TESTIMONY
BY
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NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE
HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

REGARDING THE PROPOSAL BY
THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
AND
THE SECRETARY OF THE TREASURY
TO
PERMIT FINANCIAL HOLDING COMPANIES AND SUBSIDIARIES OF NATIONAL BANKS TO OFFER REAL ESTATE BROKERAGE AND MANAGEMENT SERVICES

MAY 2, 2001

Introduction

Chairman Bachus, Ranking Member Waters, members of the Subcommittee, I am Richard Mendenhall, President of the NATIONAL ASSOCIATION OF REALTORS®. I am from Columbia, Missouri where I own RE/MAX Boone Realty, a real estate firm specializing in single-family and commercial brokerage. I have been a REALTOR® for more than 25 years; I am the fifth generation of my family in the real estate business. Our family owns or is in partnership with three real estate firms. Our firms have 140 real estate agents in residential, farm and land and commercial brokerage. In addition, we have two separate property management firms and a separate mortgage company.

The NATIONAL ASSOCIATION OF REALTORS® represents more than 760,000 real estate professionals who practice in all aspects of residential and commercial real estate. We are a grassroots organization that has membership in every state and nearly every congressional district. Our membership is interested in the health, growth, and stability of the real estate industry; and we are also committed to supporting public policy issues that break down barriers to homeownership while expanding opportunities to the largest universe of homeowners.

The proposed Federal Reserve Board-Treasury Department regulation raises important questions for the real estate industry, particularly as we consider the long-term consequences of the proposal. On behalf of the NATIONAL ASSOCIATION OF REALTORS® I want to thank you Mr. Chairman and you, Ms. Waters, for convening this hearing. We realize that oversight hearings on the implementation of the Gramm-Leach-Bliley Act of 1999 (GLB Act or the Act) were certainly forthcoming in the new Congress, but the joint proposed regulation recently issued by the Board of Governors of the Federal Reserve and the Treasury Department gives new urgency to the issue.

Congress adopted financial services modernization legislation that removed the constraints separating banking, securities, and insurance. Undoubtedly most members of Congress thought that banks and holding companies would move to exercise their new powers in securities and insurance and start to integrate the financial powers detailed by the Gramm-Leach Bliley Act (GLB or the Act) into their business plans. We were surprised, however, when we learned that banks wanted to extend their authority into commercial activities so soon after the Gramm-Leach-Bliley Act became effective.

The proposed Federal Reserve Board-Treasury Department regulation suggests that Congress did not resolve the Gramm-Leach-Bliley debates. Despite sweeping expansion in bank powers, the proposed regulation strongly suggests that the banks and holding companies want even more. REALTORS® believe that Congress agrees with us that it is much too soon to take this action.

Congressional Intent and Legislative History

Enactment of the Gramm-Leach-Bliley Act finally came after the banking industry began decrying the shortcomings of the Glass-Steagall Act nearly twenty years ago and initiated periodic attempts to rewrite the law to permit banks, securities firms and insurance companies engage in each other's businesses. As Congress debated the legislation that became the Gramm-Leach-Bliley Act, the distinction between commerce and banking was focused on securities and insurance businesses as representing commercial activities. A subtext of this distinction was a belief that real estate activities were non-banking, commercial and should not be merged with banking and financial activities.

The Gramm-Leach-Bliley Act set a course for commercial banking and investment banking to evolve into an integrated financial services industry following long deliberation and debate about the appropriate regulatory framework and related structural issues. The Act created a mechanism for banks to establish new financial holding companies and national bank financial subsidiaries to take advantage of new powers. While giving these banking institutions and their affiliates new powers, Congress adopted the GLB Act with the full knowledge that banking law and regulation in the United States customarily restricted the nonbanking activities of banks and the banking activities of nonbanking firms. The Gramm-Leach-Bliley Act changed existing law, but the restrictions retained on the mixing of banking and commerce are intended to operate in the new financial services environment. On the House floor Representative Jim Leach was quite clear that the Act repudiates the mixing of banking and commerce.

> [W]hile the financial modernization legislation provides for increased competition in the delivery of financial products, it repudiates the Japanese industrial model and forestalls trends toward mixing commerce and banking. The signal breach of banking and commerce that exists in current law is plugged, which has the effect of both stopping the potential "keiretzuing" of the American economy....
> At many stages in consideration of bank modernization legislation, powerful interest groups attempted to introduce legislative language that would have allowed large banks to merge with large industrial concerns – i.e., to provide that Chase could merge with General Motors or Bank of America with Amoco. Instead, this bill precludes this prospect and, indeed, blocks America's largest retail company from owning a federally insured institution, for which an application is pending.[1]

The Senate Report on the bill also spoke to the prohibition of a general mixing of banking and commerce. In explaining what the Board must consider in establishing new activities that are financial in nature or incidental to financial activities, the Report asserts:

> "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 the Act."[2]

The NATIONAL ASSOCIATION OF REALTORS® notes that the principal purpose of this hearing is, in essence, another policy debate about what is commerce and what is finance. The

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[1] *Congressional Record*, H11, 529 (1999).
[2] Financial Services Modernization Act of 1999, Report of the Committee on Banking, Housing and Urban Affairs to Accompanying S.900, together with Additional Views. Senate Report 106-44. April 1999. p. 21.

business of brokerage is industry-neutral. Congress determined, in conjunction with regulatory and judicial decisions that banks could engage in brokering “financial” products and services. But if brokerage is extended beyond finance into commerce as proposed by the regulation, where does the demarcation between finance and commerce end? Real estate brokerage involves the marketing and sale of tangible property, the very essence of commerce. Once real estate and property management are deemed finance, what stops the banking and financial services industries from declaring that any other business activity involving tangible products are actually financial? It is not unreasonable to ask the question, “What is next?” Will banks maintain that because they finance automobile dealership they should be permitted to own and operate them?

The 1999 financial services modernization legislation dramatically increased the ability of banks to affiliate with securities and insurance firms. The Act was the culmination of effort by Congress to halt the trend of financial modernization through regulatory decision and judicial challenges. <u>At the crux of the congressional debate was the extent to which legal and regulatory barriers to mixing commercial banking and investment banking were, indeed, outmoded and anti-competitive.</u> Congress acted, but retained legal and regulatory restraints intended to control systemic risks, conflicts of interest, and the potential for plainly objectionable and anti-competitive behavior.

Financial services modernization evolved from Glass-Steagall Act reform or banking reform, as the issue was identified in the 1980s, but there was always a distinction between banking and commerce. The most aggressive banks and largest holding companies would have members of Congress and the public ignore the demarcation between commerce and finance simply because a loan may be involved in a transaction. REALTORS® submit that by adopting a broad interpretation of what finance is, nothing would remain that is uniquely commerce. Yet we believe that Congress knew the difference between commerce and banking, based on the precedent of existing commercial and financial business practices and those tests that were already in place under the Bank Holding Company Act (BHCA) that identified permissible financial and non-financial activities for banks and holding companies. Real estate brokerage and management activities were always considered commerce.

The legislative record reflects that the purpose of Congress in giving the Board and the Treasury Department authority to expand the list of financial activities was to allow the range of permitted activities to evolve as new technological developments occur and the marketplace itself evolves. 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 enactment of the GLB Act in late 1999. The business of real estate brokerage and management remains, for all practical intents and purposes, the same today as it was on the date of enactment. Indeed, neither the marketplace nor the technology associated with real estate brokerage and management has changed since the debate on the GLB Act began earnestly in the mid-1990s. Congress did not contemplate that in less than two years changes in the marketplace, or the competition that holding companies faced, or that technology would so immediately transform real estate from clearly commerce to finance.

NAR Position On Financial Services Modernization

The banks and holding companies mischaracterize the role of REALTORS® in the public debate. "The Realtors [sic] were not involved in discussions with the Gramm-Leach-Bliley Act of 1999, and we took that as a sign that they accepted their part in the financial services industry," according to a Roger Whiting, executive director and general counsel of the Financial Services Roundtable.[3] REALTORS® did participate in the GLB debate and reiterated our longstanding policy that real estate is <u>commerce</u>, not finance; that banking and commerce should be separated:

> [W]hen financial lines of business do not yield the returns anticipated, financial institutions look to real estate and real estate-related business as potentially profitable enterprises. It is our belief that allowing a mix of banking and commerce, as anticipated in the Senate bill, would at some point tempt financial institutions to enter the real estate business. REALTORS® know from bitter experience with the aftermath of the savings and loan industry crisis and cyclical bouts of economic recession that the financial system's strength will inevitably be tested and the real estate industry will be affected.[4]

NAR urged Senators on the Banking Committee to expressly declare, "real estate brokerage, development and related activities (including property management and counseling) are not financial activities.[5]

Congress did not share the view of some in the financial services industry that real estate was a financial activity. In the Act, among the long list of automatically deemed financial in nature or incidental to a financial activity real estate activities are conspicuously absent. Effectively the GLB Act acknowledged and <u>did not change</u> the long held view that real estate was commerce, not finance.

In fact, the debate on mixing banking and commerce is also a debate about whether real estate is commerce and should be permissible to banks. In closing the unitary thrift loophole much was made about the need to limit the mix of banking and commerce because a thrift holding company has nearly unlimited authority to invest in any number of non-financial enterprises, including real estate brokerage. The American Bankers Association press release praised conferees during the House-Senate negotiations on S.900 as follows:

> The conference committee last night made the right decision to shut down the unitary thrift loophole. For three years, ABA has been working with Congress to restrict the integration of the commercial and banking industries.
>
> By barring commercial firms in the future from chartering and acquiring a thrift, the conference committee has ensured that the integrity of our nation's banking system won't

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[3] *American Banker*, Wednesday, March 21, 20001, p. 4
[4] Testimony submitted for the record to the Senate Banking Committee on the "Financial Services Modernization Act of 1999," February 25, 1999, p.2.
[5] *Ibid*., p. 3.

be compromised by risky economic concentrations of resources and the kind of the problems that contributed to the recent financial crisis in Asia.

We are pleased that the conferees' action last night ends the ability of non-financial firms to enter the banking business through the back door.…[6]

Federal Reserve Board-Treasury Department Real Estate Proposal

Last February Federal Reserve Governor Laurence H. Meyer, speaking to the American Law Institute and American Bar Association, summarized the implementation of the Gramm-Leach-Bliley Act one year after enactment. Understandably comprehensive data is relatively sparse, but Governor Meyer observed, "[The Gramm-Leach-Bliley Act] has not, as yet, induced a dramatic break with the past." Since the new law became effective "almost 500 financial holding companies were formed, twenty or so by foreign banking organizations. But surprisingly three-quarters of these new holding companies have assets of less than $500 million, and half of these have assets of less than $150 million." Governor Meyer further observes that these smaller financial holding companies seem most interested in using the insurance agency and merchant banking powers of the Act and "far less interested in securities and insurance underwriting." It seems that new holding companies are not moving quickly as was widely anticipated or predicted to exercise the new powers of the Gramm-Leach-Bliley Act.[7]

After extensive congressional hearings and debate over nearly three years, the GLB Act created a new framework that acknowledged the synergies that could result from mixing securities and insurance activities with banking. Yet the GLB Act, at Section 103(4)(F), provides that holding companies may engage in any activity that the Federal Reserve Board "has determined, by order or regulation that is in effect on the date of the enactment" of the GLB Act to be so "closely related to banking or managing or controlling banks as to be a proper incident thereto (subject to the same terms and conditions contained in such order or regulation, unless modified by the Board)." We note real estate brokerage and property management were impermissible to bank holding companies at the time the GLB Act went into effect and has been so since 1972 when the Federal Reserve Board denied real estate brokerage – a non-bank activity -- as an activity closely related to banking.[8]

But with the Act in effect for less than two years, the American Bankers Association and Fremont National Bank & Trust Co., Fremont, Nebraska and the Financial Services Roundtable and the New York Clearing House Association are pressing the Federal Reserve Board and the Treasury Department (the Agencies) to adopt regulations that would define real estate brokerage and real estate management activities as "financial in nature" or "incidental to a financial activity."[9]

[6] American Banker Association Press Release, October 15, 1999.
[7] Remarks by Governor Laurence H. Meyer before the American Law Institute and American Bar Association, Washington, D.C., February 15, 2001.
[8] Federal Reserve Board, *Bank Holding Company Act Supervision Manual*, June 2000, p.11.
[9] The Financial Services Roundtable draws its membership from the top 150 integrated financial services companies based on market capitalization or imputed market capitalization. The New York Clearing House 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 Well Fargo & Company.

The request raises the GLB Act tests of competition, and changes in the marketplace and technology for delivering financial services. The Agencies must consider factors enumerated in Section 103 of the GLB Act that include the purposes of the Act, together with the purposes of the Bank Holding Company Act. Specifically the Agencies must consider "changes or reasonably expected changes" in the marketplace in which financial holding companies compete as well as changes or reasonably expected changes in the "technology for delivering financial services; and whether such activity is necessary or appropriate" to allow a financial holding company and its subsidiaries to "compete effectively with any company seeking to provide financial services" in this country; "efficiently deliver information and services that are financial in nature through the use of technological means…"; and "offer customers any available or emerging technological means for using financial services or for the document imaging of data."[10]

The GLB Act established a mechanism that permitted the creation of new financial services. While Congress established tests for determining future financial services, the law did not – perhaps could not – specify what financial product and services might evolve over time. Under the GLB Act, the Board, in determining whether to permit a proposed activity under the rubric of it's being either "financial in nature" or "incidental to a financial activity,"[11] is required to consider, among other things, the Congressional purposes of the BHCA. The Board repeatedly has emphasized that among the intended purposes of the BHCA is to prevent the mixing of banking and commerce, as well as to "prevent the undue concentration of economic resources."[12]

These GLB Act provisions strongly suggest that Congress anticipated that new financial holding companies would engage in activities using computer and communication technology and related services information services in delivery financial services. The Senate Banking Committee Report 106-44, while giving holding companies some opportunity to engage in related commercial activities, did not give approval to a general mixing of banking and commerce. The Senate report goes on to state that the Federal Reserve Board has some "flexibility to accommodate the affiliation of depository institutions with insurance companies, securities firms, and other financial services providers <u>while continuing to be attentive not to allow the general mixing of banking and commerce in contravention of the purposes of the Act.</u>"[13] The committee report strongly suggests that the consideration of changes in the marketplace were not considered to be so expansive as to include real estate, but rather the convergence of finance and computer and information technologies to delivery of financial services and perform document imaging.

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[10] Gramm-Leach-Bliley Act of 1999 (Pub. Law 106-102), Section 103(a) (amending the Bank Holding Company Act Section 4(k)(3)).

[11] 12 U.S.C. § 1843(k)(3) ("In determining whether an activity is financial in nature or incidental to a financial activity, The Board shall take into account – (A) the purposes of this chapter and the Gramm-Leach-Bliley Act. . ..."). This "chapter" refers to the BHCA, which has been crafted in large part to prevent the mixing of banking and commerce and the attendant concentration of economic resources. Though the BHCA does not expressly enumerate its purposes, there is ample legislative history, as well as regulatory and judicial acknowledgment of those purposes.

[12] *First Commerce Corp.,* 58 Fed. Res. Bull. at 676.

[13] Senate Report 106-44, to Accompany S.900, together with Additional Views. U.S. G.P.O, Washington, 1999, p. 21. Emphasis added.

The Federal Reserve Board itself has observed that the BHCA reflects the intent of Congress to prevent situations in which a bank that has nonbanking affiliates "might deny justified credit to competitors or prospective competitors of such affiliates," or in some fashion cause bank customers to use the services of the bank's nonbank affiliates out of fear of retaliation by the bank.[14] The GLB Act did not change the requirement that the Board determine whether proposed new nonbanking activities, even if they are "financial in nature" or "incidental to a financial activity," may nevertheless contravene the purposes of the BHCA by mixing commerce and banking, with attendant adverse consequences to the public.

The proposed rule would define real estate based on a definition advanced by the banks and holding companies. Yet that definition turns on the financial aspects of mortgaging property, not the commercial aspects of the real estate business. This fairly contorted definition of real estate brokerage contradicts the very definition of brokerage for bank holding companies as defined by the Board in its Bank Holding Company Supervision Manual. Real estate brokerage is "the negotiating of a real estate contract between a buyer and seller for which the broker receives a fee or commission and in which the broker takes no possessory interest in the subject matter of the contract."[15] The Federal Reserve Board, we would note, has stated that this activity is considered impermissible for bank holding companies as a "closely related" banking activity.

The Federal Reserve Board also finalized a regulation determining, after consulting with the Secretary of the Treasury, that acting as a "finder" is an activity that is incidental to a financial activity and, therefore, a permissible activity for a financial holding company. The activity of a finder is defined as bringing together one or more buyers and sellers of any product or service for transactions that the parties themselves negotiate. The Board's final rule provides that a finder may act through any means to bring together buyers and sellers of products and services for transactions that the parties themselves negotiate and consummate. But significantly, the Board's final rule prohibits a financial holding company from engaging in any activity that would require the company to register or obtain a license as a real estate agent or broker under applicable law. This prohibition was retained from the proposed rule, despite requests from commenters asking that it be removed. The Board acknowledged that real estate agency or brokerage activities have not been determined to be financial in nature or incidental to financial activities.[16]

The Agencies specifically request comment on two related questions. First, should real estate be deemed a financial asset because it is a comparatively large asset on most individuals' balance sheet or because it is used as collateral for financial instruments? Second, should the importance, complexity, or size of a real estate transaction affect the determination of whether the transaction is financial in nature? The Agencies are direct on this matter by expressing skepticism in the preamble to the proposed regulation that "the importance, complexity, or size" of a real estate transaction should affect a determination as to whether the transaction is financial in nature.[17] REALTORS® support the Agencies' skepticism. How does real estate differ from collectable art,

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[14] *Transamerica Corp.*, 43 Fed. Res. Bull. 1014, 1016 (1957).

[15] Section 3700.3, Impermissible Activities (Real Estate Brokerage and Syndication) BHC Supervision Manual, December, 1992, p. 1.

[16] 66 Federal Reserve, January 3, 2001.

[17] 66 Federal Register, January 3, 2001, p. 211.

automobiles, or household appliances in this regard? Merely financing real estate or some other tangible asset or durable good that may or may not appreciate, or represent a major expense for the borrower simply does not turn the financed asset or good into a financial instrument. The logic simply does not follow.

Concerns and Issues

Ten years ago when 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: concentration, conflicts, unfair competition and breaches of fiduciary responsibilities.[18] Corrigan identified a second group of risks associated with permitting the merging of banking and commerce as "the dangers that such arrangements will involve the de facto extension of parts of the safety net to any firm that would own and control banks."[19]

There are strong historic reasons to keep financial institutions in the business of finance, and finance alone. Public confidence, and subsequently the national economy, would be seriously tested and lowered if banks are permitted to sell and manage the products that they finance.

There are clear ramifications and concerns that flow from the prospect that banks could act as real estate brokers and property managers. Currently the separation of real estate brokerage and agency and lender mitigates the potential for concentration of market power, conflicts of interests, and unfair competitive practices. These same issues that concerned Congress when debating the GLB Act are raised by reclassifying real estate as a financial activity.

A major concern of REALTORS® is the prospect that the financial holding companies and national banks possess unfair, federally chartered advantages not held by their real estate brokerage competitors. The real estate brokerage industry is already characterized by fierce competition, market efficiencies, and ease of entry so that there is nothing gained for consumers by permitting FHCs entrance.

As Federal Reserve Board chairman Alan Greenspan pointed out, financial holding companies receive a substantial subsidy from the federal government. As a result of the protection provided by federal deposit insurance, bank depositors are willing to accept a lower rate of return on the funds they place on deposit in banks than they otherwise would find acceptable. This significantly reduces the cost of funds for insured depository institutions. Additionally, banks enjoy special access to credit at the Federal Reserve discount window and at Federal Home Loan banks, where they can borrow at below-market rates that are not available to other businesses. All of these benefits and advantages are enjoyed directly by insured banks, and indirectly by their affiliates, and unmistakably would work to the advantage of bank-affiliated real estate brokerage and management firms. The advantages would provide substantial competitive advantages over companies engaged in real brokerage and management.

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[18] 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.
[19] *Ibid.*, p.6.

Due to their federally chartered advantages, bank ownership of real estate brokerage companies would stifle competition, limit consumer choices and predictably raise consumer costs. Further, exploiting these advantages in the commercial arena would place an unnecessary burden on U.S. taxpayers as well as create unintended consequences on the safety and soundness of the nation's banking system. An important consideration is that the direct and indirect federal subsidies enjoyed by financial holding companies provide a downstream advantage to their subsidiaries.

Concentration, conflicts, unfair competition and breaches of fiduciary responsibility

The principal reasons cited for permitting holding companies to engage in real estate brokerage and property management include better competition, changes in the marketplace and the technology that financial holding companies and subsidiaries can use to deliver financial services, and the necessity and appropriateness of banks entering into real estate.

REALTORS®do not know with certainty how bank-owned realty firms would market their services, but we can make some educated guesses based on their approach to other lines of business. Banks would likely discount their brokerage services to undercut independent brokers and make up the difference by cross-selling other services to customers. They would cross-subsidize their real estate operations with profits from taxpayer-insured operations, freeing more resources for competition. A bank-affiliated real estate firm would benefit from access to the parent institution's extensive databases of depositors, borrowers and credit card holders, which it could use for solicitation purposes.

In a world of bank-owned brokerages, we can also expect an end to mutually beneficial relationships between REALTORS® and bankers. Lenders with their own captive real estate brokerages would have little need to work with independent brokers to market their mortgage products. It can be contended that any potential effects as far reaching as these should not be created from mere rulemaking. There should be fuller, public examination of the consequences of the proposed regulation.

Competition in the marketplace

REALTORS® do not fear competition. The nature of our industry and its relative ease of entry make it one of the most competitive in America. The majority of real estate agents are independent businesspeople that are successful by virtue of their own determination and energy. A large number of real estate professionals are independent contractors that work on a straight commission basis with no guarantee of any minimum income. When new people or companies enter the market, the resulting competition takes place among equals. In our experience it is competition that leads to more and better services for homebuyers.

Competition in the real estate marketplace is fierce. The average real estate brokerage is a small business with a single-office operation with a sales force of about eight agents, who are independent contractors. Large firms do not have significant advantages over smaller firms in real estate brokerage.

The banking industry's search for increased profits through expansion into real estate brokerage is likely to prove frustrating. Banks are unlikely to benefit from economies of scale, cross-selling or diversification. Real estate brokerage contains no identifiable economies of scale to exploit because costs to enter real estate brokerage are quite low, suggesting that additional capital and increases in average firm size that would accompany bank entry into real estate 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 cross-selling financial products and services. Real estate firms' experience with packaging real estate related services has demonstrated that consumers prefer to retain choice among the various services associated with 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 services would play no factor in their choice.[20]

Cost savings and additional efficiencies could occur if combining real estate brokerage and banking offered banks greater risk diversification, but diversification opportunities are few because real estate brokerage volatility is low and will not offset the more volatile banking cycles. In fact, when a bank is likely to see its mortgage portfolio weaken, due to increased defaults and delinquencies, the bank is also likely to experience declines in fee income derived from real estate brokerage.

Competition in the real estate markets is intense largely because there is such ease of entry compared to the banking industry. Real estate brokerage is one of the few businesses where it is relatively easy to enter the business as agent or broker. Agents must meet licensure requirements and pass state licensing examination. Brokerage requires bank financing for operating costs, incorporation and licensing, offices and the accoutrements of working with independent contractors.

In contrast, entry into the banking businesses requires obtaining a charter with the necessary funds to meet capital requirements for a regulated financial institution. The bank charter carries both unique responsibilities as a depository institution, in exchange for which the bank has access to the national bank payment system, the financial safety net, and other subsidies.

NAR's concern is not about more competition in the real estate industry. REALTORS® welcome competition, as long as the rules are fair. Despite claims to the contrary, we believe that holding companies entering the real estate brokerage and management businesses will have the effect of actually limiting competition. Directly and indirectly, the holding companies and financial subsidiaries have substantial advantages derived from federal deposit insurance, favorable tax treatment, and special access to credit through the nation's payment system and the Federal Reserve System that assure that banks would not likely compete as equals in the real estate business.

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[20] The 2000 NATIONAL ASSOCIATION OF REALTORS® Profile of Home Buyers and Sellers.

Consequences of the Proposal

The proposal to permit national banks and financial holding companies to engage in real estate brokerage and management wholly fails to appreciate the nature and structure of the real estate industry, and the resulting adverse consequences that would follow from allowing such affiliation.

The proposed regulation sets out the parameters for defining new financial activities as prescribed by the Act. Yet within less than two years the banks and holding companies are seeking new financial activities that clearly would push regulators to define the outer limits of the statute. This comes at a time when Congress has not formally reviewed the implementation of the Act and the performance of regulators.

Current data indicates that, for the most part banks and holding companies are not moving to take advantage of the expanded financial activities in the securities and insurance businesses already authorized. If caution is being exercised to assess what new financial businesses or activities should be initiated, REALTORS® must ask why now is there a rush to engage in real estate brokerage and management?

Regulatory Consequences

If the regulation is finalized as proposed, the Federal Reserve Board and the Treasury Department would permit financial holding companies and national bank financial subsidiaries to engage in real estate brokerage and management activities long deemed commercial and thus off-limits. The Federal Reserve and the Treasury Department 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 Federal reserve Board previously used in determining the permissibility of activities for bank holding companies.[21] If this is true, there are far reaching consequences associated with finding that real estate is finance.

Potential Conflicts Between Federal Banking Regulators and State Real Estate Regulators

REALTORS® believe that more deliberation is needed from the policymaking and regulatory perspectives under the Act if, effectively, the definition of brokerage as related to financial activities is to now be extended to non-financial commerce. Significantly, real estate brokerage and property management firms will be regulated under banking regulations. As a consequence, there appear to be unexamined implications relative to regulating the real estate industry, which is traditionally accomplished through the various state real estate commissions and regulatory authorities. Are there conflicts of regulatory authority between federal banking regulators and state real estate regulators?

[21] 66 *Federal Register*, p. 308.

Competition from Non-Banking Entities Overstated

The banks and holding companies maintain that they are at a competitive disadvantage in the face of the involvement of diversified non-financial holding company and state-chartered bank involvement in real estate brokerage. In effect, the argument is intended to address the issue of whether it is "necessary and appropriate" for holding companies and subsidiaries to engage in real estate brokerage and property management as required by the proposed regulation.

Data documenting the competitive disadvantage that state-chartered banks and diversified thrift holding companies pose for financial holding companies and national banks does not support the bank and holding company claim, however. The data shows that the holding companies have made large inroads into the 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.

According to REALTRENDS 500, in 1999 the top twenty-five real estate brokerage firms engaged in mortgage lending accounted for only 78,708 mortgage closings or 0.8 percent of total mortgage originations. The top seventy-five real estate firms affiliated with mortgage banking companies accounted for only 1.1 percent of total mortgage originations.[22]

Banking Competitiveness Compared to Nonbanking Entities

Comparative data examining the real estate subsidiary activities of diversified thrift holding companies is meager and inexact, but a query to the Office of Thrift Supervision determined that there are 107 diversified thrift holding companies with real estate development subsidiaries and agency subsidiaries.[23] Real estate development subsidiaries among this 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 equaled $429.3 billion.

A simple comparison of the assets of diversified thrift holding companies to those of the financial holding companies petitioning the Federal Reserve Board is revealing. Third quarter, 2000 assets of selected holding companies among the top 150 bank holding companies reported by American *Banker* revealed that Citigroup had assets of $804 billion), BankOne, $284 billion, First Union, $247 billion, Well Fargo & Co., $241 billion, FleetBoston Financial, $179 billion.[24]

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[22] Cited in "*Real Estate Brokerage and Property Management Activities: The Consequences of Mixing Banking and Commerce prepared by the Economic Research, the NATIONAL ASSOCIATION OF REALTORS® .*" April, 2001. p. 28-30, *passim.* The research paper accompanied the Association's letter of comment to the Board of Governors of the Federal Reserve System and the Secretary of the Treasury regarding the proposed rule to add real estate brokerage and property management to the list of activities permissible for financial holding companies and national bank financial subsidiaries.

[23] The NATIONAL ASSOCIATION OF REALTORS® addressed a specific query to the Office of Thrift Supervision., Research and Analysis Department, April 13, 2001.

[24] American Banker, Top 150 Holding Companies by Assets, as of September 30, 2000.

According to the 2001 Conference of State Banking Supervisors profile of state-chartered banking 26 states that authorized state-chartered banks in those states to engage in real estate brokerage. The proponents cite these state-charter authorities as a reason that national banks should be authorized to engage in real estate brokerage. In this regard, we would note several points.[25] We would not agree on several points. First, the authority for state-chartered banking institutions to engage in real estate brokerage is not a new occurrence. These state authorities have existed for years with many dating from the 1980s. Second, though there is no denying that the state-chartered authorities exist, just how many state-chartered banks actually exercise the authority and just how intense the competition is in their markets is another question altogether.

Concentration of Market Power

The concentration of market power that would exist if a few holding companies were allowed to control the financial services industry and the real estate transaction would be anti-competitive, increase the potential for conflicts of interest, and limit consumer choices. 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 5 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 securities and insurance, large scale entry into the real estate business could weaken some financial holding companies' standing and place their federally insured operations in jeopardy.

Consumer Issues

Consumers, and especially less affluent homebuyers, may actually experience adverse effects if banks were allowed to become real estate brokers and managers. Independent real estate brokers that work on commission have an incentive, and an obligation, to match consumers with the best housing solution. The primary goal of bank-owned brokerages will be to sell buyers their own loans and other financial products at the best terms for their parent companies, not the consumer. Bank brokers will not have the same fiduciary relationship with consumers that non-bank affiliated real estate professionals have.

Real estate professionals work with their customers in an effort to improve their chances of successfully concluding the home buying transaction. Bank-linked brokers will not have the incentive to arrange financing for buyers whose credit history might compromise the lender's portfolio.

Real estate brokerage <u>is not</u> mortgage lending. Realty firms affiliated with mortgage banking companies and other real estate-associated firms do not enjoy any federal subsidy. The Real Estate Settlement Procedures Act (RESPA) governs the relationship between a real estate client

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[25] In addition to the substantive arguments stated in the text, REALTORS® believe, on the basis of independent research, that there is considerable reason to be skeptical of the claim that 26 states authorize state-chartered banks to act as real estate brokers. NAR contacted by telephone the office of the state banking supervisor in each of the 26 states. Authorities in 11 of those offices responded unequivocally that banks within their jurisdiction do not have authority to engage in real estate brokerage.

who may seek mortgage loan funding from a realty firm's lending affiliate. The opportunity for cross-marketing as envisioned by the banks is limited by the disclosure requirements of RESPA and the reality that real estate agents working to meet a client's needs will oftentimes spurn an affiliated mortgage lender because the real estate transaction will not be executed to the client's advantage.

Mortgage banking firms, which an increasing number of banks and holding companies already own, are not deposit-taking institutions. Their single line of business is mortgage lending. In typical fashion, mortgage banking firms operate on warehouse lines of credit borrowed from commercial banks. Realty-affiliated mortgage banking firms have their own capital at risk, not that provided directly or indirectly by the federal safety net.

We believe that this regulation, as proposed, raises additional questions regarding consumer financial information privacy. Congress recognized during the GLB Act debates that issues relating to consumer financial information privacy were complicated and deserved more comprehensive review. Several bills are already pending that are attempts to address privacy issues raised by the GLB Act and other that are coming to light as policymakers wrestle with these thorny issues. There is little clarity at this point regarding what impact the privacy provisions of the Act will have. Yet the regulation could we make the privacy issues even murkier when mortgage lending, the sale and marketing of real estate, and consumer privacy intersect.

Real Estate Brokerage and Property Management

The proposed regulation defines real estate brokerage as "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."[26] The definition of real estate brokerage as proposed flatly ignores the commercial nature of the business. In proposing that this activity be determined to be "financial in nature" or "incidental to a financial activity," the notice cites virtually every remotely similar activity that presently is permissible for financial institutions, but it completely ignores those aspects of the real estate brokerage function that clearly are commercial in nature, and not financial.

The first and most fundamental question is not whether some of the aspects of real estate brokerage, or real estate management, may be analogous to particular activities that presently are permissible for banks or their affiliates. The first and most fundamental question should be: "What is a financial activity, as opposed to a commercial activity?" Any discussion or consideration of the proposed regulation must begin at this level.

The NATIONAL ASSOCIATION OF REALTORS® submits that financial activities are those that relate to transactions in intangible assets. Commercial activities, on the other hand, are those that relate to transactions in tangible assets. Financial activities are based on the concept of notional value. For example, the value of money is solely notional, as is the value of stocks and bonds. Similarly, insurance represents a commitment to transfer something of notional value on the occurrence of some event. On the other hand, commerce involves the transfer of tangible

[26] 66 Federal Register, p. 308.

assets (such as cars, property, televisions, etc.), the value of which derives from the uses to which they can be put.

Consider the case of a local store accepting a credit card for a purchase. A retail merchant selling dry goods to a consumer who use a layaway or deferred payment plan is no more engaged in a financial activity than is the real estate agent who provides that same consumer with information about real property. If real estate is a non-financial asset, then buying and selling the property is not a financial activity not is it incidental to the financial activity. The argument from this perspective suggests that finance is more incidental to brokering of properties.

While commerce, other than through barter, inevitably entails the use of financial assets such as money, this does not mean that commerce is "financial in nature" or "incidental to a financial activity." If it were otherwise, the GLB Act would have to be interpreted as wholly abolishing the distinction between finance and commerce, meaning that financial holding companies would be free to engage in any activity that involves the use of financial assets, including the manufacture and sale of automobiles, television sets, or any other product.

Property management involves the overall management of the property, from obtaining a good, qualified tenant, to collecting the rents, taking care of renovations and repairs, hiring the best people for jobs from maintenance workers to accountants, and dealing with any legal proceedings related to the property. Property management is significantly different from banking and financial related activities, and requires considerable expertise and full accountability for economic and business risks.

The only property management activity that is incidental to financial services is cash management. To argue that this makes property management a banking related activity would open the door to include any business that maintains bank accounts as a banking related activity.

Banks ownership of property management firms could create conflicts of interest. 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 could be used by a financial institution's affiliate management company to undermine the leasing and marketing of the property by the private management firm. Banks could also use predatory pricing tactics, by offering property management services as a loss leader to gain control of the demand deposit accounts of income producing property owners.

Conclusion

When Congress adopted the GLB Act in 1999, there was justifiable reason to consider the new legislation sweeping. The Act established a new framework to expand the activities of banks. The GLB Act also expanded the scope of permissible activities and rationalized the process for banking and financial services institutions to enter into these new activities. Congress intended to enhance competition in the financial services industry by eliminating legal and regulatory barriers separating banking, securities firms and insurance companies and by facilitating affiliation among them. At the same time, Congress intended to retain the separation of banking and commerce.

Representative Jim Leach made the point of what he and his colleagues in Congress intended regarding the mix of banking and commerce in his remarks to the Conference of State Banking Supervisors at their meeting in May 2000. Representative Leach said,

> " 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 judgment 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. [27]

REALTORS® would submit that the proposed rule does not meet the tests calling on the Agencies to consider the purposes of the Bank Holding Company Act and Gramm-Leach-Bliley Act. These factors include changes or reasonably expected changes that affect financial holding companies' markets, their ability to competition with other financial companies providing financial services, and to account for technology applications that permit delivering financial services. Neither the markets, the technology, nor the competition has changed significantly to warrant expanding banks' new powers to include real estate brokerage and management.

With the new financial services modernization law in effect for little more than a year, it is too early to expand the list of new financial activities, especially since the banks have not move to take advantage of those powers that are undisputedly financial activities under the Act. Banks have not moved to use the enhanced activities automatically determined by Congress to financial in nature nor do the Federal Reserve Board and the Treasury Department have much experience in regulating their the banks and holding companies under the provisions of the new law. The banks are pressing the Agencies to make a determination far in advance of the regulatory experience needed under the provisions of the Act.

This proposed reclassification of real estate and property management is an attempt to obliterate the distinction between banking and commerce. Using the regulatory process, banks are making an end run on Congress. Any significant redefinition as proposed raises policy questions on the distinction between finance and commerce that Congress should address because it is clear Congress intended to maintain a distinction. That distinction included real estate as commerce, not finance.

Mr. Chairman and members of the Subcommittee thank you for this opportunity to present our views regarding the Federal Reserve Board-Treasury Department proposed regulation on real estate brokerage and property management. It is our hope that the Agencies will not finalize to the proposal in its current form. To go forward with the proposed regulation in so short a time since the Act went into effect seems to be an unwarranted attempt to press the very limits of the new financial services law and its implementing regulations without the further input of Congress.

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[27] Rep. Jim Leach, Remarks prepared for delivery before the Conference of State Banking Supervisors, May 12, 2000.

We would remind the Committee of Alan Greenspan's apt comments in his testimony on H.R.10, the base legislation of the Gramm-Leach-Bliley, in 1999. While discussing the advisability of mixing banking and commerce as reflected in the prospect of commercial companies owning banks, Chairman Greenspan said to the House Commerce Committee: "It seems to us wise to move first towards integrating 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."[28] REALTORS® believe this advice is also applicable in the current context of the Agencies' proposal that would in essence abrogate the commercial nature of real estate and declare real estate brokerage and property management financial activities, opening the way for financial holding companies and subsidiaries to enter these businesses long denied to banks and bank holding companies.

[28] Alan Greenspan, Testimony on H.R. 10 and the Need for Financial Reform before the Committee on Banking and Financial Services, U.S. House of Representatives, February 11, 1999. p. 3.