible, durable and exists in a fixed location. This is different in almost every respect from the financial instruments that form the basis of banking activities. If the asset is not financial, then the buying and selling of the asset is not a financial activity nor is it incidental to the financial activity. Rather, it is the financial activity that is incidental to the brokering of real estate properties.



Source: National Association of REALTORS®

CHAPTER 2

THE RESIDENTIAL REAL ESTATE BROKERAGE BUSINESS

The residential real estate brokerage industry as it exists today has large numbers of independent real estate professionals and brokerages actively competing for prospective buyers and sellers. Competition is fierce, efficiencies are high, and there are relatively few barriers to entry. These characteristics make it highly unlikely that the entry of financial holding companies and subsidiaries of national banks into the commercial real estate marketplace would benefit either business or consumer interests.

By any measure, the residential real estate industry is one of the largest sectors of the U.S. economy. More than a trillion dollars are exchanged each year in the sale of both new and existing homes. These transactions provide millions of Americans with jobs and produce hundreds of billions of dollars of economic output each year. Further, housing represents a major source of wealth building for U.S. households—nearly seven out of ten Americans own the home in which they reside. For many of these Americans, their home is the largest component of their net worth.

In addition to being a vital part of the U.S. economy, the residential real estate brokerage industry also operates in a competitive marketplace, where more than three quarters of a million REALTORS®[23] and tens of thousands of real estate brokerages compete for customers' business each day. The underlying cost structure of the industry and the relative ease of entry into the market serve as checks to the concentration of market power. The large number of industry players ensures homebuyers and sellers access to service providers who best meet consumers' needs at the lowest price possible.

STRUCTURE OF THE REAL ESTATE BROKERAGE INDUSTRY

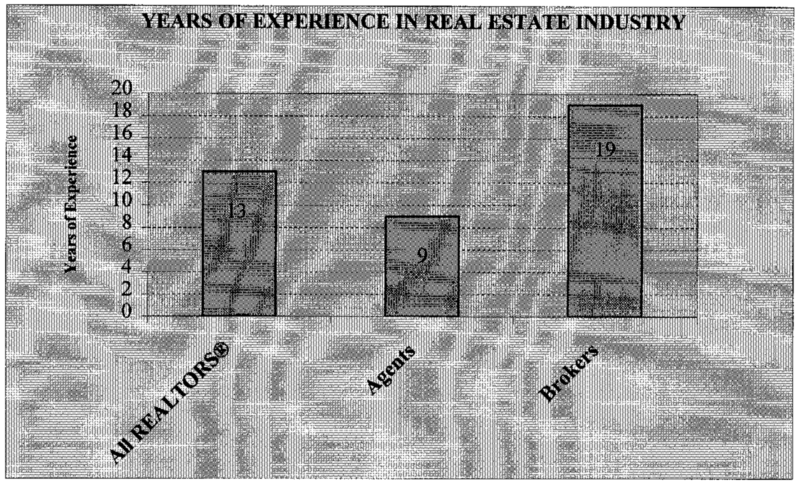
The structure of the real estate brokerage industry reflects the trait that real estate is a localized activity. The real estate industry consists of a set of industry players who differ in size, specialty and training. Real estate professionals are the primary point of contact for most homebuyers and sellers and typically serve as independent contractors to real estate brokerage firms. Real estate brokerages come in many sizes and operate under varying business models, including affiliations with regional or national franchise firms. Because real estate professionals and firms generate business primarily through referrals and personal reputations, these industry players actively compete for buyers and sellers' business.

Real Estate Professionals

There is no one "type" of real estate professional, but in nearly all cases, they exclusively serve their local market. The more than 760,000 members of the National Association of REALTORS® differ in experience, expertise, and training. Some focus primarily on homebuyers, while others prefer to list properties for home sellers. Some real estate professionals are experts on single-family homes in suburban locations, while others best serve customers looking for a condominium in a resort location. Some real estate practitioners hold a broker's license. (A broker is a real estate professional who acts as an intermediary between the buyer and seller of a home for a fee.) Each real estate office must have at least one broker to operate.

Real estate professionals bring a wealth of experience and education to the real estate transaction. The typical REALTOR® has been serving homebuyers and sellers for 13 years; the typical real estate professional holding a broker's license has been representing buyers and sellers for 19 years.

[23] There are approximately two million people who hold real estate licenses. However, not all of those are active practitioners. It should be noted that REALTOR®, REALTORS®, and REALTOR-ASSOCIATE® are registered collective membership marks that identify, and may be used only by, real estate professionals who are members of the National Association of REALTORS® and subscribe to its strict Code of Ethics.



*Source: **The 1999 National Association of REALTORS® Member Profile***

This experience translates into better service for the consumer, as agents gain expertise not only in transactions, but also increases their knowledge about the neighborhoods they serve. Real estate professionals know the schools and other qualities of the area that appeal to homebuyers. They have also established contacts with providers of goods and services that consumers need when buying or selling a home. Local experience is invaluable in providing good customer service. Real estate professionals become experts on the neighborhoods they serve.

Education enhances the experience that real estate professionals possess. New real estate agents take many hours of educational classes to earn the license required to practice in their state. Furthermore, many agents continue to take courses to stay abreast of changes in real estate laws and to learn how to better serve their customers. The typical residential real estate brokerage requires its agents to take nine hours of in-house training and education per year.[24] These courses teach agents and brokers about many real estate related issues—from the latest developments in real estate law to the release of new technologies that enable the agent or broker become more productive. Further, nearly a third of all real estate professionals participate in additional coursework to earn a professional designation showing that they have expertise in specific types of real estate transactions or other real estate related activities.[25]

Most real estate professionals are essentially small business owners. Nine out of ten real estate professionals are independent contractors who represent a real estate brokerage. As independent contractors, they do not receive a base salary; rather, they earn income by successfully matching homebuyers with sellers. As compensation, most real estate professionals receive either a percentage or all of the sales commission paid by the seller of properties. Typically, real estate professionals receive approximately 60 percent of the commission paid by the home seller to the real estate firm. With their livelihood based on their ability to successfully match homebuyers with sellers, real estate agents have the incentive to ensure a high level of customer satisfaction from the home buying and selling public.[26]

Real estate professionals work hard to give their customers a high level of customer service and, as a result, work many hours each week. The typical real estate professional works 45 hours a week, with 16 percent working at least 60 hours every week.[27]

In addition to being highly motivated professionals dedicated to their clients, real estate professionals have an additional incentive to serve their customers well. Con-

[24] *The 1999 National Association of REALTORS®* Profile of Real Estate Firms
[25] *The 1999 National Association of REALTORS®* Member Profile
[26] *Ibid.*
[27] *Ibid.*

sumers tend to choose their real estate professional based on "word of mouth." While many agents choose to market their services to homebuyers and sellers through advertising, most homebuyers and sellers choose their real estate agent because of a referral or from the consumer's own personal experience in a previous transaction. In 1999, more than a third of homebuyers chose an agent who was currently or was previously used by either a friend or relative. Another eight percent of homebuyers chose their agent because of the agent's reputation. Referrals from employers, real estate brokers, and membership organizations resulted in nearly another ten percent of homebuyers matching up with their agent.

REASON FOR CHOOSING REAL ESTATE AGENT
(Percentage Distribution)

Agent is (was referred by) friend, neighbor, relative	34%
Used agent previously to buy or sell house	10
Reputation of real estate agent	8
For sale sign/brochure box	7
Referred through my employer/relocation company	6
Personal contact by agent	6
Visited open house and met agent	6
Walked into office and agent was on duty	6
Referred through another real estate broker	3
Newspaper ad	3
Met agent through builder's model home	2
Internet/on-line/Web site	2
Homes magazine/book ad	2
Yellow pages ad	1
Direct mail	1
Referred through my membership organization	1
Seminar about home buying/selling	1
Radio/TV cable ad	*
Advertising specially	*
Real Estate telephone hotline	*
Contacted agent after news story	*
Professional Designation(s) held by real estate agent	*

**Less than 1%*

Source: The 2000 National Association of REALTORS® Profile of Home Buyers and Sellers

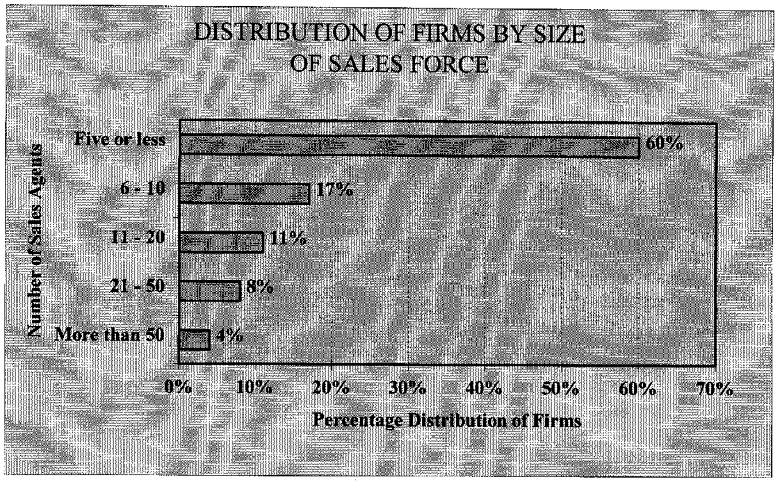
Real Estate Brokerages

Real estate brokerages are in the business of managing independent agents who arrange for the transfer of real property. There are tens of thousands of real estate brokerages throughout the United States. They range in size from a single office with just a few agents to multiple-office firms that serve an entire metropolitan area or, in a few cases, several states. As brokerages differ in size, so do their business models. For example, brokerages may choose to affiliate with a regional or national franchiser (e.g., Century-21, Coldwell-Banker, etc.). They also may offer their customers other real estate related services.

Most real estate brokerages are small operations serving local markets, but as in any other industry there are a group of larger firms. Three out of five brokerages have five or fewer agents in their sales force and an even greater proportion—82 percent—have just one office.[28] Many of these smaller brokerages are "mom and pop" operations and they operate as either a proprietorship or partnership. Yet

[28] *The 1999 National Association of REALTORS®* Profile of Real Estate Firms

while the typical brokerage is very small, most real estate professionals represent a brokerage firm with at least 20 agents.



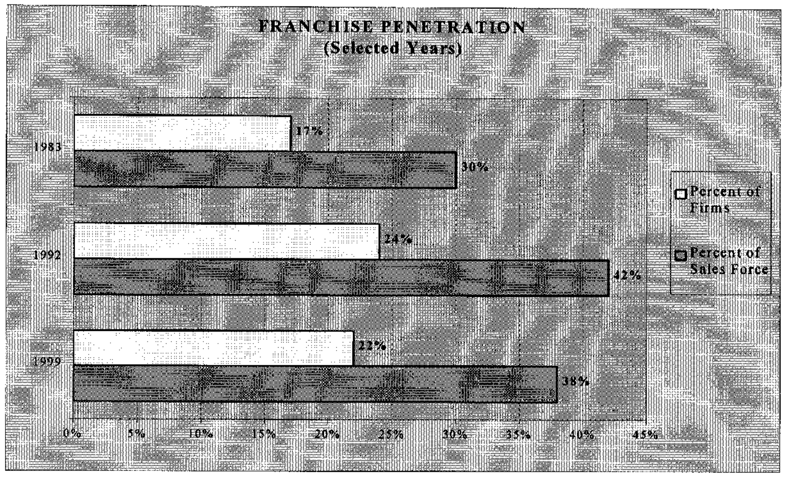
Source: ***The 1999 National Association of REALTORS® Profile of Real Estate Firms***

Brokerages of different shapes and business models are able to compete on a level playing field because most real estate professionals and firms share their property listings with other real estate professionals in their region through the multiple listing service (MLS). The MLS, a computerized database featuring detailed information of most properties offered for sale, gives all participating brokerages and their sales force the ability to access and show properties listed by competing brokerages. The MLS enables real estate professionals, whether representing large or small brokerages, to show the same homes to their clients.

Both sellers and buyers benefit from this arrangement. Homebuyers do not need to visit multiple brokerages or even the largest brokerage in town to see the best selection of homes available. Buyers have choice. They are able to choose a real estate professional or brokerage that best meets their other requirements without worrying about access to listings. Sellers also gain a similar benefit from the MLS. It guarantees the widest possible audience of potential buyers for homes, as nearly all real estate professionals can view detailed listing information. This helps ensure quick sale of a property at the best price possible.

Regional and National Franchises

Firms can differentiate themselves from their competitors by affiliating with a regional or national franchiser. In exchange for a fee that frequently is a percentage of the firm's revenues, the franchiser provides the firm with a recognized name brand and advertising abilities, training materials, and assistance in recruiting sales agents and acquiring new technologies. In 1999, 22 percent of real estate firms, including more than half of all firms with more than 50 agents, held a franchise agreement. These firms represent approximately 38 percent of the real estate agents in the industry. Among the most widely known real estate franchisers are those owned by Cendant (Century 21, Coldwell Banker, and ERA), RE/MAX, and GMAC Realty Services.



Source: ***The National Association of REALTORS® Profile of Real Estate Firms***

Franchised brokerages are still independent local brokerages. Brokerages that have an affiliation with a national franchiser are owned and operated by a local broker, who makes final decisions on firm policies and prices. Further, real estate franchisers do not produce the output sold by real estate brokerages, unlike franchised fast food restaurants and gasoline stations that purchase much of their products from the franchiser. Consequently, the national franchiser cannot even indirectly influence prices of real estate services through the wholesale pricing of the goods sold; therefore, franchised brokerages are truly local independent firms.

INDUSTRY PERFORMANCE

The residential real estate brokerage industry is characterized as an efficient and competitive one, with little concentration of market power. The key to this industry is the relative ease of entry for new professionals and real estate brokerages. With some education and a bit of entrepreneurship, new firms and agents are able to provide new choices for consumers.

Ease of Entry

Real estate brokerage is one of the few businesses where it is relatively easy to enter the business as a real estate professional. It has also been open to entry from larger corporate organizations as well. Becoming a sales agent requires an individual to pass a state licensing exam and then finding a broker who will "hang" that individual's license. Many of the largest brokerage companies provide the training required to pass the exam for a modest fee, which the brokerage would wholly or partially refund if the licensed agent starts to work with that company.

On the brokerage side, it also is relatively easy to enter the industry as start up costs and regulatory hurdles are relatively lower than they are for other businesses. The costs of renting office space and furniture, along with the necessary accounting, insurance and legal services do not compare with the costs of entering a manufacturing, technology, or even medical/dental practice with their substantial capital requirements. Furthermore, since the individual agents are largely the producers of the services and receive compensation only when a commissioned sale is closed, the broker does not have the equivalent of "inventory carrying costs" that a large retail or manufacturing enterprise must maintain.

Traditionally, real estate companies have expanded by opening new offices or acquiring existing firm offices in new locations. The locational aspect of real estate prior to computerized listing and viewing of properties made this the necessary approach. The growth of metropolitan areas in the 1950s through the 1980s made opening new offices the way to go. With the real estate cycles of the 1980s and increasing costs of computerization, litigation, and other factors that have squeezed profits, the larger, more successful companies have been able to acquire other companies' assets and locations as a means of expanding. However, there have not been significant economies of scale realized. Each new office essentially just replicates the cost structure of other offices in the firm. The traditional economies of scale from large plant manufacturing or large distribution centers or marketing capabilities do not accrue to the real estate firm. The implication is that this industry is a competitive industry of relatively small firms. (See below for discussion of efficiency and economies of scale in the real estate industry.)

Level of Competition

Today's real estate industry consists of over three quarters of a million REALTORS®, representing tens of thousands of real estate firms, as well as many other real estate licensees. It is a competitive industry providing a wide array of choices and a high level of service to both the homebuying and homeselling public. Residential real estate brokerage embodies several characteristics of a competitive market, including the existence of many buyers and sellers, freely available information, and the ease of entry and exit by firms.

Real estate firms tend to compete actively for business in three different arenas. First, firms compete for the best real estate professionals. Second, firms compete for sellers' listings and homebuyers with other real estate firms in their market area. Finally, real estate firms and professionals compete against other homebuying and selling options, including For Sale by Owner (FSBO). The result of this three-pronged competition is excellent service provided efficiently by real estate firms and real estate professionals for both buyers and sellers. But this competition also results in revenue and cost pressures that limit profitability for most real estate brokerages.

Competition for Agents

More than nine out of ten real estate professionals are independent contractors of the firms they represent. Typically, they neither receive a guaranteed salary nor do they receive benefits such as health insurance or paid vacation. Agents frequently switch firms to receive a better commission split or other benefits. The typical agent has been affiliated with their firm for five years, with over a third of agents representing their firm for fewer than two years.[29] As agents become very successful, they often seek better compensation terms from either their present firm or from a firm that is seeking their services.

To attract or keep top agents, firms may raise the commission split paid to those agents or provide additional marketing assistance. As agents gain more experience and generate a loyal clientele of buyers and sellers, they tend to earn a greater percentage of the commission paid by home sellers. Agents with fewer than five years of experience tend to split half of the commission with their firm, while agents with between 16 and 25 years of experience tend to get 60 percent of the commission split. In some cases, agents will receive 100 percent of the commission paid by the seller of a property, instead of a commission split.

[29] *The 1999 National Association of REALTORS®* Member Profile

COMPENSATION STRUCTURES FOR REALTORS®
(Percentage Distribution)

	All REALTORS®	Broker/ Broker Associates	Sales Agent
Percentage Commission Split	68%	52%	82%
100% Commission	20	28	13
Straight Salary	3	4	1
Salary plus Share of Profits	4	7	2
Commission Plus Share of Profits	3	6	2
Share of Profits Only	2	4	*
Median Starting Percentage Commission Split	60%	60%	55%
Median Year End Commission Split	60	65	60

**Less than one percent*
Note: Detail may not add due to rounding

Source: ***The 1999 National Association of REALTORS® Member Profile***

Typically, the firm's portion of the commission split is a major source of revenue that covers the firm's overhead and marketing costs as well as its profit margin. Under a 100 percent commission compensation arrangement, agents pay their firm "desk costs" that covers the firm's costs and profit margin. Given the relative high expense of desk costs, only top agents—approximately 20 percent of agents in 1999—have 100 percent commission agreements with their firms.

In addition to better compensation, brokers may make commitments to their best agents to make investments in new technologies and advertising campaigns. The rise of the Internet has increased costs spent on new technologies. To keep and attract the best agents, firms will continue to invest heavily in the Internet and other computer technologies.

Competition Among Firms for Consumers' Business

Consumers are able to choose their real estate firms based on many factors—the commission rate charged by the firm, the firm's area of expertise, or the firm's sales force, among a few. Large real estate firms aggressively advertise on TV and in newspapers, promoting their brand name to future homebuyers and sellers. More recently, in an attempt to attract customers on the Internet, many firms have developed Web sites to attract homebuyers and new listings. With 37 percent of 1999 homebuyers using the Internet in their home search, those firms that have been slow to invest in the Internet have had trouble competing.[30]

Real estate brokerage is an industry that is not particularly concentrated. According to data published by Real Trends in 2000, the top 500 firms "employ" 26.8 percent of the nation's real estate agents and brokers. These firms also account for 28.9 percent of transaction sides[31] in 1999.[32] However, even this figure exaggerates the level of market concentration in the real estate industry. The nation's largest real estate firm is NRT, which owns numerous, locally managed real estate brokerages. NRT has just over four percent of the nation's REALTORS®, while the second largest firm—Homeservices.com (Minnesota)—has less than one percent. Among the rest of the top 500 firms, the vast majority has between 50 and 100 agents and serves relatively small geographic regions, such as a single metropolitan area. With few large firms accounting for a relatively small proportion of the market, consumers are able to choose among a large number of real estate brokerage firms to find the one that best suits their specific needs.

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[30] *The 2000 National Association of REALTORS®* Profile of Home Buyers and Sellers

[31] Each real estate transaction consists of two sides, where both the buyer and seller each represent one side.

[32] As stated earlier, franchised firms are managed independent of the franchiser. The local ownership makes the final decisions on firm policies and on pricing. As a result, franchised firms are treated individually for these calculations.

MARKET SHARES FOR 1999
(Percentage)

Firms	Sides	Agents
Top 20	11.1	11.5
Top 100	18.3	18.5
Top 150	20.8	20.8
Top 200	22.7	22.2
Top 300	25.3	24.2
Top 400	27.3	25.6
Top 500	28.9	26.8

Source: The 2000 Real Trends 500

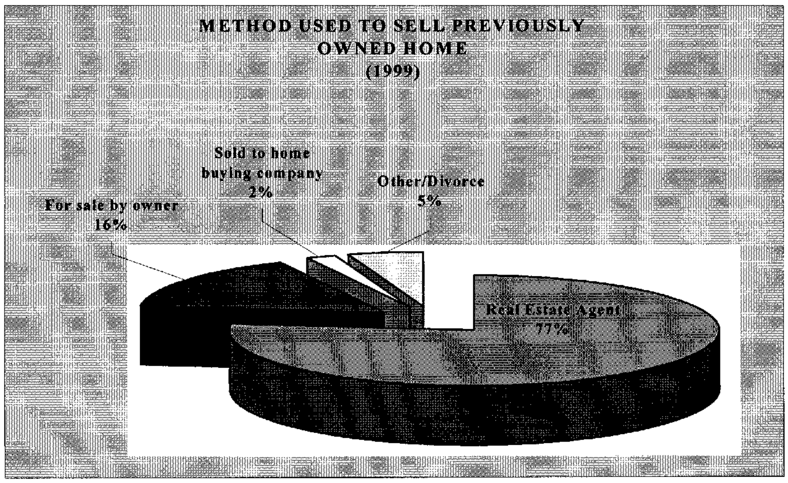
The result of this fierce competition is relatively low profit margins for real estate brokerages. The real estate brokerage industry faces continued low profitability, as revenues are not able to rise as quickly as expenses. The typical firm earned profits of just 2.3 percent of the firm's gross revenue in 1996.[33] The two largest areas of expenses paid by firms are sales commissions and bonuses, which represent more than half of all gross revenue, overhead, and advertising.

Competition with Other Methods of Buying and Selling a Home

Both homebuyers and sellers have choices when making a real estate transaction. While the vast majority choose to use a real estate professional for their housing needs, approximately one out of every five consumers choose to conduct their housing transactions without one.

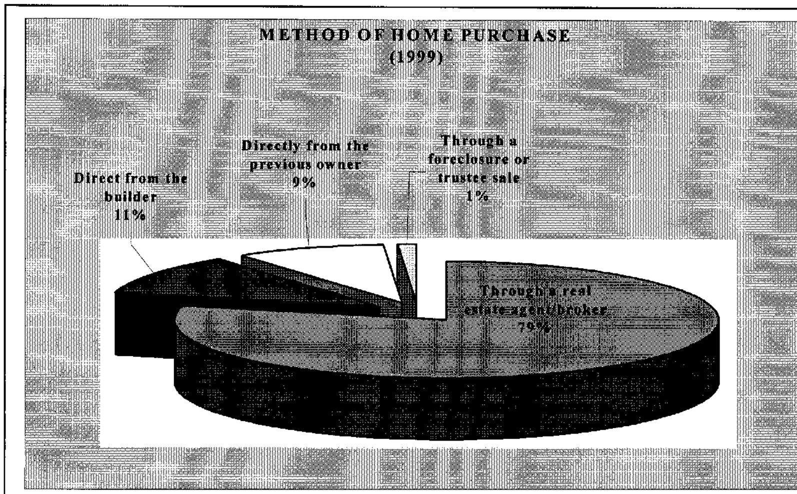
Some home sellers eschew the use of a real estate professional when they put their home on the market. They can place a "for sale" sign outside their home or buy advertisements in the newspaper. More recently, some sellers have placed detailed information about their home on the Internet. In 1999, 16 percent of home sellers sold their home without the assistance of a real estate professionals. Another seven percent of home sellers disposed of their home through a variety of methods, from selling the property to a home buying company to selling the home to family or an ex-spouse.

[33] *Residential Real Estate Brokerage: Income, Expenses, Profits (1997), National Association of REALTORS®*



*Source: **The 2000 National Association of REALTORS® Profile of Home Buyers and Sellers***

Many homebuyers also choose not to use the services of a real estate professional when purchasing their home. While real estate professionals are still the most popular source of information about homes, homebuyers have a variety of information sources available to them while they conduct their home search, including newspapers, the Internet, yard signs, home magazines, and open houses. Over a quarter of homebuyers learned about homes on the market from friends, neighbors, or relatives or directly from the seller. Eleven percent purchased their home directly from a builder and another nine percent purchased their home directly from the seller.



*Source: **The 2000 National Association of REALTORS® Profile of Home Buyers and Sellers***

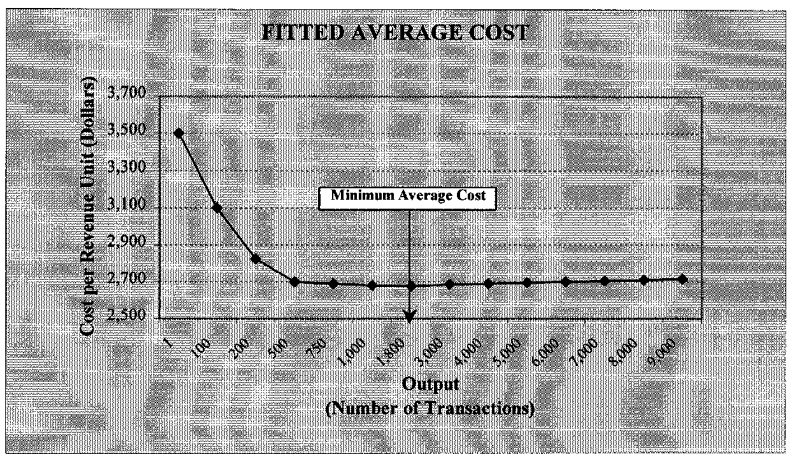
In spite of these other resources, 79 percent of 1999 homebuyers purchased their home through a real estate professionals. But because homes can be bought and sold without a real estate professional, agents and brokers must earn their customers' business each day during every step of the housing transaction. Consumers' ability to complete transactions without the assistance of real estate professionals provides agents and brokers with one of their greatest sources of competition, as well as the additional impetus to better serve their current and future clients.

EFFICIENCY

The current structure of the brokerage industry—large numbers of relatively small, local firms—is quite efficient. Analyses of the underlying cost structure of the real brokerage function reveal that there are few, if any efficiencies to be gained by the entrance of larger, more highly capitalized firms, including commercial banks. This could explain why the brokerage industry has seen relatively little movement towards increased concentration over the past 20 years.

Average Costs

One way to measure the efficiency of the real estate brokerage business is to examine its underlying cost structure. Zumpano [34] describes a study that used financial data from 279 real estate brokerage firms to estimate a cost function relating the average unit costs of the brokerage to its number of sales agents (see below). For the most part, the curve was relatively flat. Although they found modest economies of scale for smaller brokerages, they also found that average costs begin to rise once the firm has reached a certain size (in this case, 1800 sides). Their analysis suggests that real estate brokerage firms can operate over a broad range of sizes without experiencing an appreciable change in average costs. More important, their findings suggests that "large [real estate brokerages] do not command any competitive advantages over smaller [brokerages], at least as far as unit costs are concerned." If anything, very large brokerages are less efficient than their smaller competitors.



Source: Zumpano (op. cit.)

These findings are not surprising given the composition of the typical real estate brokerage's operating costs and the contractual relationship between the agent and the brokerage. The single largest component of operating costs is salesperson compensation, which accounts for over 60 percent of total expenditures. Since the majority of sales personnel are essentially independent contractors who work on a commission basis, unit costs remain relatively constant with increases in output, or sales.

These general results were corroborated in a study that drew upon a sample of real estate firms to measure what economists call "X-efficiencies." [35] Such efficiencies are related to the management of resources used in the production of a product or service, such as offices, agents, and administrative support. The study found that the average real estate brokerage operates close to its "efficient frontier,"

[34] Leonard Zumpano, "The Possible Consequences of Allowing Banks into the Real Estate Brokerage Industry," Consultant Study for the National Association of REALTORS®, April 2001.

[35] Leonard Zumpano, "The Possible Consequences of Allowing Banks into the Real Estate Brokerage Industry," Consultant Study for the National Association of REALTORS®, April 2001.

confirming that today's brokerage firms are quite efficient in managing their resources. In fact, smaller brokerages appear to be somewhat better in this regard than either their medium-size or larger counterparts. Again, this finding is consistent with the conclusion that the real estate brokerage industry would have little to gain from the entrance of large-scale organizations like commercial banks.

Indirect Cost Measure

Another way to test for the existence of economies of scale, which is used by the Federal Trade Commission and the Department of Justice, is through a simple tool called the "survivor technique." In principle, the ability of a firm to survive over time can be viewed as *de facto* evidence of its efficiency. For example, if firms of a given size continue to operate over an extended period of time while others lose market share, the size of the surviving firms can be considered optimal. Likewise, if the firms that survive are the ones that grow while smaller firms decline, then economies of scale are most likely present.

Despite this important caveat, an analysis of trends in the size of real estate brokerages over the last 20 years suggests that the industry does not have significant economies of scale. For the most part, the size distribution of brokerages has remained relatively constant since 1983. Brokerages with a sales force of five or less currently hold 60 percent of the real estate market, up from about 55 percent in 1983. In contrast, brokerages with a sales force of more than 50 agents have yet to reach even a five-percent market share. These patterns are consistent with the analyses of unit costs described above, and again suggest that the real estate industry has little, if any, to gain from potential economies of scale.

DISTRIBUTION OF FIRMS BY SIZE OF SALES FORCE
1983 - 1999
(Percentage)

Size of Sales Force	1983	1990	1996	1999
Five or less	55	51	55	60
6 - 10	23	23	18	17
11 - 20	13	13	14	11
21 - 50	6	9	9	8
More than 50	3	4	4	4

*Source: **1999 National Association of REALTORS® Profile of Real Estate Firms***

One can find a similar result by analyzing the market concentration of the real estate industry. As mentioned earlier, an analysis of 1999 *Real Trends* data shows that the real estate brokerage industry is not particularly concentrated. Our bottom-line calculation is that in 1999, the *Real Trends* Top 500 account for about 28 percent of the national market, based on sides (28 percent) and agents (26.8 percent). Furthermore, in the *1997 Economic Census*, the U.S. Bureau of the Census found that there were an estimated 60,620 individual establishments in the residential real estate brokerage business. Given that it is hard for even 500 of the biggest, richest firms to dominate production, the industry is clearly is competitive and efficient.

SUMMARY

With more than 760,000 REALTORS® (as well as other real estate licensees) and over 60,000 real estate brokerages competing for the business of homebuyers and homesellers, today's residential real estate brokerage industry provides a vast array of choice for consumers. Real estate brokerages compete each day on three different fronts: for agents, for consumers' business against other brokerages, and for consumers' business against other methods of buying or selling homes. Further, there is little evidence that a further increase in market concentration could generate a market structure that is more efficient. Finally, the relative ease of entry into real estate brokerage acts as a check on market power that may be generated through market concentration.

CHAPTER 3

THE RISKS OF COMBINING REAL ESTATE AND BANKING

Ten years ago, the modern assault on what became financial services modernization began. E. Gerald Corrigan, then president of the Federal Reserve Bank of New York, testified before the Senate Banking Committee on the separation of banking and commerce. Corrigan identified the risks historically associated with mixing banking and commerce: increased concentration, conflicts of interests, unfair competition and breaches of fiduciary responsibilities.[36] Corrigan also identified a second group of risks associated with the merger of banking and commerce: "the danger that such arrangements will involve the *de facto* extension of parts of the safety net to any firm that would own and control banks."[37] These same factors, and others, are relevant to the current debate on the advisability of allowing banks to engage in the real estate brokerage activities.

This chapter describes the risks involved in combining banking with real estate brokerage. The first section examines the expansion of bank powers, the resulting concentration of the industry and the likely impact on the banking industry of further expansion into real estate brokerage activities. The second section examines the impact of the expansion of bank powers on the real estate brokerage industry, including the effect on competition, market concentration and market performance. The third section examines the consequences for American housing and banking consumers, including the potential for increases in real estate and banking fees, limits on consumer choice and service to consumers, and violations of consumer privacy. Based on these analyses, we conclude that the unprecedented expansion of banking powers into the real estate brokerage industry would have little, if any positive effects for either the banking or real estate brokerage industries. On the contrary, the proposed regulation poses significant risks to the banking industry, the real estate brokerage industry, and American consumers.

THE EXPANSION OF BANKING POWERS

Since the 1864 National Banking Act imposed limits on allowable activities of banks, history records a continual expansion of bank powers[38] through legislation, regulation or court decisions, including the recently passed Gramm-Leach-Bliley Act of 1999 (see Chapter 1 for details). However, the expansion has not resulted in meaningful or improved banking industry profitability and performance. The most significant result has been an increase in market concentration. There is little evidence demonstrating that the addition of real estate brokerage activities to the powerful banking arsenal would meaningfully improve bank profitability or performance, either. Clearly, banks do not need the addition of real estate brokerage activities to remain competitive. In fact, there could be risks to expanding the power of banks to own real estate brokerages.

Expansion of Banks into Insurance and Securities

Traditionally banks have been limited to a narrow range of activities, often excluding several financial activities such as insurance and securities brokerage. For instance, the National Banking Act of 1864 placed strict limits on national bank involvement in insurance: banks could sell insurance only in small towns (less than 5,000 people).[39] The justification for this exception was based on the economic market failure argument that small towns could not support specialists in both banking and insurance and thus the functions needed to be combined.

[36] E. Gerald Corrigan, President, Federal Reserve Bank of New York. Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, May 3, 1990, p.5.
[37] *Ibid.*, p.6.
[38] Bernard Shull, *Real Estate Brokerage and Management Services as Permissible Activities for Banking Organizations: An Evaluation of the Agencies' Proposal of December 2000*. Consultant study for the National Association of REALTORS®, April 25, 2001.
[39] Kroszner, Randall S. "The Economics and Politics of Financial Modernization" in the Federal Reserve Bank of New York *Economic Policy Review* Oct 2000 6(4), pp. 25–37.

In 1986, the Office of the Controller of the Currency (OCC) ruled that national banks could sell insurance *anywhere* if *one* of its branches was in a town of less than 5,000 people. The economic basis for the provision was completely lost in this expansion of bank powers. The limits on banking involvement in insurance crumbled further with the elimination of restrictions on interstate bank branching in 1994. These regulatory and legislative changes were inspired by the experience of the 1980s when the failure of banks and savings and loan institutions cost taxpayers billions of dollars. While the causes of the crisis in banking were many, the solution involved support for the diversification of financial institutions.[40]

A similar pattern developed for securities sales by banks. In 1987, the Federal Reserve allowed "subsidiaries of a small group of holding companies to underwrite certain previously prohibited securities—such as municipal revenue bonds, commercial paper, and mortgage-related securities—on a limited basis."[41] The desire to expand the liquidity and provide service to markets that were small and served social purposes, such as the funding of sewers and affordable housing, was a wedge that allowed banks to expand their powers without regard for economic justification. They based their authority on Section 20 of the 1933 Banking Act language that prohibited affiliation with firms "engaged principally" in securities. Thus they limited the bank revenues from securities to five percent. Two years later this authority was expanded to include corporate debt and equities. The revenue limit was raised to 10 percent in 1989, 25 percent in 1996 and eliminated by 1997.

Available evidence also indicates that the integration of insurance and securities brokerage activities has added little, if any, to bank profitability and performance. Examination of German universal banking finds mostly diseconomies and inefficiencies associated with combining lending and investment brokerage services.[42] Research on U.S. banks has also found little potential diversification gains from combining securities brokerage and bank lending.[43] While simulation analyses of mergers between holding companies and other firms reveal that mergers between bank holding companies and life insurance firms would likely decrease bank holding company bankruptcy risk, mergers with all other types of financial firms would likely increase risk.[44] Other research also finds bank economies of scope to be overall insignificant.[45] It is clear that more time and more data is needed to effectively gauge the impact of the integration of insurance and securities brokerage on bank profitability and performance.

Consolidation in the Banking Industry

The U.S. commercial banking industry is highly concentrated. Even before the passage of GLB, banks began to consolidate. Banking is increasingly dominated by a few large firms. Between the 1930s and the 1980s the number of commercial banks in the United States ranged from 13,000 to 15,000. From 1985, the number of banks quickly declined to 8,581 in 1999.[46] Mergers continued during periods of poor profitability and high profitability. Industry concentration has increased along with mergers and acquisitions. From 1980 to 1998, approximately 64 percent of bank mergers were made by bank holding companies or their bank subsidiaries. The 25 largest banking organizations accounted for 29.1 percent of the assets in 1980, 34.9 percent in 1990, and 51.2 percent in 1998.

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[40] *Ibid.*

[41] Lown, Cara S., Carol L. Oster, Philip E. Strahan, and Amir Sufi. "The Changing Landscape of the Financial Services Industry: What Lies Ahead?" in the Federal Reserve Bank of New York Economic Policy Review Oct 2000 6(4) pp. 39–54.

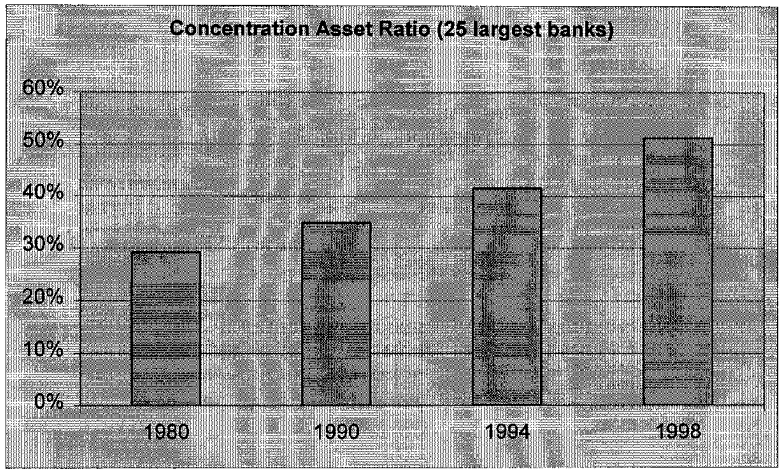
[42] Lang, Gunter and Peter Welzel, "Technology and Cost Efficiency in Universal Banking a "Thick Frontier"—Analysis of the German Banking Industry," *Journal of Productivity Analysis*, 10(1), July 1998, pp. 63–84.

[43] Kwast, M.L., "The Impact of Underwriting and Dealing on Bank Returns and Risks," *Journal of Banking and Finance*, 13(1), March 1989, pp. 101–125.

[44] Lown, Cara S., Carol L. Oster, Philip E. Strahan, and Amir Sufi. "The Changing Landscape of the Financial Services Industry: What Lies Ahead?" in the Federal Reserve Bank of New York *Economic Policy Review* Oct 2000 6(4), pp. 39–54.

[45] Berger, Allen N., Gerald A. Hanweck and David B. Humphrey, "Competitive Viability in Banking: Scale, Scope and Product Mix Economies," Journal of Monetary Economics, 20(3), December 1987, pp. 501–520.

[46] *Historical Statistics in Banking,* Federal Deposit Insurance Corporation, various years.



Source: Rhoades, Stephan A., "Bank Mergers and Banking Structure in the United States, 1980-1998," Staff Study 174, Board of Governors of the Federal Reserve System, September 2000

Concentration of control over aggregate U.S. bank deposits among the largest banks increased substantially from 1980 to 1998. The 100 largest banks today control almost 71 percent of deposits. In contrast, the 100 largest real estate firms control roughly 18 percent of the real estate market.

The unprecedented level of consolidation in the banking industry has been associated with a belief that gains can accrue through expense reduction, increased market power, reduced earnings volatility, and economies of scale and scope.[47] Value gains have not been verified by empirical findings, whether looking at accounting data or the stock market returns. Economies of scale apply only to very small banks.[48] Research on the mergers of bank subsidiaries between 1981 and 1987 found that bank mergers do not improve net profits. Any gains in efficiency were negated by increases in management fees, director fees, and data processing charges.[49]

Research has shown that increased bank acquisition of non-bank companies has not improved bank profitability. In addition, a variety of studies have indicated that increasing the scope of permitted activities of bank holding companies has also increased the volatility of bank returns.[50] Banking is a highly concentrated industry whose vertical integration into other lines of business has shown little propensity to increase competition or benefit consumers.

Since 1997, banks have acquired 140 insurance agencies and by the end of 2001 banks will own 40 of the nation's 100 largest insurance agencies. Overall, insurance agencies acquired by banks have performed poorly. In terms of growth, the average insurance agency is growing at an annual rate of roughly five percent in total commissions and fees, while bank-owned agencies are actually shrinking at a 0.3 percent rate. If banks do not fare better in real estate than they have in insurance,

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[47] Pillof, Steven J. and Anthony M. Santomero, "The Value Effects of Bank Mergers and Acquisitions," in Amihud, Yakov and Geoffrey Miller (eds.), *Bank Mergers and Acquisitions.* New York University Salomon Center Series on Financial Markets and Institutions, vol. 3, pp. 59–78. Boston. Dordrecht and London: Kluwer Academic, 1998.

[48] Smith, Roy C. and Ingo Walter, "Global Patterns of Mergers and Acquisition Activity in the Financial Service Industry," in Amihud, Yakov and Geoffrey Miller (eds.), *Bank Mergers and Acquisitions.* New York University Salomon Center Series on Financial Markets and Institutions, vol. 3, pp. 21–36. Boston. Dordrecht and London: Kluwer Academic, 1998.

[49] Chamberlain, Sandra L., "The Effect of Bank Ownership Changes on Subsidiary-Level Earnings," in Amihud, Yakov and Geoffrey Miller (eds.), *Bank Mergers and Acquisitions.* New York University Salomon Center Series on Financial Markets and Institutions, vol. 3, pp. 137–172. Boston. Dordrecht and London: Kluwer Academic, 1998.

[50] Mester, Loretta J., "Efficient Production of Financial Services: Scale and Scope Economies," in Anthony Saunders, Gregory F. Udell, Lawrence J. White, *Bank Management and Regulation: A Book of Readings.* Under the general editorship of Alan S. Blinder. Mountain View, CA: Mayfield, 1992, pp. 27–37. (Previously published 1987.)

large-scale entry into the real estate business could weaken some financial holding companies' standing, and place in jeopardy their federally insured operations.

Additional research[51] found that the largest bank holding companies are not necessarily more profitable nor more efficient than smaller banking firms are, indicating a lack of scale or scope economies in banking. A separate study examining profit performance of the banking industry in an international context[52] concludes that there are very limited economies of scale, but substantial X-inefficiencies in the banking industry, suggesting that increases in scale and scope could pose additional inefficiencies for the banking industry.

Banks Expanding into Real Estate Brokerage

The banking industry's search for increased profits through expansion into real estate brokerage activities is likely to prove futile. Real estate brokerage firms, on average, are not highly profitable. Banks are unlikely to benefit from economies of scale, cross-selling or diversification.

As demonstrated in Chapter 2, real estate brokerage contains no identifiable economies of scale to exploit. Entry costs are quite low, suggesting that additional capital and increases in average firm size that would accompany bank entry into real estate brokerage would add little, if any, efficiency gains because there are no economies of scale to exploit.

Bank entry into real estate brokerage would generate few additional profits for banks from their cross-selling of financial products and services. Real estate firms' experience with the packaging of real estate related services has demonstrated that consumers prefer to retain choice among the various components and services surrounding the home sale or purchase. Neither homebuyers nor sellers choose a real estate firm specifically because of the firm's comprehensive service package. Just 27 percent of homebuyers said they would choose a real estate agent in the future based on the availability of a menu of real estate related goods and services. Another third of respondents said such goods and service would play no factor.[53]

Costs savings and additional efficiencies could occur if combining real estate brokerage and banking offered banks greater risk diversification. However, diversification opportunities are low since real estate brokerage volatility is low and will not offset the more volatile banking cycles. Non-brokerage real estate related activities such as real estate investment may have played a significant role in bank crises and failures. These activities are very distinct from real estate brokerage. In fact when a bank is likely to see its mortgage portfolio weaken, due to increased defaults and delinquencies, it is also likely to see any fee income derived from real estate brokerage decline.

Without economies of scale, cross-selling revenue or diversification, the synergies from combining banking with real estate brokerage activities are severely limited. In fact, the profit of the average real estate brokerage firm is low compared to that of BHCs. In 1996, the typical real estate firm earned profits of just 2.3 percent of the firm's gross revenue.[54] Banks, by comparison earned a profit of more than $52 billion in the same year.[55] In contrast to insurance, securities dealing, and banking, profit opportunities from real estate brokerage activities would be few.

Ability to Compete in the Mortgage Market

Nationally chartered financial holding companies contend that the current law preventing the FHCs from entering into real estate brokerage business puts them at a significant disadvantage in gaining access to the real estate related financial activity, primarily in mortgage loan originations and mortgage loan servicing. Further, they argue that under the current law some financial institutions already engage in real estate brokerage and property management activities. According to the Conference of State Banking Supervisors, 17 states allow state-chartered banks to engage in real estate brokerage activities. The Office of Thrift Supervision (OTS) also has permitted the service corporation subsidiaries of federal savings associations to provide general real estate brokerage services. FHCs believe that they must extend their powers to include real estate brokerage activity to adequately compete with these banks and thrifts.

[51] Stiroh, K., "Are Bigger Banks Better?" The Conference Board, Research Paper, March 1999.

[52] Scholtens, Bert, "Competition, Growth and Performance in the Banking Industry," Working Paper Series 00–18, The Wharton School, Center for Financial Institutions, University of Pennsylvania, February 2000.

[53] *The 2000 National Association of REALTORS®* Profile of Home Buyers and Sellers

[54] *Residential Real Estate Brokerage: Income, Expenses and Profits, National Association of REALTORS®*, 1997.

[55] Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, fourth quarter 1996.

But whatever non-banking activities may be authorized under state law does not alter the analysis of whether real estate brokerage is commercial or financial in nature, anymore than it would alter the analysis of whether television manufacturing was commercial or financial. Further, the determination of the OTS to permit thrifts' service corporations to engage in an activity does not have anything to do with the nature of the activity in question, and has no relevance to the issue at hand.

The data, however, do not support the view that FHCs are at a disadvantage. Comparative data is meager, and inexact, but a query to OTS determined that there are 107 diversified thrift holding companies with real estate development subsidiaries and agency subsidiaries. Real estate development subsidiaries among these institutions totaled 229; there were only 14 real estate agency subsidiaries among these institutions. We would note that total assets among the 107 thrift holding companies equals $429.3 billion.

A simple comparison of the assets of diversified thrift holding companies to those of the FHCs petitioning the Federal Reserve Board is revealing. Third quarter, 2000 assets of selected FHCs among the top 150 FHCs reported by the *American Banker* revealed that Citigroup had assets of $804 billion, BankOne $284 billion, FirstUnion $247 billion, Wells Fargo & Co. $241 billion, FleetBoston Financial $179 billion.[56] Clearly the financial holding companies have little to fear from thrifts.

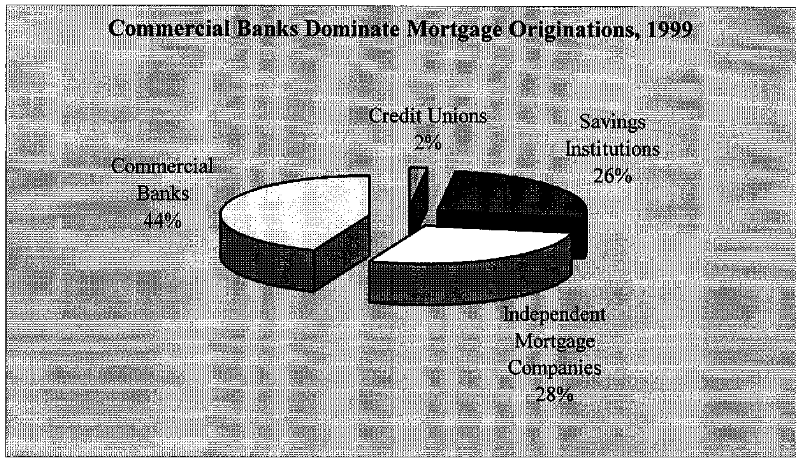
The data, in fact, show that FHCs have made large inroads into mortgage origination and servicing business. Furthermore, the market share of thrifts has declined and the influence of a few real estate brokerages engaged in mortgage lending has been minimal.

Mortgage Originations are Dominated by Commercial Banks

According to 1999 Home Mortgage Disclosure Act data (HMDA), commercial banks and the subsidiaries of commercial banks accounted for the largest market share with 44 percent of the mortgage originations. Independent mortgage companies, which are not depository institutions and therefore do not lend depositors' monies, accounted for 28 percent of the market. Savings institutions and mortgage companies who are subsidiaries of savings institutions accounted for 26 percent of all residential mortgage originations. Credit unions held two percent of the market.

Not only do commercial banks dominate mortgage originations, but according to *The REALTRENDS 500*, those real estate brokerage firms engaged in mortgage lending accounted for a minimal amount of mortgage lending. In 1999, the top 25 real estate brokerage firms accounted for only 78,708 mortgage closings or 0.8 percent of total originations. The top 75 accounted for only 1.1 percent.

[56] *American Banker,* Top 150 Holding Companies by Assets, as of September 30, 2000.



Note: Mortgage company share includes those originations from mortgage companies affiliated with real estate brokerage firms.
Source: Home Mortgage Disclosure Act data.

The thrift share of originations may include those mortgages originated through real estate brokerage operations. However, only eight thrifts engage in direct real estate brokerage activities of helping customers buy and sell real estate.

THRIFTS WITH REAL ESTATE BROKERAGE OPERATIONS

Institution	Assets ($000)	Mortgage Originations (in billions)
Standard Federal Bank (MI)	$30,595,091	$24.285
Indymac Bank, FSB (CA)	$5,732,351	$10.861
Community Bank of Excelsior Springs (MO)	$101,024	N/A
Progress Bank (PA)	$898,795	N/A
Sterling Savings Bank (WA)	$2,651,771	$0.200
New South Federal Savings Bank (AL)	$1,221,110	$0.012
Bank United FSB (OH)	$4,632,231	$5.084
Mutual Savings Bank (WI)	$1,804,339	N/A
TOTAL	~$47,636,283	~$40.548

~ Approximate Value

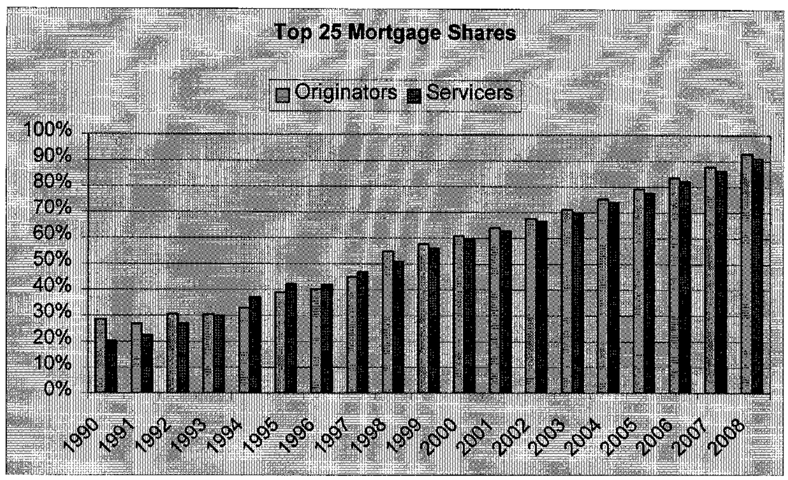
Note: The exact dollar amount of mortgage originations for three of these thrifts is not separately reported, but as these thrifts account for less than $4 billion in assets, the amount of mortgage originzations is likely minimal. The total mortgage originations by thrifts with agency operations are likely to be under $50 billion, or less than 5 percent of the total mortgage originations. This would be included in the savings institution share of mortgage originations

Source: Office of Thrift Supervision, Financial Call Reports database

Mortgage Originations and Servicing Are Dominated by the Largest Firms

There is a significant concern arising from increased concentration in the mortgage origination and mortgage servicing markets. In 1999, the top 25 mortgage originators represented 54.4 percent of total mortgage originations and the top 25 mortgage services account for 55.9 percent of mortgage servicing outstanding.[57]

While real estate brokerage markets are local, financial markets are national and are supported by international capital markets and so can benefit from economies of scale in financial transactions. Thus there is potential for the largest firms to continue to grow. It is not surprising that the market shares of the top 25 mortgage originators and the top 25 servicers have increased dramatically during the 1990s. The share of originations for the top 25 originators rose from 28.4 percent in 1990 to 54.4 percent in 1999. The servicing share of the top 25 servicers has an equivalent leap, rising from 20.2 percent in 1990 to 55.9 percent by 1999. Projections from the Mortgage Bankers Association indicate that the shares for the top 25 in both originations and servicing could be greater than 90 percent by 2008. (The projections shown assume a continued rate of growth in market concentration based on recent years.)

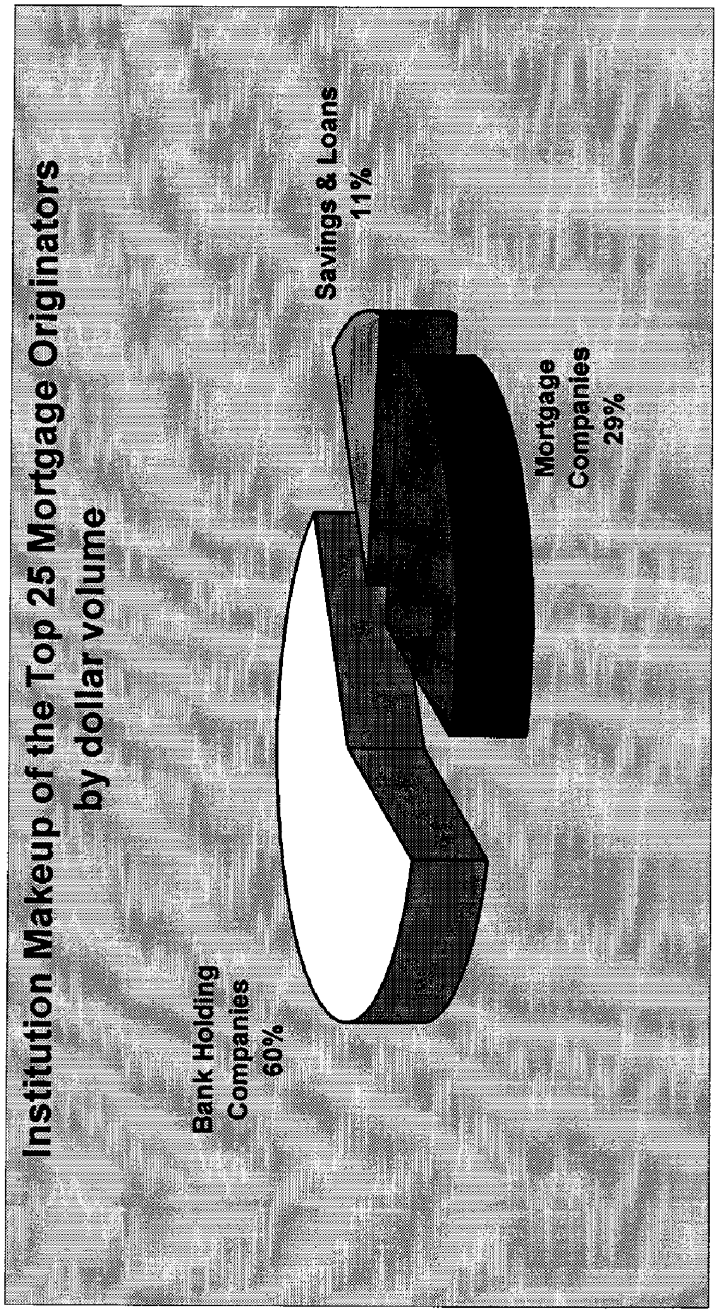


Notes: Trend extrapolated for 2001-2008. Fourteen of the top 25 mortgage originators (40.3% market share) and 14 of the top 25 servicers (41.6% market share) are subsidiaries of bank holding companies.

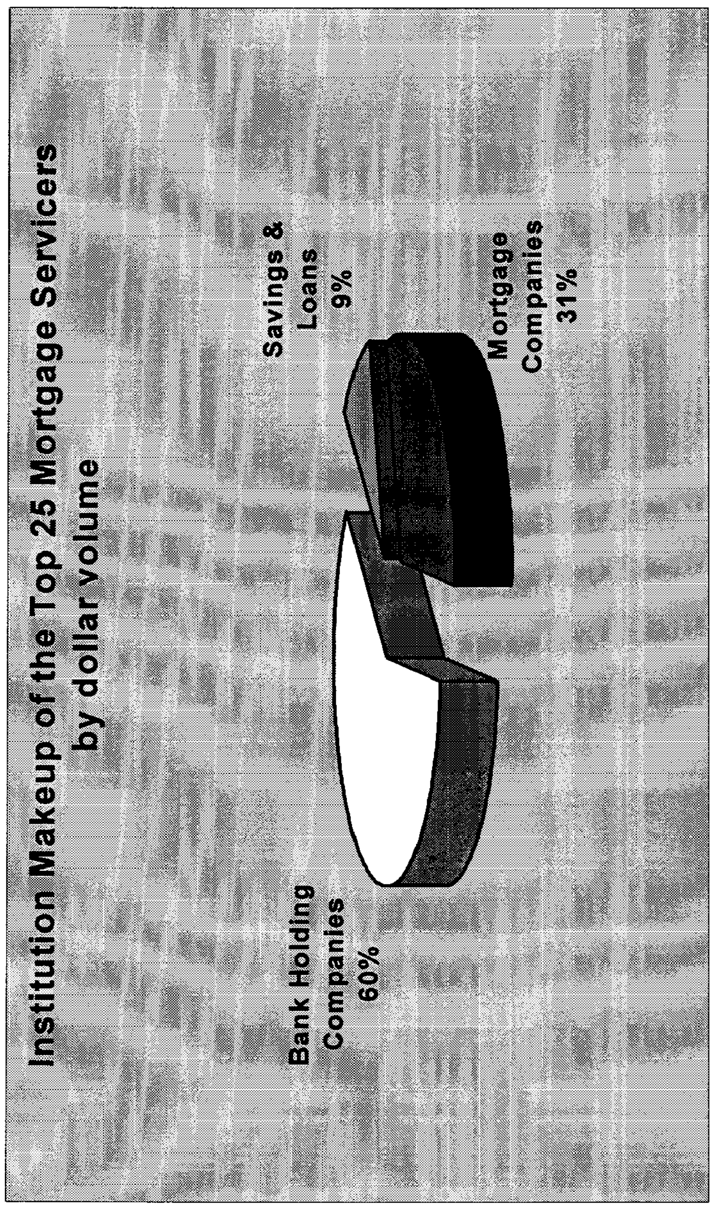
Source: Inside Mortgage Finance, Projections by Mortgage Bankers Association

Most of the increase in concentration is occurring from the merger and acquisition activities of FHCs. Not only do banks dominate mortgage originations, but BHCs also dominate when one considers the largest firms in the industry. Originations by BHCs represent 60.1 percent of originations by the top 25 mortgage originators, and servicing by BHCs a similar proportion—59.4 percent of the servicing held by the top 25 servicers.

[57] *Inside Mortgage Finance, 2000.*



Source: Inside Mortgage Finance



Source: Inside Mortgage Finance

The fourteen BHCs in the top 25 group originated $421 billion in mortgages, and represented 33 percent of total mortgage originations. Similarly, the 15 BHCs in the top 25 servicers held $1,577 billion, or 33 percent of mortgage servicing outstanding.

These statistics and trends are confirmed by others sources. From 1990 to 1999, banks' holding of mortgage debt grew from $373 billion to $879 billion. Thrifts' holdings fell from $669 billion to $549 billion during the same period. There appears to be no end in sight for the increases, as indicated by estimates from *Inside Mortgage Finance*; the share of mortgage originations by FHCs continued upward to 41.4 percent of total mortgage originations in 2000 from 38 percent in 1999. The holdings of servicing followed the same pattern rising to 43.1 percent of mortgage servicing held. With the major provisions of the GLB Act still being implemented, the end is not in sight.

Safety and Soundness Concerns

The historic separation of banking and commerce rests primarily on the fear of unfair competition arising from banks' federally chartered competitive advantages. Another concern is the extension of the federal safety net, and hence taxpayers' liability, to non-banking affiliates of bank holding companies. Classifying real estate brokerage as a financial activity would further blur the line between finance and commerce, possibly opening other lines of commercial brokerage, such as automobile sales, to bank activity. Further, bank entrance into commerce would likely extend federal supervision and guarantees to greater and greater segments of the economy.

Real estate brokerage is fundamentally a commercial activity. Brokering the sale of a house or an office building is a vastly different transaction than selling homogeneous financial instruments, like Treasury bonds. While commerce, other than through barter, inevitably entails the use of financial instruments such as currency, this does not transform a commercial activity into one that is "financial in nature" or "incidental to a financial activity." If real estate were accepted as "financial in nature"—a possibility raised in the Federal Reserve/Treasury proposal—then how far behind could commercial operations that are real estate intensive be, e.g., real estate development and farming? [58] Allowing banks to broker real estate would undermine arguments for separating banking and other lines of commercial brokerage. Without drawing a clear bright line between commerce brokerage and banking, federal regulators risk extending the full faith and credit of the federal government to wide variety of commercial activities.

Federal guarantee of commercial companies should be left to Congress. In 1981 when Chrysler Corporation was on the verge of failure, Congressional guarantees of its debt and credit extensions from the Federal Reserve were provided. Importantly, Federal Reserve assistance was not provided until after Congressional support for Chrysler was established. Chairman Volker characterized Chrysler as "under government protection." This protection was not extended until after Congress had an opportunity to debate its merits. If Chrysler at the time had been owned by a bank holding company, Federal Reserve protection could have been extended without the benefit of Congressional debate.

Risk of Bank Failure

As discussed above, bank expansion into real estate brokerage would provide little opportunity for diversification of risk. Research at the Federal Reserve Bank of Minneapolis suggests that combining bank holding companies with real estate firms would increase the volatility of returns and increase the risk of failure.[59]

While bank failures are relatively rare events; since 1934, there have been 2,133 bank failures. But bank failures do not occur only in economic recessions or depressions. In the Great Depression decade, the yearly average was about 70 bank failures for a decade total of about 800, including a number of non-FDIC-insured banks. There were 1,127 failures during the 1980s, and in the 1990s decade, when the economy grew at a robust pace, there were 440 bank failures.

Threats to the Federal Safety Net

There is also the concern that the federal safety net for the nation's banks would be at risk. If banks or bank holding companies are permitted to engage in real estate activities, the federal safety net for banks would *de facto* extend to affiliated real estate brokerages. This would expose the nation's payment and monetary systems to additional risk, potentially undermining the safety and soundness of the nation's banking system. It is likely, in times of stress, that financial holding companies will attempt to extend this safety net to their affiliated businesses, when these businesses are in distress.

The Federal safety net can be extended to banks of any size. Even allowing only small banks to engage in real estate brokerage would not insulate the financial sys-

[58] Bernard Shull, *Real Estate Brokerage and Management Services as Permissible Activities for Banking Organizations: An Evaluation of the Agencies' Proposal of December 2000*. Consultant Study for the National Association of REALTORS®, April 25, 2001.

[59] Boyd, John and S. Graham, "The Profitability and Risk Effects of Allowing Bank Holding Companies to Merge with Other Financial Firms: A Simulation Study," *Federal Reserve Bank of Minneapolis, Quarterly Review*, 12 (2), Spring 1988, pp. 3–20.

tem from possible distress. Approximately 217 small Texas banks went belly-up from 1987–1989. And large banks can benefit as well. In the mid-1980s, the FDIC sought to contain the bailout of Continental Illinois to its deposits and creditors. However, because of the holding company structure, the FDIC payment benefited the bondholders of the holding company and thus the other affiliates—not just the depositors and creditors.[60] If Continental Illinois had owned a real estate brokerage, it, too, would have benefited from the federal safety net.

Bank failures were not isolated in a single region. Similar events transpired in New England. In late 1989, the Bank of New England declared a major loan loss provision. There were 108 bank failures in New England between 1989 and 1992. This same pattern was repeated along the mid-Atlantic and even in Washington, D.C.

Real estate has not only been the cause of banking problems in the U.S. but also in other countries. Japan is a prime example. Beginning in the early 1980s, bank lending to the real estate industry grew rapidly, doubling its share of bank portfolios between 1982 and 1988. Following a rise in discount rates, Japan's real estate bubble burst in 1989, leaving many banks burdened with worthless loans. While American banking has seen its share of nonperforming real estate loans, the close relationship between Japanese banks and their commercial borrowers, particularly real estate companies, exacerbated the crisis. Since many Japanese banks held equity in the companies they had lent to, banks were reluctant to write-down loans or refuse to continue lending to insolvent clients. Such a system only prolonged a banking and economic crisis that has yet to be resolved. Allowing American financial holding companies to extend their activities down this path could have serious consequences for the safety of U.S. banks and the U.S. economy.

THE IMPACT ON THE REAL ESTATE INDUSTRY

The expansion of banking powers that would permit FHCs to engage in real estate brokerage activity will have a detrimental effect on the real estate brokerage industry. As discussed elsewhere, the real estate brokerage industry today is a highly efficient, competitive market. It is comprised of many firms competing to best serve the housing needs of Americans.

The banking industry, by contrast, can best be described as an oligopoly, with a few dominant firms controlling a significant share of the total market. FHC entry into the real estate brokerage business would introduce unfair competition to the marketplace, increase concentration, and could pose particular danger to small real estate firms which make up a large portion of the real estate brokerage industry. As banks increase their role in the real estate brokerage business, the industry would change from a localized, highly competitive industry to one that is dominated by nationwide, federally chartered firms.

Unfair Competition

The real estate brokerage industry has welcomed competition from all players regardless of size, type of organization or level of capitalization as long as the competition is conducted on a level playing field. But FHCs bring with them inherent advantages through the potential upstreaming of the advantages held by their federally insured bank subsidiary. These advantages could be used to undercut real estate brokerage firms and have the potential of making the government a player in the real estate brokerage market.

Advantages of the Banking Charter

The federal banking charter offers a wide variety of advantages to federally insured banks and not offered to real estate brokerage firms.

(For a more detailed discussion of the advantages of the federal bank charter, see Appendix A.)

[60] FDIC, *History of the Eighties: Lessons for the Future*, Washington, DC, FDIC, 1997.

Advantage	Impact on Banks
Federal Home Loan Bank membership	Increased liquidity and lower capital
Federal Reserve payment system guarantees	Reduced borrowing costs
Federal Reserve Fedwire system guarantees	Increases funds available for lending
Bank debt receives preferential risk-based capital treatment	Reduces the cost of funds for banks
Federally guaranteed deposit insurance	Lowers the cost of capital relative to non-banks
Federal Reserve's discount window access	Increases funding available for lending
Government-imposed barriers to entry	Limits direct competition

Implications for Banks

Most of the advantages of the bank charter directly add to bank profitability via a reduced cost of borrowing and guaranteed sources of borrowing. A guaranteed and subsidized source of funds offers banks a significant competitive advantage over other firms that would be competing in the same market.

Our fractional reserve banking system allows banks to maintain both small amounts of equity and reserve funds in order to maintain profitability. Researchers at the Federal Reserve Board find that on average banks carry 2.5 percent less equity relative to total assets then do non-bank financial holding companies. Not only do banks have relatively less capital, they also have low levels of capital on an absolute basis. Compared to non-farm non-financial corporations, the Federal Reserve's Flow of Funds data indicates commercial banks hold only a penny of equity for every dollar of financial assets, while non-farm non-financial corporations hold 50 cents in equity for every dollar of assets. This greater leverage allows banks to have both a much smaller amount of their own money at risk and receive a much greater return on equity.

Balance Sheet for Commercial Banks and Non-farm Non-financial Corporations 3rd Quarter, 2000

	Banks	Corporations
Total Assets	6344.2	16714.5
Total Liabilities	627.4	8387.4
Equity	70.2	8327.1
Debt to Equity Ratio	89.37	1.01
Equity to Assets	0.01	0.5

Source: Federal Reserve, Flow of Funds, Z.1.

Implications for Bank Holding Companies

The advantages described above accrue to banks—not to bank holding companies. In addition, while not explicitly stated, many financial institutions are viewed by the public as being too big to fail. Quite simply the capital markets and depositors believe that the failure of some institutions would have such a dramatic impact on the nation's financial and payments systems that the federal government would not let these institutions fail. All debt issuances, whether private or government, are priced to account for the probability of default. One possible reason for defaulting on a debt issuance is the failure of the issuer. The likelihood of default is one of the reasons for the large difference in debt prices between government and private issued debt. While bank debt issuances are not viewed as safe as U.S. Treasury bonds, the implicit backing of large banks that are "too big to fail," does allow these banks to borrow funds at reduced cost.

These advantages are reflected in the reduced cost of debt, not only to the banks, but also to the bank holding company as well. According to research by the Federal Reserve, banks have a cost of capital 20 to 30 basis points below that of non-banks. Bank holding companies have a smaller, but still significant funding advantage, perhaps as much as 18 basis points.[61]

Before passage of the GLB Act, the Chairman of the Federal Reserve Alan Greenspan warned that "Losses in financial markets—large losses—can occur so quickly that regulators would be unable to close the failing operating subsidiary . . . before the subsidiaries' capital ran out."[62] Based on this testimony and Mr. Greenspan's other concerns, changes were made in the GLB Act to prevent activities in a bank subsidiary that are now being contemplated in the proposed regulation. Regulatory controls are inadequate to prevent the use of subsidies to finance real estate brokerage.

Implications for Competition in Real Estate Brokerage

Because of the advantages inherent in the banking charter, financial holding companies would have an unfair advantage in the real estate brokerage marketplace. Banks are in a position to undercut existing, mostly small, real estate brokerage firms, posing a threat to competition and quality of service. The combination of banking and real estate brokerage provides an incentive for predatory pricing behavior, and would result in increased concentration in the real estate industry with no efficiency gains. Independent real estate brokerage firms could be eliminated from the market.

Impact on Market Concentration

Allowing banks to expand their powers to engage in real estate brokerage activities would reduce the level of competition in the real estate brokerage industry. There is likely to be a significant decline in the number of firms and, specifically, the number of small firms that represent a key segment of the industry.

The level of competition could decline due to increased concentration and vertical integration. The banking industry would enter the real estate brokerage industry with a history and tradition of using mergers and acquisitions to expand leading to a highly concentrated industry. As discussed in detail above, the number of banks has declined and continues to do so, and the largest banks are getting larger. In addition, banks have a business model that defines market coverage in terms of states and regions.

Contrast this with the profile of the real estate brokerage industry which is made up of large number of real estate brokerage firms of varying sizes (although predominantly small) and operates on a business model that defines markets in terms of localities. FHCs could purchase existing real estate brokerage firms using their advantages of a low-cost-of-funds and the imprimatur of a federally supported institution. These bank brokerages could increase in size and come to dominate the real estate brokerage market, thus increasing the concentration of the industry. Smaller, independent real estate brokerage firms would be forced to merge in an attempt to compete. In addition, potential changes to the typical real estate brokerage business model—from a commission compensation structure to a salaried work force, for example—could disrupt the incentive structure and lead to further concentration to cover the higher fixed costs associated with salaried employees.

The obvious increase in vertical integration of the homebuying and home financing markets could have the predictable effect of magnifying the market power of the integrated firms. One of the key aspects of this market power is the ability to raise barriers and limit the entry of new firms. The fact that the integrated firm includes a bank whose barriers to entry are high by government fiat only increases the ability of bank brokerages to limit the level of competition.

If the proposal to expand banking into real estate brokerage activities is approved, any structural change that has adverse affects on the more efficient sector—real estate brokerage—undoubtedly will be adverse to the interests of consumers of real estate brokerage services, and is bound to result in an overall decline in efficiency.

[61] *Federal Reserve Bulletin*, June 1999.
[62] *Ibid., p. 422.*

Impact on Small Local Firms

The increased concentration that would follow from FHC expansion into the real estate brokerage activities could reduce the number of independent, local real estate firms offering services and expertise tailored to local needs. Large national corporations are less likely to provide the range of services and expertise available today. The local market-specific knowledge that real estate agents possess and convey to their clients would be lost if real estate agents became employees of large national financial holding companies. Entry by FHCs into real estate brokerage activities hurts small real estate brokerage firms and changes the nature of real estate brokerage from a competitive local business reflecting the needs and supporting the demands of America's communities to a market dominated by federally subsidized institutions.

Cross-subsidies and Pricing

Cross-subsidization is when a firm is able to take the profits from one activity to finance the losses from another operation. As will be described later, banks have been able to use banking fees or even profits from their mortgage operations both to increase profitability and to subsidize their entry into insurance and other financial services. Real estate activities of FHCs are no different. FHCs entering the real estate brokerage industry would be able to take these income streams from other operations to finance their entry into real estate brokerage. Consequently, all banking customers, whether or not they purchase or sell a home, would be financing the entry of FHCs into real estate brokerage. The cost to those customers—actually a wealth transfer from American consumers to financial holding companies—could be substantial. Appendix B describes a scenario where the ten-year cost of this cross-subsidy could be $48 billion.

Further, FHCs' ability to cross-subsidize their new real estate brokerages tilts the playing field towards FHCs. Few traditional real estate brokerages have access to outside income streams to subsidize the real estate brokerage business. Because of the advantages of the federal charter, FHCs brokerages would be able to make greater investments in their real estate brokerages compared to owners of independent real estate brokerages. The final result could be the exit of numerous real estate brokerages as they are unable to respond to their well-financed new competitors. In the worst case scenario, these cross-subsidies could finance years of predatory pricing designed to eliminate competition from traditional real estate brokerages.

The basic definition of predatory pricing is where a firm prices their good or service below the cost of production for the sole purpose of eliminating competition. Once the predator is successful in eliminating its competition, the firm with increased market power could raise prices well above competitive levels. Traditional models of predatory pricing rest upon the ability of predator firms to under-price their competitors, or potential competitors. The sustainability of predatory pricing depends upon the ability of the predator to sustain losses in the short run. This can be accomplished through the ability to cross-subsidize from other subsidiaries of the FHC. However, incumbent firms would not have access to capital or outside income streams to defend itself from a predator.

The entry of FHCs into real estate brokerage appears to be a prime candidate for predatory pricing behavior. As described above, FHCs have access to numerous subsidies and outside income streams that could finance a sustained period of below-cost pricing. At the same time, few real estate brokerages have access to outside revenue streams or capital that can help it defend itself against a well-financed FHC. As a result, traditional real estate brokerages would be forced to exit the industry—but not because of an inability to provide efficient quality service to the consumers. Rather, the exit of these players would be the result of below-cost pricing designed to eliminate viable competition and to allow monopoly pricing over the long run. By reducing choice, the detrimental impact of predatory pricing on consumers would be considerable.

IMPACT ON CONSUMERS

Combining real estate and banking services will impose significant costs to consumers. The costs will come in the form of higher prices and fees paid by consumers, reduced level of real estate brokerage services, limited consumer choice, and discomforting intrusion into consumer privacy. Rather than seeing consumer costs go down, as claimed by the FHCs, the cost, even in the best scenario, will likely increase.

Impact on Prices and Fees

Allowing banks to enter the real estate brokerage industry will not lead to lower costs for consumers. If anything costs could rise. The increase cost will be from two fronts: real estate brokerage services fees and banking fees.

As demonstrated above, the current real estate brokerage industry can best be characterized as a competitive industry. Entry barriers are low and little start-up capital is needed. Continued entry and exit of firms into and out of the industry assure that prices will remain at the lowest economically feasible level.

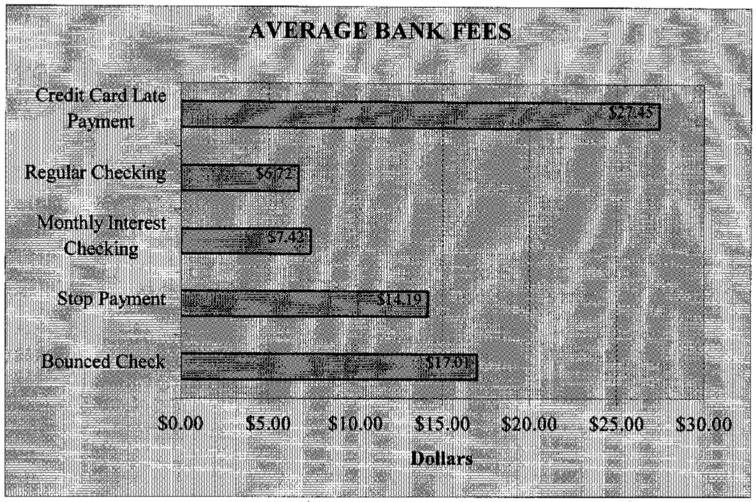
It is unclear what FHCs could bring to the market that would increase competition or efficiency. Any additional entry will not necessarily lower costs. FHCs' claim that consumer costs will go down, but those lower costs can only be realized by introducing economies of scale or scope, cross-subsidization, or predatory pricing. The latter two reasons are not permanent benefits for consumers. Only the first—economies of scale—enhances consumer welfare. Without an increase in efficiency, there would be no cost savings to pass along to consumers. But as demonstrated earlier, there are limited economies of scale in the real estate brokerage industry. Furthermore, FHCs made the same claims of economies of scale in expanding into newer markets such as investment security brokerage and insurance underwriting. But the initial claims of economies of scale have never materialized.

Any reduction of real estate services costs will be made up for in other FHC lines of business. Such cross-subsidization would be anti-competitive to many independent real estate brokerages that would be unable to compete effectively. Similarly, predatory pricing is a potential option open to FHCs (see above). Predatory pricing is not possible in the currently competitive real estate brokerage industry. Even if real estate services fees were reduced temporarily through predatory pricing, increased concentration would result in increased fees due to the industry being less competitive. The end result could be that more and more independent real estate brokerage firms are driven out of the market. With fewer competitors and a fundamental industry shift away from a competitive market structure, a price rise for real estate services fees is likely.

Even if banks were able to reduce real estate brokerage fees temporarily, any savings to homebuyers would be offset by higher costs for bank customers. Absent economies of scale, lower real estate brokerage fees can only come via cross-subsidization from other business arena. The higher banking fees are likely to become permanent features of the banking system, given barriers to entry and concentration of market power, while reductions in real estate brokerage fees could be temporary as firms start to exit the industry. According to a recent poll, nearly two thirds of consumers believed that bank fees would rise if FHCs entered the real estate brokerage industry.[63]

This is not the first experience of holding companies entering new fields and using their banking and credit card operations to subsidize their entry. Over the last couple of years as BHC entered both the insurance and securities brokerage industries; consumers experienced an increase in ATM fees, checking account fees, and bounced check fees, with the latter reportedly the most profitable activity for a bank. According to a 1998 Consumer Federation of America report, consumers pay $25 billion a year on checking and bank card fees each year.

[63] *National Association of REALTORS®* and Public Opinions Strategies



Source: Consumer Federation of America

Banks are able to shift these costs to banking customers because they do not compete aggressively for the deposits of average customers. Therefore, rather than lowering fees and offering competitive interest rates on deposits, banks have been able to hike fees to generate new revenue streams. Banks, over the past 10–20 years, have relied on non-deposit sources, including new bank fees, for an increasing proportion of their revenues and profits. Some examples include fees for ATM usage, banking with a teller, bounced checks, and late credit card payments. In a five-year span between 1996 and 2000, the share of BHC income from all non-interest income rose from 29.9 percent to 40.5 percent.[64]

Elsewhere, banks have lowered interest rates on customers' deposits and have raised interest rates on some loan products. Consolidation of the banking industry has lessened the number of alternatives for consumers to avoid these new fees. This consolidation has enabled banks to raise fees without fear of customer retribution. In addition, to undercut non-bank-affiliated real estate brokerages, banks may use real estate brokerage as a loss leader, later recouping their costs via higher mortgage servicing and origination charges. This could ultimately cost consumers as much as $48 billion over ten years (see Appendix B.)

Impact on Consumer Service

Combining real estate brokerage and banking services would also decrease the level and type of services real estate customers would receive, because the incentives to "serve the customer first" would be diminished. Homebuyers rely on their real estate professional to guide them to other real estate related service providers such as home inspectors, lenders, and moving companies. A recent study by Weston Edwards shows that 73 percent of real estate professionals recommend two or more mortgage lenders to their clients.[65] This is the kind of one-stop shopping consumers value, not the scenario where one-stop shopping means obtaining their mortgage from the same place they get their home.

Many bank mergers have attempted to achieve cost savings via workforce reductions. While reducing staff redundancies, layoffs in bank staff have also reduced customer service. Typical is the recent acquisition of Core States by First Union. While costs were slashed by reducing staffing levels, customer service suffered. Since there is little overlap in staff between banks and real estate brokerages, cost savings via staff reductions would mostly serve to reduce consumer service.

[64] Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, 2000.
[65] Weston Edwards and Associates, *Changes in the Ways Homes Are and Will Be Bought and Sold*, Consultant Study, 1998.

In addition, holding companies may provide less attention to those housing consumers who need high-touch customer service the most, such as first time homebuyers and lower income consumers. High-income customers may be more attractive, as they would be more willing and able to purchase the bank's other services and they purchase more expensive homes. Repeat homebuyers are similar. In 1999, the typical repeat homebuyer purchased a $150,000 home while a first-time buyer's home cost $104,000.[66] Higher priced homes represent higher commission rates and, perhaps more importantly, larger, more profitable mortgages, both of which would add to the bottom line of the BHC.

Impact on Consumer Choice

It has been demonstrated that the expansion of banking powers that would permit financial holding companies into the real estate brokerage business will result in increased concentration and decreased competition in the industry. But it will also limit consumer choice in selection of a real estate professional and other real estate related service providers.

Homebuyers and sellers rely on their real estate agents for advice on a wide variety of real estate related goods, services and advice. In fact, three quarters of homebuyers receive advice about related services from their agents, and 90 percent of those buyers use at least one of their agent's recommended providers.[67] The inherent parent/child relationship between FHCs and their subsidiary real estate brokerage business will likely steer consumers to the FHCs' subsidiaries. Agents working for an FHC-owned real estate brokerage firm would have less incentive to find a loan provider or other real estate settlement service vendor that best fits their customers' needs.

It is also probable that the typical "brokerage model" would change. Banks entering the real estate brokerage industry would likely retain their real estate agents as salary-based employees, rather than commission based independent contractors. Their real estate "employees" would focus on the FHC's profits, attempting to cross-sell the holding company's other services to increase its profits. Consequently, consumers would not receive valuable, impartial advice when they most need it. This shift in focus from the client to the FHC's profitability would limit the agent's incentive to ensure that customers find the home and real estate services best suited to their needs.

For instance, real estate agents have traditionally suggested several different lenders to their clients, helping their clients find the lowest rate available.[68] Real estate agents tied to a particular financial institution would be less likely to recommend getting a mortgage with a financial institution other than their employer. The immediate result would be a reduction in competition among mortgage originators, thus limiting consumer choice in financing. If banking powers expand to allow FHCs to engage in real estate brokerage activities, there would be implicit, if not explicit, disincentives for real estate professionals to recommend that homebuyers seek financing from unaffiliated banks, and real estate brokerage firms' practices or policies of recommending multiple financing sources would be far less prevalent if, indeed, such practices are not entirely eliminated.

As discussed above, bank-affiliated brokerages would have an unfair advantage also in the listing of properties, and thus would limit consumer choice of lenders. A prospective homeseller would naturally want to increase his/her likelihood of having prospective purchasers qualify for financing. The sellers' selection of a real estate professional almost always occurs prior to any direct discussions with a bank. Thus, even assuming that a bank with a real estate brokerage affiliate were to make disclosure that the availability of mortgage financing provided by it could not be affected by whether the property to be financed were listed with its affiliated brokerage company, so listing the property would create no greater likelihood of credit approval, the seller selection of a broker will have already taken place prior to such disclosure. As a result, the disclosure will have come too late in the process to affect the selection of the broker. The anti-competitive advantages enjoyed by the bank-affiliated real estate professional will already have succeeded in obtaining additional listings before any disclosure has been made to the listing party—that doing business with a bank-affiliated broker will not improve the chances that a prospective buyer can readily obtain credit approval from the broker's affiliated bank.

Increased concentration that would follow from FHCs' expansion into the real estate brokerage industry would reduce the number of independent, local real estate

[66] *The 2000 National Association of REALTORS®* Profile of Home Buyers and Sellers
[67] *Ibid.*
[68] Weston Edwards and Associates, *Changes in the Ways Homes Are and Will Be Bought and Sold*, Consultant Study, 1998.

brokers offering services and expertise tailored to local needs. The local market-specific knowledge that real estate agents possess and convey to their clients would be lost if real estate agents became employees of large national financial holding companies. Ownership of real estate brokerages by bank holding companies would directly reduce the competition among brokerages in a local real estate market, effectively reducing consumer choice along with possible increases in consumer costs.

Privacy Concerns

In addition to the risks to the marketplace, potential bank failures, and the spectre of another "taxpayer" bailout" of financial institutions, there are concerns about consumer privacy, especially the ability of ever expanding FHC to use private financial information on a client of another business unit and obtain a competitive advantage and unique price setting power. Access to information regarding real estate brokerage customers' home purchases or indebtedness is increasingly a source of concern as financial companies have access to vast databases of credit and payment history records. Merging of financial and real estate value/credit records would help centralize private information holdings with the largest banks.

Financial institutions are permitted to share information with their FHCs and subsidiaries. The Gramm-Leach Bliley Act of 1999 only requires financial institutions to notify consumers of the institution's policy on sharing nonpublic personal information to those third parties not affiliated with the institution.

Recent research demonstrates that consumers are concerned about financial information privacy and the use of their nonpublic information. Four out of five (81 percent) of Americans are worried that their bank could use their private information to sell real estate services to them.[69] Americans who have bought or sold a home in the past ten years are significantly more concerned than those who have not (84 percent vs. 79 percent, respectively) about their bank using their private financial information to sell real estate services to them.[70]

The proposed expansion of bank powers which would allow financial holding companies to own real estate brokerages and property management companies could expose consumer information normally kept private to a much larger group. Bank owned real estate brokerage and property management firms would have access to even more nonpublic information that could then be shared among third parties under the stated exceptions of the GLB Act.

With the opportunity for extensive information-gathering on a consumer's demographic profile, purchase habits, and individual preferences, FHCs will be better positioned to extract consumer surplus via price discrimination strategies. With the continued and drastic reduction in computing cost, the use of data mining software by large corporations is becoming a common practice. Data mining is a process of analyzing massive databases to automatically "mine" the data for potential relationships between variables using regression, neural networks, artificial intelligence, fuzzy logic, and other mathematically sophisticated techniques. As one large software vendor (Oracle) puts it, the use of this software will "improve customer retention and acquisition." By analyzing data such as joint account status, age, when a home was purchased, how many calls were made to call centers, the time lag between mortgage rate changes and inquiries regarding refinance, and endless combination of variables, data mining software allows companies to anticipate likely behavioral outcomes. For instance, it would enable a company to expect a 40 percent probability of customer defection within a month of a price increase, and compute present discounted value of profits of each individual customer. It also allows companies to better identify those customers less likely to switch even with a price increase. FHC-operated real estate brokerage operations could have access to seller/client financial records and use that private credit information to the detriment of a home seller to affect the commission rate on a future listing.

SUMMARY

There are substantial risks of combining banking with real estate brokerage. Financial holding companies, through legislation, regulation and court decision, have

[69] Yankelovich Partners, Inc. *A Study about REALTORS®*, March 22, 2001. Yankelovich Partners conducted an omnibus study on behalf of the National Association of REALTORS®. A regionally representative sample of 2,049 Americans aged 18 or older were interviewed by telephone using an unrestricted Random Digit Dialing technique that significantly reduces serial bias and ensures that respondents with both listed and unlisted numbers are reached. Only one interview was conducted per household. Interviews were conducted between March 15 and March 19, 2001. To ensure a reliable and accurate representation of the total national adult population, completed interviews were weighted to know proportions for age, gender, geographic region, and race. The margin of error for the total sample was +/- 2.2%.

[70] *Ibid.*

expanded their powers to conduct insurance and securities brokerage with little positive effect on earnings and/or performance. The most troubling change in banking over the last two decades has been the dramatic increase in the concentration of economic power through mergers and acquisitions. The 25 largest banks now represent more than 50 percent of the assets in the banking industry.

While real estate brokerage is not a profit opportunity, it is also not a threat to the dominance of banking in mortgage finance. Indeed, there is more concern over the lack of competition in the mortgage market than too much competition. Commercial banks already have the largest market share—44 percent—of mortgage originations, compared to 1.1 percent market share for mortgage companies affiliated with real estate brokerage firms. And the top 25 financial holding companies account for more than 41 percent of total mortgage originations and 43 percent of mortgage servicing. Projections by the Mortgage Bankers Association indicate that the share of the top 25 mortgage originators and servicers could rise above 90 percent in the next decade.

Another concern is the blurring of the line between commercial and financial activities. If financial holding companies are permitted to engage in real estate brokerage activities, then it is quite possible that real estate development could also be added to the list of permissible activities. With the federal safety net for banks extending to affiliated real estate firms, there is the potential for undermining the safety and soundness of the nation's banking system.

In the meantime, the competitive and efficient real estate brokerage industry could be facing unfair competition from FHCs where weak firewalls could provide access to the federal subsidy. Banks are in a position to undercut existing real estate brokerage firms, and increase their dominance through predatory pricing.

The expansion of bank powers to allow financial holding companies and subsidiaries of national banks to engage in real estate brokerage activities also poses risks to consumers in the form of potentially higher fees for both banking and real estate services. Without any source for increased efficiencies, reduced real estate services costs could come temporarily only from cross-subsidization or predatory pricing and would result in higher banking fees. Higher bank fees could become permanent given the barriers to entry and concentration of market power in banking.

In addition to higher bank fees, the current high level of customer service provided by real estate professionals would decline. Not only would real estate customers lose their own agent, but there would be limits to a consumer's ability to select a real estate professional and other real estate service providers. Finally, combining real estate brokerage and banking under one corporate roof would allow banks to exploit customer-specific information without giving the consumers the opportunity to restrict the sharing of their private data.

CHAPTER 4

IMPLICATIONS FOR HOMEOWNERSHIP

Homeownership is key to achieving the American dream and has both social and economic benefits. Homeowners are more likely to vote and participate in our political institutions.[71] Long-term commitment of homeowners to their primary residence, limits the volatility of home prices. Given the value of homeownership in American life, federal housing policy as well as that of many states and localities has consistently supported the growth of homeownership.

The expansion of bank powers that would permit financial holding companies (FHCs) and subsidiaries of national banks to engage in real estate brokerage activities is likely to have a long-term negative impact on homeownership in the United States, particularly through increased foreclosures. It could also effect a reduction in service to low-income buyers—a group which represents a high potential increase in homeownership. These threats should be considered seriously given the central role of homeownership to both economic and political stability in the United States, and any negative impact of the proposal on homeownership in our society should be heeded.

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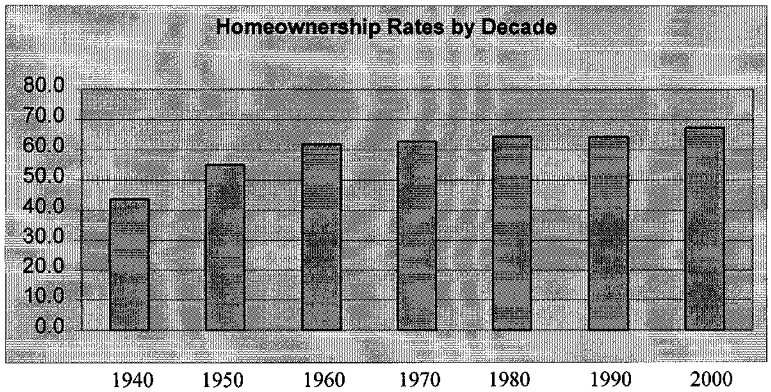
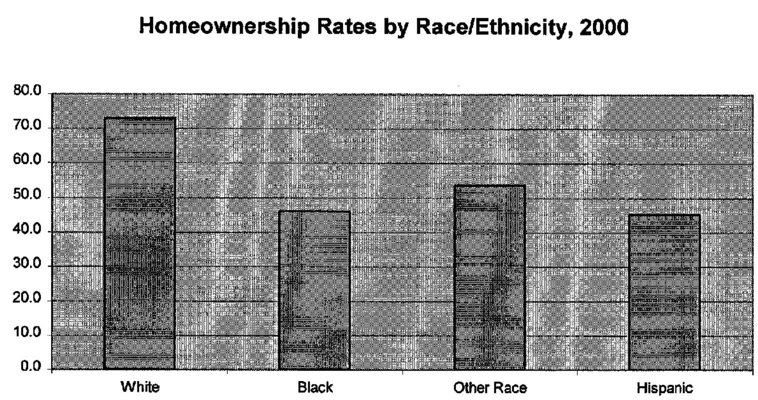
[71] DiPasquale, Denise and Edward Glaser, "Incentives and Social capital: Are Homeowners Better Citizens," *Journal of Urban Economics*, 45, 1999, pp. 354–384.



Source: U.S. Bureau of the Census, Current Population Survey

After stagnating and sometimes even declining for some years in the 1970s and 1980s, the U.S. homeownership rate has grown throughout the 1990s to an all-time high of 67.4 percent in 2000. However, not all groups in the population have achieved this high rate of homeownership. While the percentage increases in homeownership rates for Black and Hispanic households were than that of White households for the last several years, their overall rates remain well below that of White households. Making changes in the path to homeownership by radically restructuring the real estate brokerage market could create unnecessary barriers just as some households are beginning to achieve the American Dream.



Source: U.S. Bureau of the Census, Current Population Survey

INCREASED FORECLOSURES

If banks or financial holding companies are allowed to expand their powers to include real estate brokerage activities, then homeowners could be more likely to face foreclosure in the event of financial difficulties. Many households struggle to achieve homeownership and most of those who purchase a home find it necessary to arrange for a mortgage to finance the purchase. They work hard to save money and establish a good credit record so they can fulfill the stiff requirements of banks to qualify for financing.

However, the struggle to achieve homeownership pales in comparison to the implications of foreclosure. Losing one's home, and eliminating the possibility of purchasing another home for as long as five years, are devastating for the households involved. The repercussions can impact neighborhoods as well.

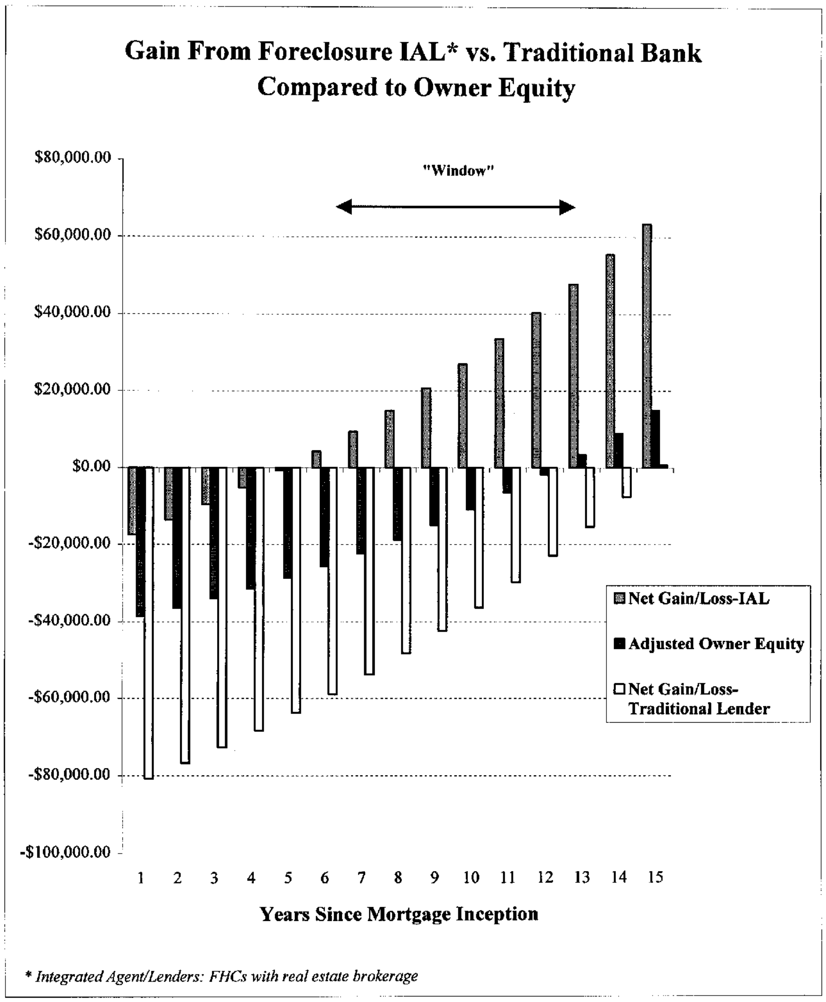
The mortgage agreement provides an initial payment by the bank to purchase the home in exchange for the timely repayment of principle over 15 or 30 years. The house serves as collateral for the mortgage. The typical mortgage contract amortizes the mortgage debt with fixed payments that combine a large initial interest payment with a small initial principle one. Over time, the interest payment declines and the principle payment increases while the total payment remains the same. There are benefits to this amortization. The homebuyer benefits from an immediate tax break from the mortgage interest deduction. The bank benefits from front-loaded interest payments.

But, one disadvantage is that, initially, the owner's equity builds slowly. If the owner decides to sell the home early in the life of the mortgage, transaction fees can result in a financial loss. For instance, if an owner faces some financial difficulties and a monthly payment is late, interest charges and penalties accrue. Even if the home is sold, the owner is still responsible for these fees. If the owner does not sell the home, the bank may begin foreclosure proceedings to satisfy the debt. The bank can sell the home, but often the new buyers of the foreclosed property work with an independent real estate professional. Should the buyer needs financing, the real estate professional may or may not recommend the bank that foreclosed on the property.

When selling the home, the bank faces high transaction fees and often loses money in the early years of a mortgage due to the high loan balance and the accumulated interest and penalty fees. These fees can easily overwhelm the small amount of equity in the foreclosed property. In such cases, it is not unusual for a bank to develop a plan that allows the homeowners to keep their homes and also minimizes losses for the bank. The bank's and the owner's incentives are therefore aligned. By the time a foreclosure becomes profitable for the bank, the owner could sell the property to recover from the debt without incurring the financial penalty of bad credit.

If regulators approve the proposal allowing the expansion of bank powers into real estate brokerage, the alignment of homeowner and bank interests would be eliminated and so a perverse set of incentives could be substituted. These new incentives could increase the incidence of foreclosure. Owners will continue to become delinquent with the same frequency as they do now. If FHCs and their subsidiaries are permitted to engage in real estate brokerage activities, the FHC would benefit from other revenue derived from their non-banking subsidiaries that have profited from the foreclosure. Thus, the bank is less likely to accommodate the delinquent owner.

The bank will refer the foreclosed property to the bank brokerage that will promote the property so as to eliminate a non-performing asset from the books of the FHC. The revenue generated from the sale of the property will accrue to the FHC. If the new owner requires financing, the bank broker—most likely an employee of the FHC—will encourage the homebuyer to arrange financing through the bank. The revenues from the real estate brokerage fees and the higher probability of replacing the delinquent loan with a performing loan increase the profitability of foreclosure. Recent research by Capital Economics demonstrates that the bank would have a larger incentive to foreclose on delinquent borrowers. The perspective of the owner has not changed so the bank is now willing to foreclose before sufficient payments have been made to allow the borrower to sell the house and retain the equity. (See chart below.)



Source: Capital Economics, "An Economic Analysis of the Proposal to Allow National Banks to Compete in the Real Estate Brokerage Market." Consultant Paper. April 2001.

While the bank and the FHC profit from the transaction, the owner is likely to receive two penalties: first, the loss of her home, and second, derogatory information in her credit history that would make it difficult to finance the purchase of a home in the near future. The neighborhood faces a rapid turnover in ownership. The society as a whole suffers from the social cost of foreclosure and the likely decline in homeownership.

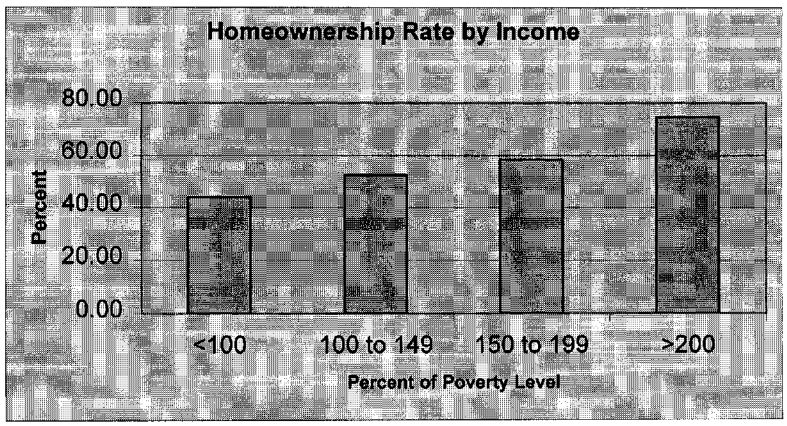
SERVICE TO LOW-INCOME AND FIRST-TIME HOMEBUYERS

The expansion of banking powers into real estate brokerage activities could also reduce the incentive of banks to serve low-income and first-time homebuyers, and possibly lead to credit restrictions or misallocations of credit. First-time homebuyers account for a significant portion of the total homebuying population. In 1999, first-time homebuyers were 42 percent of all homebuyers.[72] First-time buyers play an important role in a real estate professional's business, since real estate professionals

[72] *The 2000 National Association of REALTORS®* Profile of Home Buyers and Sellers

often build their business through referrals and repeat business, First-time homebuyers are tomorrow's repeat buyers. Independent real estate professionals seek out first-time homebuyer transactions as an investment in their future. These buyers are also an investment in the nation's economic health.

But many first-time buyers have lower incomes than repeat homebuyers do. In 1999, the median income for first-time buyers was $49,700; repeat buyers' median income was $68,600.[73] It is already more difficult for lower-income buyers to acquire the downpayment and establish a good credit record. Changing long-standing policy that may limit the opportunities of potential first-time buyers to achieve homeownership could have serious implications for home sales and homeownership.



Source: American Housing Survey, 1999

The business of FHCs is to sell financial products and services. They seek to maximize sales and thus profits by selling these products and services to current customers of the FHC (cross-selling). Customers who already purchase multiple products and services (checking accounts, on-line banking, trust services, life insurance, a mortgage, mutual funds, etc.) are more likely to have sufficient resources and thus demand additional products from the bank. These customers are the higher-income customers. The profitability of the FHC depends on attracting customers to these business lines with higher profits. According to researchers at the Federal Reserve Bank of Chicago, profitability at large banking organizations is derived from "less than 20 percent of the customers."[74] To induce—and to reward—purchases, banks are likely to provide a higher level of service to the customer with multiple points of contact with the FHC.

Lower-income customers are less likely to require all of these products and services, therefore the incentive to invest in the future homebuyer evaporates when the when the real estate professional is employed by an FHC. As an FHC employee, the real estate professional need not develop relationships in the community and develop an independent reputation for customer service. Business will come because of the reputation of the FHC and the reputation for customer service will accrue to the FHC, not the real estate professional.

The benefits to the FHC would come from referrals and repeat business with the original, higher-income customer when other sales of FHC products and services occur months or years in the future. Because the benefits of the transaction accrue to the bank, not the real estate professional, the bank real estate professional will target and encourage buyers who are important to the bank holding company: those who can afford many services. The benefits from working with first-time homebuyers come from referrals and repeat business only in real estate, but those benefits do not occur immediately. Thus, doing business with first-time buyers would be

[73] *Ibid.*

[74] Frieder, Larry and Peter Sherrill, "Customer Value Management: Decision Support and Knowledge Management as the Missing Links," Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, *Proceedings*, May 1997, pp. 76–85.

less valuable to FHCs, and so lower-income buyers may not receive the same level of service or even the same price for real estate brokerage services.

Another concern is the potential impact of FHCs on mortgage lending for underserved areas and populations. Nothaft and Surrette[75] examined the period 1993 to 1999 for the effects of consolidation of the financial services industry on mortgage loan originations to low-income and traditionally underserved families. They concluded that "large organizations tend to do less affordable lending." Thus, increased concentration of FHCs with vertical integration may produce some socially undesirable lending outcomes, including credit restrictions for low-income households.

SUMMARY

The expansion of banking powers that would permit financial holding companies and subsidiaries of national banks to engage in real estate brokerage activities may cause unintended consequences that reduce the nation's homeownership rate. Lower-income buyers and potential buyers are not likely to receive the same level of service from FHC as higher-income, more profitable customers. In the extreme, access to credit may be denied to this important sector of our society and our economy—the first-time homebuyer.

For those households who have accomplished the difficult task of saving money and establishing a good credit record, FHC-owned real estate brokerage firms may make it more difficult for those households to buy and keep a home. An increase in the number of foreclosures is likely if the revenue stream from real estate brokerage is retained by FHCs. Merely redirecting the revenue stream from an independent real estate professional to an FHC may be enough to increase foreclosures. The importance of homeownership requires a thorough analysis of the consequences, intended and unintended, that could result from the proposed radical change in the interpretation of the nature of real estate brokerage.

CHAPTER 5

REAL ESTATE PROPERTY MANAGEMENT AND COMMERCIAL BROKERAGE

The joint proposed rule by the Federal Reserve and Treasury Department also includes real estate management and commercial brokerage to the list of activities permissible for financial holding companies (FHCs). The activities involved in real estate management and commercial brokerage are disparate from financial activities. This chapter examines the activities involved in property management and commercial brokerage and explains their lack of synergy with banking operations. In addition, this section will delve into the risks arising from combining real estate management and banking.

THE COMMERCIAL REAL ESTATE INDUSTRY

Commercial real estate plays an integral role in the U.S. economy. Total commercial real estate in the U.S., including office, retail, industrial, lodging, multifamily and other special-purpose properties, is valued at $4.0 trillion as of year-end 1999. An estimated $1.9 trillion of commercial real estate is held by institutions for investment purposes, while the balance is owned by corporations used for conducting their business activities. Institutional companies typically include pension funds, life insurance companies, real estate investment trusts (REITs), commercial mortgage-backed securities (CMBS) issuers, foreign investors, saving associations, and commercial banks. Retail and multifamily properties account for the largest share of commercial properties—at least in dollar value.[76]

[75] Nothaft, Frank and Brian Surrette, "The Industrial Structure of Affordable Mortgage Lending," presented at the *Symposium on Low-income Homeownership as an Asset-building Strategy*, Joint Center for Housing Studies at Harvard University, November 14–15, 2000.

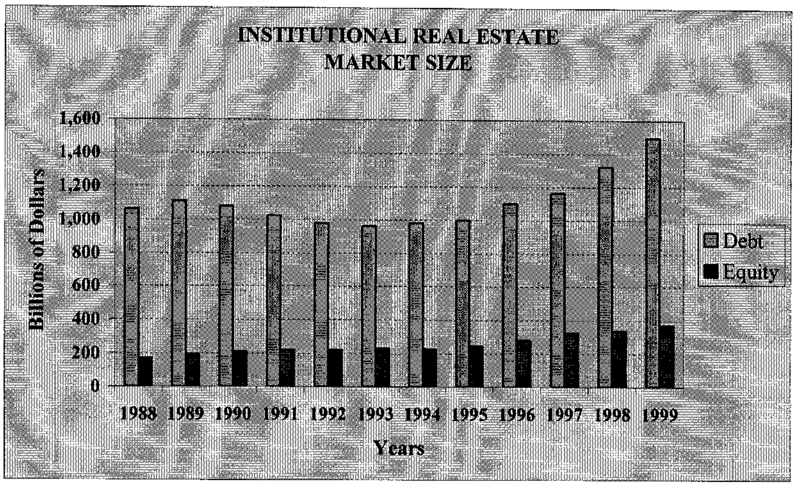
[76] Miles, Mike and N. Tolleson, "A Revised Look at How Real Estate Compares with Other Major Components of Domestic Investment Universe," *Real Estate Finance Journal*, Spring 1997, pp. 11–20.

Private Fixed Investment in Commercial Improvements: 2000
(Billions of Dollars)

Nonresidential Buildings	$201.1
Multifamily Buildings	22.8
Total	$223.9
% of Total Fixed Investment	13%
% of GDP	2%

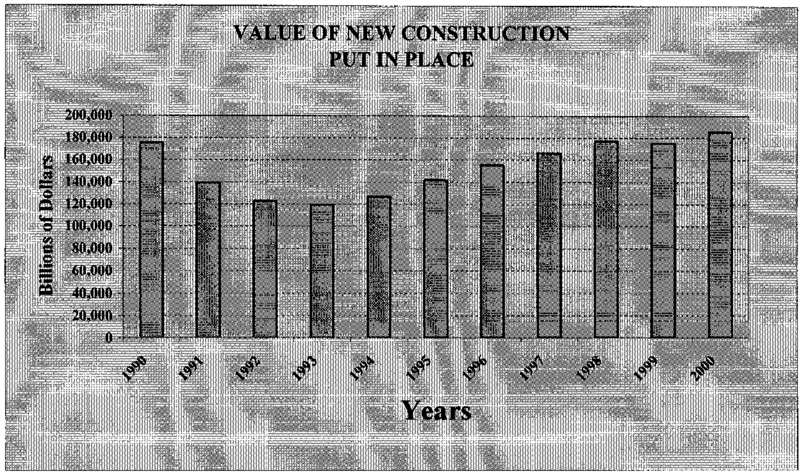
Source: Bureau of Economic Analysis

It comes as no surprise that commercial real estate is a significant component of national wealth. Commercial real estate constitutes roughly 21 percent of the nation's wealth.[77] This large base of assets was accumulated by devoting about two percent of each year's GDP to the construction and renovation of commercial properties. This is also substantiated by the consistently high value of new construction put in place.



Source: Lend Lease Real Estate Investments (1989 to 1998), National Association of REALTORS®, 1999

[77] DiPasquale, Denise and W. Wheaton, "The Markets for Real Estate Assets and Space: A Conceptual Framework," *Journal of American Real Estate and Urban Economics Association* 1992, 20(1), pp. 181–197.



Source: U.S. Bureau of the Census

The sustained investment in commercial real estate is attributed to the substantial amount of capital provided by institutional lenders and equity investors for development and maintenance of these assets. Loan volumes grew at a compound annual average of four percent between 1989 and 1999, while overall equity contributions increased at a compound annual rate of eight percent over the same period.

The importance of commercial real estate to the national economy is also reflected in national employment figures. According to the Bureau of Labor Statistics, about 353,000 worked as property managers in 2000 with two-thirds managing residential properties. Total wages paid to both residential and commercial property managers reached nearly $9.0 billion in 2000. Managers of commercial properties received a higher compensation, averaging $31,944 per year as compared to the annual average of $21,904 paid to residential property managers. Aggregate revenues generated by these property management firms totaled $21 billion in 2000, with more than 60 percent contributed by residential property management firms.

COMMERCIAL REAL ESTATE BROKERAGE IS NOT FINANCIAL

The role of commercial brokers encompasses a wide range of activities, which are clearly commercial and not financial in nature. While the process of bringing buyer and seller together is the same for whatever type of property, the operations of commercial brokerage firms are different from their residential counterparts.

- Commercial real estate brokerage firms that encompass more than one market segment (retail, office, etc.) tend to be organized in divisions that focus on those segments. Similarly, individual commercial real estate professionals often specialize in a particular segment
- Commercial brokers deal with a variety of buyers, sellers, landlords and tenants. This requires them to determine their clients' precise objectives in order to "match" them with the appropriate property
- Transactions involve both the lease and sale of commercial space, and can be completed in a few months and even extend to years especially for complex ones

Space was the commercial broker's primary concern in an earlier time. The key to a successful transaction was knowing what commercial space was available and what pricing the owner was seeking. Success also hinged on finding a suitable tenant to fill that space before someone else did.

However, the role of a commercial broker today de-emphasizes the "matchmaking" aspect of the profession. Clients now regard their commercial real estate brokers (and their teams which include lawyers, CPAs, architects, and computer and technology consultants) not just as transaction brokers but as strategic advisers and consultants. They use their brokers for advice and counsel on myriad issues ranging from technology utilization to employee commuting patterns and even corporate acquisition strategies.

Not only are clients demanding that brokers play a bigger role in business strategy, but also are looking for brokerage firms to provide a bigger role in business services. Hence, it is increasingly common to find brokerage firms building expertise in specific industries such as telecommunications and call center operations as a means to capture new business.

Commercial brokers often take part in the due diligence process as "strategic adviser and consultant" by providing financial analyses to the "client" and in the search for financing. Today's brokers are expected to have a thorough understanding of financial analysis and financing. But this is only a minute component of their job.

REAL ESTATE PROPERTY MANAGEMENT

The contribution of commercial real estate to the national economy suggests the constant need for effective real estate management for both maintaining and enhancing the value of these assets. Again, the detailed nature of property management indicates that it is clearly a commercial activity and thereby requires a thoughtful and structured approach.

Property management's goal is to preserve and enhance the value of property through good management on a daily basis. This can best be done by trying to achieve the highest and best economic use for the property.

Top Ten Property Managers

1.	Jones Lang LaSalle, Inc.	700 MSF
2.	Trammell Crow Co.	539 MSF
3.	Colliers International	417 MSF
4.	CB Richard Ellis Services, Inc.	326 MSF
5.	Cushman and Wakefield, Inc.	304 MSF
6.	Insignia/ESG Inc.	263 MSF
7.	Apartment Invt. & Mgt. Co.	260 MSF
8.	Lincoln Property Co.	212 MSF
9.	Simon Property Group	190 MSF
10.	Equity Residential Prop. Trust	173 MSF

Source: Commercial Property News, "Top Property Managers", August 1, 2000

The varied responsibilities involved with property management focus on the operation and maintenance of real property. The basic functions of property management include:

- Early involvement with the property development process, including establishing a management plan
- Creating a budget tied to that plan
- Marketing and leasing space, collecting rent
- Monitoring and responding to tenant issues
- Maintaining accounting and operating records
- Directing and performing preventive and remedial building maintenance

- Supervising staff and contract personnel
- Evaluating regulatory issues
- Addressing risk management-related issues
- Coordinating insurance, managing real and personal property tax valuations
- Procuring inventories and supplies

The level of management varies widely depending on the type of property and its size. Generally, the more services required and the more often space turns over, the higher the degree of management is needed. But regardless of the type of property, financial activity plays little part in real estate management. While maximizing the economic value of the property through increased revenues and decreased expenses is a financial goal, the actual activities entailed in professional property management are not financial in nature.

The complex issues facing property management underscore that managers need expertise in a variety of areas and the flexibility to continuously adapt properly new skill sets due to changing market conditions. An examination of the main management functions for each property segment supports this view.

Residential

It is common among property managers of apartments, for example, to manage intensively. Apartments require interior-exterior maintenance, and for some types, the additional amenities such as clubhouse, pool and sports facilities require additional maintenance and monitoring. Given the short term nature of residential leases, property managers strive for a high renewal rate in order to prevent vacated units that must be repainted, repaired, and re-leased in as short a time as possible. Most large apartment managers now have sophisticated tenant marketing and retention programs.

Office

Service is particularly important in office building management because that many office tenants regard the amount of rent as secondary to the efficient provision of services. Office buildings are also managed intensively. Property managers are responsible for ensuring that premises are kept clean and secure, that elevators run reliably, that utilities work, and that the structure looks and is well maintained. In class A space, the service may be more intense as the buildings feature better HVAC, cleaning, landscaping and other maintenance along with valet services and telecommunications.

Industrial

Industrial properties typically require minimal amount of management because they are frequently leased on a net basis, that is, the tenant is responsible for operating expenses and sometimes, real estate taxes and insurance. The most critical function of management is to identify the appropriate tenant, with the objective of minimizing the cost of tenant improvements.

Retail

The management of retail centers depends on the sub-property type. In free standing and big box retailers, management has little involvement with the tenant. In community centers, management may or may not participate in tenant association activities such as advertising and common area maintenance. In regional malls, the management is very involved in the tenant business as tenant mix and common area maintenance is part of the marketing that draws business to the center.

Hotels

The most important function of hotel management is marketing the hotel. Hotels require constant management given the high frequency of guest turnover and the significant number of service offerings. The lease period is very short (i.e. one night) so that management must find tenants for vacated space. Typical initiatives to boost bookings and maintain the hotel property's appeal include promotions, offering of loyalty programs and corporate discounts, and the addition of services.

Health Care Facilities and Other Special-Purpose Facilities

Service is a crucial factor for special-purpose facilities so they require very specialized management talent, frequently recruited from the professions involved.

REAL ESTATE MANAGEMENT IS A COMPETITIVE INDUSTRY

Like residential real estate brokerage, real estate management is a fiercely competitive industry. To evaluate the competitiveness in the industry we assessed the degree of concentration for the top 75 real estate management firms in 1999. Data on real estate properties managed by the top 75 property managers were obtained from a survey conducted by the Commercial Property News publication (http://www.cpnrenet.com) in August 2000. The Herfindahl-Hirschman Index will be used to determine the level of concentration among the top real estate management firms.

The Herfindahl-Hirschman Index is defined as:

$$HHI = \sum_{i=1}^{N} S_i^2$$

where S_i is the percentage of total square footage (market share) by the i^{th} firm and N is the number of large firms in the industry. Thus, the index is the sum of the squares of the market share percentages of the top real estate management firms in the industry. A value of 1, or 100%, for the index would indicate only one real estate management firm, or a pure monopoly market structure. The HHI is often presented as an integer where 100% is equivalent to 10,000. The index value declines as the number of firms increase and increases as inequality among a given number of firms increases. The HHI weights the market shares for large firms more heavily than the small ones as indicated by the squaring of market shares.

The Justice Department's merger guidelines suggest that industries with HHI values below 1000–1800 are competitive. Real estate management firms have an average HHI value of 387, which is clearly below the threshold set by the Justice Department. Based upon this guideline, we conclude that the level of concentration for the leading real estate management firms should not be a significant concern. There is no dominant firm even among the largest 75 real estate management firms. If data on smaller firms are included in the sample, the HHI value is expected to be lower.

One possible explanation of the low concentration is the relatively low barriers to entry with numerous real estate management firms offering what is perceived to be essentially the same service. Moreover, the abundance of information, especially through the Internet, allows property owners to easily engage property managers, therefore leading to a higher level of competition with a lower level of concentration for real estate management firms.

However, the entry of FHCs in the real estate management industry could erode the healthy competition among existing firms and thereby generate a misallocation of resources. It is possible that FHCs can exploit their federally chartered advantages to establish a dominant position given their access to capital. They can drive down management fees in the short term, subsidized by their other operations, and eliminate small property managers. This could then lead to higher concentration of firms in the long run, which may push up management fees.

THE RISKS OF COMBINING REAL ESTATE PROPERTY MANAGEMENT AND BANKING

The apparent lack of synergy between real estate property management with FHC's existing operations as explained earlier should translate into more risks that could ultimately harm the FHCs and impose increased potential claims on the deposit insurance fund and the safety net in general.

Allowing FHCs to enter real estate management and commercial brokerage may also have negative consequences for real estate markets and consumers. The risks include:

- Increased concentration in real estate property management and commercial brokerage industries
- Conflicts of interest
- Safety and soundness issues

Market Concentration

Commercial banks continue to dominate the commercial real estate lending landscape, accounting for nearly 40 percent of total mortgages in 1999. However, this share does not accurately reflect the entire influence of banks in the commercial real estate debt market. Banks also provide substantial amounts of short-term credit to a number of commercial mortgage-backed securities (CMBS) originators and other real estate-related businesses.

The role played by banks in financing commercial real estate activities underscores their massive lending power and influence. Consequently, allowing banks or FHCs to enter into real estate property management and commercial brokerage could eliminate the healthy competition among firms and result in concentration in these industries. Banks could then use predatory pricing tactics by offering property management services as a loss leader to cross-sell other financial products, i.e. gain control of the demand deposit accounts of income producing property owners.

Commercial Mortgage Debt Outstanding by Source

Source	1999 (billion)	1989 (billion)	Change from 1989
COMMERCIAL (INVESTMENT) BANKS	$584.7	$380.6	53.6%
INSURANCE COMPANIES	$212.4	$238.9	-11.1%
GOVERNMENT-SPONSORED ENTERPRISES/ FEDERALLY RELATED MORTGAGE POOLS	$80.2	$37.7	112.7%
PRIVATE CMBS/CONDUITS*	$247.0	$11.3	2085.8%
PENSION FUNDS	$36.0	$29.6	21.6%
SAVING INSTITUTIONS	$119.9	$240.9	-50.2%
OTHER	$207.0	$115.5	79.2%
REAL ESTATE INVESTMENT TRUSTS (REITS)	$10.6	$7.9	34.2%
TOTAL	$1,497.8	$1,062.4	41.0%

**Asset-backed securities issuers, finance companies, mortgage companies*
Source: Flow of Funds, Federal Reserve System

Conflicts of Interest

Conflicts of interest constitute another major concern when banking is integrated with commerce. For instance, compensation of property managers is typically a percentage of effective gross revenue receipts (often three to five percent) and operating profits. However, it can also be a fixed amount particularly when the services require a predictable amount of time (for example, maintaining property records) or when the owner deems that incentives for extraordinary effort is unnecessary.

Property managers may also receive equity shares in the company that owns the property as shown in the case of public REITs such as Host Marriott and MeriStar Hospitality. J.W. Marriott, Jr., an equity shareholder and a member of the Board of Directors of Host Marriott, serves as an officer of Marriott International, a public company that manages the properties of Host Marriott. Similarly, MeriStar Hospitality shares four members of its board of directors with its management company, MeriStar Hotels.

It raises potential problems when FHCs are allowed to manage properties and receive equity stakes in the corporations that own the property. In acting as manager and owner at the same time, there would be conflicts of interest when making decisions relating to the management agreements.

Other potential conflicts of interest are listed below:

- Banks may restrict the supply of credit to the competitors of its real estate property management and commercial brokerage firms, showing preferential credit treatment towards their affiliate firms. Notably, any disruption to the financial flows may have harmful effects on real estate property management and commercial brokerage industries as well as harming consumers by offering low deposit rates and high loan rates.
- Banks may use their lending powers to tie customers, such as property owners to their affiliate real estate management firms and corporate clients to their affiliate commercial brokers. Economic theory is very clear in specifying that the market conditions under which tying arrangements are profitable are extremely limited. In particular, if a firm has market power in one market and attempts to tie a customer to product sold in another competitive market, e.g. by price cutting, its overall profits may well decrease.

- Banks may continue to make loans to failing affiliate real estate property management and commercial brokerage firms. Such practice might ultimately threaten the safety of the banks.
- Banks have access to financial information about a property (which would be disclosed during the loan application process), including the underlying economic assumptions of the property, the length of leases and lease terms, as well as tenant information. This information is often valuable to its affiliate real estate management company so that a fear exists that there would be a transfer of information that could be used to undermine the leasing and marketing of the property by another real estate management firm.

Safety and Soundness

The affiliation of a bank with real estate property management and commercial brokerage firms could raise the risks of bank failure and thus impose greater costs on the federal safety net. The federal safety net may be defined as encompassing:

- The deposit insurance system
- The payments system (especially Fedwire—the wholesale payment system)
- The lender of last resort (discount window) facility[78]

Central to this fear is that FHCs will alter the competitive environment in which their subsidiaries operate. Consider the example where the FHC controls the bank and real estate property management and commercial brokerage firms and exports the bank's funding subsidy to its affiliates. The affiliation of real estate property management and commercial brokerage firms with the bank should cause them to pass on lower costs to their customers through lower prices. Of course, the amount of subsidy that leaks out will depend on the demand for their services. If demand is elastic,[79] then a drop in price will result in a demand for more services from these real estate property management and commercial brokerage firms, which creates an unleveled playing field. In addition, allowing the safety net subsidy to trickle out of a bank will result in an enlarging of the absolute value of the subsidy passed on from the government to the private sector.

FINAL THOUGHTS

It is plain that real estate brokerage and management are activities that are inherently commercial, and that authorizing financial holding companies to engage in such activities not only would contravene the longstanding judgment of Congress that the mixing of banking and commerce is not in the best interest of the American people, but would represent nothing less than a sea change in the Board's consistent determination to ensure that commercial activities are kept separate and distinct from financial activities.

The proposal, if adopted, could involve financial institutions in commerce to an extent that manifestly could threaten the public interest. Allowing bank affiliates to engage in business as real estate brokers and managers would create an unprecedented potential for excessive concentration of economic resources, and for business combinations uniquely suited to gain advantage from anticompetitive practices in an industry with which million of the nation's consumers and businesses transact business annually, all to the detriment of public interest.

No regulatory framework, and no mandated regimen of disclosures, would be sufficient to prevent or avoid the potential conflicts of interest that would be created by permitting business organizations that finance real estate transactions to engage at the same time in brokering such transactions and in managing real estate. The governmental subsidies that benefit FHCs would be available to benefit their affiliates that are engaged in real estate brokerage and management and that compete in those fields against firms that enjoy no such subsidies.

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[78] See Chapter 3 for a more complete explanation of how FHCs could exploit the advantages their bank subsidiaries have from their federal charter.

[79] Elasticity of demand measures the relationship between price and quantity demanded. When the demand for a good is highly elastic, people are willing to reduce their consumption significantly in response to a given price increase. This is most likely when a good has many close substitutes.

APPENDIX A

THE ADVANTAGES OF THE FEDERAL BANK CHARTER

1. *The Federal Reserve's payment system guarantees* allow banks to borrow funds at rate far below that available to firms outside the payment system. The payment system allows banks to borrow funds at a low cost in exchange for offering demand deposits—accounts with payment on demand used by millions of households to purchase goods and services. In addition to the interest rate spread earned on demand deposits, depository institutions also receive interest income during the time between the request to withdraw funds and the payment to the third party.
2. Being part of the nation's *payments system* also allows banks access to the Federal Reserve District Banks' Fedwire system. Fedwire reduces the risk facing banks by offering a Federal guarantee of inter-bank fund transfers. The Federal Reserve provides overdraft protection to banks similar in nature, but lower in cost, to the protection banks provide to their account holders. Access to the Fedwire system allows banks to maintain fewer reserves thus enabling banks to lend more and generate greater revenues.
3. One of the largest advantages offered to depository institutions is *federally guaranteed deposit insurance*. The existence of deposit insurance allows banks to operate with less capital for any given level of risk and thus lowers the cost of capital relative to any nonbank competitor. Conversely, at a given level of risk, banks can borrow funds at rates below what they would have to pay in the absence of federal insurance. In a competitive market, this subsidy would largely pass to consumers (depositors), however the tightly controlled entry of firms into banking could allow much of this subsidy to remain with the bank and its holding company.
4. Bank access to the *Federal Reserve's discount window* reduces a bank's probability of failure, and hence, its cost of capital and borrowing. While solvent banks facing temporary liquidity problems have to provide collateral to access the Federal Reserve's discount window, the discount window does serve as a "lender of last resort" that is unavailable to non-banks. This source of liquidity allows depository institutions to take greater risks and hold less in liquid assets—creating the potential for greater losses. Hence even banks that never use the discount window, still receive a substantial benefit from having the option available.
5. *Membership of the Federal Home Loan Bank System* is open to all depository institutions purchasing stock in one of the Federal Home Loan Banks. Members have direct access to advances (loans) from the Federal Home Loan Banks that allow depositories to fund mortgages at lower costs. In addition, members can sell conforming mortgages to a Federal Home Loan Bank. The ability of banks to sell loans from their portfolio to the FHLB system greatly increases bank liquidity which encourages both higher volume and higher risk lending. Banks have joined the Federal Home Loan Bank system as the lower costs and ability to expand lending help to increase profitability.
6. Debt instruments issued by federally insured depositories also receive *lower risk weights for risk-based capital requirements at other depositories*. This preferential treatment provides a ready source of demand for bank debt and allows banks to pay a lower yield on debt since these securities provide a benefit to the buyer through lower capital requirements.
7. In addition to subsidies received via government backing and guarantees, banks also receive a substantial benefit from *government-imposed barriers to entry* into the banking market. To operate, depository institutions require either a state or federal charter. One variable used in deciding whether a charter is issued is whether the market in question is currently being served or not. If there are already several depositories in a market, the safety of those existing institutions can weight against the issuing of a charter to a potential competitor. This limiting of direct excess competition allows existing depositories some relief from competitive market pressures. These limits on entry can have substantial positive impacts on the profitability and pricing schemes of depository institutions.

APPENDIX B

AN ESTIMATE OF CONSUMER COSTS IF FINANCIAL HOLDING COMPANIES ENTER THE REAL ESTATE BROKERAGE INDUSTRY

The ultimate cost to consumers if financial holding companies (FHCs) enter the residential real estate brokerage industry could total $48 billion over ten years, as FHCs raise revenue elsewhere to cover for revenue shortfalls in the brokerage industry. More importantly, the costs would be borne not only by homebuyers and sellers, but by all consumers of commercial banks. This section describes one scenario by which all banking customers would pay for the FHCs entry into the residential real estate brokerage industry.

To quickly gain market share in residential real estate brokerage, an FHC may choose to drop commission rates. The bank will be able to subsidize the resulting losses at the real estate brokerage by raising new revenues from their banking customers. In the past, banks have been able to raise additional revenues through the implementation of new and increased fees and the raising of other fees. As a consequence, all bank customers—whether or not they are recent homebuyers or sellers—will bear the burden of FHC's attempts to quickly gain market share.

THE METHOD

Arguably one of the quickest methods for a FHC holding company to gain market share in the real estate brokerage industry is to significantly reduce commissions paid by home sellers. Typically, home sellers compensate both real estate agents—the one representing the buyer and the one representing the seller—involved in a transaction. Rarely does the buyer of the home compensate either agent. The compensation, which is negotiable between the home sellers and the real estate agent, is usually in the form of a percentage of the final sales price of the home.

A bank holding company wanting to gain market share quickly may choose to lower these commission rates. One issue that a FHC would encounter with discounting the commission rate is the motivation of buyer agent's to show the home to their clients. Typically, a commission is split 50–50 between the buyer's agent and the seller's agent. If the overall commission rate is relatively low, then, naturally, the buyer's agent's split is also low. Some argue that real estate agents may be less likely to show homes where the commission is low.

FHC brokerages can overcome the hurdle by changing the traditional split between the agent's from 50–50 to a ratio that results in the buyer's agent receiving a commission split approximating what he/she would have received previously. For example, if commission rates were typically six percent before discounting, where both the buyer and seller's agents received three percent each, then adjusting the split would give three percent to the buyer's agent and one percent to the seller's agent. As a result, the buyer's agent has the same incentives as before to show the FHC's listings.

THE COST

Note that reducing commission rates and changing the traditional split will be a costly transformation. Most real estate agents are independent contractors and rely on sales commissions for their compensation. To motivate their sales staff, the FHC will have to compensate their listing agent for the drop in commission.

The FHC may consider paying the agent directly for lost commission dollars. So, in the example presented above, the FHC will pay the agent the two percentage points lost by the discounted commission. Or, the FHC could shift the agent from independent contractor status to paid employee with a set salary and benefits. With either option, the FHC will have to tap other revenue sources to cover the commission shortfall.

Further compounding the costs of this transformation is the fact that real estate brokerage is not a highly profitable business. In 1996, the typical real estate brokerage earned a profit of just over two percent of the firm's gross revenue. Facing already slim profit margins, FHCs will need to recover the commissions lost from other sources, such as its banking customers. Over a ten-year period, the present value of the lost commissions that FHC must recover from other sources may total as much as $48 billion, or roughly $500 per American household.[80]

[80] This estimate of $48 billion is based on the following assumptions:

- FHCs enter the market with 10 percent market share
- FHCs gain 5 percentage points in market share each of the following nine years
- FHCs drop commission rates below market rates by two percentage points
- 2000 EHS and Census home sales data is the baseline

Cost to Banking Customers of FHC Entry in Real Estate Brokerage

Year	Market Share of FHC Brokerage	Commission loss to be recovered from Banking Customers
1	10%	$ 1,962,599,332
2	15%	$ 2,943,898,998
3	20%	$ 3,925,198,664
4	25%	$ 4,906,498,331
5	30%	$ 5,887,797,997
6	35%	$ 6,869,097,663
7	40%	$ 7,850,397,329
8	45%	$ 8,831,696,995
9	50%	$ 9,812,996,661
10	55%	$10,794,296,327
	10 Yr Present Value	**$48,275,271,208**

Source: National Association of REALTORS® Economic Research

The overall consumer impact of decreased commission rates paid by the bank is a transfer of wealth from banking customers to home sellers and the FHCs. Increased banking fees, in combination with lowered interest rates on deposits and increased interest rates on many loans and credit cards, will pay for the FHC's below-market commission rates on real estate brokerage services.

However, these below market commission rates will harm even home sellers (and buyers, too) over the long-run. The goal of this predatory pricing is to reduce competition from traditional real estate brokerages. As traditional real estate firms exit the industry, unable to compete with the subsidized FHC brokerages, FHC brokerages will be able to raise commission rates to levels above current market rates. At this point, with higher rates along with lowered customer services, even home sellers would lose.

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THE POSSIBLE CONSEQUENCES OF ALLOWING BANKS INTO THE REAL ESTATE BROKERAGE INDUSTRY

PREPARED FOR:
THE RESEARCH DIVISION OF THE NATIONAL ASSOCIATION OF REALTORS®
BY LEONARD V. ZUMPANO
CHAIR OF REAL ESTATE, EXECUTIVE DIRECTOR OF THE ALABAMA REAL ESTATE RESEARCH CENTER, AND PROFESSOR OF FINANCE
THE CULVERHOUSE COLLEGE OF COMMERCE AND BUSINESS ADMINISTRATION
THE UNIVERSITY OF ALABAMA

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INTRODUCTION

The Board of Governors of the Federal Reserve System and the Secretary of the Treasury have requested comment on the possible consequences of permitting financial holding companies and financial subsidiaries of national banks to engage in real estate brokerage, brokerage management, and property management. Such a proposal has been advocated by the American Bankers Association (ABA) and the Fremont National Bank and Trust Company.

The principal rationale for this recommendation is that it will preserve and enhance the competitive ability of financial holding companies and national banks. Part of the justification for allowing banks entry into the real estate brokerage market hinges, at least in part, on whether real estate brokerage, brokerage management, and property management activities are financial activities or incidental to a financial activity and, therefore, permissible activities for financial holding companies and financial subsidiaries of national banks. Much less attention has been directed at what is arguably the far more important question: What will be the impact on the consumer if financial institutions are allowed into the real estate brokerage market? Will entry increase competition within this industry and result in more efficient allocation of resources and lower real estate brokerage commissions or, alternatively, lead to even greater concentration within the industry, a reduction in allocative efficiency, and higher fees and commissions? These are the some of questions this paper seeks to address.

The primary objective of this study is to identify and explore the possible consequences of bank entry into the real estate brokerage market. This paper is not meant to be an exhaustive study of this issue, nor, necessarily, will it provide definitive answers to all of the questions posed above. Rather, it is intended to help readers assess whether the potential benefits of bank provided real estate brokerage services outweigh the potential risks to the consumer. At the very least this study should be food for thought for regulators contemplating whether to allow banks into this market. Admittedly, the scope of this paper is limited. It does not address the possible benefits that may accrue to the banking sector from entry into the real estate market. I will leave it to the banking experts to make those arguments.

Because the emphasis here is the effects of bank entry into the real estate brokerage market on the consuming public, this study will examine three specific areas of concern: the effect on competition within this market, the impact on market efficiency, and, finally, how the types and quality of services provided to the consumer may be effected.

This study is organized as follows. In the next section we present an overview of the structure of the real estate brokerage industry and the type of competition that characterizes this market. This overview includes a review of the relevant research on the market for real estate brokerage services, which outlines what we do and do not know about this market. It will also provide us with a framework wherein we can analyze and assess the possible consequences of bank supplied real estate services.

This evaluation is followed by an assessment of the market efficiency implications of bank entry into the real estate brokerage market. This will allow us to then examine the changes taking place in this industry and identify the reasons for these changes. Part 5 will examine how bank provision of real estate brokerage services may affect the types of brokerage relationships entered into by homebuyers and sellers. The last section of this report will summarize the findings and conclusions of this research.

MARKET STRUCTURE AND COMPETITION

During the last five decades the market for real estate brokerage services has been the subject of intense scrutiny by various government agencies, attorneys, academicians, and consumer groups. Over the years this attention and the research it has engendered have led to claims that this market is operationally inefficient and suffers from excess capacity (Yinger, 1981). Others have characterized this market as a cartel where various types of entry barriers, such as licensing requirements, the MLS, or collusive arrangements allow existing participants to enjoy monopoly power (Maurizi, 1974; Owen, 1977; FTC, 1984). Crockett (1982) and Miller and Shedd (1979) argued that the industry was characterized as monopolistic, where firms can differentiate their products and realize short-run excess profits. Wachter (1985) argued that percentage commissions are a form of price discrimination and market imperfection.

Other researchers, examining this same market have concluded just the opposite; that this market is highly competitive (Schroeter, 1987; Knoll, 1988) that the multiple listing services improve market efficiency (Turnbull and Sirmans (1993), licensing improves the quality of brokerage services (Shillings and Sirmans, 1988) and percentage commissions reduce agency costs (Caroll, 1989). With all these differing opinions, Zumpano and Hooks (1988) noted the need to resolve these issues by directly examining the underlying production function for firms within this industry.

Up until relatively recently many of these discussions and arguments remained theoretical, with little empirical evidence in support of the numerous and often conflicting hypotheses regarding the performance of this market. However, during the late 1980s and 1990s a great deal of empirical research appeared which has significantly advanced the state of our knowledge of this market. Knowing what type of competition characterizes a market is important because it allows researchers to assess how efficiently markets operate as well as predict the effects of changes that occur in markets. What follows is a review of these different types of market structures and what the empirical research says about the performance of the market for brokerage services.

Perfect Competition

The performance standard as far as market structure is concerned is perfect competition. In general perfect competition can only exist in markets where very specific conditions are satisfied. Specifically, there must be a large number of buyers and sellers, none of whom are large enough to exert control over price, entry to and from the industry is free and unencumbered, the products sold in such markets must be homogeneous, and market participants possess all the relevant information about the product or service being traded.[1] Entry, by increasing market supply, causes price to fall. Since products are homogeneous consumers shop only on the basis of price. When these conditions prevail, excess profits are competed away as firms continue to enter the industry, until only normal profits are being earned. This, in turn, forces firms to operate at the most efficient level of output and sell their products at the lowest price. In reality these conditions rarely prevail and can only closely be approximated in the markets for unprocessed agricultural products and in the equity markets of publicly traded corporations. All other markets are said to be characterized by imperfect competition.

Monopolistic Competition

Most alternative characterizations of the market for real estate brokerage services rely explicitly or implicitly on the model of monopolistic competition. As with perfectly competitive markets, monopolistically competitive markets are atomistic, made up of a large number of small firms, with relatively easy entry and exist of competitors. Here, however, firms produce differentiated products and services so that each firm faces its own, downward sloping demand curve. If economic profits are being generated by existing firms within the industry, this will encourage entry by new competitors. In contrast to pure competition, however, entry causes the demand curve facing individual firms to decline as existing demand is being distrib-

[1] The concept of market efficiency is very closely related to the nature of the competition that characterizes a market. When talking of efficiency we are concerned with how efficiently resources are allocated within a market and the extent to which prices reflect all the relevant information about a product or service. In general, it is only perfectly competitive markets, where all participants are presumed to have full knowledge of supply and demand conditions and know the costs of all alternative activities, that are truly efficient. That is, perfect competition is a necessary condition for market efficiency. To highlight the different implications of market structure and market efficiency, however, we will treat efficiency issues in the next section of this paper.

uted among a larger number of firms. If the original firms had previously been operating at optimal plant size, reduced demand would result in a new long-run equilibrium for individual firms at output levels below those that minimize their average costs. If total demand remains unchanged then firms in this market compete for market share through various forms of non-price competition. Entry stops once all excess profits are eliminated. The ultimate effect of entry into such monopolistically competitive markets is excess capacity with existing firms producing less output and at higher cost.[2]

The monopolistic competition model has been criticized on a number of theoretical grounds. Harrod (1952) questions the excess capacity result, which is obtained because firms are assumed to equate long-run marginal costs and short-run marginal revenue in determining output. If long-run demand is more elastic, the use of long-run marginal revenue results in greater firm output. Becker (1971) questions the generality of the normal profit result. Firms in this situation would have the incentive to merge in the hope of capturing more market share and reducing costs in order to increase profits. Cohen and Cyert (1965) challenged the behavioral assumptions of this model. If firms learn from experience and cease their myopic behavior, then some other market model such as monopoly, oligopoly, or even perfect competition is more appropriate, depending upon the extent to which barriers to entry exist.

Another consideration is relevant here. The welfare loss associated with imperfectly competitive market conditions may be the price we pay for more choice—a larger market basket of new, innovative, and better quality goods and services to choose from. So long as the welfare losses are small relative to the gains from enhanced consumer choices no market intervention or corrective actions are warranted.

How then do these various models of economic behavior stand up to the light of reality and actual business practice within the real estate brokerage industry? In so far as the axioms and assumptions underlying these models are truly descriptive of reality, then the deductions and policy prescriptions that logically flow from these models have some validity. On the other hand, to the extent that these models fail to explain market reality and/or market outcomes, their use as policy guides become questionable.

WHAT THE EMPIRICAL RESEARCH TELLS US

Charges that the real estate brokerage industry is a cartel or collusive oligopoly can be easily dismissed. First, it has been shown by Shillings and Sirmans (1988) and Johnson and Loucks (1986) that pre-license educational requirements and testing have little effect on limiting entry into this industry, a major requirement for an oligopolistic market structure. Instead, the major impact of licensing requirements was to reduce the number of complaints against real estate brokers. Stated differently, state license laws accomplish what they are intended to do; enhance the operations of markets where the quality of products or services is difficult for consumers to evaluate. Certainly the large number and relatively small size of most full-service brokerage firms are not characteristic of an oligopolistic market. Whether this state of affairs can be expected to continue is addressed later on.

Other researchers[3] looked to the Multiple Listing Service (MLS) as evidence for collusion and cartel pricing. The argument here was that the MLS was an implicit mechanism for fixing prices. For cartels to survive, cartel members must be able to catch price-cutters and drive them out of the industry. With the MLS brokers pool their listings and agree to split commissions on cooperative sales. In the past, the total compensation per listing was also published which facilitated both price coordination and a means to detect price-cutting activity. A price-cutter would be quickly identified and lose the cooperation of other brokers within the MLS. The resulting loss in revenues to price-cutters (or even the threat of loss) would insure the stability of the cartel.

While this argument may have had some merit in the past, policy changes by NAR have made it all but impossible to detect price concessions by MLS participants. Since 1980 local multiple listing services have been prohibited from publishing the total commission on MLS listings. Now only the selling portion of the

[2] Because firms are forced to produce at output levels where they cannot take advantage of economies of scale, unit production costs are higher. Yinger (1981) develops an alternative hypothesis that generates a similar outcome. Using a search model under conditions of uncertainty Yinger defines the market for brokerage services as one where home buyers and sellers seek each other out with brokers acting as match makers. If the total number of matches is fixed, entry of additional brokers into the market will spread existing listing among more brokers reducing the probability that a buyer will find a match with any given broker.

[3] See Owen (1977), Crockett (1982), and Miller and Shedd (1979).

commission can be reported on multiple listings. The stated purpose of this policy change was to eliminate any "conscious parallelism" in the establishment of fees for the sale of real estate through multiple listing services.[4]

Well, if the market cannot be characterized as oligopolistic or collusive, what type of competition does this market exhibit? Certainly, many of the attributes of monopolistic competition and to a lesser degree, perfect competition)many firms, relative small firm size, freedom of entry and exist, differentiated products, and non-price competition—are present in this market. The only unresolved issues are which of the market outcomes, associated with the model of monopolistic competition actually characterize the market for real estate brokerage services.

The starting point for such an assessment is estimation of the underlying production and cost functions of the industry. Such a determination is important if we want to ascertain whether entry into the real estate brokerage industry will result in more efficient production and less costly output or lead a situation where a very few large firms control output and pricing decisions. This latter scenario can occur when output is characterized by economies of scale throughout the relevant range of production. In this case, unit cost curves would be downward sloping; the more production the lower the unit costs. The outcome here is eventually monopoly as the largest firm ends up being the low cost provider driving other competitors out of the market. Alternatively, and most commonly, the cost curve is U-shaped. As output increases firms can take advantage of economies of scale, with the result that unit costs fall. At some point, however, if firms continue to produce they encounter diseconomies of scale, which causes unit costs to rise; hence, the U-shaped cost curve. Here, there is no threat of monopoly as large firms do not have a competitive advantage over smaller firms, at least as far as costs are concerned.

Zumpano, Elder, and Crellin (1993) were the first to estimate the production function for the real estate brokerage industry. Employing a national database from the NAR's Survey of Residential Brokers (Income, Expense, and Profits), the authors estimated a translog cost function to model the underlying production function. Firm size was measured on the basis of revenue transactions (the number of listings and sales),[5] which for the sample ranged from as few as 10 for the smallest firms to over 40,000 transactions for the largest firm in the sample.

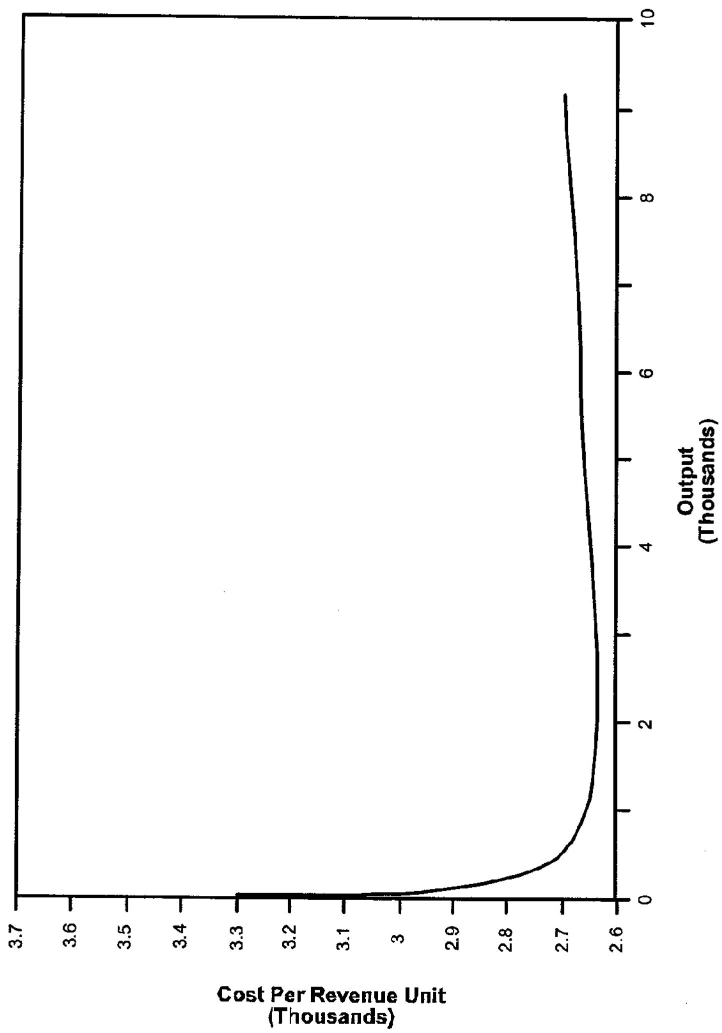
The Zumpano, Elder, and Crellin study found the presence of modest economies of scale throughout almost the entire range of firm sizes. Not surprisingly, scale economies were strongest for the smallest firms, became less pronounced as firms got larger, and turned negative, indicating diseconomies of scale, for the largest firms. The construction of a cost curve, which was calculated using actual output levels matched to input prices fixed at their sample means, is the best way to visualize the effects of firm size on production costs. It can be seen from Figure 1 that after an initial and substantial decline, average total costs remain essentially unchanged over a very wide range of output. Minimum average cost occurs at approximately 1,800 transactions, with a gradual increase in unit costs of less than $50 up to 8,000 transactions. Although not shown in the graph, above this level, unit costs rose much more sharply. It is worth noting that the mean revenue transactions for the sample was 850 units, and less than 15 percent of the firms surveyed registered output levels of 1,000 or more transactions.

[4] See the April 1980 issue of NAR's Executive Officer.

[5] This study also used the number of salespersons as a measure of firm size. The results were the same no matter how a firm's size was quantified.

Figure 1

Fitted Average Total Cost Curve



What was apparent from this study was that despite the presence of scale economies many of the real estate firms surveyed in 1988 were too small to take full advantage of the cost savings possible with a larger scale of operation. Many of the firms in the sample could have realized cost savings by increasing the scale of their operations.

Just as importantly, it was also determined that the larger firms did not command a competitive advantage over smaller firms, at least as far as unit costs were concerned. The "U-shaped" industry average total cost curve indicating the presence of diseconomies of scale at high output levels would work to discourage monopoly. Consequently, growth in firm size, within limits, would not pose a threat to competition or result in increased market power.

While the authors expected to see average firm size grow over time if their estimations were correct, they also speculated as to why more firms weren't taking advantage of scale economies. Transactions costs associated with extended market areas such as multi-state licensing requirements and multiple board memberships could inhibit the growth of firm size, especially for firms whose market area split over into neighboring states and political jurisdictions. Alternatively, many markets may simply be too small or thinly populated for large firms to operate efficiently. The authors also suggested that economies of scope might be present in this market which were not revealed in the data or captured by the cost function estimations, which might allow firms to operate efficiently at a smaller sizes.

Since the publication of this study, a number of state real estate commissions have authorized reciprocal licensing agreements for out-of-state brokers and board-of-choice multiple listing arrangements have reduced transaction costs. A follow-up study by Zumpano and Elder (1994) did find the presence of significant economies of scope [6] within the residential real estate brokerage industry. As firms grow in size they may be better able to exploit sharable inputs to produce multiple outputs. Treating listing and sales as distinct outputs, Zumpano and Elder estimated a multi-product translog cost function. The results of this study suggested that the composition of output is an important source of the scale economies reported in the earlier study. The most important finding of this study was that a balanced output mix of listing and sales was more cost efficient and that specialization in either listing or sales was sub-optimal under the institutional arrangements then present in the market. Once firms get large enough, individual agents within the firm can specialize in listing or sales activities and better utilize sharable resources, with the consequent result that the firm produces both more efficiently. In effect, the presence of scope economies allows firms to achieve economies of scale in production. This finding maybe one reason for the growth in the use of dual agency and non-agency transaction brokerage arrangements.

More recent empirical research not only lends additional support to the finding of economies of scale within the real estate brokerage industry, but have generated more inclusive estimates of overall operational efficiency of residential real estate brokerage firms. Although firms can take advantage of economies of scale, when present, by changing the size of the firm, firms can still be operating sub-optimally. A firm may utilize the same allocation of resource inputs as other firms, but produce still produce less output because it fails to utilize its resources efficiently. The difference between how a firm could potentially utilize its resources versus its actual utilization is termed X-inefficiency. Stated differently, to be X-efficient requires that the firm is able to operate at the lowest possible cost, given current prices and output levels. Leibenstein (1996) argues that the majority of X-inefficiency losses can be attributed to inadequate motivation by firm management, which, he suggests is directly linked to the structure and competitiveness of the market in which the firms operate.

Using a stochastic frontier approach, Anderson, Lewis, and Zumpano (2000a) estimate X-inefficiency [7] levels in the Residential Real Estate Brokerage Market from a national sample of real estate firms taken from the 1990–91 NAR Income, Expense, and Profit survey . The results of this study indicate that real estate brokerage firms were shown to be operating efficiently. In fact, the mean efficiency score of 88% is higher than the scores reported in most banking and financial institution

[6] Economies of Scope refer to cost savings that result from the utilization of sharable inputs that can be used to produce multiple products. One classic example is railroad track that can support both passenger and fright traffic.

[7] Technically, what is being measured are deviations from what is called the "efficient frontier."

studies.[8] As noted earlier Leibenstein states that high efficiency scores are related to the competitive environment in which firms operate. Therefore, it can be argued that these findings suggest that the market for residential brokerage services is relatively competitive.

This study also examined the relationship between firm size and efficiency levels. Smaller firms were found to operate closer to their efficient frontier than their larger counterparts. These results suggest that thee are limits to the benefits from increasing firm size. Beyond certain output levels, economies of scale may be offset by a loss in productive efficiency.[9]

This study has to be interpreted with some caution since it is based on 1990–91 data. Although the firm size categories used in this study—small (less than 194 revenue transactions), medium (196–525 revenue transactions), and large (525 revenue transactions and over), were a reasonable representation of the size differences in the sample and the industry, firm size has grown appreciably since then. Many of the firms that were included in the large category would be considered relatively small by today's standards.

A study by Anderson, Lewis, and Zumpano (2000b)[10] using somewhat more recent data (1995–95) provides updated efficiency estimates that also includes the more inclusive measure of profit efficiency. A brokerage firm with relatively high input costs may appear to be inefficient if only costs are examined, but may be relatively efficient from an overall profitability perspective.[11]

Using cross-section data collected from the 1994–95 NAR Income, Expense, and Profit Survey, the authors found that mean X-efficiency levels for real estate brokerage firms ranged from 72 to 84 percent, which suggests that firms, on average, could reduce costs by approximately 16 to 28 percent if they operated on their efficient frontier. Although still high, in comparison with other industries, these are lower scores than the mean score of 88.7 percent reported in the study using 1990–91 data. Profit efficiency levels, not calculated in the earlier study, ranged from 49 to 67 percent, suggesting that, despite high cost X-efficiency levels, additional profit gains could be realized by re-examining input and production mix decisions.

The lower efficiency scores reported using the 1994–95 data may also reflect differing market conditions. In the prior study that used 1990–91 data, the economy was in recession and the residential housing market was relatively depressed. The market in 1994–95 was much stronger and the economy was expanding rapidly. As pointed out earlier X-efficiency levels are closely linked to market conditions. When the economy is strong, brokerage firms may operate less efficiently and still survive because they are under less competitive pressure. Decreased efficiency levels can also reflect technological and structural changes taking place in the market place as well increased concentration in the industry. Larger firms tend to be less efficient than smaller firms and some may be producing at levels where unit costs are rising due to diseconomies of scale. Unfortunately, this study did not estimate or categorize X-efficiency levels by firm size. However, other industry research does shed additional light on these issues by offering a longer-term view of industry performance.

In "The Residential Real Estate Brokerage Industry: An Overview of Past Performance and Future Prospects" (2000), Zumpano, Elder, and Anderson examine the performance of the residential real estate brokerage industry over a ten year time interval, 1987 through 1996. This period was chosen so that the industry performance could be studied over a complete business cycle. During the study period, the economy moved from an expansion in 1987 to recession in 1990 and back again in one of the longest sustained recoveries in the history of this county. Fundamental

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[8] For representative studies of the banking industry see Ferrier and Lovell (1990), Berger and Humphrey (1991, 1992), and Berger, Hunter, and Timme. (1993).

[9] These results are also consistent with an earlier study by Anderson, Zumpano, Elder, and Fok (1998) that estimated firm efficiency using a different technique called Data Envelope Analysis or DEA. Most of the inefficiency found in the sample of residential real estate firms was related to scale inefficiencies, reflecting the fact that the majority of firms in the industry were relatively small. These same firms, however, were found to be efficient as far as resource utilization was concerned.

[10] In contrast to the earlier study, this paper presented efficiency estimates based upon both traditional stochastic frontier estimations using maximum likelihood and a Bayesian statistical model, where parameter estimates are expressed in terms of a probability distribution function.

[11] For example, consider a firm operating in an exclusive neighborhood where property owners do not wish to compromise their privacy by having signs in their yards or advertisements in the newspaper. The brokerage firms may be forced to employ more expensive marketing techniques such as advertising in select magazines, prescreening prospects, and special home showings.

changes in the structure of the economy and the nature of the real estate business also emerged during this period.

The empirical analysis relied upon an extensive financial data base which was collected from literally thousands of real estate brokerage firms in the form of nationwide Income, Expense, and Profit surveys regularly conducted the NAR. This data was analyzed using statistical procedures to isolate trends in firm size, output, income, costs, and overall performance.

Following the relatively prosperous late 1980s, the analysis reveals that real estate brokerage profits fell during the recession of 1990. While the decline in profitability could be attributed, at least in part, to the downturn in the business cycle, the average real estate brokerage firm has continued to be less profitable even as the economic moved into a strong expansionary phase. The principal culprit was the dramatic increase in costs that occurred during the period, which, in turn, triggered a period of consolidation in the industry. Firms consolidate as a way of adjusting to higher levels of costs by taking advantage of economies of scale in the production of output.

As Table 1 shows that a strong housing market coupled with growth in firm size made for impressive gains in agent productivity during the study period. The average firm in 1996 had more output than in 1998 (also a year with a strong housing market) by nearly seventy-five revenue transactions, yet this output was produced with fewer salespersons. On a transactions basis, gross revenues and margins increased over the entire period, both up approximately 27%. In contrast, profits did not follow this pattern. Despite a healthy increase in revenues over the period and a reduction in the average sales force, profits per transaction were lower in 1996 than they were in 1988. These results are consistent with the cost and profit efficiency estimates noted earlier.

Part of the explanation can be found on the cost side. Total costs per transaction increased 42% between 1988 and 1996. The increases in costs, which is reflected in both fixed and variable costs, can be attributed to a number of factors. Compliance costs have risen as more states passed both agency disclosure and property condition disclosure statutes and the reliance on caveat emptor has declined. The marketing process has also changed with the introduction and increased use of Internet marketing techniques and online multiple listing services. In addition, the very strength of the housing market may have hurt residential brokerage firms, as competition for productive salespeople dramatically raised compensation costs. While the average total cost curve characterizing the industry remains U-shaped, there has been a substantial increase in unit costs at every level of output.

The severity of the impact of these regulatory, industry, and structural changes varies with firm size. Tables 2 through 5 summarize the financial performance of residential brokerage firm on the basis of size. The smallest firms have been especially hard hit. The increasing requirements of technology as well as regulatory demand have increased their overhead, and smaller size means higher fixed costs per unit of output. Between 1988 and 1966 these fixed costs increased by almost 46 percent.[12] This compares to only a 5.9% increase in fixed cost for the largest firms. These findings also provided the rationale for the merger activity that took place during this period. As a result there are fewer firms in this size category and those that remain are smaller. Anecdotal evidence suggests that these firms survive by finding niche markets that require specialized knowledge and marketing skills.

At the other end of the spectrum, the largest firms are being squeezed by increasing variable costs. In particular, competition to maintain and increase market share, and still operate a leaner workforce, means, that productive sales personnel come at a premium. The evidence of this is especially noticeable when commission incomes and payouts are compared. As Table 6 illustrates that for the largest firms, the increase in commission payment has far outstripped the increase in revenues. A trend toward larger firms will not ease the pressure on commission costs. These firms have remained the most profitable of all the firms in the sample only because their size has allowed them to spread their fixed costs. However, continued growth in firm size could prove counter-productive as greater output will increasingly come at the cost of less efficient production. Agent productivity levels fall as firm size increases and, since the industry cost curve is U-shaped, there are limits to economies of scale in production.

Will these trends continue into the 21st century. Unfortunately, 1997 was the last year that NAR conducted the Income, Expense, and Profit survey of its membership. However, there has been some subsequent research and online surveys by NAR that

[12] In contrast, the smallest firms experienced a much smaller increase in variable cost which reflects the increase in agent productivity that occurred during the study period.

allows for some enlightened speculation. The biggest change to effect the real estate brokerage industry during the last 10 years has been the Internet.

As with many other industries, real estate firms have been implementing this technology into their day to day business operations. NAR's On-line Technology surveys, conducted in 1999 and the 2000 National Association of REALTORS® Profile of Home Buyers and Sellers provide some revealing information regarding the pace of technological innovation taking place in this industry. These surveys reveal that 23% of all potential homebuyers have searched for a home on-line. Such activities include virtual tours of listed properties, obtaining neighborhood and quality of life data, and determining affordable price ranges and loan amounts using home price and mortgage calculators. Although the most on-line shoppers were using the Internet to find a home rather than a broker, the vast majority of Internet searchers ultimately ended up using a real estate broker in consummating the sale. These surveys also revealed that 67% of the REALTORS® surveyed in 1999 accessed the Internet for business purposes. The recent approval of electronic signatures should also make it more likely that much of the paperwork associated with home purchase and sale transactions will be completed on-line.

There is certainly no question that the implementation of on-line technology has and will continue to change the cost structure and marketing operations of firms in the real estate brokerage industry.

Technological innovations such as the fax, cell phone, digital cameras, and, most important, the world wide web created new opportunities for broader, much more effective, and less costly dissemination of market information to consumers. The interactive nature of this new technology also allows both real estate professionals and the consumers with whom they work to respond much more quickly to new market information.

The technological innovations noted above are also associated with significant economies of scale, that involve substantial introductory costs, but lower operating costs once these systems are up and running. It is not coincidental that agent productivity has increased during the last decade.

Not only will the growing use of Internet real estate applications reduce information and transaction costs and speed transactions, they may also work to reduce the demand for real estate brokers and lower commissions.[13] At a time when there are probably no more gains to be made by further consolations or growth in firm size, banks are considering entering the real estate brokerage industry.

THE CONSEQUENCES OF BANK ENTRY

Greater Industry Concentration

What might be the consequences for consumers and the economy if banks do enter the market for real estate brokerage services? In the ideal scenario bank entry would improve the delivery and quality of brokerage services and reduce commission costs to consumers. Such an outcome, however, is unlikely given the findings of the research described earlier. While the entry of banks into the real estate brokerage market could be affected either through acquisition of existing firms or by establishing new brokerage operations, the market outcomes will likely be the same.

If bank entry into the industry is by way of acquisition of existing firms, this will not increase competition, but could instead, lead to even more concentration within the industry. If the real estate brokerage industry becomes dominated by a few very large firms the result will be less rather than more competition. With fewer firms in the industry, what was a relatively competitive market would quickly become oligopolistic. The survival of smaller firms could be threatened by predatory pricing and new firms may be discouraged or even prevented from entering the industry.

We know from the research cited earlier that much of the early consolidation that characterized this industry in the early 1990s was triggered by the increasing realization that most firms were simply too small to take advantage of economies of scale in production. As competitive pressures increased firm size, firms were better able to improve their cost efficiency, a result predicted by the earlier economies of scale research.

The presence of scope economies also indicates that a real estate brokerage firm does not have to grow into a super regional firm in order to realize cost savings. By taking advantage of sharable resources, firms, once they grew large enough to allow individual agents to specialize in listing and selling, could produce more coop and in-house sales. In contrast, firm production that is heavily weighted towards either listing or sales is more costly, on a per unit basis, than a more balanced output of both listing and sales. If follows from this analysis that institutional changes

[13] See Baen and Guttery (1997) and Tuccillo (1997) for similar arguments.

which allow more effective utilization of sharable inputs and a more balanced output of listing and sales will be more cost effective for the industry. If bank-owned real estate companies concentrate on the buying side of the real estate transaction because this facilitates loan origination these scope economies may not be realized.

The research also showed that very large firms are less efficient than smaller firms in terms of resource utilization. Revenue transactions per agent fall as firm size increases. For the very largest firms in the residential brokerage industry, the expression "making it up on volume" appears to be true, at least so far. For the majority of firms in the industry the presence of scale economies have helped offset the reduction in agent productivity as they grew in size. However, the research also indicates that the industry cost curve is U-shaped; beyond some output level, diseconomies of scale will work to increase costs. After a significant fall in average total costs that occurs at a relatively small output level, average total costs remain relatively constant over a substantial range of output. However, beyond that point, costs begin to rise. Further consolidation could result in a situation where firms become so large that they are producing in the range were diseconomies of scale prevail as well as suffer from inefficient resource utilization. Consequently, continued consolidation and growth in average firm size may not be result in increased market competitiveness or improved operational efficiency.

Unfair Competitive Advantage?

Alternatively, if bank entry initially results in the addition of new firms in the market, their ability to tie financing to the sales transaction could drive out independent brokers, which again could result in increased concentration within the industry, fewer firms, and monopoly power. Where then would the competition come from?

Historically, limited barriers to entry meant that brokers had to differentiate their product in order to maintain market share. This is reflected in advertising campaigns that emphasize the quality of broker services, the use of cable TV programs, Internet marketing strategies, franchising, and the provision of referral and relocation services. Would not banks be expected to do the same?

The ability to market both real estate brokerage services and mortgage loans, even in the absence of a coercive or formal tying agreement, gives banks a major competitive advantage over independent real estate brokerage firms. Will not consumers feel that they may stand a better change of being approved for a loan if they use bank provided brokerage services?

Research has shown that brand name capital represents an important asset to real estate companies and is strongly linked to the success of real estate companies. Will consumers perceive that bank supplied real estate brokerage services are somehow superior to the services provided by other brokers, even when that is not the case, because banks are larger and have statewide, regional, or even national name recognition? If so, such perceptions, even if untrue, would give bank-owned brokerage firms an unfair advantage over independent brokers.

Market Structure Problems

If banks are found not to have a competitive advantage, there still could be major dislocations resulting from their entry into the real estate brokerage market. Although there are still a large number of firms within the industry and entry is relatively easy, competition is not perfect because the services of brokers are not homogeneous. The residential real estate brokerage market is characterized by advertising and other forms of non-price competition. Consequently, each firm faces its own downward sloping demand curve for its services. In such a market entry of banks could result in excess supply and reduced allocative efficiency. If more firms come into a monopolistically competitive market, it would result in a reduction in market share for everyone. In the classic case, the demand curve facing individual firms would decrease forcing firms to operate further up on their average total cost curve. The end result would be an equilibrium where that are more firms in the industry, each producing less output than before at more costly output levels, which in turn, could put upward pressure on commissions.

Even if one questions some of the underlying assumptions of the monopolistic competition model, there will still be market dislocations, some temporary and some possibly permanent, that could result from bank entry into real estate brokerage. The industry has already experienced upward pressure on commission splits as a result of the competition by the larger firms for productive salespeople. Bank entry could further exacerbate this problem. Even if this was a temporary problem, ameliorated by the eventual entry of more salespeople attracted by the higher compensation, by the time conditions improve, many of the smaller real estate firms may no longer be in existence.

An increase in the number of salespeople without a corresponding increase in the demand for their services simply spreads the number of listing across more and more brokers, thereby decreasing the probability that any individual salesperson generates a sale. The result is a net reduction in salesperson productive efficiency, excess capacity in the industry, and a serious misallocation of resources for the economy.[14]

A Moral Hazard Problem

There is also the question of conflict of interest. Are bankers into real estate as a way to make more loans or provide more consumer services? What is it that banker-brokers will bring to the table that can't already be supplied by traditional, independent brokers? If it's primarily to make more loans, then the interests of the homebuyers and sellers may be subordinated to this goal. Consumers might feel coerced into using a bank-affiliated broker even if the quality of the services provided by the broker were sub-par. What about the situation where a bank affiliated broker is acting as an agent[15] of the buyer and knows that his client could get a better loan deal from a competitor. How likely would it be that this broker would send his client to another bank? Failure to direct the client to the bank offering the superior loan package would constitute a breach of the broker's fiduciary responsibility to the principal. This moral hazard problem would extend to other real estate related services provided by banks such as appraisals. This could certainly be the case if the real estate brokerage component of their business is ancillary to the marketing of loans. Alternatively, if bank affiliated brokers view mortgage financing as a way to generate more home sales, would loan underwriting standards and the validity of property appraisals be comprised by pressure to sell houses? In an economic downturn, the integrity of our financial system could be jeopardized if the foreclosure of mortgage loans resulted in substantial loan losses because of inflated appraisals or under-collateralized mortgages.

It is markets where information is difficult, costly, and time-consuming to collect that institutionalized intermediaries evolve. These intermediaries, by taking advantage of economies of scale in information gathering can generate benefits for the consumers they represent by reducing information and transaction costs. Real estate is such a market. Traditionally real estate brokers served as agents of home sellers. One of the problems endemic to markets for intermediaries is how to align the interests of the agent with the interests of the client. Because the typical home seller is an infrequent participant in the market, the seller may be unable to accurately assess the quality of the information or value of brokerage services received. Nor are consumers generally able to effectively monitor the performance of their agent. Hence the moral hazard problem of insuring that the best interests of the client are being served by the agent. This is the reason that incentive compatible employment contracts are commonly used in such markets. In the case of seller agency a percentage commission based upon selling price is an example of just such a contract because it encourages the broker maximize the selling price. Developing incentive compatible compensation arrangements has become more difficult in today's real estate market because the use of disclosed dual agency, buyer agency, and non-agency, transaction brokerage have become more common. This problem will become even more difficult to resolve in the case of broker-lenders.

Just what type of brokerage arrangements will be used or favored by bank-affiliated brokers? If bank affiliated brokers work mostly with buyers then exclusive buyer agency might be most appropriate. Would they avoid using exclusive or single agency arrangements because of possible conflicts of interests, even if this type of brokerage arrangement might be best for the consumer? The use of disclosed dual agency might make the problem worse. This arrangement has already been criticized for the potential conflict of interest inherent in its structure. If, instead, banker-brokers act as non-agency transaction brokers, then who will represent consumers when they need help? Some critics charge that the use of transaction brokerage arrangements is simply a way for brokers to work both sides of the real estate transaction without the legal liability problems that might attach to a agency situation. Consumers, both buyers and sellers, are demanding more services from their brokers than in the past that goes way beyond marketing—partly because of greater agency disclosure, partly because the real estate transaction has become more complex. Our research suggests that this trend will continue and brokers will have to become far more service oriented than in the past. It seems to me that banks would

[14] This is the market outcome Yinger (1981) hypothesizes when he examines the market for real estate brokerage services within the context of a search model.

[15] Agent is used in the strictly legal sense where the broker is the legal fiduciary of a home buyer or seller.

be hard pressed to claim that all the services associated with a modern real estate sales transaction are primarily financial in nature.

CONCLUDING COMMENTS

Over the last 20 years we have witnessed a major transformation of the residential real estate brokerage industry. What was once characterized as a low tech "Mom and Pop" industry made up of very small firms that included many part-time salespersons, has now become what the Department of Commerce ranks as one of the most information technology intensive sectors in the economy.

Firm size has grown over time and real estate brokers and salespersons, increasingly drawn from the ranks of college graduates, are full-time professionals, required to take continuing education courses in order to maintain their licenses. As this research has shown, part of the explanation for the growth in firm size is the recognition that there are substantial economies of sale in the provision of information and market intermediation services. Other factors also played a part in the transition of this industry and accelerated the move to larger firms. The extremely strong housing market of the 1990s increased the demand for the most productive salespersons, increasing commission splits and compensation costs to broker-owners. The growth in the Internet and on-line real estate applications have created new opportunities for broader and less costly dissemination of market information to consumers. The interactive nature of this new technology also allows both real estate professionals and the consumers with whom they work to respond much more quickly to new market information.

The technological innovations noted above are also associated with significant economies of scale, that involve substantial introductory costs, but lower operating costs once these systems are up and running. It is not coincidental that agent productivity has increased during the last decade. It is also important to remember that it has been the smaller firms that have benefited most from the increase in agent productivity.

This research also suggests that continued growth in firms size and further consolidation of the residential real estate brokerage industry that could be triggered by bank entry would be counter-productive. Now that the up-front costs of technological implementation have been largely absorbed, the prospects for the survival of the smaller and mid-sized real estate firms have improved. Market forces may now be a work that actually discourage further consolidation and growth in firm size. How then will bank entry into this industry improve the overall operating efficiency of this industry?

The cost curve of the typical real estate firm is U-shaped; beyond some output level diseconomies of scale will work to increase unit costs of production. If bank entry results in additional concentration within the real estate industry, the real estate brokerage business could easily become dominated by a few, very large firms. There is no question that the ability of banks to tie the provision of mortgage loans to the provision of brokerage services, even in the absence of formal tying agreements, will, if only in the consumer's mind, give banks an insurmountable competitive advantage over independent real estate firms. Such a competitive advantage would allow bank-owned or affiliated real estate firms to operate beyond the range of achievable scale economies and extract monopoly profits. Their shear size would then constitute an additional and even more significant barrier to the entry of new and competing firms. Large firms, facing higher operating costs, have little incentive to lower commission rates. Bank induced industry consolidation could actually reduce current competitive pressures that would otherwise work to reduce commission costs to consumers.

It is no doubt true that real estate salespeople have a major impact on where consumers go to get their mortgage loans. In a market that is estimated to be worth over $5 trillion, the ability to influence where consumers shop for loans constitutes a very strong incentive for bank entry into the real estate brokerage industry. Will then the interests of homebuyers and sellers be subordinated to loan origination if they work with bank controlled real estate brokerage firms? The very real possibility that consumers may feel coerced into using a bank-affiliated broker in order to procure a mortgage loan, even if the quality of broker services was sub-par, constitutes a serious moral hazard problem. Consider the situation alluded to earlier in this study of a bank affiliated broker acting as the legal fiduciary of a buyer who knows that a competing bank offers a better loan package. How likely is it that the consumer would be directed to the bank with the better loan terms?

Alternatively, if bank-owned brokerage firms offer liberal mortgage financing as a way to market their real estate listings, loan underwriting standards could be compromised, thereby threatening the solvency of the banking system. Allowing banks into the real estate brokerage industry is to invite these conflict of interest situations.

Ideally, the decision to allow banks entry into the real estate brokerage market should be based upon whether bank provided real estate brokerage services will increase consumer welfare. Normally, ease of entry into an industry works to increase efficiency through enhanced competition. Both the industry and the consumer benefit. However, in the case of financial institutions, entry into the real estate industry could have just the opposite effect, as outlined in this paper. Bank provided real estate brokerage services should only be permitted if advocates can offer compelling evidence that the potential benefits outweigh the potential risks to the consumer.

Table 1
Revenues, Profits and Expenses of Residential Brokerage Firms
Full Sample: 1988, 1990, 1994 and1996

	1988	1990	1994	1996
Revenue Transactions	741.4	593.9	351.0	815.9
	(2833.7)	(1422.8)	(1059.4)	(1934.0)
Full Time Equivalent Sales Persons	59.2	46.1	23.6	51.8
	(243.6)	(109.9)	(78.6)	(115.4)

These Calculations Per Revenue Transaction

Gross Revenue	2961.2	3257.2	3436.0	3759.9
	(1928.5)	(2500.9)	(3970.9)	(3340.1)
Gross Margin	1212.6	1376.4	1902.9	1551.6
	(828.6)	(1188.8)	(4202.8)	(1908.5)
EBIT	267.5	158.2	235.2	217.7
	(360.1)	(647.3)	(2530.7)	(1204.3)
Net Income	237.8	131.1	207.8	200.4
	(336.1)	(645.2)	(2533.4)	(1207.9)
Owner's Income	469.5	391.3	692.6	439.7
	(564.9)	(853.1)	(2756.4)	(1197.7)
Commission Payments	1296.1	1678.5	1277.1	1617.8
	(940.8)	(1501.5)	(1339.2)	(1784.0)
Variable Costs	1607.9	1999.5	1644.4	1922.7
	(1117.6)	(1679.9)	(1511.2)	(1995.6)
Fixed Costs	620.1	839.3	1044.0	866.2
	(466.5)	(730.2)	(1634.8)	(1125.7)
Total Costs	2227.9	2838.8	2685.6	3166.7
	(1474.4)	(2213.0)	(2548.7)	(3088.5)

Number of Firms	375	448	267	201

Table 2
Revenues, Profits and Expenses of Residential Brokerage Firms
Group 1: Firms with Revenue Transactions between 0 and 100
1988, 1990, 1994 and 1996

	1988	1990	1994	1996
Revenue Transactions	59.0 (27.5)	51.8 (29.3)	40.6 (29.6)	48.5 (28.4)
Full Time Equivalent Sales Persons	8.2 (19.1)	5.6 (4.7)	3.7 (8.3)	4.2 (3.8)
These Calculations Per Revenue Transaction				
Gross Margin	1565.8 (1154.2)	1985.0 (1744.6)	2562.9 (5538.7)	1940.3 (2922.5)
Gross Revenue	3432.0 (2642.4)	3923.6 (3264.6)	3738.5 (5076.7)	3968.7 (4926.8)
EBIT	512.7 (525.3)	365.2 (1014.0)	304.9 (3393.9)	238.1 (1549.0)
Net Income	458.4 (485.4)	330.8 (1005.6)	263.4 (3398.3)	212.0 (1546.4)
Owner's Income	896.3 (866.6)	771.0 (1336.6)	975.3 (3670.9)	535.5 (1536.0)
Commission Payments	1165.8 (1228.0)	1586.6 (1881.2)	954.1 (1278.8)	1272.3 (2313.4)
Variable Costs	1563.0 (1484.6)	1991.9 (2150.4)	1382.4 (1515.4)	1664.0 (2694.4)
Fixed Costs	761.1 (656.7)	1123.2 (1063.3)	1389.5 (2114.1)	1110.1 (1450.0)
Total Costs	2324.1 (1969.2)	3118.2 (2899.6)	2778.1 (3064.1)	3302.4 (4133.3)
Number of Firms	109	120	148	61

Table 3
Revenues, Profits and Expenses of Residential Brokerage Firms
Group 2: Firms with Revenue Transactions between 100 and 250
1988, 1990, 1994 and 1996

	1988	1990	1994	1996
Revenue Transactions	162.8 (40.8)	170.5 (43.1)	174.6 (41.1)	161.7 (41.1)
Full Time Equivalent Sales Persons	15.2 (11.5)	14.3 (12.2)	9.7 (6.3)	11.5 (9.8)
Per Revenue Transaction				
Gross Revenue	3006.7 (1730.6)	3164.3 (2578.3)	2936.4 (1889.8)	3764.3 (3105.3)
Gross Margin	1191.5 (705.0)	1290.2 (1009.9)	1073.4 (683.1)	1697.3 (1833.5)
EBIT	203.5 (216.7)	104.6 (621.1)	177.7 (340.7)	226.7 (1675.1)
Net Income	183.9 (206.8)	74.8 (628.9)	161.4 (333.8)	203.0 (1689.4)
Owner's Income	415.4 (333.7)	356.8 (760.7)	444.2 (406.9)	506.5 (1630.6)
Commission Payments	1370.6 (851.6)	1659.6 (1577.5)	1553.1 (1344.9)	1444.6 (1405.0)
Variable Costs	1699.9 (1029.3)	1983.0 (1715.3)	1835.8 (1490.8)	1743.3 (1537.4)
Fixed Costs	601.0 (397.2)	794.7 (593.6)	554.5 (380.8)	860.4 (1442.2)
Total Costs	2300.9 (1348.4)	2777.8 (2158.7)	2354.7 (1745.0)	3042.3 (3267.0)
Number of Firms	116	122	64	50

Table 4
Revenues, Profits and Expenses of Residential Brokerage Firms
Group 3: Firms with Revenue Transactions between 250 and 500
1988, 1990, 1994 and 1996

	1988	1990	1994	1996
Revenue Transactions	363.3 (66.4)	359.4 (77.8)	367.0 (71.2)	355.5 (66.7)
Full Time Equivalent Sales Persons	23.5 (12.2)	26.0 (20.5)	22.4 (10.7)	24.6 (12.8)

These Calculations Per Revenue Transaction

Gross Revenue	2308.9 (1042.0)	2953.7 (1577.1)	3140.8 (2041.1)	3480.5 (1648.6)
Gross Margin	908.7 (434.1)	1066.3 (530.0)	1084.5 (577.6)	1245.2 (693.7)
EBIT	208.4 (282.4)	82.6 (285.2)	153.6 (185.3)	259.6 (526.3)
Net Income	189.9 (276.0)	61.8 (283.3)	147.7 (186.1)	252.1 (527.6)
Owner's Income	317.7 (270.9)	245.3 (346.0)	287.8 (186.4)	422.7 (527.1)
Commission	1066.0 (528.5)	1737.2 (1099.5)	1793.5 (1537.8)	1879.2 (1391.1)
Variable Costs	1307.8 (616.5)	2019.9 (1182.5)	2116.0 (1701.8)	2144.8 (1462.9)
Fixed Costs	430.2 (213.0)	667.7 (457.7)	638.7 (370.5)	726.3 (463.3)
Total Costs	1738.0 (762.3)	2687.6 (1558.4)	2754.7 (2020.9)	3115.4 (1724.3)

Number of Firms	74	85	27	38

Table 5
Revenues, Profits and Expenses of Residential Brokerage Firms
Group 4: Firms with Revenue Transactions of 500 and above 1988, 1990, 1994 and 1996

	1988	1990	1994	1996
Revenue Transactions	2574.3 (5479.7)	1723.4 (2394.2)	2381.2 (2483.2)	2681.6 (3135.5)
Full Time Equivalent Sales Persons	211.9 (484.0)	132.3 (184.6)	161.4 (195.0)	170.4 (193.9)

These Calculations Per Revenue Transaction

Gross Revenue	2930.9 (1673.5)	2903.2 (1908.0)	3264.0 (1213.2)	3729.5 (2076.2)
Gross Margin	1106.7 (661.1)	1077.6 (696.3)	1099.5 (479.2)	1198.8 (657.4)
EBIT	131.2 (172.1)	60.1 (188.5)	77.3 (119.2)	152.3 (264.4)
Net Income	106.1 (166.0)	38.6 (194.3)	77.8 (131.6)	143.9 (263.4)
Owner's Income	198.1 (182.5)	152.2 (233.2)	156.1 (139.1)	278.2 (386.2)
Commission Payments	1535.2 (904.5)	1747.5 (1231.4)	1854.9 (950.8)	1998.8 (1585.3)
Variable Costs	1788.2 (1046.3)	2009.3 (1407.3)	2137.3 (1041.9)	2236.4 (1733.3)
Fixed Costs	649.5 (398.6)	720.1 (493.6)	746.7 (419.0)	687.9 (473.9)
Total Costs	2437.7 (1381.7)	2729.4 (1842.8)	2884.0 (1301.0)	3164.4 (2204.1)

Number of Firms	88	121	28	52

Table 6
Commission Income and Commission Payments
(Calculations are Per Full-Time Equivalent Salesperson)
Commission Income

Year	Overall	RT < 100	100 < RT <250	250 < RT < 500	RT > 500
1988	40433.5	39268	39152.3	42187.7	42109.8
	(24259.6)	*(26760.5)*	*(23045.2)*	*(23732.4)*	*(23188.3)*
1990	40643.4	36979.8	39120	45674.6	42258.6
	(21640.1)	*(26007.2)*	*(18445.2)*	*(21498)*	*(19240.6)*
1994	51705.4	45872.8	64940.4	51683.5	52304.7
	(42481)	*(43559.3)*	*(51149.3)*	*(24837.5)*	*(12162)*
1996	57288.4	55842.1	61157	54963.4	57273.7
	(45641.1)	*(65251.1)*	*(39382.6)*	*(31012.1)*	*(31574.8)*

Commission and Fee Payments

1988	23355.1	20146.5	22807.9	25150.9	26577.1
	(15868.3)	(16651.4)	(14178.5)	(15216.6)	(16940.2)
1990	24322.4	17555.6	23633.2	30010.7	27727.4
	(15062.2)	(15684)	(12071.7)	(14517.5)	(15052.9)
1994	21140.3	13177.4	30736.4	31108	31684.7
	(20077.6)	(18320.5)	(18448.8)	(20636)	(12620.7)
1996	30906.9	24526.1	29110.5	35391.8	36841.9
	(27896.5)	(31979.2)	(25089.2)	(23040.7)	(27495.4)

Commission Payments to Agents

1988	15791.5	11401.1	15510.7	17469.4	20239.4
	(12805.7)	*(12333.4)*	*(11457.2)*	*(11644.8)*	*(23188.3)*
1990	18858.7	11745.5	16829.1	24850	23778.9
	(13559.3)	*(12884.1)*	*(9728.3)*	*(13401.4)*	*(13982.2)*
1994	16331.2	9887	23369.4	24804.3	26135.3
	(17551)	*(16364.6)*	*(17072.2)*	*(15913.7)*	*(11672.2)*
1996	20930.5	10604.2	19526.8	27107.9	29879.6
	(20264.2)	*(16000.1)*	*(18561)*	*(17207.5)*	*(22886.2)*

[Note: Standard Deviations in Parentheses]

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An Economic Analysis of the Proposal to Allow National Banks To Compete in the Real Estate Brokerage Market

By
Capital Economics
1299 Pennsylvania Avenue, N.W.
Washington, DC 20004

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I. INTRODUCTION

The Board of Governors of the Federal Reserve System and the Secretary of the Treasury have jointly proposed amending the rules that prevent federally chartered banks from offering or owning real estate brokerage and management services. The proposal calls for reclassifying real estate brokerage and management as one that is either "financial in nature or incidental to a financial activity" and therefore permissible for national banks.

The Gramm-Leach-Bliley Act of 1999 amended federal law by allowing national banks to engage in activities that are considered either financial in nature or incidental to a financial activity. As a direct result there has been an explosion of new products and services offered by federal banks into markets from which they had previously been barred. If the proposed reclassification is enacted national banks would similarly be allowed to enter and compete with real estate agencies in the provision of real estate related services. Pursuant to the proposed rule change the Federal Reserve and Treasury have officially sought comments from interested parties regarding their opinion as to the legitimacy of reclassifying real estate brokerage and management as a financial activity.

We do not intend to comment directly on whether or not real estate brokerage is a financial activity, we will leave that for others to decide. What does concern us however, is the ramifications if the proposal is enacted as described. Currently the separation of agent and lender prevents the bank from gaining financially in the event a borrower defaults on their loan. As a result banks typically go to great lengths to screen for credit worthy customers, and if those customers do fall behind on their payments banks generally only chose foreclosure as a remedy of last resort. Additionally, the separation between the broker and lender has provided the valuable benefit of constraining potential conflicts of interest between a homebuyer and their agent. Because agents are normally compensated as a percent of the sale price they stand to gain by placing their client into a more expensive home. But because the bank is eager to prevent default they are not willing to grant a loan beyond what the customer can afford. Therefore a stand alone lender balances out the adverse incentives facing real estate agents.

The Fed proposal to allow the combination of agent and lender would remove these valuable benefits and create new incentives that run counter to the public welfare. Our analysis reveals that by creating integrated agent/lenders (IALs), banks would have a positive, vested, financial interest in seeing homeowners default on their loans. As a consequence there would likely be an increase in predatory type behavior whereby banks would engage in unscrupulous practices in order to facilitate default and eventual foreclosure of the borrower's property. Similarly, the creation of IAL banks would remove the existing forces that offset the incentives for agents to place potential homebuyers into homes outside of their price range. Based on the negative incentives that would be created by the rule change we strongly urge that the Federal Reserve and Treasury consider all the costs and benefits of the proposal and not just concern themselves with the financial definition of real estate brokerage and management. Absent substantial efficiencies or other benefits resulting from the new rule we would recommend against the proposed action.

II. ANALYSIS

A. Allowing Integrated Agent/Lenders (IALs) Changes the Existing Incentive Structure to the Detriment of Consumers

Allowing mortgage lenders to act as real estate agents fundamentally alters the relationship between lender and borrower. Traditionally the lender stands to gain financially only when the borrower faithfully repays their loan commitment. This is because the loan payments (and any associated fees) generate the entirety of the lender's income. When these payments are missed and the borrower stumbles into default the bank looses its only source of income. At this point the bank can attempt to recoup their investment by starting the foreclosure process in order to take possession of the home for eventual resale. But due to the time and expense of such an effort only rarely does this fully compensate the lender.[1] Therefore, in the vast majority of cases the lender has no incentive to foreclose on the property, and in fact will likely take proactive steps to work with the owner to prevent default. The lender's incentives, or lack thereof, regarding default can be seen in table 1.

Table 1

Original Home Value	$250,000
Sum of Annual Mortgage Payments	$22,207
at a mortgage rate of:	8%

Years Since Mortgage Inception	Present Value of Remaining Mortgage Income Stream[1]	Cost to Foreclosure[2]	Net Gain/Loss from Foreclosure[3]	Adjusted Homeowner Equity[4]
1	$305,674	$25,000	($80,674)	($38,500)
2	$301,807	$25,000	($76,807)	($36,293)
3	$297,709	$25,000	($72,709)	($33,910)
4	$293,364	$25,000	($68,364)	($31,336)
5	$288,759	$25,000	($63,759)	($28,556)
6	$283,878	$25,000	($58,878)	($25,553)
7	$278,704	$25,000	($53,704)	($22,311)
8	$273,219	$25,000	($48,219)	($18,809)
9	$267,406	$25,000	($42,406)	($15,026)
10	$261,243	$25,000	($36,243)	($10,942)
11	$254,711	$25,000	($29,711)	($6,530)
12	$247,787	$25,000	($22,787)	($1,766)
13	$240,447	$25,000	($15,447)	$3,380
14	$232,667	$25,000	($7,667)	$8,937
15	$224,420	$25,000	$580	$14,939
16	$215,679	$25,000	$9,321	$21,421
17	$206,412	$25,000	$18,588	$28,421
18	$196,590	$25,000	$28,410	$35,982
19	$186,179	$25,000	$38,821	$44,147
20	$175,143	$25,000	$49,857	$52,966
21	$163,444	$25,000	$61,556	$62,490
22	$151,044	$25,000	$73,956	$72,776
23	$137,900	$25,000	$87,100	$83,885
24	$123,967	$25,000	$101,033	$95,883
25	$109,198	$25,000	$115,802	$108,840
26	$93,543	$25,000	$131,457	$122,834
27	$76,949	$25,000	$148,051	$137,948
28	$59,359	$25,000	$165,641	$154,271
29	$40,714	$25,000	$184,286	$171,899
30	$20,950	$25,000	$204,050	$190,938

[1] Assumes a discount rate of 6%.
[2] Assumes the cost to foreclosure is 10% of the property value.
[3] The value of the property less the PV of the remaining payments less the cost to foreclosure.
[4] Is the remaining equity assuming the seller must absorb a 10% loss to sell the property quickly and a 6% cost for closing.

Table 1 shows the actual gains/losses for the lender from a foreclosure for each year during a 30 year fixed mortgage at 8%. The hypothetical example is for a home valued at $250,000 that does not appreciate for the life of the mortgage.[2] The lender's gain/loss from foreclosure is calculated by taking the value of the property, less foreclosure costs (10% of the property value), less the forgone revenue (the present value of the remaining mortgage payment). That is, the bank gains the value of the property (less the cost of foreclosure) but suffers the loss equal to the future stream of mortgage payments. As can be seen from the table for the first 14 years the lost income from the mortgage payments exceeds the gain from the taking of the property. Therefore the lender would incur a real loss from a foreclosure initiated during the first half of a 30-year mortgage.

[1] According to the National Home Equity Mortgage Association equity lenders lose money in 93 percent of foreclosures. http://www.nhema.org

[2] Assuming a rate of property value appreciation does not materially alter the implications drawn from the example as it both increases the value of foreclosure but also increases the rate of equity appreciation for the property owner.

Only when the present value of the remaining mortgage payments has fallen sufficiently when compared to the property value is there any benefit to the lender from foreclosure.[3] This does not occur however until year 15 (where it is marginal) and beyond. Once this point is reached the lender would gladly foreclose on a property owner with late payments since it would result in a net gain for the bank. But at this stage in the mortgage the property owner has built up sufficient equity in the house that, if needed, they could sell the property to prevent foreclosure.[4]

The property owner builds up equity in their home over time as they make mortgage payments that exceed the value of the accumulated interest. As the loan matures the borrower slowly pays down the outstanding debt, which in effect translates into owning a greater portion of their home. As most homeowners know well, the pace of debt reduction is slow for the early part of the loan as the bulk of the payment goes to interest rather than debt reduction. As a result the pace of equity accumulation is slow as well. This fact however, can prevent the homeowner from selling their home (or at least force them to come up with additional monies at closing) if they chose to sell in the early years of the loan. To see this remember that there is a cost associated with selling ones home, (the seller pays the agent's commission, typically 6%) in addition to the necessity of paying off the remainder of the loan. When these costs are greater than the sale price of the home the seller must come up with additional cash in order to consummate the sale. This requirement can be prohibitive for cash strapped individuals, and is further exacerbated by those having financial difficulty that need to rapidly sell their home. In order to have a high probability of quickly selling their home in the event of financial duress the seller must be willing to absorb a significant discount. We estimate that such a discount would be in the range of 10% of the value of the home, although there is certainly room for argument that it could be more or less than our amount. In table 1 we show the remaining equity available to the seller in the event that they need to quickly sell their home in order to stave off foreclosure. The seller equity is calculated by taking the home value less the 10% quick sale discount, less 6% agent fees, less the remainder of the loan. When this value is negative the homeowner would be unable to complete a "quick sale" as they would have to come up with additional cash in order to do so.[5]

Therefore, according to table 1 for the first 12 years of the loan the homeowner would be unable to stave off pending foreclosure by undertaking a quick sale to pay off the remaining loan balance. But note, more importantly by year 13 they are able to do so, which is two years *before* the bank would find it profitable to foreclose on the home. This is a crucial point; that by the time the lender would find it profitable to foreclose the homeowner would have sufficient equity to prevent such an event. This shows why property foreclosures are such an infrequent event and typically only occur in situations where the borrower can not meet their financial obligations and does not take advantage of work outs offered by the lender.

This eminently desirable outcome is reversed for banks however, if they can serve as both real estate agent and lender. Because an integrated agent/lending bank upon foreclosure can re-list that same property for sale they are able to generate two additional sources of income that they otherwise would not have. First they get the commission for the real estate transaction, which generally ranges around 3% of the sale price of the property. The second, and more important source of income derives from the fact that the IAL bank will likely provide the loan to the buyer of the foreclosed property. Thus, while the IAL bank loses the current payment stream this is more than replaced by a new mortgage which has an even higher present value of payments. The present value of the new loan is higher of course, due to the fact that there are more years remaining compared to the partially paid down existing loan.[6] Therefore the IAL bank does not merely replace the lost mortgage with one of equal value, they replace it with one of greater value. Adding this to the sales commission gives the additional income from foreclosure for the IAL bank above that received by a traditional bank. This scenario is shown in table 2.

[3] The present value of the remaining payments decreases as the loan is paid off and there are fewer payments remaining.

[4] The owners equity is calculated by: Value of the house—10% loss (to sell quickly)—6% closing costs—remaining balance on the mortgage loan.

[5] Note that we are implicitly assuming in this situation that the homeowner is under financial duress and unable to meet their mortgage payment obligation. As a result we assume that they would not have sufficient cash in the event of negative equity to complete a quick sale.

[6] This assumes the size and rate of the loans are equivalent.

Table 2

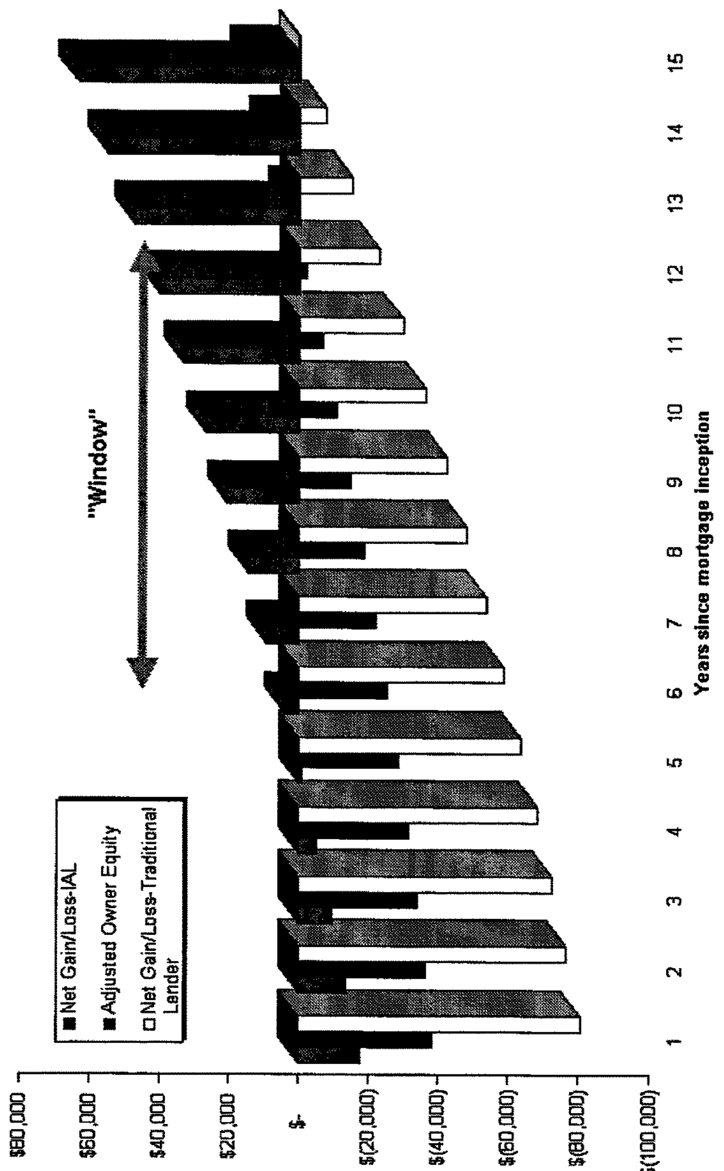
Original Home Value	$250,000
Sum of Annual Mortgage Payments	$22,207
at a mortgage rate of:	8%

Years Since Mortgage Inception	Traditional Net Gain/Loss from Foreclosure	Sales Commission	Present Value of New Mortgage[1]	New Net Gain/Loss from Foreclosure	Adjusted Homeowner Equity
1	($80,674)	$7,500	$55,674	($17,500)	($38,500)
2	($76,807)	$7,500	$55,674	($13,634)	($36,293)
3	($72,709)	$7,500	$55,674	($9,535)	($33,910)
4	($68,364)	$7,500	$55,674	($5,191)	($31,336)
5	($63,759)	$7,500	$55,674	($586)	($28,556)
6	($58,878)	$7,500	$55,674	$4,295	($25,553)
7	($53,704)	$7,500	$55,674	$9,470	($22,311)
8	($48,219)	$7,500	$55,674	$14,954	($18,809)
9	($42,406)	$7,500	$55,674	$20,768	($15,026)
10	($36,243)	$7,500	$55,674	$26,930	($10,942)
11	($29,711)	$7,500	$55,674	$33,463	($6,530)
12	($22,787)	$7,500	$55,674	$40,387	($1,766)
13	($15,447)	$7,500	$55,674	$47,727	$3,380
14	($7,667)	$7,500	$55,674	$55,507	$8,937
15	$580	$7,500	$55,674	$63,753	$14,939
16	$9,321	$7,500	$55,674	$72,495	$21,421
17	$18,588	$7,500	$55,674	$81,761	$28,421
18	$28,410	$7,500	$55,674	$91,583	$35,982
19	$38,821	$7,500	$55,674	$101,995	$44,147
20	$49,857	$7,500	$55,674	$113,031	$52,966
21	$61,556	$7,500	$55,674	$124,729	$62,490
22	$73,956	$7,500	$55,674	$137,129	$72,776
23	$87,100	$7,500	$55,674	$150,274	$83,885
24	$101,033	$7,500	$55,674	$164,207	$95,883
25	$115,802	$7,500	$55,674	$178,975	$108,840
26	$131,457	$7,500	$55,674	$194,630	$122,834
27	$148,051	$7,500	$55,674	$211,225	$137,948
28	$165,641	$7,500	$55,674	$228,814	$154,271
29	$184,286	$7,500	$55,674	$247,460	$171,899
30	$204,050	$7,500	$55,674	$267,224	$190,938

[1] The present value of the 30 year stream of mortgage payments less funding costs discounted at 6%.

The net gain/loss from foreclosure for the IAL bank is the gain/loss for the traditional bank as shown in table 1 plus the sales commission and present value of the new mortgage. Not surprisingly the additional income dramatically changes the payoff structure. Under the new scenario the IAL bank earns a positive return from foreclosure by year 6, *7 years before the property owner has sufficient equity to prevent default*. Over the course of this 7 year span the IAL bank not only gains from foreclosure, but the borrower is unable to prevent such an occurrence through a quick sale of their home. The 7-year period therefore represents a window of opportunity during which an IAL bank would be able to profitably complete a foreclosure. But even more importantly the window represents a radical realignment of the incentive structure facing an IAL bank. During this period instead of desiring to work with troubled borrowers the incentives push IAL banks toward initiating a speedy foreclosure. Figure 1 shows the change in financial incentives graphically for the first 15 years of the mortgage.

Figure 1
Gain From Foreclosure IAL Vs Traditional Bank Compared to Owner Equity



As can be seen from figure 1 the payoff from default for the IAL bank is positive far sooner, and before positive equity for the consumer, than compared to the traditional bank. The appendix contains several additional iterations of figure 1 that vary key variables. Attachment 1 assumes that the value of the home rises by 2% per-year. Notice that while this rapidly accelerates the rate of equity appreciation it does not alter the incentive structure regarding foreclosure. Attachment 2 responds to potential criticism that the IAL bank could not expect a 100% guarantee that a homebuyer going through them would also use them as their mortgage provider. Therefore the bank would adjust its expectation downward based on the probability that the buyer would not use the full service of products. To calculate a reasonable probability we turn to data compiled by the National Association of REAL-

TORS®®. According to their *Profile of Home Buyers and Sellers* over 75% of home-buyers that receive a lender recommendation from their real estate agent follow the agent's advice.[7] We would expect that banks would have an integrated retention rate at least this high.[8] Therefore for the next iteration shown in Attachment 2 we conservatively assumed that the IAL bank would only provide mortgages for 75% of the homes that they list and sell. This obviously reduces the value to foreclosure for an IAL bank, but still does not alter the unpleasant incentive structure that would exist. Finally, attachment 3 assumes a home price appreciation of 2% and a loan probability of 75%.

Figure 1 and the attachments show the radical change that would take place in the home lending market as a result of the proposed rule changes. Allowing banks to serve as both lender and agent creates the dangerous incentive structure where the lender has a vested, positive, financial interest in seeing the borrower default on the loan. Banks could potentially use their significant information advantage and leeway in interpreting late fees and initiating foreclosure proceedings to potentially press borrowers into default. In a worse case scenario unscrupulous banks could use deceptive trade practices to prey upon fragile populations in an effort to cash in on foreclosure. Such a practice would be tantamount to a new form of "predatory lending" created as a direct result of the proposed new rules.

B. The Incentive and Ability for Predatory Lending Would Increase if the Proposed Rule Changes Were Enacted

Predatory lending has only recently been thrust into the national limelight with accounts of personnel horror stories that were soon followed up by Congressional hearings and legislative wranglings. Unfortunately, there is as of yet no clear definition or even consensus as to exactly what constitutes predatory lending.[9] Principally it appears to be an emotional response to protect fragile populations from fraudulent lenders who take advantage of the poor educational or financial background of their victims. These are people with generally poor credit that are confined to the subprime market.[10] Some of the complaints that people have labeled as predatory include loan flipping, charging of excessive fees, outright fraud, and equity stripping or asset based lending.[11] Of particular concern for our analysis here is the practice of asset based lending.

Asset based lending is generally defined as the granting of a loan not based on the customer's ability to repay, but on the existing equity in the customer's home. When the customer is unable to meet the financial obligations of the loan the lender takes possession of the house and cashes out via the sale. As was shown above however, this is only profitable when the value of the house after foreclosure is greater than the present value of the outstanding loan. Fortunately with a traditional lender this point is not reached until the property owner has built up sufficient equity to stave off foreclosure. Therefore we would expect that predatory lending whereby the lender designs to inevitably cause foreclosure to be a rare phenomenon. Unfortunately, there is no available data that measures the extent of predatory lending (a point made in congressional hearings by some of the critics of the proposed reforms) and any foreclosures resulting from the practice. We do know however, that the majority of subprime lending is made in good faith and only rarely ends in default.[12]

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[7] The National Association of REALTOR®s®, "Profile of Home Buyers and Sellers." 2000, at 25.

[8] We actually expect that IAL banks would provide mortgages on the house they list much closer to 100% of the time than 75%. This seems logical given that buyers take their agents advice 3 out of 4 times. An IAL bank would have similar input as the agent, plus would have the advantage that they could serve the buyer then and there, as opposed to the buyer having to actively follow their agents advice in contacting the lender.

[9] There is considerable debate as to exactly what constitutes predatory lending and how pervasive it really is, if at all. Some have called for immediate reform to crack down on what they consider predatory behavior, while others have been more reticent to move forward citing a lack of evidence and further concern that any new laws or regulations would only serve to dampen credit to lower income populations. Our issue is not with the current state of the debate but with the concern that the proposed rule changes would open the door for a new type of predatory lending that makes foreclosure profitable in the prime as well as subprime lending market.

[10] One of the few areas of agreement among commentators on predatory lending is that it is limited to the subprime lending market.

[11] For a review of predatory lending see: The Department of Housing and Urban Development and the Department of Treasury report on Predatory Lending. June, 2000.

[12] The National Home Equity Mortgage Association reports that only 2% of home equity borrowers end up in foreclosure proceedings compared to 1% for prime borrowers.

The proposed changes however, threaten to increase predatory behavior as they throw the lender's incentives out of whack with the customer's best interest.[13] For example, an IAL bank would find it profitable to grant a loan to a customer knowing that they could not pay for it and would fall into default in just a few years. This is truly a form of predatory lending, i.e. granting a loan based solely on the projection that the borrowers default will prove profitable. The lender could also design their loans to increase the probability of default by increasing the use of balloon payments, call options, or variable interest rate loans while shrouding the downsides to uneducated and fragile customers.[14] While we do not desire to detail the strategies predatory lenders might employ we do want to reiterate a key point regarding the proposed rules; that they change the incentive structure to one that makes it profitable to engage in predatory practices that cause consumers to lose their homes.

C. The Lender's Behavior May Not be Deliberately Predatory to Have Adverse Consequences

The lender's behavior does not need to be deliberately predatory for the proposed changes to have negative effects on the home lending market. Consider that in the majority of late payment cases the lender is often willing to work extensively with the customer in order to get the payments current and stave off default. An IAL would have no such incentive and would be much more likely to cut a borrower loose at the earliest possible opportunity. Consider for a moment a homeowner that falls into early trouble on their loan. The IAL bank would be much more likely to foreclose because in many instances doing so would prove profitable. Additionally, foreclosing on the troubled customer has the advantage of replacing a problem loan with a new one that would hopefully be of less risk. Such behavior on the part of banks would certainly not be illegal but does run counter to what many would consider the public interest. It is however, in the best interests of the bank.

D. Predatory Behavior Short of Foreclosure

The proposed rule changes create incentives for IALs to engage in predatory practices that fall short of causing foreclosure. The incentive structure to motivate this behavior does not currently exist and would be a direct result of the new regulations.

As described above once the property owner holds sufficient equity it is unlikely that they would ever fall into foreclosure because they could sell their home to stave of such an unfortunate occurrence. But this begs the question, what is the impact of a "forced sale" on the income of a traditional versus IAL bank?[15] The analysis is similar to what was done above, except in the case of a "forced sale" the lender does not bear foreclosure costs, nor do they receive the income from the sale of the property. The traditional bank gains the owed principal less the present value of the remaining mortgage payments. This value is *always* negative since the revenue from the mortgage payments must exceed the outstanding loan balance as long the mortgage rate is greater than zero.[16] In contrast the IAL gains the owed principal less the present value of the remaining mortgage plus the present value of the new mortgage (less the cost of funds). Effectively the IAL bank has merely traded out the existing mortgage with the new one. The value of the new mortgage must always be higher than the value of the current one since there are more years remain-

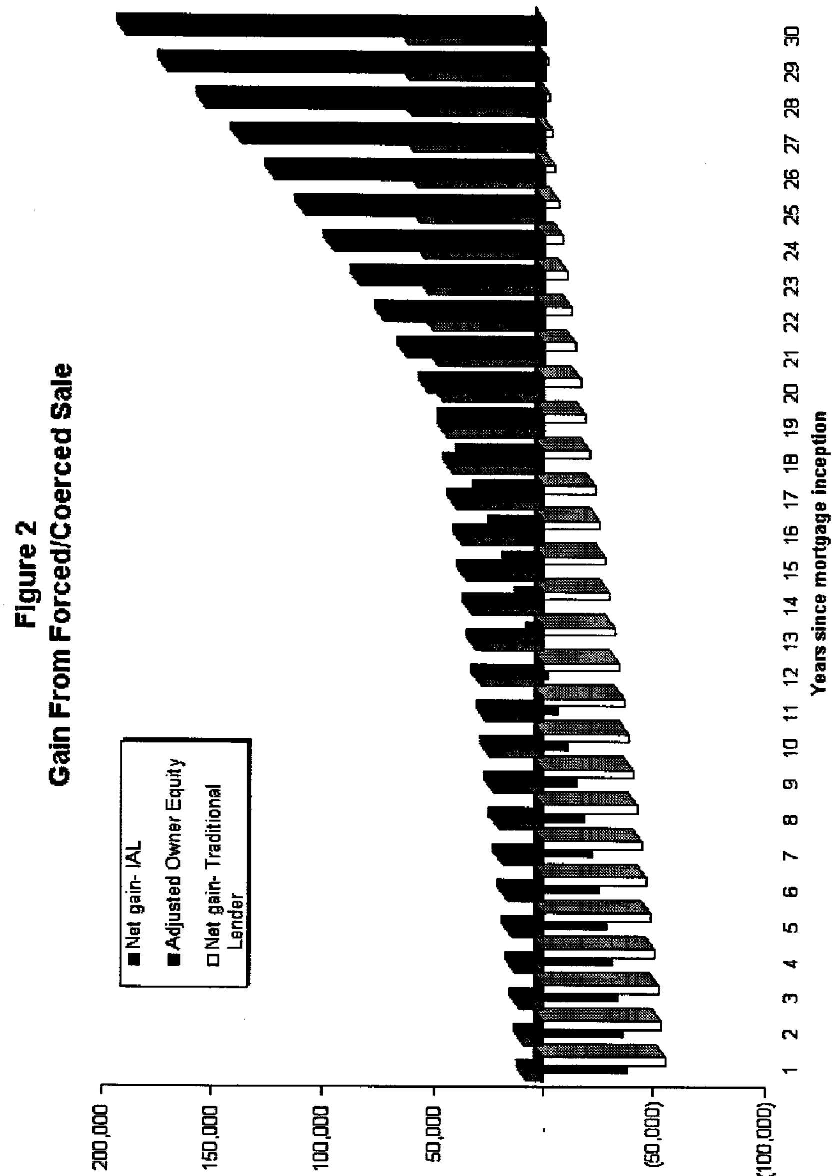
[13] Additionally, the rule changes would bring predatory lending practices to the prime market as well. This would be detrimental to one of the few remedies to subprime predatory lending that receives broad support; encouraging lenders in the prime market to participate in the subprime market. The belief is that the increased competition in the under-served communities would diminish the influence of unscrupulous lenders. See The Department of Housing and Urban Development and the Department of Treasury report on Predatory Lending. June, 2000.

[14] We do not mean to imply that these loan options themselves are predatory in nature, indeed they offer valuable benefits to well informed consumers. The literature on predatory lending does suggest however, that unscrupulous lenders will use loan terms of these types and deliberately mask the potential downsides. As a result when the balloon payment comes do, or interest rates rise, the consumer may be caught unprepared and forced into default.

[15] We define a forced sale as a homeowner having to sell their home to prevent foreclosure.

[16] We do not count as revenue the income stream that would be generated from the alternative investment from the repaid principal balance. This is because the next best investment is assumed to be the equivalent of the discount rate, therefore the income stream from the repaid balance is already in present value form. The assumption that the next best investment is equal to the discount rate is reasonable. Assuming that the markets are efficient, all profitable mortgages have been made, therefore there is no available mortgage opportunity for the repaid balance and the money can earn no better than the discount/(risk-free) rate. Only the IAL can lend at a higher rate because they can re-capture the mortgage with the subsequent home sale.

ing on the life of the loan.[17] As a result the payoff to an IAL bank for a forced sale is positive for all years. This situation is shown graphically in figure 2.



The salient feature of this analysis is that the IAL always benefits from a forced sale while the traditional lender never does. This opens the door for abusive behavior that would not otherwise exist. For example, a practice described in the literature on subprime predatory lending is lenders notifying owners that they will be evicted within days if they do not comply with the lender's demands, even when

[17] Once again we are assuming equivalence of the loan amount and mortgage rate.

they in fact have no ability to force an eviction in such a short timeframe.[18] An IAL bank could engage in a similar practice, for instance threatening homeowners that are late in payments with rapid foreclosure and eviction if the owner does not agree to quickly liquidate their property. IALs might also increase their use of balloon payments, becoming less forgiving in late payments, or engage in outright fraud in an effort to force property owners to sell. Of particular concern is that this predatory behavior would likely focus on long time homeowners whom are nearing the end of their mortgage. When the mortgage is paid in full the IAL not only loses the income stream they also lose any power and influence they might have had to force a sale. Therefore as the 30th year approaches we would expect to see more desperate, (or less accommodating) action by the lender. Unfortunately most homeowners nearing the 30th year tend to be the elderly, a group that as a whole is much more susceptible to unfair trade practices and one that has been a preferred target of predatory lenders in the subprime market. Once again, we do not desire to detail all the potential types of predatory practices the lender might use (indeed such a list would be impossible as the creativity predatory lenders have shown in the subprime market in creating deceptive practices would be truly impressive if not for the negative consequences), we simply want to show that incentives now exist for behavior that otherwise would not.

E. Conflict of interest

Currently agents represent buyers and sellers in the home buying process while other services such as mortgages are provided by outside third parties. Typically the agent's compensation is a percentage of the property's selling price so that the agent receives more income the more expensive the home. Under this remuneration policy, the agent does have the incentive to encourage the buyer to purchase a more expensive home.[19] But the traditional separation between agent and lender has provided a market based constraint on such behavior since the mortgage provider wants to minimize the risk that the borrower will default on their loan. As a result the lender will only offer loans of a size that they believe the borrower can repay, which acts as a constraint to potential "upselling" on the part of the agent.

The proposed rule changes of course, remove this important restraining device. By combining agent and lender, and making default profitable for the lender, there is no longer any offset to upselling. The new incentive structure encourages the IAL to convince the buyer to purchase a more expensive home than perhaps they could afford. This comes with a considerable downside risk to the buyer but little or no risk to the IAL (and in fact as shown above would likely be profitable). Given the significant information asymmetries and the reliance customer's place on their agent, removing the constraints on upselling raises the potential for significant abuse. This could come in the form of outright predatory behavior, or in more subtle ways such as lax credit standards that are not themselves illegal. Such behavior, whether illegal or not, would likely result in a significant number of homeowners being placed in properties beyond their means putting them at a greater risk of default and foreclosure.

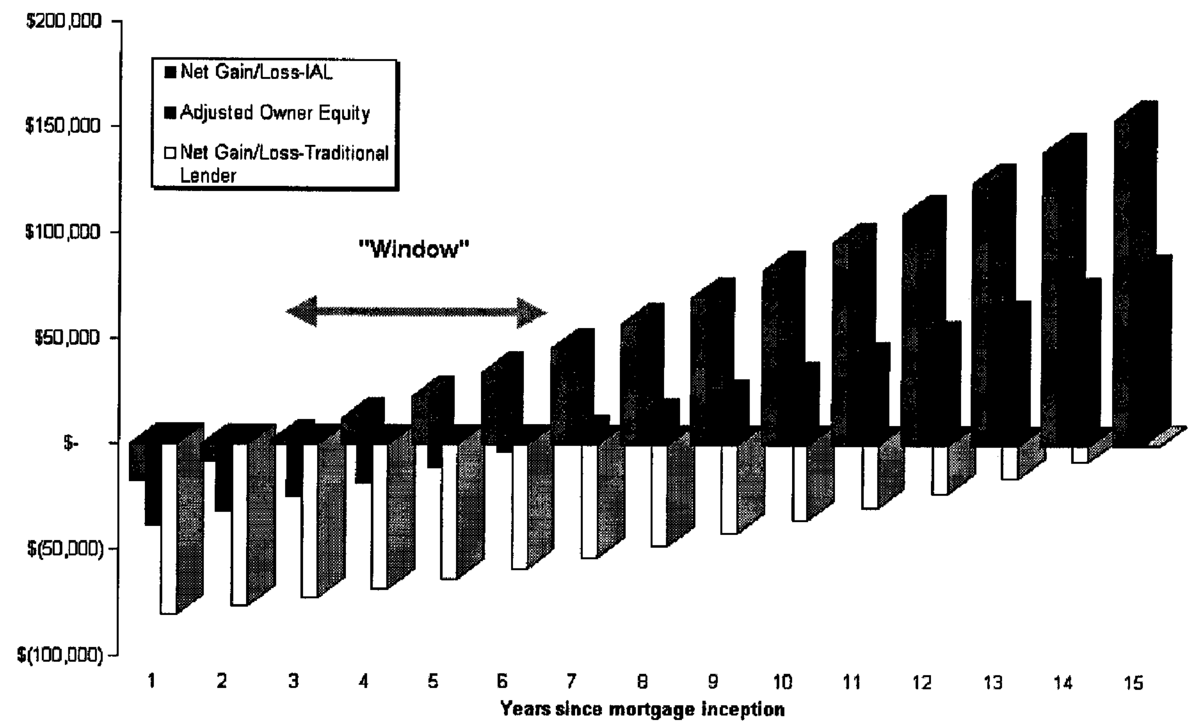
III. CONCLUSION

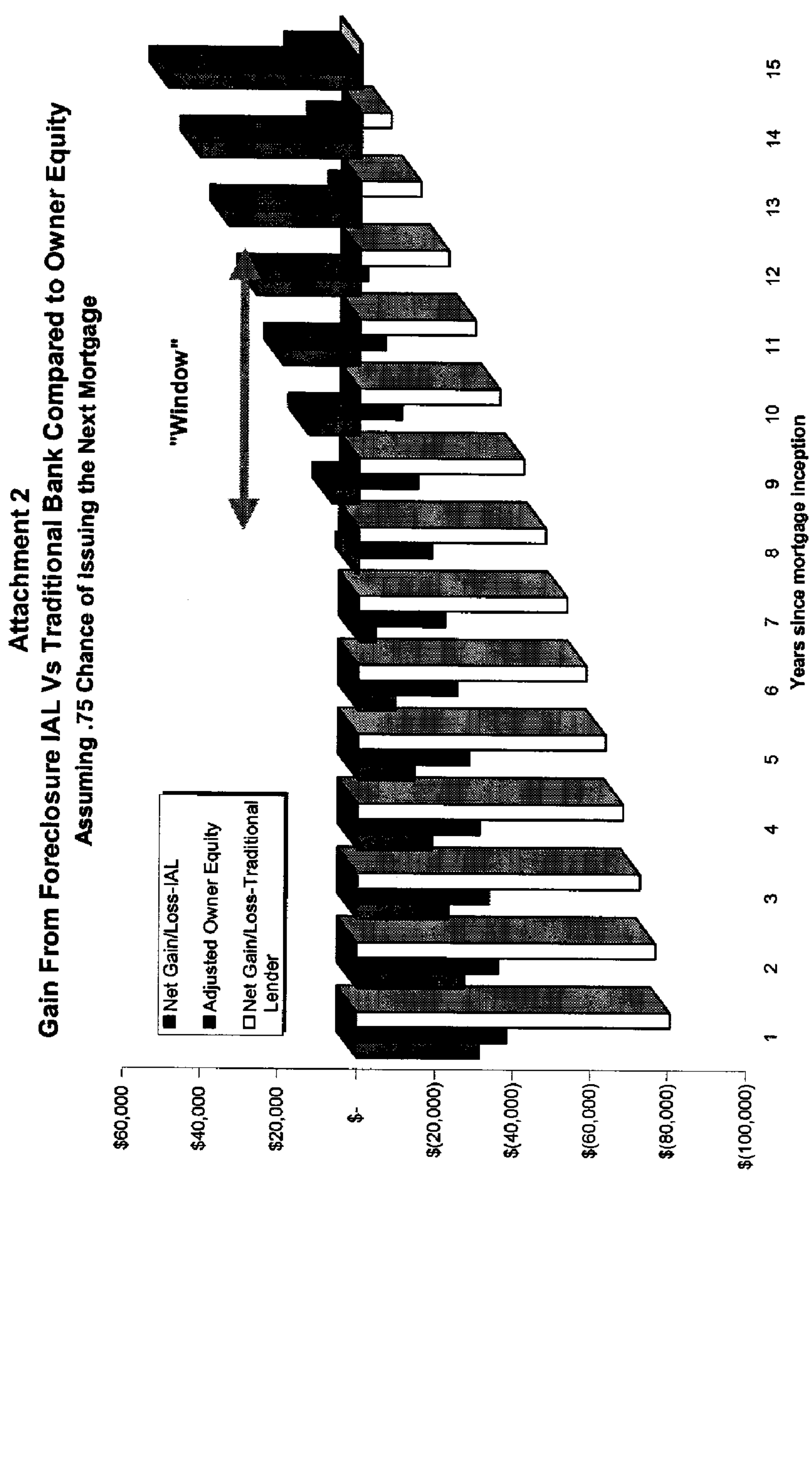
We have shown that the proposed rule changes to combine real estate agency with mortgage lending to have serious downside results. The new rules would fundamentally alter the incentive structure facing banks in their dealings with homebuyers and borrowers. As a result we would expect to see an increase in predatory and other unscrupulous behavior in the prime lending market and a corresponding increase in home foreclosures. Therefore, absent sizeable efficiencies we recommend against enactment of the rules as proposed by the Federal Reserve and Treasury.

[18] Neighborhood Reinvestment Corporation Joint Center for Housing Studies of Harvard University. Understanding Predatory Lending: Moving Toward a common Definition and Workable Solutions. October 1999.

[19] In reality this potential conflict of interest is offset by the desire of the agent to quickly complete the transaction and the importance of reputation capital to the agent.

Attachment 1
Gain From Foreclosure IAL Vs Traditional Bank Compared to Owner Equity
Assuming 2% Home Price Appreciation





Attachment 2
Gain From Foreclosure IAL Vs Traditional Bank Compared to Owner Equity
Assuming .75 Chance of Issuing the Next Mortgage
Net Gain/Loss-IAL
Adjusted Owner Equity
Net Gain/Loss-Traditional Lender
"Window"
$60,000
$40,000
$20,000
$-
$(20,000)
$(40,000)
$(60,000)
$(80,000)
$(100,000)
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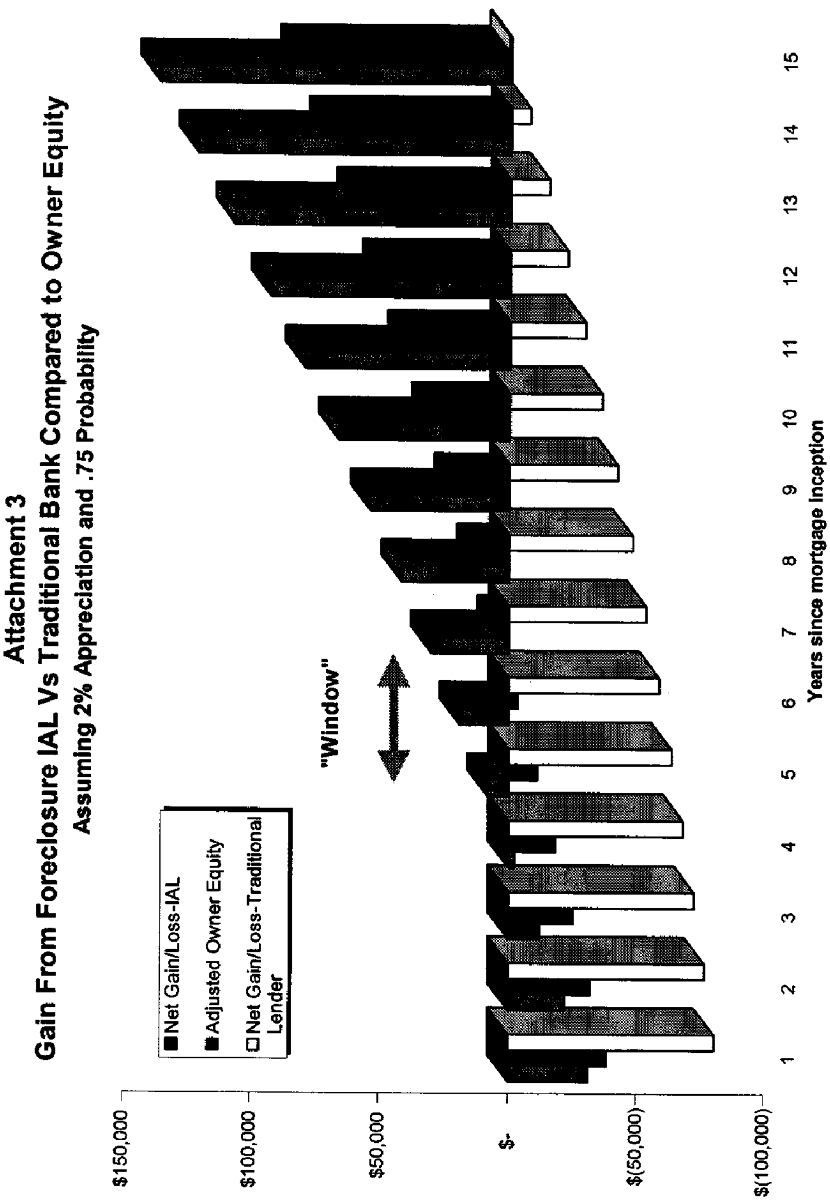
Years since mortgage inception


Attachment 3
Gain From Foreclosure IAL Vs Traditional Bank Compared to Owner Equity
Assuming 2% Appreciation and .75 Probability
Net Gain/Loss-IAL
Adjusted Owner Equity
Net Gain/Loss-Traditional Lender
"Window"
$150,000
$100,000
$50,000
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$(50,000)
$(100,000)
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Years since mortgage inception

REAL ESTATE BROKERAGE AND MANAGEMENT SERVICES AS PERMISSIBLE ACTIVITIES FOR BANKING ORGANIZATIONS: AN EVALUATION OF THE AGENCIES' PROPOSAL OF DECEMBER 2000

BY BERNARD SHULL [1]
PROFESSOR, HUNTER COLLEGE/CUNY

A PAPER PREPARED FOR THE NATIONAL ASSOCIATION OF REALTOR®S®
APRIL 25, 2001

I. INTRODUCTION

The Board of Governors of the Federal Reserve System (Board) and the Secretary of the Treasury (Secretary) (in combination, the Agencies) have proposed rules and requested comment (the "Proposal") that would establish real estate brokerage and management services as "financial in nature or incidental to a financial activity" under provisions of the Gramm-Leach-Bliley Financial Modernization Act of 1999 (GLB).[2] The rules would make these activities permissible for financial holding companies (FHCs) and financial subsidiaries of national banks (FSs).

This paper provides an evaluation of the analysis supporting the proposed rules. Section II presents a brief historical background of limits on banking activities. Section III outlines the purpose of GLB, the activity expansion it facilitates, and the legislative guidelines for the determination of new "financial" activities. Section IV examines the Agencies' "Proposal," describing and evaluating its analysis supporting the proposed real estate brokerage and management services rules, and summarizes the principal issues raised by this examination. Conclusions are presented in Section V.

In their "Proposal," the Agencies present information suggesting that real estate brokerage and management services are "closely related to banking" and, by inference, "financial in nature or incidental to a financial activity," that they are "necessary and appropriate" for banking organizations, and that there is little likelihood of adverse effects. They entertain arguments that the activities should be included as a statutorily listed financial activity.

This review raises a number of related analytic, factual and public policy issues with respect to these views. Among other things, it suggests that further information is needed to determine that an activity is "closely related to banking" and is "necessary and appropriate;" and that the Agencies' should provide a more extensive analysis of possible adverse effects. Overall, the review indicates the "Proposal" is incomplete. Appendix A provides a description of several studies that would help fill the gaps.

II. LIMITS ON BANK ACTIVITIES IN THE UNITED STATES

The corporate charter available to most private business firms in the United States provides a general right to engage in any lawful business. The banking charter has, from the earliest days of banking, limited the activities in which banks can engage. In parallel fashion, other commercial and industrial firms have been restricted from engaging in certain banking activities, in particular offering liabilities payable on demand. The limitations have changed over the years, with the GLB Act being the latest Congressional effort to define what banks, their affiliates and subsidiaries can and cannot do.[3]

The first rationale for limiting bank activities was that banks, because of their affiliation with government, had competitive advantages over other businesses and would tend to monopolize nonbanking markets.[4] This rationale was subsequently augmented by the belief that nonbanking activities could have adverse effects on

[1] Professor, Department of Economics, Hunter College of the City University of New York

[2] Board of Governors of the Federal Reserve System, "Proposed Rule on Real Estate Brokerage and Management Services." Page references are to the "Proposed Rule with Request for Public Comment," (referred herein to as the "Proposal") distributed under the Federal Reserve Press Release of December 27, 2000. The "Proposal" has been published in the Federal Register: Federal Reserve System, 12CFR Part 225 [Regulation Y; Docket No. R–1091] and Department of the Treasury, 12 CFR 1501, RIN 1505–AA84.

[3] For a more extensive review of the developments described in this section, see Shull, 1994.

[4] The earliest bank activity restrictions were embedded in bank charters, copied from the charter of the Bank of England that prohibited that Bank from dealing in merchandise. ". . . to the intent that their Majesties subjects may not be oppressed by the said corporation by their monopolizing or engrossing any sort of goods, wares or merchandise. . . . "

bank safety and soundness. Over the years, a succession of banking laws modifying activity restrictions have emphasized one or the other rationale, or both.

In the early decades of the Twentieth Century, both bank securities affiliates and bank holding companies became mechanisms for circumventing activity restrictions on banks. Bank affiliation with securities firms was dissolved with passage of the Banking Act of 1933 (Glass-Steagall Act provisions). The essentially unrestricted growth of bank holding companies was terminated with the Bank Holding Company Act of 1956. Bank holding companies were defined as organizations that owned 25 percent or more of the stock of two or more banks. Activities in which registered bank holding companies could engage were to be "of a financial, fiduciary, or insurance nature" and "so closely related to *the business of banking* or managing or controlling banks as to be a proper incident thereto" (emphasis added).

The Federal Reserve Board narrowly interpreted the term "the business of banking" to mean a relationship between the customers of specific banks and their nonbanking affiliates. Effectively, this interpretation prohibited bank holding company control of most nonbanking firms.

Initially, nearly all transactions between banks and their holding company affiliates were prohibited by Section 6 of the Act. In 1966, Section 6 was repealed and Section 23A of the Federal Reserve Act, which limited interaffiliate transactions, became effective.[5] Amendments in 1982 substantially liberalized transactions among affiliated banks. Section 23B was added to the Federal Reserve Act in 1991, requiring that interaffiliate transactions be on an arms-length basis.

In 1968 and 1969, large banks, wishing to expand the scope of their activities, began to reorganize as unregulated one-bank holding companies.[6] A number of public officials, including then President Nixon, viewed the new diversified one-bank holding companies as a threat to the competitive, free market system. They contended, among other things, that these companies would be able to coerce or induce from their customers tying and reciprocal agreements permitting them to leverage market power and injure competitors in the new lines into which they were entering.[7]

Congress simultaneously recognized that bank diversification through holding companies could intensify competition in some of the new markets entered, permit banking organizations to become more efficient, and contribute to customer convenience.[8] The Amendments to the Bank Holding Company Act in 1970 were an attempt to reconcile likely costs and benefits.

A key addition to the new legislation was in Section 4(c)(8) which authorized the Board to establish, under statutory guidelines, permissible lines of activities, into which all bank holding companies could enter. The guidelines authorized the Board to permit activities it had determined are "so closely related to banking or managing or controlling banks as to be a proper incident thereto."[9]

The "closely related to banking" phrase was elaborated in a Circuit Court decision in 1975. The Court indicated that the Board was required to ". . . articulate the ways in which banking activities and the proposed activities are assertedly connected, and must determine, not arbitrarily or capriciously, that the connections are close." It indicated that the following kinds of connections may qualify: "(1) banks generally have, in fact, provided the proposed services; (2) banks generally provide services that are operationally or functionally so similar to the proposed services as

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[5] With certain exceptions, Section 23A imposes a maximum of 10 percent of capital stock and surplus on loans by a bank to any one affiliate, and a 20 percent maximum for loans to all affiliates. The extension of credit is to be collateralized by securities having a market value at least equivalent to the credit extended.

[6] The exemption of one-bank holding companies under the 1956 Act had permitted some large commercial and industrial firms, including W.R. Grace, R.H. Macy and Corn Products Refining, to own a small bank, principally to accommodate employees. Until the mid-1960s, however, the one-bank company remained, for the most part, a small firm, controlling a small bank in a unit banking state.

[7] See, for example, the statement of President Nixon reprinted in Bank Holding Company Act Amendments, Conference Report, 1970, pp. 11–12. He and others indicated that the new holding companies might be able to achieve Zaibatsu-like status.

[8] The "purposes" of the Amendments of 1970 are not spelled out in the legislation itself. The factors leading to the legislation are, however, discussed in detail in congressional reports. See *Bank Holding Company Act Amendments*, Conference Report, 1970, pp. 11–13; *Bank Holding Company Act Amendments of 1970*, Senate Report, pp. 1–4; and *Bank Holding Companies*, House Report, 1969, pp. 2–3. The principal concerns leading to the legislation are also discussed in Goodell and Proxmire, 1970, pp. 34–43.

[9] The phrase "so closely related to the business of banking or managing or controlling banks. . . . " in the old Act was modified to eliminate the term *"the business of"* with the intention of making clear that the new nonbanking activity should be related to banking in general, and not to the business of specific institutions.

to equip them particularly well to provide the proposed services; and (3) banks generally provide services that are so integrally related to the proposed services as to require their provision in a specialized form." [10]

The law itself made clear that the "proper incident thereto" phrase established a "net public benefits" test that required the Board, when evaluating a new activity, to weigh the potential benefits from greater convenience, increased competition, or gains in efficiency against the potential costs of undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices.[11]

In Hearings in 1969 and 1970, insurance agents, travel agents, security brokers and dealers and data processors, among others, expressed concern about the difficulties of having to compete with banks.[12] Then Assistant Attorney General Richard McLaren and Chairman of the Federal Reserve Board, William McChesney Martin testified to the effect that tie-in and reciprocal agreements were mechanisms by which commercial banks might create high levels of concentration in the United States.[13] Even though the Board was directed to consider whether a new activity might result in decreased or unfair competition and an undue concentration of resources in applying the "net public benefits" test of Sec. 4(c)(8), Congress also enacted the anti-tying restrictions of Section 106 as a complement.

> "Section 106 . . . will largely prevent coercive tie-ins and reciprocity. . . . But the dangers of 'voluntary' tie-ins and reciprocity are basically structural and must be dealt with by the Board in determining the competitive effects of bank holding company expansion . . . under Section 4(c)(8)." [14]

III. THE GRAMM-LEACH-BLILEY ACT

Activity restraints, under the Bank Holding Company Act, were both circumvented and modified by law and regulation in the 1980s and 1990s. Beginning in the early 1980s, nonbanking firms found it possible to acquire so-called "nonbank banks" that were, by definition, not banks for holding company purposes but could provide deposit services or commercial loans. Unitary thrift holding companies were permitted affiliation with all types of businesses.[15] The Board interpreted the Glass-Steagall Act and Section 4(c)(8) of the Bank Holding Company Act to permit holding companies to deal in otherwise non-permissible securities (Section 20 subsidiaries).[16] Court decisions expanded the scope of insurance activities of national banks.[17]

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[10] *National Courier Association v. Board of Governors of the Federal Reserve System*, 516 F.2d 1229, 1237 (1975).

[11] The Board has generally applied the "net public benefits" test to the specific facts of a holding company application to engage in a "closely related" activity. For a recent evaluation of a holding company application to engage in a previously unauthorized activity, see *Bayerische Hypo- und Vereinsbank AG*, 86 Fed. Res. Bul. 56 (2000). But the Board has also had the occasion to apply the test more generally to a new activity, aside from the specific facts of an application. It did so in evaluating whether the operation of a savings and loan association was a permissible activity in 1977; and found that, while "closely related," the operation of a savings and loan association was not "a proper incident thereto." See *D.H. Baldwin & Co.*, 63 Fed. Res. Bul. 280 (1977). Because of automatic approval procedures based on notification, a former Assistant General Counsel to the Board suggested, a few years after passage of the 1970 Amendments, that applying the test more generally was appropriate; approvals of specific applications might not be warranted unless ". . . the balance of public benefits would normally be favorable . . ." in the event of entry that did not require Board approval; i.e., *de novo entry*. See Heller, 1976, pp. 230–31, note 3.

[12] *Bank Holding Company Act Amendments*, April, May, 1969; *One Bank Holding Company Legislation of 1970*, May 1970.

[13] Martin, 1969, pp. 196–204; McClaren, 1969, pp. 91–95; and, McClaren, 1970, pp. 238 ff. and pp. 268–74.

[14] On the legislative background and economic significance of the restrictions imposed by Section 106, see Shull, 1993.

[15] Legislation in 1959 limited such holding companies to no more than one insured S&L. The S&L Holding Company Act of 1968 left unitary S&L holding companies unrestricted if they maintain a minimum percentage of assets in residential mortgages and other specified securities. Because S&Ls and other thrift institutions were granted new banking powers in 1980, permitting them to offer commercial loans and checkable deposits, unitary thrift holding companies were able to combine traditional banking products with other financial and commercial activities.

[16] *Citicorp/J.P. Morgan/Bankers Trust N.Y. Corp.*, 73 Fed. Res. Bul., 473 (1987).

[17] Offering insurance was not included among the powers provided national banks by the National Banking Act (1863–64). In 1916, however, Congress provided that national banks located and doing business in towns with a population of not more than 5,000 could act as the agent for any fire, life, or other insurance company. In 1995, the Supreme Court, accepted the OCC's

Continued

Passage of GLB in 1999 established a new framework for activity expansion for banking organizations in the United States. Its general purposes, the kinds of new financial activities it permits, and the legislative guidelines it provides for determining an activity to be "financial" are described below.

A. Purposes

GLB is complex legislation that establishes new types of permissible activities, new corporate organizational arrangements for engaging in these activities, new methods for determining additional activities, and a new regulatory framework. It expands the scope of permissible banking organization activities and rationalizes the process through which these activities can be entered.

In general, Congress intended GLB to enhance competition in the financial services industry by eliminating legal and regulatory barriers separating different types of financial service providers and by facilitating affiliation among them. In particular, GLB aims at facilitating the affiliation of commercial banks, securities firms and insurance companies.[18] At the same time, Congress intended to sustain the traditional separation between banking and commerce.

Prior to GLB, the separation of banking and commerce was debated extensively. Congressman Leach, a principal author of the Act, has repeatedly voiced his objections to mixing:

> ". . . initially the Department of the Treasury, powerful banking and commercial interests, and the majority of my Committee and of the leadership of Congress advocated a modernization approach that would have mixed commerce and banking. Three years ago the Fed announced support for a 'basket' approach that amounted to much the same thing. Of all the things I am proud of in the modernization legislation it is that our government's two principal financial bodies—the Treasury and the Fed—changed judgement and today adamantly stand with me against mixing commerce and banking. There should be no misunderstanding. If this precept had been included in the final legislative product, I would have done my best to pull the plug on financial modernization.[19]

The intention to disallow a general integration of banking and commerce is explicit in the Senate Report on the bill. In explaining what the Board must consider in establishing new activities that are "financial in nature or incidental to financial activities," the Report states:

> "This authority includes authority to allow activities that are reasonably connected to one or more financial activities. . . . The authority provides the Board with some flexibility to accommodate the affiliation of depository institutions with insurance companies, securities firms, and other financial service providers while continuing to be attentive not to allow the general mixing of banking and commerce in contravention of the purposes of this Act."[20]

With a view toward maintaining separation, GLB imposes restrictions on permissible merchant banking activities. It prohibits the chartering of new unitary thrift holding companies, that provided a relatively unrestricted method for combining banking and other businesses, and the sale of existing companies to commercial firms.[21]

The Board recognized Congressional intent to maintain a separation between banking and commerce soon after the Act was passed when it issued its interim rule on merchant banking.

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determination that the brokerage of annuities should be classified as investments, not insurance, and could be reasonably be included as an "incidental power. See *NationsBank v. Variable Annuity Life Insurance Co.*, 115 S.Ct. 810 (1995). In 1996, the Court held that state law could not prevent a national bank, affiliated with a bank holding company, and doing business through a branch in a small town, from selling insurance through a state-licensed insurance agency. States could not prevent or interfere with the ability of a national bank to sell insurance from a "place" with a population of less than 5,000, even if the actual insurance sales were outside the small town See *Barnett Bank of Marion County N.A. v. Nelson*, 517 U.S. 25 (1996).

[18] *Conference Report on Gramm-Leach-Bliley Act*, 1999, pp. 1, 151.

[19] Leach, 2000.

[20] *Financial Services Modernization Act of 1999*, Senate Report, 1999, p. 21; Also see "Additional Views of Senators Sarbanes, Dodd, Key, Bryan, Johnson, Reed, Schumer, Bayh and Edwards," pp. 70–76.

[21] However, those in existence on or before May 4, 1999, or that filed an application before that date, retain authority to engage in nonfinancial activities. Mutual thrift holding companies can also engage in new financial activities authorized under Act.

> "Section 4(k)(4)(H) provides that a financial holding company may acquire or control shares of a company under that section 'as part of a bona fide underwriting or merchant or investment banking activity.' The Board and the Secretary wish to emphasize the importance of this requirement in preventing circumvention of one of the fundamental purposes of the GLB Act of maintaining the separation of banking and commerce." [22]

A recent public statement by a Board member confirms this general understanding; e.g., "the Congress specifically rejected commerce and banking in GLB. . . . " [23]

B. New Activities

GLB permits new activity expansion by repealing key sections of the Glass-Steagall Act that, for over 60 years, had limited the securities dealings of commercial banks and their affiliates.[24] It also amended the Bank Holding Company Act by adding a new section [4(k)] that permits holding companies that qualify to establish themselves as financial holding companies. These are permitted to engage in a broader range of activities than other holding companies, including activities that are "financial in nature, incidental to such activities" or "complementary" to financial activities, and merchant banking activities. National banks that meet similar qualifications are permitted, through a new type of financial subsidiary, to engage in some, but not all of the activities permitted to FHCs.[25] Insured state-chartered banks are permitted to engage in expanded activities through financial subsidiaries on essentially the same basis as national banks.

C. Legislative Guidelines

The Board has responsibility for determining activities that are "financial in nature, incidental to financial activities" in consultation with the Secretary of the Treasury. The Conference Report for GLB states that "permitting banks to affiliate with firms engaged in financial activities represents a significant expansion from the current requirement that bank affiliates may only be engaged in activities that are closely related to banking." [26]

The Act itself [Section 4(k)(5)] directs the Board to define, "consistent with the purposes of this Act," certain activities as "financial in nature or incidental to a financial activity." These "statutorily listed" financial activities include: (i) lending, exchanging, transferring, investing for others, or safeguarding money or securities; (ii) providing any device or other instrumentality for transferring money or other financial assets; and (iii) arranging, effecting or facilitating financial transactions for the account of third parties.

The Act also indicates four groups of factors that the Agencies' need to consider in determining whether an activity is "financial in nature or incidental." [27]

> (A) "the purposes of this [Bank Holding Company] Act and the Gramm-Leach-Bliley Act Act;
>
> (B) changes or reasonably expected changes in the market place in which financial holding companies compete;
>
> (C) changes or reasonably expected changes in the technology for delivering financial services; and
>
> (D) whether such activity is necessary or appropriate to allow a financial holding company and the affiliates of a financial holding company to
>
> > (i) compete effectively with any company seeking to provide financial services in the United States;

[22] Board of Governors of the Federal Reserve System and Treasury Department March 17, 2000, pp. 8, 9.

[23] Meyer, 2001, p. 11.

[24] GLB repeals two of the four sections of the Banking Act of 1933 known as the Glass-Steagall Act. It repeals Section 20, that prohibited banks from having affiliates principally engaged in dealing in securities, and Section 32, that prohibited interlocks of directors and officers of securities firms and banks. It does not repeal Section 16 of the Glass-Steagall Act, that limits banks that deal in and underwrite securities to specified types—obligations of the Federal government and general obligations of states and political subdivisions. Nor does it repeal Section 21, that prohibits firms dealing in securities from accepting deposits. These sections continue to preclude "universal banking," in which all investment banking activities may be conducted within the bank itself (Title I, Sections 101).

[25] With some exceptions, activities explicitly not permitted to national banks include: 1) insurance or annuity underwriting; (2) insurance company portfolio investments; (3) real estate investment and development; and (4) merchant banking.

[26] Conference Report, Gramm-Leach-Bliley Act, 1999, p. 153.

[27] Title I, Section 103; see also "Proposal," p. 4.

(ii) efficiently deliver information and services that are financial in nature through the use of technological means, including any application necessary to protect the security or efficacy of systems for the transmission of data or financial transactions; and

(iii) offer customers any available or emerging technological means for using financial services or for the document imaging of data."

Factors listed in B, C and D clearly reflect the congressional intention to permit the FHC and FSs a broader range of financial activities. Factor A cites the purposes of the Bank Holding Company Act and GLB. A purpose of both Acts was to maintain a separation of banking from commerce.

GLB also makes Sections 23A and B of the Federal Reserve Act applicable to national banks and their financial subsidiaries. The anti-tying provisions of the Bank Holding Company Act (Sec. 106) are also made applicable to national banks and their subsidiaries. Cross-marketing among depository institutions and their affiliates and subsidiaries are subject to rules and regulations imposed by the Federal banking agencies.[28] The Act does not permit cross-marketing arrangements between depository institutions and affiliated non-financial (commercial) businesses. The "adverse effects" terminology of the Bank Holding Company Act is used in giving the Board authority "to impose restrictions or requirements on relationships or transactions. These include: (A) between a depository institution subsidiary of a bank holding company and any affiliate . . . ; or (B) between a state member bank and a subsidiary of such bank; . . . " to prevent significant risks to bank safety "and other adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices." The Act provides the OCC with similar authority for national banks and their subsidiaries.[29]

IV. THE AGENCIES' ASSESSMENT OF "FINANCIAL IN NATURE"

The Agencies' assessment begins by evaluating the "closeness" of real estate brokerage and management services to banking. This is followed by a consideration of whether these activities are "necessary or appropriate," an evaluation of the likelihood of adverse effects if they are held to be so, and, finally, the likelihood that the activities can be subsumed under one or more of the statutorily listed financial activities.

In the following sections, the Agencies' views in each of these areas are first summarized, and then followed by commentary.

A. "Closely Related to Banking"

The "closely related to banking" test, as discussed, was introduced in 1970 under Sec. 4(c)(8) of the Bank Holding Company Act. It is not included in GLB among the factors to be considered in determining whether an activity is "financial in nature or incidental to a financial activity."

1. "Proposal"

The Agencies contend that the "closely related" standard is relevant in evaluating whether an activity is "financial in nature or incidental." The "Proposal" states:

> "Because the new 'financial in nature or incidental' test appears to be substantially broader than the old 'closely related to banking' test, the Agencies believe that they should consider an activity to be financial in nature or incidental to a financial activity to the extent that it meets the old standard."[30]

As noted, for an activity to be "closely related to banking," it must be shown that banks generally have provided the proposed services, generally provide services that are operationally or functionally similar to the proposed services, and generally provide services that are integrally related to the proposed services. In 1972, the Board held that ". . . real estate brokerage is not an activity that the Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto."[31] In the same year, the Board indicated that it did

[28] Experience has indicated that cross-marketing of banking products with the products of other affiliates may create customer misunderstanding as to whether a product is that of an insured depository institution, regulated, supervised and the beneficiary of a Federal "safety net," or of some other affiliated company; and, in particular, whether a debt instrument is or is not a federally-insured deposit.

[29] Title I, Sec. 114(a) and (b).

[30] "Proposal," p. 5.

[31] *Boatmen's Bancshares, Inc.*, 58 Fed. Res. Bul. 427, 28 (1972); see also "Proposal," pp. 6, 7.

". . . not consider property management services [to be] a permissible activity for bank holding companies under Section 4(c)(8)." [32]

The Agencies suggest that changes in the financial services environment may, today, lead them to a different conclusion.[33] They begin their consideration by presenting information on the "closeness" of real estate brokerage and management to banking.

The "Proposal" supplies a substantial amount of information it judges relevant. Among other things: (1) some states permit state-chartered banks to act as real estate brokers; (2) the Office of Thrift Supervision (OTS) permits savings association service corporations to engage in real estate brokerage; (3) banking organizations engage in other real estate activity, and in most aspects of typical real estate transaction; (4) banking organizations engage in functionally and operationally similar activities; (5) many aspects of real estate brokerage are permissible under the new "finder authority" the Agencies have found permissible; (6) banking organizations have the authority to assist third parties in obtaining commercial real estate equity financing for others; and (7) national banks are permitted to assist in a variety of ways in the purchase or sale of real estate.[34]

With respect to real estate management, the Agencies find that neither OCC nor state banking departments have permitted banks to provide general services. But thrift holding companies and thrift service corporations have been permitted to do so. Some real estate management services appear to be functionally and operationally similar to other activities of banking organizations; e.g., collecting rent, maintaining security deposits, making payments, providing accountings. Moreover, "banks and bank holding companies have a long history of managing real estate assets that are part of trust estates, that are used by the banking organization in its own operations, or that are acquired as the result of foreclosure.[35]

2. Discussion.

The Agencies' view that activities determined to be "closely related to banking" must be "financial in nature or incidental to a financial activity" raises a question as to the balance of public benefits in permitting FHCs and FSs to engage in the activity. FHCs may engage in any activity that is determined to be "financial in nature" without prior approval. In consequence, no Board evaluation of net public benefits, in general or on a case by case basis, is likely to be required if an activity is determined to be "financial in nature" because it is "closely related." Traditional holding companies, on applying to enter a new activity, must still satisfy a net public benefits test on the determination that the activity is "closely related to banking." Since the "net public benefits" test was designed to protect against the problems raised as a result of activity expansion that breaches the banking/commerce barrier, its avoidance by more highly diversified FHCs is an anomaly.

Some of the information in the "Proposal" may be relevant for the "closely related" evaluation; but some is of dubious significance; and some, if accepted as relevant, would imply little or no limit as to what nonbanking activities are "closely related." Questions related to information are discussed below as follows: (a) other legal and regulatory arrangements that permit banks or savings associations to offer real estate brokerage; (b) real estate-related activities in which banks currently engage; and (c) services by real estate brokers and managements that are functionally similar to services provided by banking organizations. Also discussed below (d) is what changes, if any, since the Board's 1972 decisions on real estate brokerage and management, suggest that the activities are more closely related to banking now than then.

a. Other legal and regulatory arrangements. The fact that some states permit state-chartered banks to act as real estate brokers, and that the OTS permits the service corporations of savings association to engage in real estate brokerage is of questionable significance. In the United States, multiple regulators produce an impressive, sometimes baffling, diversity of law and regulation affecting similar institutions.[36] Without further information on the circumstances in which other regulators have made their decisions, the invocation of an activity so authorized to sup-

[32] "Bank Holding Companies: Property Management Services," 58 Fed. Res. Bul. 652 (1972); see also "Proposal," p. 19.

[33] "Proposal," p. 16.

[34] "Proposal," pp. 8–11.

[35] "Proposal," p. 18.

[36] See, for example, Howard Hackley, "Our Baffling Banking System," *Virginia Law Review*, Parts I and II, May-June, 1966; former Chairman of the Board, Arthur F. Burns, complained about "a competition in laxity." See "Maintaining the Soundness of Our Banking System," Address at the American Bankers Association Convention, Honolulu, Hawaii, October 21, 1974.

port a “closely related” determination grants the other regulator(s) an unwarranted influence.

The “Proposal” also indicates that bank trust departments have, for many years, been involved in the purchase and sale of real estate. But trust departments, fully insulated from the everyday operations of banks by law and regulation, have long been permitted to engage in a wide variety of nonbanking activities. The citation of one or more of these nonbanking activities as supporting a “closely related” determination is a mismatched comparison of the proposed new activity to an activity that has been kept separate from ordinary banking operations.

With respect to real estate management, the Agencies find that neither the OCC nor state banking departments have permitted banks to engage in this activity. The “Proposal” does refer to authority granted thrift holding companies and thrift service corporations, but this comparison raises the same questions as those noted above with regard to real estate brokerage.

b. Real estate-related activities. Banking organizations have engaged in a number of the real estate-related activities cited for many years. The “Proposal” observes, as noted, that banking organizations have long managed real estate assets in trust, for their own operations and that are acquired in foreclosure. It is worth noting that when the Board rejected real estate management as a permissible activity in 1972, this was also the case. In its announcement, the Board indicated that its action was not “. . . intended to limit the authority presently conferred by statute or regulation on bank holding companies and their subsidiaries to engage in . . . property management activities with respect to . . . : (a) properties held in a fiduciary capacity. (B) properties owned . . . for conducting its own . . . operations. (C) properties acquired . . . as a result of a default on a loan.”[37] Banks have been active in these areas for as long as they’ve had the authority to act as fiduciaries, make loans collateralized by real estate, and seize collateral when loans default.

c. Activities that are functionally similar. The “Proposal” contends that services provided by real estate brokers are functionally and operationally similar to brokerage services that banking organizations are permitted to provide; e.g., services related to securities derivatives and insurance. The functional similarity appears to involve brokerage, and not the underlying asset (real estate). If underlying assets are ignored, the brokerage services of banking organizations may be viewed as functionally and operationally similar to any type of brokerage services be it for commodities, automobiles, armaments, or even Tennessee walking horses. If so, there might be no limit to the nature of the transaction services FHCs and FSs might be permitted to provide.

The Agencies also cite recent decisions by the Board and the OCC permitting title insurance and other insurance related to real estate transactions; and also “finder authority” with regard to real estate transactions. The use of earlier regulatory agency decisions to support later decisions implies a expanding set of “closely related” activities. Thus, if real estate brokerage and management services are determined to be “financial in nature or incidental,” real estate itself could be viewed as closer to banking. If real estate was accepted as “financial in nature,” a possibility raised in the “Proposal,” then how far behind could commercial operations that are real estate intensive be; e.g. real estate developments and farming.

Similarly, the finder authority permitting FHCs and FSs to bring buyers and sellers of financial and nonfinancial products together could serve to make banking “closely related” to any transaction activity, with the underlying assets, then, becoming more “closely related to banking.”

Making payments and providing accountings, among other things, are cited as functionally and operationally similar to some of the services of real estate management. These activities are, of course, functionally and operationally similar to activities in any commercial enterprise. If they support a “closely related” determination for real estate management, they could support a “closely related” determination for any type of activity.

d. Changes since 1972. The question remains as to what, if anything, has changed between 1972 and 2001 to persuade the Agencies to alter the Board’s determination that real estate brokerage and management are not “closely related to banking.” As noted, some of the activities cited are old, and were permitted to banking organizations long before 1972. Some are recent and, if used to support the proposed change, provide a basis for a seemingly unlimited expansion of the set of activities that are “closely related to banking.”

More generally, the Agencies state that: “. . . the financial services environment has changed significantly in the past 30 years, and what may have been an inappropriate activity for bank holding companies in the early 1970s may be appropriate

[37] 58 Fed. Res. Bul. 652 (1972).

for the diversified FHCs of the early 21st Century."[38] The recent powers granted by the Agencies aside, there is no indication in the "Proposal," except for the allusion to "the diversified FHCs of the early 21st Century," as to what specific environmental changes compels a change in the Board's 1972 determination. The implication of less risk in more highly diversified FHCs is unsubstantiated in the "Proposal." Moreover, if the point has relevance, it would not be in meeting the "closely related to banking" standard, but in considering the likelihood of adverse effects, or in applying the "net public benefits" test.

B. "Necessary and Appropriate"

As described above, GLB indicates four sets of factors to be considered by the Board in determining whether an activity is "financial in nature or incidental." The principal focus in the "Proposal" is on whether real estate brokerage and management are "necessary and appropriate to allow a FHC . . . to compete effectively with any company seeking to provide financial services in the United States. . . ."[39]

1. "Proposal"

Prior to the passage of GLB, the Agencies indicate, the law did not explicitly authorize the Board to consider whether other financial service firms engaged in an activity in evaluating whether or not it would be permissible. The change significantly expands the Board's authority "to consider the competitive realities of the U.S. financial marketplace in determining the permissibility of activities for FHCs."[40]

The Proposal indicates that the American Bankers Association (ABA) has addressed the question as follows: ". . . buyers and sellers of real estate are increasingly looking to a single company to provide all their real estate-related needs."[41] The ABA has also provided information about a number of diversified nonbank financial companies that provide real estate brokerage services. Reference is made to GMAC, Prudential Insurance Co., Cendant Corporation, and Long & Foster.[42] Similarly, with respect to real estate management, the ABA has argued that competitive considerations support the proposed rule.[43]

2. Discussion

Given that the "financial in nature or incidental" standard provides for a broader range of activities than the "closely related" standard, its parameters are not completely clear. GLB, as noted, provides a list of activities, in general terms, that are "financial," and a list of factors the Board is to consider when making a determination. But it does not provide an operational definition comparable to the one provided in the *National Courier* case for "closely related to banking".

The information provided by the ABA is not sufficient to conclude that real estate brokerage and/or management are necessary to allow FHCs to compete effectively for several reasons. First, there is no information, even of an anecdotal nature, indicating that customers place value on one-stop real estate shopping that includes the related services banks provide, such as mortgage loans, and real estate brokerage and/or management.

Secondly, the evidence that nonbank affiliated companies provide real estate brokerage and/or management services is, at best, an intermediate step in evaluating whether the activities are "necessary and appropriate." As indicated above, the "necessary and appropriate" consideration is to allow a FHC and FSs to compete effectively with other financial service companies. The question of "effective competition" is not resolved simply by finding companies that offer a service not offered by these banking organizations. There needs to be some showing of loss or likely loss to banking organizations that have not been permitted to engage in the activity.

A need to show an impact on effective competition places a limit on the extent to which the aim of "competitive equality" drives an expansion of activities in the existing financial services environment; i.e., in an "industry" in which differences among different kinds of banking and nonbanking financial companies will exist as long as any significant separation between banking and commerce is maintained. For example, the fact that nonbanking companies provide one or more services that the banking organizations are not permitted ignores the fact that banking organiza-

[38] "Proposal," p. 16.
[39] "Proposal," pp. 11, 12.
[40] "Proposal," p. 11.
[41] "Proposal," p. 12.
[42] "Proposal," p. 12.
[43] "Proposal," p. 18.

tions provide services that nonbanking companies are not permitted to provide; i.e., depository services.

C. Adverse Effects

The likelihood of adverse effects was a critical element in evaluating new activities under the Bank Holding Company Act. The Agencies proceed differently under GLB.

1. "Proposal"

The Agencies recognize the possibility of adverse effects in determining new activities to be financial in nature or incidental.[44] But they indicate that real estate brokerage appears not to present significant risks to FHCs or FSs or their depository institutions. No principal, liquidity or market risks would be taken in connection with the real estate brokered. They do recognize the possibility of some operational and legal risks.[45]

The Agencies also cites safeguards in the law that would, presumably, mitigate adverse effects. These include the applicability of the anti-tying provisions of Section 106, limits on bank-affiliate financial transaction imposed by Sections 23A and 23B, and the restrictions on cross-marketing in GLB. Also cited are provisions of the Real Estate Settlement Procedures Act aimed at protecting customers. Finally, the "Proposal" notes the authority of the Board and the OCC to impose additional restrictions on transactions or relationships between a depository institution, and its subsidiaries and affiliates if it is found necessary to avoid adverse effects.[46]

Similarly in the case of real estate management services, the Agencies contend that permitting real estate management services does not expose FHCs or FSs, or their depository affiliates, to significant risk. However, it recognizes that there may be increased operational, legal and reputational risks.[47] As in the case of real estate brokerage, the "Proposal" cites the protections afforded by current law and regulation.[48]

2. Discussion

As indicated above, a number of potential adverse effects of activity expansion were included in the "net public benefits" test added by the 1970 Amendments to the Bank Holding Company Act. The Board was charged with considering effects, such as, but not limited to, undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices, as well as possible benefits.

In the "Proposal," as noted, the Agencies have evaluated the risks to the safety and soundness. With respect to other possible adverse effects, they rely on law and regulation as safeguards.

Sole reliance on existing law and regulation to forestall adverse effects is questionable, and runs counter to earlier congressional views and Board procedures. As discussed above, the anti-tying provisions of the Bank Holding Company Act (Sec. 106) were added by Congress in 1970 as a complement to the "net public benefits" test of Section 4(c)(8), not as a substitute. The same complementary function can be imputed to the Sec. 23A limits on interaffiliate transactions since they had been in existence for close to 40 years when the "net public benefits" test was added.

The "firewalls" erected by Sections 23A and B, discussed above, are intended to serve soundness and competitive objectives by preventing the transmission of injury from a floundering nonbanking affiliate to a federally-insured depository institution, and to prevent the extension of subsidies from the latter to the former. It is widely believed that they work reasonably well in good times, are prone to deteriorate in bad times, and are unlikely to work at all in extremis. Chairman Greenspan told Congress that he had "serious questions about the ability of firewalls to insulate one unit of a holding company from the funding problems of another."[49] Ricki Helfer, then Chairman of the FDIC stated in discussing Sections 23A and 23B, that "these firewalls are not impenetrable . . . of course, in times of stress firewalls tend to weaken, and transgressions have occurred both within and outside the reach of the regulators . . . pressure can be exerted on a bank from its holding company as well as from subsidiaries."[50] While such anecdotal evidence is illuminating, there ap-

[44] "Proposal," pp. 12–13, 19.
[45] "Proposal," pp. 23, 14.
[46] "Proposal," p. 13, note 28.
[47] "Proposal," p. 19.
[48] "Proposal," p. 19.
[49] Greenspan, 1990. On the imperfect nature of firewalls, see Shull and White, 1998.
[50] Helfer, 1997, pp. 62, 67 ff.

pears to be no systematic data or empirical analysis on the extent to which firewalls are effective, in good times and bad.[51]

A similar critique might be made with regard to the anti-tying provisions of Sec. 106. Based on an examination of private suits under this Section over its first twenty-two years of existence (there were no government actions) it seems clear that, whatever purpose it has served, it has not been the procompetitive purpose envisioned by Congress.[52]

Uncertainty as to the effectiveness of the legal and regulatory safeguards, suggests the possibility that the structural transformations effected by the Agencies' determinations under GLB may impose pressure for regulatory interventions, based on Sec. 114 of GLB, to prevent "undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices." The conditions that might invoke such interventions, or their likely effectiveness are not evaluated in the "Proposal."

Over the past two decades, the merger movement in banking has resulted in a substantial increase in banking concentration. Even before passage of GLB, the growth of banking organizations to unprecedented size raised new concerns about the adequacy of supervision, the possibility of supervisory forbearance and federal government assistance for large banking organizations that are in difficulty.[53] The impact of the increasing size of banking organizations and rising concentration, as it applies to activity expansion, is not addressed in the "Proposal."

D. Real Estate Brokerage and Management as Statutorily Listed Activities

As noted above, GLB lists several general activities that it directs the Board to define as "financial in nature or incidental to a financial activity." Specific activities may be subsumed under these generalized activities.

1. "Proposal"

The "Proposal" indicates that the ABA has argued that real estate, itself, is a financial asset because (i) the home is the largest asset for many individuals; (ii) real estate services are the underpinnings for mortgage-backed securities; and (iii) real estate serves as a means of wealth creation and providing tax benefits. Therefore, real estate brokerage should fall within the listed financial activity of "lending, exchanging . . . safeguarding financial assets other than money or securities.[54]

The Agencies recognize that if real estate is a financial asset, its purchase and sale would be included as a listed financial activity. They acknowledge ". . . that real estate does have certain important attributes of a financial asset; namely, that individuals often purchase real estate, at least in part, for investment purposes and with a view toward the financial benefits of the transaction."[55] But they point out that financial assets are generally thought to be intangible property, and real estate is tangible. Moreover, many tangible assets with substantial value are used as collateral, but generally considered to be nonfinancial. They also note that many nonfinancial assets are purchased for investment purposes; e.g., stamps, art. Finally, real estate may be held for non-investment purposes as well.[56]

The ABA also argues that purchase, sale or lease of real estate is a financial transaction because it is the most important, complex, and financially difficult transaction most individuals undertake. It falls within the listed activity of "[a]rranging, . . . facilitating financial transactions for the accounts of third parties." The Agencies do not accept these characteristics as determining whether a transaction is financial in nature. But they do recognize that real estate transactions often are for investment purposes and, to that extent, have some aspects of a financial transaction.[57]

Similarly, the ABA contends, with respect to real estate management, that it should be subsumed in the listed activity of "lending, exchanging, transferring, investing for others . . . assets other than money."[58] The Agencies recognize that if it were to conclude that real estate is a financial asset, the argument would have merit. The ABA has also argued that Agencies should find real estate management

[51] Violations of Sections 23A and 23B for the years 1990 and 1991 are reviewed in a study of bank insider activity by the General Accounting Office, 1994. Data deficiencies are discussed on pp. 59–63.
[52] Shull, 1993.
[53] For an elaboration of these issues, see Shull and Hanweck, 2001, Ch. 6. On the growth of concentration in U.S. banking, see Rhoades, August 2000.
[54] "Proposal," p.14.
[55] "Proposal," p. 14.
[56] "Proposal," pp. 14, 15.
[57] "Proposal," p. 15.
[58] "Proposal," p. 19.

a listed activity included in "arranging, effecting, or facilitating financial transactions for the account of third parties. The Agencies acknowledge that real estate management does facilitate financial transactions; but it has nonfinancial attributes as well.[59]

2. Discussion

The Agencies do not accept the argument that real estate is a financial asset, but indicate that it has certain attributes of financial assets. Nor do they accept real estate transactions as a financial transaction, though they recognize that, to the extent such transactions are often for investment purposes, they have financial aspects.

The Agencies' position appears to be that assets and transactions have financial and nonfinancial attributes, and that financial attributes may be inferred from the use of assets or transactions that serve the purposes of investment and financial benefit.[60] Then, presumably, activities involving assets and/or transactions, with some "measure" of financial attributes, are "financial and nature or incidental" or subsumed by the statutorily listed group of financial assets.

The ability to determine "financial activities" on the basis of attributes suggests a well-specified paradigm, including careful definition of what are financial and nonfinancial attributes of assets and transactions, a method of aggregation, and a decision rule on the "attribute characteristics" of activities that are "financial." If the Agencies have such a paradigm, it should be fully disclosed so that public comment can be forthcoming.

E. Review of Principal Issues

The "Proposal" to make real estate brokerage and management services permissible for FHCs and FSs raises a number of issues that have been examined as they developed in the course of the Agencies consideration of the concepts of "closely related," "necessary or appropriate," "adverse effects," and "statutorily defined." The principal questions found in this examination are summarized below as issues of analysis, fact and public policy. References to the above subsections of IV in which each issue is discussed are indicated in parentheses.

1. Analytic Issues

On the belief that any activity found to be "closely related to banking" must be "financial in nature or incidental," the Agencies present a variety of evidence in support of real estate brokerage and management as being "closely related to banking." The presumption that "closely related" transforms into "financial in nature" under the Gramm-Leach-Bliley Act, without any "net public benefits" test, raises the anomaly of permitting FHCs and FSs to engage in activities that may involve net public costs and that would not be permitted for traditional bank holding companies (A.2).

Some of the changes in material factors over the recent past, arguably making the real estate brokerage and management services more "closely related to banking," derive from the laws or regulations applicable in other regulatory domains. By implication, other regulators may expand the scope of what is "closely related to banking" (A.2).

Some of the changes derive from recent Board and Treasury (OCC) decisions. The approval of new activities found to be "financial in nature or incidental" serves to move other nonbanking activities closer to banking—not closer to the banking of 1972, or even the pre-GLB banking of 1999, but to the set of financial activities approved for FHCs and FSs under GLB. This approach to determining "closely related" is a recipe for unlimited activity expansion. (A.2).

"Necessary or appropriate" is the principal factor, among the four sets that GLB charges the Board to consider that is addressed in the "Proposal." The first set of factors requires consideration of the purposes of the Bank Holding Company Act and GLB. One key purpose of both these laws was to maintain a separation of banking and commerce. This purpose is not considered in the "Proposal" (B).

2. Factual Issues

The "closely related" factors presented in the "Proposal" may or may not be sufficient to overcome the Board's 1972 determination that neither real estate brokerage nor real estate management are permissible. Many of the characteristics cited and

[59] "Proposal," p. 20.

[60] Of course, some financial assets may be held for financial benefit, but not as "investments" in the conventional sense; e.g. money held for precautionary and transactions purposes; the same is true of some financial transactions that are for financial benefit, but not investment; e.g., cashing checks.

comparisons made in the “Proposal” could have been cited in 1972 or earlier. There is little systematic information in the

“Proposal” about changes since that time that would compel a different determination (A.2).

That real estate brokerage and management services provided by non-bank affiliated financial service companies, does not in itself permit a conclusion that these activities are “necessary or appropriate” for FHCs and FSs to compete effectively with them. There is no discussion in the “Proposal” as to how the question of effective competition should be addressed. A “necessary or appropriate” finding should require information on loss or likely loss, if any, to banking organizations deriving from their inability to engage in a particular activity (B.2).

The Agencies consideration of whether real estate brokerage and management may be included as statutorily listed financial activities suggests an approach for making such a determination based on financial and nonfinancial attributes of assets and transactions. It may be inferred that the Agencies have a model for such determinations. If such exists, it should be available for public comment (D.2).

3. Public Policy Issues

The Agencies explicitly evaluate a number of the risks that real estate brokerage and management activities present to FHCs, FSs and their depository affiliates. With respect to other possible adverse effects, including undue concentration of resources, decreased or unfair competition, and conflicts of interest, they contend that existing law should provide sufficient protection (C.1).

Experience suggests that legal and regulatory restrictions, however well intended, are not dependable remedies for adverse structure-generated behavior that might develop out of Board and Treasury determinations. This is why Congress established a “net public benefits test” when it amended the Bank Holding Company Act in 1970, in addition to the anti-tying provisions of Section 106 and the interaffiliate transaction limits of Section 23A. Effective public policy requires that the likelihood of adverse effects be evaluated before, not after, a new activity is approved (C.2).

The limited attention given to the likelihood of adverse effects, the endogenous process for defining what is “closely related to banking” and “financial in nature or incidental,” and an expansive interpretation of what is meant by a level playing field, implies few limits on the scope of what is likely to be determined a “financial activity.” This approach runs counter to congressional intention to maintain a separation between banking and commerce.

The possibility that the cumulative decision-making by the Agencies will expand the scope of “banking” at the expense of “commerce” has been recognized by Governor Meyer. In a recent address about GLB, he states:

> “[T]he structure, of course, has some obvious tensions that, themselves, reflect some difficult compromises. These tensions . . . mean that both the regulators and the regulated face no bright lines on the commerce and banking front.” [61]

He goes on to note the wide discretion afforded the Agencies:

> “The Congress specifically rejected commerce and banking in GLB but empowered the Federal Reserve and the Treasury to add to the permissible activities list any activity that is either “financial,” without much guidance as to that means, or is “complementary” to financial activities, with no guidance. . . . GLB grants the agencies authority to move toward mixing banking and commerce at the margin as markets and technology begin to dim the already less than bright line between them.” [62]

The lack of a standard for modifying at the margin is reflected in the ABA contention in the “Proposal,” that real estate itself is a financial asset, and the Agencies’ agreement that it does have financial attributes. It is also reflected in an FHC contention that: “. . . anything done by a financial holding company or anything that includes processing a payment is intrinsically financial.” [63] Without a standard, the perceived absence of limits in mixing banking and commerce is understandable.

There are, nevertheless, guiding principles that are relevant. These involve the reasons why the banking and commerce have been kept separate for over 200 years in the United States. They were explicit, in part, in the adverse effects of the “net public benefits” test of Section 4(c)(8). They include effects on competition, conflicts of interest and concentration, as well as on bank safety and soundness. These stated

[61] Meyer, 2001, p. 3.
[62] Meyer, 2001, p. 11, 12.
[63] Meyer, 2001, p. 12.

effects are not exclusive, and historically have included the expansion of government regulation to and intervention in broad areas of the free market economy.

In recent years, new technology and market changes may seem to have dimmed the line between banking and commerce. But, in fact, the line has never really been bright. Incentives to integrate have always been present, as is apparent in the universal banking systems of many other countries. They have been forestalled in the United States by public policy which has set limits based on the likelihood of adverse effects.

VI. CONCLUSIONS

A distinctive feature of the U.S. banking system, from its earliest days, has been limits on bank activities that have, along with the exclusion of nonbanking firms from specific banking services, established a separation of banking from commerce. The Gramm-Leach-Bliley Act is the latest in a long line of legislation that has modified bank activity limits and, thereby, the parameters of banking and commerce. At the same time, Congress, in passing the law, has reaffirmed its intent to maintain a separation between the new banking/financial service organizations it has permitted and commercial companies.

In their "Proposal" to determine real estate brokerage and management services are "financial in nature or incidental" and, therefor permissible to FHCs and FSs, the Board of Governors and the Treasury have examined information suggesting that these activities are "closely related to banking," that they are "necessary and appropriate" for banking organizations, that the possibility of adverse effects is of little significance. They have entertained arguments that the activities should be subsumed under one or more statutorily listed financial activities.

This review of the Agencies' "Proposal" has raised a number of analytic, factual and public policy issues. The analytic problems suggest that further consideration needs to be given to the approach taken in defining "financial in nature." The factual issues suggest a need for additional information. The public policy issues indicate a need to consider limits to activity expansion, in part through a more extensive examination of possible adverse effects.

Overall, the review indicates that the "Proposal" is incomplete and that further analysis and investigation is required. Appendix A provides a list of studies that would be useful.

APPENDIX A
ADDITIONAL STUDIES

The examination of the Agencies' "Proposal" indicates a need for additional information and analysis with respect to a number of issues. The "Proposal" itself, solicits comments generally, and also at specific points in its text.[64] The studies briefly described below reflect gaps in the "Proposal" indicated by this review, are not fully in accord with the Agencies' perception of what is needed. The information provided by these studies would ideally be undertaken by the Agencies, but might also be pursued by proponents and/or opponents of the Agencies' proposed rules.

A. Basis for Earlier Board Decisions on Real Estate Brokerage and Management

In 1972, the Board determined that real estate brokerage and management were not permissible activities under Section 4(c)(8) of the Bank Holding Company Act. Subsequent Board actions, and those of the OCC, with respect to the real estate activities of banking organizations, are briefly mentioned in the "Proposal."[65]

In considering the proposed reversal of the 1972 determinations, it would be useful to review the analysis underlying the Board's earlier real estate related determinations, and also the proposed determinations of the past 30 years. In the course of the review, an attempt should also be made to identify the market and/or technological changes, if any, of the past 30 years, that would contribute to the proposed change. The "Proposal" suggests that significant changes have taken place, but is cryptic as to precisely what they are.

The Agencies have made clear that the proposed rules need not be based on a change in the "closely related to banking" finding, because "financial in nature and

[64] Among others things, the "Proposal" seeks comments on the extent to which U.S. financial service companies provide real estate brokerage and/or management services; on possible adverse effects and whether special restrictions are needed; on the characteristics of real estate transactions that might make them "financial in nature;" on whether real estate brokerage and/or management should be included as a statutorily listed activity; and on whether the proposed real estate management rule would help ensure competitive equity.

[65] See "Proposal," pp. 6, 7, note 8, and p. 18, note 35.

incidental" is broader. But this review should provide a fuller understanding of the "Proposal's" institutional roots, or lack thereof.

B. Safety and Soundness Considerations

The "Proposal" indicates that real estate brokerage and management services raise only minor risks for banking organizations and their depository affiliates. At the same time, real estate itself and a number of real estate-related activities have beeen prohibited for many years, on safety and soundness grounds, to banking organizations. This study would examine historical records involving bank experience, legislative debates, legislation and regulatory determinations that, at least since passage of the National Banking Act, have resulted in significant limits on permissible real estate and real estate-related activities for banks. If it were found that safety and soundness considerations have been important in the past in prohibiting banking organizations from engaging in real estate brokerage and management, this study would also extend the study described in "A" by looking for reasons as to what if anything has changed in recent years to justify the "Proposal's" conclusion that these activities now present minimal risks.

The investigation would be particularly useful if the Agencies were to make a determination, suggested as a possibility in the "Proposal" but seemingly unlikely at this time, that real estate brokerage and management services are statutorily listed financial activities because real estate itself is a financial asset.

C. Impacts on Banking Organization Profitability

In evaluating whether an activity is "financial in nature or incidental," GLB requires that the Board consider, among other things, whether the activity ". . . is necessary or appropriate to allow a financial holding company and the affiliates of a financial holding company to—(i) compete effectively with any company seeking to provide financial services . . . ; (ii) efficiently deliver information and services that are financial in nature . . . ; and (iii) offer customers any available or emerging technological means for using financial services. . . ." The "Proposal" provides some information on the real estate brokerage and management services provided by non-banking companies, but none on the significance of this information for "effective competition" indicated in (i) or for the factors indicated in (ii) and (iii).

As noted, the provision of such services by others does not mean, in and of itself, that banking organizations cannot "compete effectively" with non-banking companies. To reach such a conclusion, it would be necessary to show that the real estate brokerage and/or management services prohibition has resulted in loss or is likely to result in loss in the real estate-related activities in which banks do engage, or in some other way adversely affected bank profits.

This study would review bank profits over the past decade and, to the extent possible, the profitability of the real estate related activities in which banking organizations engage. It would then make an effort to evaluate the effect on bank profits resulting from the existing prohibition on real estate brokerage and management services.

D. Impacts on customer convenience.

In the "Proposal," the Agencies report an ABA assertion that customers involved in real estate transactions are inconvenienced by their inability to obtain all their real estate services from individual providers. Closely related to the study suggested on bank profitability, would be a study of the impact of the existing prohibition on customer convenience.

This study would develop evidence on whether or not there has been any significant customer inconvenience, and what effect the provision of these services might have on customer convenience, positive, neutral or negative. The study would require a review of existing literature on the subject and, possibly, one or more surveys of customers recently involved in real estate transactions.

E. Competitive Effects

The intensity and maintenance of competition in relevant markets is a principal concern of both the Bank Holding Company Act and GLB. Activity expansion for banks has been justified by the need for new entry into less than competitive markets. At the same time, bank entry into new activity markets, particularly by merger, may have little or no effect on competition, or might reduce it. The "Proposal" does not address the question of whether there is a need for more competition in real estate brokerage and management markets.

This study would review the literature on competition in real estate brokerage and management markets, and supplement it, to the extent necessary, in defining markets, evaluating their structure and the behavior of firms in them. If it is found that these markets are now highly competitive, with relatively easy entry, no significant procompetitive benefit from bank entry is to be expected. The actual effect on competition, whether neutral or negative, would depend on the kinds of affiliations that developed under the proposed rules, and require additional analysis.

F. Concentration Effects

"Undue concentration of resources," as an adverse effect in the "net public benefits" test, and also in Sec. 114 of GLB, is subject to various interpretations. After over a decade of large bank mergers, rising banking concentration, and recognition of the special supervisory difficulties and systemic issues created by large banking organizations, "undue concentration" should be given more weight now in Board determinations of permissible activities than in the past. This is particularly the case in light of the seemingly extensive possibilities for bank activity expansion under GLB,

This study would define the term "undue concentration of resources" in connection with trends in the financial sector and in the economy. It would consider the likely impact on concentration of bank activity expansion and bank mergers over the next several years, and draw conclusions as to the likely effects in the wider economic, political and social areas addressed in the legislative deliberations on GLB. It would consider the potential effects of the proposed new rules for real estate brokerage and management in this broader context.

G. Framework for Determining Statutorily Listed Financial Activities

The discussion of financial and nonfinancial attributes of assets and transactions in the sections of the "Proposal" on real estate brokerage and management as "statutorily listed" financial activities is cryptic. As discussed in the text, the "Proposal" implies some sort of paradigm for deconstructing assets and transactions into financial and nonfinancial attributes; classifying, aggregating and deciding on some, unspecified, basis what is a financial activity.

To the best of my knowledge, no such paradigm exists in the economic or financial literature. This study would attempt the development of such a paradigm. The exercise is likely to throw light on the difficulties of making determinations along the lines suggested in the "Proposal."

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