Banks in Real Estate

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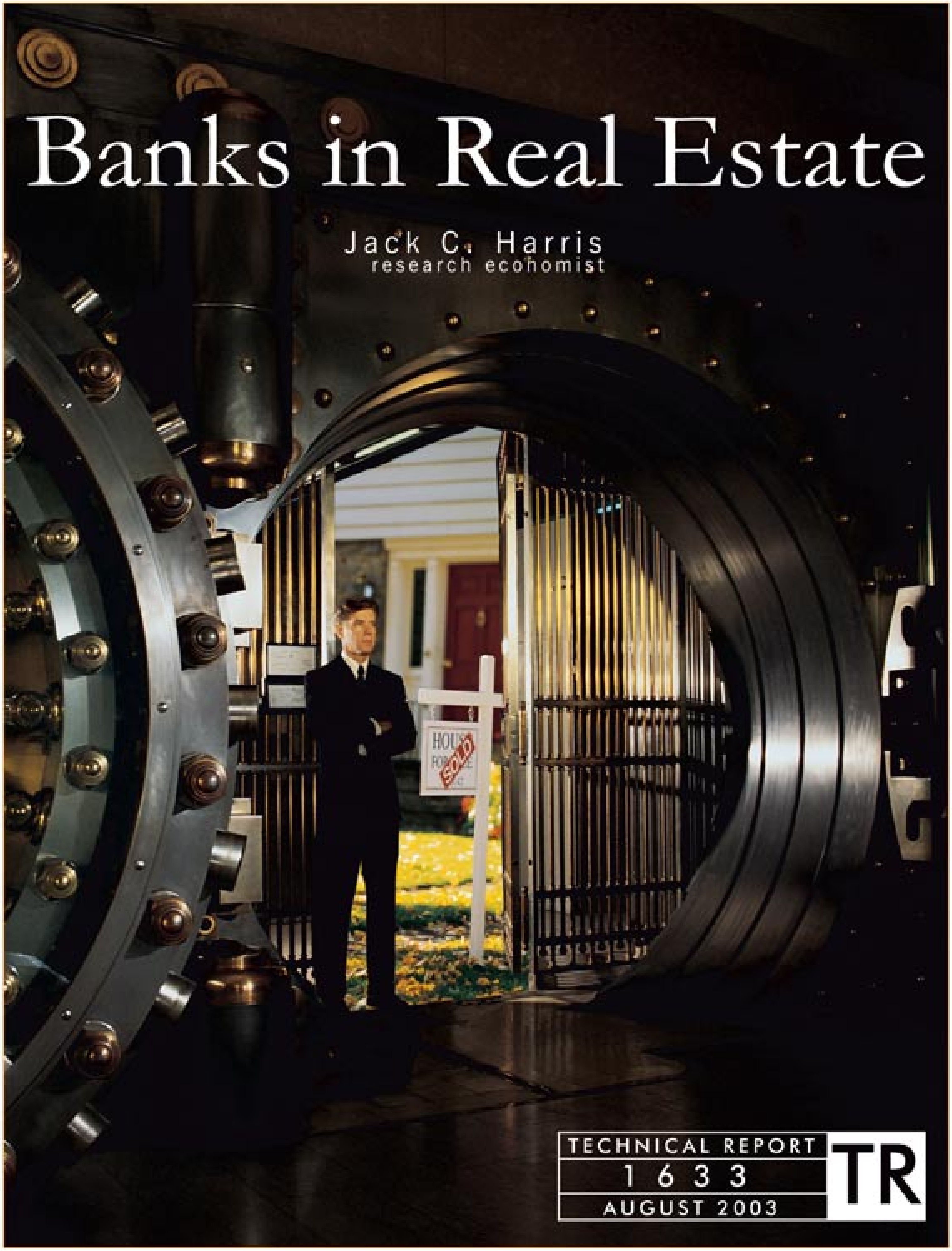

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A few years ago, mortgage bankers were up in arms over the threat posed by real estate agents who were getting involved in the loan origination process. Using computerized loan origination systems, agents were beginning, and in some cases completing, loan origination. Some were creating Controlled Business Arrangements, which allow real estate brokers to own and operate mortgage banking operations.

Mortgage bankers feared that real estate agents were so influential that homebuyers would give all their mortgage business to lenders affiliated with the broker. As it turned out, the threat was overblown. Mortgage companies learned how to work with the innovation by improving the way they did business.

Now the situation is reversed, and the real estate industry is battling to keep lenders — specifically commercial banks — from encroaching on their business. Longstanding restrictions on the activities of federally chartered banks were largely wiped out in 1999, allowing banks to engage in a wider array of financial and complementary services. Thus far, this change has allowed banks to underwrite securities and sell insurance. Now banks are looking to expand into real estate brokerage to funnel more business to their mortgage loan operations.

The National Association of Realtors (NAR) has sponsored bills to declare real estate brokerage and property management off-limits to banks. How much of a threat would banks entering the brokerage business pose for real estate professionals?

Segregation of Financial Functions

After the freewheeling financial dealing of the 1920s ended in the stock market crash of 1929, the prevailing sentiment of reformers was that financial firms and institutions should stay within businesses they know, rather than be allowed to branch out into any field they wanted. During the New Deal years, central regulators were empowered to enforce this segregation of functions in the industry.

Public suspicion and fear of concentrated power was greatest with regard to the banking sector. People felt that because banks controlled the money, they also could dictate which firms and projects would be successful. Consequently, the Banking Act of 1933 included the Glass-Stegall provision, which was designed to rein in the power of big banks and put the nation's financial system on a smooth, regulated path. Banks accepted the reform with relief, fearing outright nationalization of the banking function.

The 1930s was not a time for business expansion. Like other businesses, most banks were fighting to survive. Regulation offered a way for the larger firms to come under the protective wing of the government while their smaller competitors faded away.

The Glass-Stegall provision prevented banks from making the types of speculative investments that were common in the 1920s by keeping them out of the investment banking business. Many people felt that such speculation was a major factor in the stock market collapse and the ensuing economic depression. There was also widespread fear of the concentration of power represented by big financial institutions. At the same time banks were confined to the banking business, they were granted important concessions — federal deposit insurance, a ban on paying interest on checking accounts and limits on the rates they paid for deposits.

By the 1990s, many of the Glass-Stegall restrictions had been weakened. Many banks were offering insurance services even before the restrictions were officially repealed with the 1999 passage of the Gramm-Leach-Bliley Act (GLBA).

Under GLBA, federally chartered banks can create financial holding companies to conduct any business that is financial in nature and may provide services that are incidental or complementary to these financial services. Banks cannot engage in complementary activities directly but can create and control subsidiaries to conduct such business. The law defines specific allowable services, and the Federal Reserve Bank and the U.S. Department of the Treasury have the authority to add other services. The act expressly prohibits real estate investment and development.

Shortly after passage of GLBA, the American Bankers Association (ABA) petitioned the Fed and Treasury for authorization to offer real estate brokerage and property management services. Strong opposition from NAR prompted officials to extend the time allowed for consideration of the proposal. As of mid-2003, a decision has yet to be rendered.

NAR is attempting a preemptive strike to prevent real estate activities from being added to the list of allowable services. At NAR's urging, Senate Bill 98 and House Bill 111 were introduced in 2003 as the "Community Choice in Real Estate Act." The bills would amend the Bank Holding Company Act of 1956 to prevent the Fed and Treasury from finding real estate brokerage or property management to be legitimate activities for bank holding companies. In February 2003, NAR announced that the House of Representatives had included a provision in the omnibus spending package that would prevent the Fed and Treasury from spending money to implement such a ruling during the current fiscal year.

This battle between NAR and the ABA centers around five questions:

1. Would bank-provided real estate services create conflicts of interest that would victimize home sellers and buyers?
2. Would bank involvement in real estate brokerage compromise customers' privacy?

3. If banks enter the real estate brokerage market, would there be a higher or lower level of competition among service providers?
4. Are the makeup and nature of commercial banks well suited to the real estate brokerage business?
5. What would be the effect on existing real estate brokerage firms?

Conflict of Interest

NAR contends that if brokers work for banks, they might persuade buyers to obtain loans from banks even though those loans might not be the best ones for the borrowers. The broker, NAR says, may even lead the buyer into thinking the sale is contingent on using the bank's financing.

Real estate agents routinely, often at the buyer's urging, recommend specific vendors for a range of services associated with the transaction. Sales agents often gain a position of trust with the buyer, particularly when a formal buyer representation agreement is in place. Some critics of banks entering real estate maintain that the only reason a bank would want to be in the business would be to funnel customers into its mortgage lending and insurance businesses.

The ABA responds to these objections by pointing out that banks are covered by the conflict of interest provisions of the Real Estate Settlement Procedures Act (RESPA) as well as specific "anti-tying" laws applied only to commercial banks. RESPA prohibits referrals in which the agent receives a kickback for sending customers to the service provider. If the recommended service provider is owned by the brokerage firm, that fact must be disclosed to the customer. Anti-tying laws prevent agents from requiring a buyer to use a particular lender before showing a home.

Regardless of legal and regulatory constraints, it is difficult to police referrals, particularly if there is no direct monetary compensation to the agent. It is impossible to protect buyers who refuse to shop the market and who are unaware of their rights.

Shopping for a mortgage involves more than comparing terms. An agent's experience can be valuable in finding the lender who provides the best service. How can regulators tell whether an agent is making a referral based on the best interest of the buyer or on business relationships?

Consumer Privacy

NAR points out that a financial firm brokering real estate would have the ability to construct a database of homebuyer characteristics that they could use to market other services. This database would consist largely of confidential information the buyer shared with the agent while shopping for a home, not realizing it would be shared with other bank affiliates.

The ABA asserts that there are legal prohibitions against such practices. One of the purposes of GLBA is to strengthen privacy protections in the banking laws. This is the law that compelled financial institutions to send customers notices explaining privacy policies.

Competition

The ABA maintains that bank entry into real estate brokerage would provide consumers more choices and lead to more reasonable pricing (that is, lower commissions) and better service. Moreover, it maintains that the level of competition in the financial services field would be raised.

NAR counters that the brokerage market is already competitive and that banks entering the business actually could reduce the level of competition. Recent research by University of Alabama professor Leonard Zumpano supports this view.

Zumpano explains that for new entrants to promote competition, the market for brokerage services would have to be perfectly competitive, with many buyers and sellers and little differentiation in product. But theory and research indicate that the brokerage market follows the pattern of monopolistic competition: that is, there are many buyers and sellers and few barriers to entry despite licensing requirements, but the product is highly differentiated. Some agents are better than others, and not all brokers provide the same services.

In a monopolistic competitive market, suppliers attempt to maintain market share through nonprice competition. Instead of offering lower prices, they portray their product as being higher quality than others. In such a market, selling homes for a lower commission rate will not necessarily attract more clients. However, demonstrating that you can sell homes faster and at higher prices certainly will.

Firms spend their resources promoting a successful image. When new competitors enter the market, they tend to spread the business more thinly rather than stimulate demand through lower prices. The result is a lower overall level of efficiency as all suppliers scale down their operations. The likely result is higher prices and lower quality service, according to Zumpano.

While the brokerage industry is dominated by small, independent firms, recent trends have been toward consolidation. Zumpano cites research indicating economies of scale and scope that promote this trend. In other words, larger firms can spread fixed costs over a larger scale of operation for a lower average cost per transaction.

Nevertheless, there is a point at which economies of scale reverse — an optimum scale — and some large firms are probably already beyond this optimum. Such diseconomies of scale may explain why large brokerage firms have not taken over the brokerage industry.

Banks could enter the industry by either buying up existing firms or starting new ones. Either way would facilitate the move toward consolidation, with no improvement in competition but with higher prices and diminished services, according to Zumpano. Buying up small firms would simply reduce the number of competitors and could move the market from monopolistic competition to oligopoly. An oligopoly is a market dominated by a few large firms that charge what the market will bear.

If banks create new firms, the result could be much the same, as small independents could be driven out of the market while trying to compete with large companies that can offer convenient financing along with the home purchase. Even if that is not a compelling advantage, clients may be swayed by the impression that a firm with a familiar name (Chase Realty, for example) offers superior services.

Such scenarios may be overestimating the potential impact of bank entry. Certainly, similar projections were made when national franchises began to move into the market in the 1980s. The market penetration by franchises reached about 30 percent quickly but has failed to advance much further. Perhaps the same would be true of bank-owned brokerage firms. While research cannot answer that question definitively, it does indicate that the effect of new market entrants is not as simple as described by those who advocate banks entering real estate.

Brokerage as a Financial Service

One of the intentions of GLBA is to allow banks to offer a full array of financial services. The law specifically designates only real estate investment and development, insurance underwriting, insurance portfolio investments and merchant banking as outside the range of financial and complementary services. Whether real estate brokerage and property management qualify is the major contention between NAR and the ABA.

NAR maintains that selling real property is not a financial service but a commercial business outside the purview of the law's intent. According to this view, little in the process of brokering real estate or managing property resembles financial services such as collecting and investing deposits, underwriting bond issues and mortgage banking. They also see little similarity to services newly authorized by GLBA, such as selling insurance.

Furthermore, NAR feels banks are poorly suited to real estate brokerage and property management. Banks, according to NAR officials, lack knowledge and experience of real estate markets, are not accustomed to serving customers in the role of principals in a transaction and are unfamiliar with laws governing brokerage.

The ABA counters that allowing banks to engage in real estate brokerage is not the stretch portrayed by NAR. Half of the states already allow state chartered banks to offer real estate services. Texas does not. Before GLBA, NAR promoted the concept of "one-stop shopping" through real estate firms operating mortgage banking subsidiaries or computerized loan origination systems. According to ABA, now that banks want to provide similar convenience with a wider array of services, NAR calls it a bad idea.

The double standard may have to do with the advantages banks enjoy as a result of their unique legal status and connection to the national banking system. Unlike other firms, federally chartered banks can offer investors federal deposit insurance and access to low-cost financial assistance from the Federal Reserve Bank and the Federal Home Loan Banks. While there are few barriers to setting up a real estate brokerage business, there are substantial hurdles to becoming a federally chartered bank. The simple image of knocking down walls to allow competition is complicated by the significant regulatory differences between the potential competitors.

Effect on Existing Firms

Banks are generally perceived as being large, national firms, while real estate brokerage firms are mostly small businesses. While there is some basis for these impressions, both are oversimplifications. The ABA points out that 90 percent of nationally chartered banks are community banks and that 40 percent have fewer than 25 employees. Still, large, powerful banks do exist, and they are in fact the ones most likely to form real estate brokerages.

A recent poll of Texas real estate licensees revealed that almost 48 percent work in offices with fewer than six licensed agents. At the same time, consolidation is going on, and large brokerage offices employ more than one-fourth of the professionals in the industry.

The image of large, powerful corporations invading the provinces of small business is the backdrop for another point of contention between banking and brokerage interests. NAR feels that bank entry into real estate will threaten the small-company, local orientation of the real estate business. Customer service, it is said, might be sacrificed to highly standardized services aggressively marketed to the broadest segment of customers.

The ABA asserts that most banks are not large and exist in communities often not served by real estate firms. Besides, ABA officials say, large financial firms like Prudential own real estate brokerage operations without affecting the structure of the market. The ABA contends that by allowing commercial banks to become players, everyone would benefit. Consumers would have more choices of service providers, agents would have a wider range of places to work and owners of existing firms would face a better market when they wish to sell their businesses.

Of course, this assumes that the consolidation of bank-owned brokerage firms described earlier does not take place. If it does, consumers would face more limited options, fewer agents and broker-managers would be needed and there might be no market for existing firms.

NAR points out how consolidation within the banking sector has affected the quality of service to banking customers, alleging that service has not improved or become more affordable but that instead an emphasis on automation has largely eliminated personalized assistance to customers. A similar result in real estate brokerage would greatly transform the nature of the service.

Cause for Concern?

It is tempting to dismiss this issue as a squabble between two powerful trade organizations. If banks are allowed to enter the industry, the effects probably will not be as drastic as portrayed by the opposition, nor as wonderful as predicted by proponents.

GLBA did not authorize banks to go into the real estate business. It merely left the question open for future consideration. The law did enumerate specific fields that banks can pursue, such as selling insurance.

The ABA petition asks that real estate be considered a "financial or complementary" activity under the law. But how much of real estate brokerage is financial or complementary to normal banking activities?

There is a financial aspect to buying and selling real property, of course, but it is usually secondary to the process of touring properties and negotiating contract terms. Sales of income-producing property to investors may be largely financial, involving portfolio analysis and estate planning. But most of the financial aspects of buying a home, including arranging the financing, are external to what real estate brokers do. Selling real property is a different task from selling bonds or even insurance.

If bank-owned realty brokerage does become a significant part of the business, how might this affect consumers? Most consumers probably would notice little change. Real estate operations likely would be handled through subsidiaries working out of offices much as brokers do now.

There would, however, be a closer relationship with the mortgage banking and possibly with the insurance brokerage operations of the mother bank. Referrals from real estate agents to the bank's services would operate under the oversight of RESPA. The agents themselves could not be given incentives to make referrals, but there might be affinity-like discounts for applicants who use the bank's mortgage or insurance services.

The referral connection is an important one. In a 2001 survey of Texas homebuyers, 68 percent of respondents rated "referring a good mortgage lender" a "very important" service provided by real estate agents. Twenty-three percent bought homes with the help of a lender referred by the agent, and another 20 percent applied for their loans in the real estate agent's office.

Real estate agents smooth the transition from home shopping to loan shopping by matching borrowers and lenders. Research conducted by Anthony Pennington-Cross, research director for the Research Institute for Housing America, found that buyers who use real estate agents to buy a home are 25 percent less likely to have their mortgage applications rejected by the lender. Would the system remain as effective if the agent is biased in the selection of lender?

The impact on agents would depend on whether bank-owned firms were successful in dominating the industry. If the brokerage-financing connection proves overwhelming and banks drive out most independent firms, there may be a difference in how brokerage firms deal with their sales agents.

Banks would want to run brokerages more like banks, meaning agents would be treated more as employees and less like independent contractors. Expect a move away from all-commission compensation and back toward the more traditional commission-salary split. The bank-owned firms would not have this effect unless they possessed a competitive advantage in the market. Otherwise, they would have to offer comparable terms to hire the best agents.

How bank entry would affect the owners of brokerage firms also depends on the success of the integrated banking-brokerage approach. The ABA claims there would be an enhanced market for owners who wish to sell their firms. This probably would be true only for initial sellers. If the bank model dominates the market and consolidation of ownership takes place, early sellers would find eager buyers in the growing bank-connected brokerage.

But if enough consolidation occurs to tilt market power toward the banks, there would be little demand for independent brokerage firms. The larger, bank-related firms would simply hire away the best agents. If the banks have limited success in gaining market share, the bank-sponsored firms might buy up brokerage firms at first, then become much less of a factor as their market share stabilizes.

The real tension probably would be between bank-affiliated firms and brokerage franchisees because each brings similar advantages to the business. In this scenario, the two competing models would fight for the 30 to 40 percent of the market now controlled by the franchises.

At this point, it looks like Congress will favor NAR's effort to forestall the entry of banks into the business. However, banks have found ways to sidestep regulations when the result makes economic sense. Some of the services authorized by GBLA were already being offered through exceptions in the law. So it is worthwhile to think about how this change might affect the market for brokerage services, agents and firms.

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