CALIFORNIA ASSOCIATION OF REALTORS®

Statement of

THE CALIFORNIA ASSOCIATION OF REALTORS â

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

PRESENTED BY

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Chairman Bachus, Representative Waters and members of the subcommittee. Thank you for inviting the California Association of REALTORS® to testify at this hearing on H.R. 3424, the Community Choice in Real Estate Act. As you know, CAR and its 110,000 members strongly support this legislation, along with 246 cosponsors in the House, as a restatement of congressional intent that banking and commerce should remain separate. I hope this is a step toward enactment of the bill, and that this committee will seek input from dozens of other consumer and business groups supporting H.R. 3424.

The members of the association are California real estate licensees who are engaged in the business of real estate brokerage, sales, mortgage brokerage and property management. Currently, the California membership accounts for approximately one-seventh of the nation's REALTOR® population and well over 90% of the 504,430 residential resale transactions occurring last year in California. As such, the membership is well versed in the nature of sales brokerage and property management and very well suited to comment on the proposal to allow banks and bank holding companies to engage in real estate brokerage and real property management.

Real estate plays a vital role in sustaining our Nation's economy. Today, the real estate industry is as vibrant and strong a force as it has ever been in history. Indeed, it is currently one of the few shining stars bringing our nation back to recovery. Thus, it is crucial that it continue to be allowed to function at its full capacity spurred on by zealous competition. The proposed rule by the Treasury Department and Federal Reserve Bank would smother the current flame of competition by allowing banks to enter and unfairly dominate the real estate industry. Banks and financial holding companies would be able to exploit their sizeable federal advantage to the detriment of consumers. History has shown us time and time again the evils that result when an industry is vested in a handful of behemoths. The end result is reduced choice and flexibility for the consumer ultimately resulting in increased overall costs. H.R. 3424 will ensure that the real estate industry remains strong, providing an abundance of choice at prices inspired by full competition to the benefit of consumers and our Nation's economy.

Background

Late in 2000, the American Bankers Association ("ABA") and Fremont National Bank & Trust Company, Fremont, Nebraska, asked the Board and the Secretary 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, requested that the Board permit financial holding companies ("FHC") to engage in real estate brokerage activities.

Consequently, in January, the agencies jointly issued a proposed rule and sought comment on whether 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 sought comment on whether real estate management activities could be considered financial in nature or incidental to a financial activity.

The Gramm-Leach-Bliley Act (Pub. L. No. 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 qualified as a financial holding company to engage in a broad range of activities that are defined by the GLB Act to be financial in nature. 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. The GLB Act also permits FHCs and financial subsidiaries of national banks to engage in other activities that the Board determines, by regulation or order and in consultation with the Secretary of the Treasury, to be financial in nature or incidental to a financial activity.

When considering a request for a determination that an activity is financial in nature or incidental to a financial activity, the GLB Act directs the Board to consider a variety of factors including (i) the **purposes** of the BHC Act and the GLB Act; (ii) the changes or reasonably expected **changes in the marketplace in which FHCs compete;** and (iii) 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. The Secretary must consider a virtually identical set of factors in determining whether an activity is permissible for financial subsidiaries.

It is the belief of the directors of the California Association of REALTORS® that real estate brokerage and property management fail to meet these tests. In particular, this change in bank and FHC powers cannot be:

- justified on the basis of Congress intent as evidenced by the legislative history and text of the GLB bill as well as the subsequent Congressional comments to the agencies on the proposed rule,

- found consistent with a defensible definition of real estate as a financial activity as opposed to its long held categorization as a commercial activity;

- classified as appropriate since there have been no changes in the environment within which the banks and FHCs exist and outlined by the Acts that would warrant the proposed changes, and

- justified by a finding that real estate sales and property management are incidental to a financial transaction.

Furthermore, many of the arguments to support the proposed rule are based on incomplete and/or incorrect information. In particular, the proposed changes will:

- not create a level playing field that will allow banks to compete with real estate brokerages who reportedly are involved in the" banks' business" by virtue of their mortgage operations,

- create a competitor for the real estate brokerage/property management companies with which the existing real estate firms cannot expect to compete given the federally-bestowed advantages enjoyed by the new entry, and

- not be in the best interests of consumers.

Conformity with the Purpose, Language and Congressional Intent of the GLB Act

C.A.R.'s leadership and membership do not believe that the proposed rule is in line with the purposes of the GLB Act. This belief is founded in the stated purposes of the GLB Act, the resulting language of the GLB Act, itself, and the response to the proposed rule of members of Congress who were involved in the passage of the Act.

Purpose: When Congress repealed Sections 20 and 32 of the Banking Act of 1933 as a part of the Gramm-Leach-Bliley Act, the intent was to strike the proper balance between the needs of financial institutions to compete in the modern marketplace, protect and serve consumers and assure the integrity of the financial system. What Congress was very careful not to do, however, was to allow the mix of commerce and banking.

This intent is best illustrated by comments made by Representative Jim Leach, chairman of the House Banking Committee when he addressed the ABA Leadership Council in March of 2000. He said " ...let me stress that it is important to note what the bill does not do. While opening financial markets to greater competition between banks, insurance companies and securities firms, *it forestalls the mixing of commerce and banking* and plugs the loophole in current law that breaches this principle." Rep. Leach, Chairman, House Banking and Financial Services Committee. Remarks Before ABA Leadership Council, Press Release, House Committee on Banking and Financial Services. March 28, 2000 (Emphasis supplied.)

The "loophole in current law that breaches this principle" was addressed in the debate about financial institutions and commercial firms owning each other and issues related to the commercial-owned unitary thrifts. As you are well aware, the GLB Act included provisions that specifically eliminated the ability of a commercial firm to own a unitary thrift.

Significantly, throughout the debate of the GLB Act, Congress resisted and continually rejected efforts by the representatives of the financial services industries to include real estate activities among the definition of new financial service activities in which financial institutions would be permitted to engage. Congress engaged in a thorough debate on the issue and decisively voted in both chambers to exclude real estate development and investment – the most financially related components of all real estate activities - as a permissible activity for national banks' financial subsidiaries.

While Congress could have eliminated the barriers between financial services and commercial business, the express language of the Gramm-Leach-Bliley Act makes clear that was not its intent. Ultimately, the conclusion must be reached that Congress had no intention to include real estate activities among the new financial activities to be allowed financial holding companies under the provision of the Gramm-Leach-Bliley Act because those activities were always considered by Congress to be commercial, not financial, in nature.

Congressional Reaction to the Proposed Rule. Perhaps the most telling indication that it was not the purpose of the Act nor the intent of Congress to allow banks and bank holding companies to enter into the real estate brokerage and property management business has been the way in which members of Congress have responded to the proposed rule with surprise and chagrin. As one member of the last year's Banking committee commented to Mr. Greenspan during the Federal Reserve Board chairman's recent appearance before the newly constituted Financial Services committee,

> *"…when we voted to massively expand the activities that banks could engage in, (we) did not anticipate that they would get involved in activities outside dealing with securities, investments and intangibles, but would instead become brokers for the quintessential opposite of intangible property, namely, real property." (Rep. Sherman, February 2001 Financial Services Committee hearing)1*

The letters sent to the Federal Reserve and Treasury by more than 160 members of Congress, including 33 out of 51Californians, have echoed Mr. Sherman's characterization of what had been Congress' intent. These same letters have expressed their concerns with the likelihood that financial and commercial firms would be mingled. The members of Congress who have written represent all areas of the nation, all political persuasions and members from both sides of the aisle. A more bi-partisan response is hard to imagine.

Legislative Language of the GLB Act. As noted above, the GLB Act as enacted specifically defines activities that are financial in nature. The allowed activities are described as follows:

- Lending, exchanging, transferring, investing for others, or safeguarding financial assets other than money or securities;
- Providing any device or other instrumentality for transferring money or other financial assets; and
- Arranging, effecting, or facilitating financial transactions for the account of third parties.

Real estate brokerage and property management are not included in this list of permissible activities, either explicitly or through any logical/sensible extension of these criteria. We believe that the arguments put forth by the banking industry that "investing for others" could be used to describe the residential purchase transaction and, therefore, real estate brokerage should be considered a financial activity are the result of a wishful stretch of logic.

For most individuals and families, the purchase of a house is not undertaken for investment purposes but is rather the first step in creating a home, a place to call their own. It is a purchase that arises out of a job change, the need for more space or a better neighborhood, or the simple desire to have a permanent place to live that can be tailored to meet their individual needs. These reasons for a home purchase have been documented by C.A.R.'s Housing Finance Survey for twenty years. In the most recent study, 20.8 percent were attributed simply to being "tired of renting," i.e. the desire for a permanent place to live and modify as needed; 21.4 percent of moves resulted from a need for more space; 16.3 percent resulted from a desire for a home in a better neighborhood; and 8.1 percent of transactions were motivated by a job change.

It is true that, as the result of the growth of the U.S. economy and population, some homes have appreciated and have been "good investments." Unlike a stock or securities purchase where the motivation is to own an intangible asset whose sole reason for existing is to increase in value, the investment advantages that accrue from the purchase of a home are secondary in nature. This is especially true the past ten years here in California where people are very aware that homes can also lose value as they did here from 1989 to 2000. In the most recent C.A.R. Housing Finance Survey, only 10.6 percent of homebuyers indicate that their home purchase was motivated by either a desire to invest or for tax considerations.

As the Board and Treasury requests for comments also pointed out, just because an item might be purchased for investment purposes does not necessarily imply that the item purchased is a financial asset. Boats, jewelry, paintings and antiques are prime example of goods that clearly are not financial goods but are purchased for their potential appreciation and investment purposes.

Real Estate as a Financial Vs. Commercial Activity

Given the intent reflected in the legislative history of the GLB Act and the bank powers discussions and debates of prior years, it is clear that Congress did not intend to allow the mix of banking and commerce – a mix that Congress, the Board and the Secretary had long argued was not desirable. The next questions then must be: Are real estate brokerage and property management commercial or financial activities? Is there any basis for making a finding that these activities should now be considered a financial activity?

Traditionally, financial assets and commercial assets have been distinguished on the basis of their tangibility. Financial assets are intangible, i.e. they represent value but have either no intrinsic value or no material being in and of themselves. Examples would include stocks, bonds, securities, insurance policies, good will, and the like. Those assets that are tangible, i.e. corporeal and able to be appraised for value, have been considered commercial assets. Examples of tangible goods or assets would include foodstuffs, clothing, books, cars, boats and real estate. This approach has been reflected in the common definitions of the terms, "finance" and "commerce." Webster's New World Dictionary, for example, defines finance as the money resources, income, etc. of a nation, organization or person and commerce as the buying and selling of goods.

Some proponents have argued that real estate brokerage should be considered a financial activity since the purchase of real estate involves a financial activity, i.e. the making of a loan. C.A.R. believes that accepting this argument as a basis for determining what is an allowable activity for a bank or bank holding company is fraught with problems. A car or boat purchase is also commonly financed with a loan – does this mean that banks and BHCs should be allowed to broker car or yacht sales? With this guideline, there would be few activities that would not be allowed to banks and BHCs.

To argue that real estate is a financial asset is to fly in the face of the long-standing and common usage. The California Association of REALTORS® strongly believes that there is no justification for identifying real estate and property management as financial in nature.

Is Real Estate Incidental to a Financial Activity

A question that must be addressed by the Board and Secretary in any finding of a new financial activity under the terms of the GLB Act is Are real estate brokerage and property management incidental to a financial transaction? Webster's New World Dictionary defines incidental as:

> *"a. happening as a result of or in connection with something more important, b. likely to happen as a result or concomitant (to or with)..."*

While supporters of the proposed rule have argued that a real estate brokerage transaction is incidental to a financial service, i.e. the mortgage loan, C.A.R. believes that, in fact, the opposite is really the proper characterization. That is, the loan transaction is incidental to the purchase of the home. Without the home purchase, there would be no mortgage loan and therefore no financial activity. Likewise, in the case of a refinance, second mortgage or home equity line transaction, there would be no financial activity if there were no home to collateralize the transaction. The home purchase therefore would seem to be the necessary and "more important" condition for the financial transaction.

Furthermore, it is possible to have a real estate transaction without a loan transaction, either as the result of an all cash sale, a tax deferred transaction or a trade of equivalent properties or other assets. In California in 2000, for example, fully 15.7 percent of sales transactions involved no bank financing. The converse – a mortgage loan without a home - is not possible.

To characterize the real estate transaction as incidental to the loan transaction seem to be a case of stretching the logic of what constitutes an incidental activity much too far.

Do Real Estate Brokerage Firms Compete Unfairly with the Financial Service Firms for the Mortgage Business?

One of the main arguments used by the supporters of the proposed rule in their meetings with members of Congress and the press has been that integrated real estate firms currently provide a

full array of services including brokerage, mortgage lending, title insurance and property insurance and therefore, banking institutions should be allowed to compete in brokerage.

It is true that many real estate firms today offer an array of services connected to the home purchase transaction including mortgage services. It is important, however, to understand what sorts of mortgage services are provided by these firms and the source of the funding provided. The overwhelming majority of real estate brokerage firms act as a mortgage broker. In this capacity, the mortgage broker searches out the best loan product for the potential homebuyer. He/she takes a mortgage application and from the information provided and his/her knowledge of loan products offered by a large numbers of banks, thrifts or mortgage banking firms matches the potential buyer with the institution making the loan. This structure is the most common way for the majority of firms to provide mortgage services since even most large regional firms do not have the financial resources to fund any volume of loans.

Though the paperwork and packaging for the loan is done by the mortgage broker associated with the real estate brokerage, the actual ban funding typically comes from the very banking industry that is objecting to this activity. Mortgage brokers have existed for decades now and account for more than 50% of all loan transactions. Perhaps most interesting is the fact that, in many cases, these broker-lender relationships have been established by the lending institution themselves as a way to increase their capture rate in a given market area.

In addition to these arrangements, there are a few national realty firms that have begun to offer mortgage funding directly. It is important to note that these companies do so in accordance with all state and federal laws. What funding these real estate companies do, however, they do so without the federal subsidies and marketplace advantages available to a FHC.

As Chairman Greenspan testified on July 13, 1997, before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services of the U.S. House of Representatives, there is an inherent government subsidy of commercial banking institutions, which exists at both the holding company and bank levels. The Chairman noted that this provides a competitive advantage of the entire banking organization relative to its non-bank competitors.

Federal deposit insurance, access to the Federal Reserve discount window, 10-12% discount on debt offerings, market position as part of the nation's payment system which attracts billions of dollars in non-interest bearing checking accounts, and the inherent advantage of being " too big to fail" are just a few reasons why banks would have an unfair competitive advantage over even the integrated real estate companies such as Cendant.

Purported Consumer Benefits

If the agencies were to promulgate this proposed rule as a final rule, C.A.R. believes that this massive change in industry structure will significantly alter the nature of the services that a consumer will receive from a real estate agent.

Today, the preponderant portion of the approximately 40,000 real estate brokerage firms nationwide are small, locally based, independent offices -- according to the National Association of REALTORS® survey data, eighty-two percent of brokerage firms have a single office, and only five percent have more than three offices. The average brokerage firm operates one office and has a sales force of about eight agents, while the median firm has four agents. Sixty percent of firms have five or fewer agents.

Each agent typically acts as an independent contractor and competes for a clientele. As a consequence, what typically distinguishes a successful agent is the level of knowledge and individual service they provide a client. It was not by chance that the tag line, ***"You have a life. We let you live it. Real estate is our life."™*** was chosen for the successful REALTOR® advertising campaign.

Our research has shown that agents typically play a major role in the choice of settlement service providers. When surveyed as to who influenced their choice of lender, California homebuyers indicated identified the sales agent as the primary influence. Agents will recommend those lenders, who they have found, provide a range of loan products designed to meet the needs of the prospective buyer. Mortgage brokers have become a favorite of agents and consumers, in part, because they offer clients loan products chosen from multiple lenders. In many large firms, company policy may even spell out that an agent must recommend more than one lender. N.A.R survey data indicates that agents representing larger brokerage offices typically recommend three prospective lenders to a buyer.

As Cendant and others with in-house lending operations have discovered, an in-house lender will not be used by the independent contractor sales agent – whose livelihood depends upon a closed transaction - unless the in-house lender has proven that they can provide an equal or better product and higher level of service than an outside lender or mortgage broker. Anecdotal evidence would seem to suggest that an in-house brokerage that is able to capture 30 percent of an office's loan business is a very successful operation.

We question whether or not agents affiliated with a lender-owned brokerage would or, indeed, could continue to fulfill this function of providing independent advice to buyers. At the very least, there would be implicit, if not explicit, disincentives for agents to recommend that buyers seek financing from unaffiliated lenders. It is also likely that brokerage firm practices or policies of recommending multiple financing sources would be far less prevalent.

More troubling, though, is the perception that a homebuyer may have that dealing with a bank-owned sales brokerage will increase their chance of obtaining a loan or more favorable loan terms. This perception will give a bank-owned real estate brokerage a competitive advantage that no independent firm could counter. It is unlikely that a local independent real estate broker would be able to counter the multi-million dollar "branding" television, radio and magazine ads that are undertaken by large financial entities and which will benefit any bank-owned realty operation.

Property Management as a Financial Activity or Incidental to a Financial Activity

Property management is a service of some real estate brokerage firms and a larger number of property management-only firms. The primary functions of property managers include day-to-day on-site management, attending to maintenance needs both immediate and long-term, and leasing.

Nothing among this entire range of activities bears any logical, rational, or even incidental relationship to banking and financial activities, and we respectfully suggest there simply is no basis for determining that real property management is "financial in nature" or "incidental to a financial activity".

Conclusion

C.A.R. believes that the proposed rule goes far beyond the authority given the Federal Reserve Board and the Department of Treasury by the Gramm-Leach-Bliley Act. Congress originally exhibited its wisdom by requiring financial and commercial activities to be kept separate, so that each industry could focus on its strengths and to prevent banks from unfairly exploiting their federal advantages. We strongly urge Congress to reaffirm its original wisdom by passing H.R. 3424, preventing financial institutions from entering the real estate industry. By so doing, the real estate industry will continue to shine with the brilliance generated by full competition and serve as our Nation's guiding light towards recovery. On behalf of the members of the California Association of REALTORS®, I thank you for your consideration of our view.