A Reprint from *Tierra Grande*

Banks in Real Estate

By Jack C. Harris

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 brokers 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

The Banking Act of 1933 included the Glass-Stegall provision, which was designed to rein in the power of big banks by prohibiting them from entering the investment banking business and other financial services businesses such as insurance. This, it was believed, would put the nation's financial system on a smooth, regulated path. By the 1990s, however, many of the Glass-Stegall restrictions had been weakened. 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officially repealed with the 1999 passage of the Gramm-Leach-Bliley Act (GLBA).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. 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 this year 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.

HOMEBUYERS MIGHT *not notice a difference if banks enter the brokerage business. Buyers would likely interact with personnel of bank subsidiaries operating out of local offices.*

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.

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 that apply only to commercial banks. RESPA prohibits referrals in which the agent receives a kickback for sending customers to a particular service provider.

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.

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. Economists consider the brokerage market to be a monopolistic competitive market, in which 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.

Results of Competition

When new competitors enter the market, they spread the existing business more thinly rather than stimulate greater 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.

Banks could enter the industry by either buying up existing firms or starting new ones. 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 trying to compete with large companies that can offer convenient financing along with the home purchase.

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.

Brokerage as a Financial Service

One of the intentions of GLBA is to allow banks to offer a full array of financial 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.

Furthermore, NAR feels banks are poorly suited to real estate brokerage and property management. Banks, according to NAR, 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 perating mortgage bank subsidiaries or computerized loan origination systems. Now that banks want to provide similar convenience, 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

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 a consolidation of bank-owned brokerage firms 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.

Cause for Concern?

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.

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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.

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.

For more information, see Center technical report 1633, *Banks in Real Estate,* at http://recenter.tamu.edu/pdf/1633.pdf.

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Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year.