Competition in Real Estate Brokerage from National Banks and Financial Holding Companies

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Jud, G. D. and D. T. Winkler. “Competition in Real Estate Brokerage from National Banks and Financial Holding Companies,” Journal of Real Estate Practice and Education, vol. 8, no. 1, 2005, 83-98.

Abstract:
The passage of the Gramm-Leach-Bliley Act (GLB) in 1999 permits nationally-chartered banking institutions to engage in real estate brokerage business if certain conditions are met. However, the Community Choice in Real Estate Act legislation seeks to prevent the GLB Act from being enacted. A survey of banking institutions involved in real estate brokerage finds that these institutions are smaller, less profitable and growing more slowly than the average state-chartered bank. These banks appear to be seeking more profitable lines of business. The results also reveal that most banks are concerned about a substantial loss of loan referrals and other business from Realtors®.

Article:

Introduction

In 2003, homeowners in the United States traded 6.1 million existing homes at an average price of $216,200, a trading volume of $1.32 trillion. Assuming that the average brokerage commission can be estimated at 5.4%, residential real estate sales commissions are estimated to amount to some $71.2 billion.1 The growing size of the residential brokerage industry (brought about by low interest rates and concomitant surging home sales) has attracted a number of new entrants, including insurance and finance companies.2 Financial service companies have been attracted by the growing revenues generated by the brokerage industry as well as the prospect of offering homebuyers one-stop access to other financial service products such as insurance, credit services and wealth management.

Until 1999, the Banking Act of 1933 (Glass-Stegall Act) and the Bank Holding Company Act of 1956 (BHCA) acting together prevented national banks and their subsidiaries from engaging in real estate brokerage, as well as in other financial and non-financial activities. In November 1999, President Clinton signed the GrammLeach-Bliley Act (GLB Act), which repealed certain provisions of the Glass-Stegall Act and the BHCA, allowing banks to engage in securities, insurance and other activities, and investment banks and insurance companies to participate in certain banking activities. The GLB Act also established a mechanism for allowing banks to enter new lines of business in the future. It permits the Federal Reserve Board and the Treasury to allow banks to enter new areas of business if the Fed and the Treasury determine that the new businesses are financial in nature or incidental to a financial activity.

In February 2000, a group of banks petitioned the Fed and the Treasury to allow national bank subsidiaries to enter into the real estate brokerage and management business. The petition did not include state banks because they are regulated by banking commissions in the various states and because the banking commissions in 26 states already allow state-chartered banks to engage in real estate brokerage. In January 2001, the Fed and the Treasury issued a proposed rule that would permit banking entities to begin operating real estate brokerage and management businesses.

Following the issuance of the proposed rule, the National Association of Realtors® (NAR) began to lobby very intensely against the proposal. In October 2001, the NAR sent the White House staff 35,000 letters opposing the proposal. The NAR also has pushed for legislation to prohibit financial holding companies and national banks from directly or indirectly engaging in real estate brokerage or real estate management activities. Known as the Community Choice in Real Estate Act (CCREA), the NAR-backed legislation seeks to prohibit financial holding companies and national banks from directly or indirectly engaging in the real estate brokerage or real estate management activities. The CCREA amends the BHCA by prohibiting the Federal Reserve Board or the Treasury from determining that the real estate brokerage and management businesses are financial activities or complementary to financial activities.

An interesting aspect of the debate is that some banks are already allowed to operate real estate brokerage businesses. State-charted banks in 26 states are permitted to do brokerage business either directly or through a subsidiary as shown in Exhibit 1, although very few have actually done so. The number of state-chartered institutions that are already allowed to engage in real estate brokerage totals 4,684, or 51% of the banking institutions in the nation. These 4,684 institutions hold 45% of the assets of state-charted banks, or 18% of all the banking assets in the nation.

This paper explores the arguments of allowing national banks and financial holding companies into the real estate brokerage business. It also reviews the parallels found in studies of bank entry into the insurance business. In addition, it evaluates the pros and cons of bank entry points into real estate brokerage. The results of a survey of state banks already operating brokerage businesses are also presented. The final section summarizes relevant findings and evaluates likely future trends.

Opponents of the Community Choice in Real Estate Act

The Financial Services Roundtable represents the 100 largest integrated financial services companies, providing banking, insurance and investment products. Testifying before Congress, the Roundtable stated its opposition to the CCREA. They believe that the Treasury should be permitted to complete the rulemaking of the GLB Act. In particular, they favor permitting financial holding companies and national bank subsidiaries to compete in arenas that are "financial in nature," inclusive of real estate brokerage and real estate management.

The benefits to consumers arising from increased competition in the brokerage industry are cited as the key reason for permitting financial holding companies and national bank subsidiaries to enter the business. Among the benefits to consumers are more choices, lower prices and better customer service. In this regard, the trend toward one-stop shopping for consumer goods is relevant. A 1999 NAR study suggests that 76% of home buyers find it appealing to get all or some of their home buying services from one company. If the GLB Act is implemented for real estate brokerage, consumers would be able to receive virtually all services in one location (mortgage loan, title insurance, property insurance, home searching assistance), thereby expediting the delivery of financial services and simplifying the consumer's life.

Exhibit 1
States Allowing State-Chartered Banking Institutions to Engage in Real Estate Brokerage

		Population	Nationally Chartered Institutions		State Chartered Institutions	
		2000	Number	Assets	Number	Assets
No.	United States	282,124.6	2,816	5,372,667.8	6,366	3,704,109.2
1	Alabama	4,451.5	32	22,432.5	130	192,318.5
2	Arizona	5,165.3	20	57,582.9	30	3,155.4
3	California	34,000.4	115	809,522.7	203	153,409.8
4	Connecticut	3,410.1	17	19,676.9	46	36,207.2
5	Delaware	786.2	15	174,689.9	19	41,492.2
6	District Of Columbia	571.1	5	802.5	1	78.2
7	Florida	16,054.3	110	64,820.4	194	45,857.5
8	Georgia	8,229.8	79	30,169.3	266	183,907.7
9	Idaho	1,299.3	105	1,323.1	1,451	3,404.7
10	Indiana	6,090.0	75	82,083.7	131	35,348.0
11	Iowa	2,927.5	72	22,155.0	350	33,778.0
12	Maine	1,277.0	12	30,177.3	28	10,088.1
13	Massachusetts	6,357.1	31	17,895.2	178	196,267.7
14	Michigan	9,952.0	41	64,455.5	137	132,899.7
15	Nebraska	1,712.6	80	29,284.7	190	16,321.6
16	New Hampshire	1,239.9	9	15,663.0	22	14,028.8
17	New Jersey	8,429.0	55	16,096.0	91	90,296.0
18	New Mexico	1,821.3	23	14,722.2	37	5,811.8
19	North Carolina	8,077.4	21	976,627.0	83	125,258.9
20	Pennsylvania	12,282.6	117	199,918.1	153	97,166.6
21	South Dakota	755.5	23	75,693.1	71	9,727.7
22	Tennessee	5,702.0	49	92,683.4	159	25,899.3
23	Texas	20,946.5	338	120,960.4	360	79,230.3
24	Washington	5,908.4	20	12,502.0	80	65,893.6
25	Wisconsin	5,372.2	63	41,891.9	248	67,517.5
26	Wyoming	494.0	20	2,797.9	26	2,763.5
	% of U.S. Total	61%	55%	56%	74%	45%

Note: The source is the Federal Deposit Insurance Corporation. Assets expressed in $1,000,000s and population in 1,000s.

The implementation of the GLB Act for real estate brokerage would benefit the financial services industry, but in fact, federal thrifts and credit unions as well as state-chartered banks in 26 states already are permitted to act as real estate brokers. Moreover, banking organizations are already engaged in a wide variety of real estate-related activities, such as real estate lending, real estate settlement and escrow services, real estate investment advisory services, title insurance and commercial real estate equity financing. Banking advocates contend that brokerage activities are just one more aspect of their on-going service offerings. Therefore, the implementation of the GLB Act would only be permitting financial holding companies and national bank subsidiaries to have the same rights that state-chartered banks and other financial service companies already possess.

Banking opponents of the CCREA assert that real estate brokerage falls into the category of "financial in nature" as required by the GLB Act, and that the Fed and the Treasury should find it "incidental to a financial activity." They contend that buying a home is financial in nature, as required by the GLB Act, because it is one of the largest financial transactions that the average person is likely to undertake, and mortgage payments are just like an investment in an annuity or a stock in that the value of the underlying asset fluctuates. Accordingly, the Roundtable contends that real estate brokerage is a part of the business of financial holding companies.

Proponents of the Community Choice in Real Estate Act

The NAR's advocacy of the CCREA is based principally on the proposition that the federal government should maintain the separation of banking and commerce. Realtor® supporters contend that real estate brokerage is not a financial activity as required by the GLB Act because most parties to a brokerage transaction do not need a mortgage. None of the sellers (half of all the transactors) need a loan to sell a house, and only 80% of the buyers require a mortgage, according to the American Housing Survey. Therefore, banks should be excluded from real estate brokerage just like they are excluded from other non-financial activities like building and development.

Banks are special because a large portion of their debts (deposits) are insured by the federal government through the Federal Deposit Insurance Corporation (FDIC). Because of FDIC insurance, banks are able to borrow at lower cost and operate with greater leverage than are other commercial enterprises. Thus, banks have a special competitive advantage stemming from their lower cost of funds, which is denied to commercial enterprises in other sectors. Accordingly, competition between banks and traditional real estate brokerage firms would be inherently unfair. It is asserted that this un-level playing field would eventually drive small, traditional brokerage firms out of business and lead to the monopolization of the brokerage industry and the concomitant reduction in consumer choice.

The GLB Act requires that the Federal Reserve take into account changes in the marketplace and changes in technology for delivering financial services before permitting financial holding companies and national banks to engage in real estate brokerage or real estate management activities. The NAR suggests that there have been no significant changes in the marketplace or in technology since the passage of the GLB Act.

The separation of banking from non-bank affiliate risks (such as real estate brokerage) has been proposed through the use of a "firewall." However, NAR contends that the possibility of improper transactions would raise concerns about banks' safety and soundness. In particular, banks might not let a real estate brokerage fail, thus, imperiling the banking unit. In addition, firewalls are not impenetrable, and are most vulnerable during bad times.

The NAR asserts that consumers would be poorly served by allowing banks into the brokerage business. The argument is that banks have a moral hazard problem. Because banks make most of their money by making loans, they may be tempted to provide home buyers and sellers with advice, which may not be in customer's best interest but which benefits the bank's lending business. Consumers, for example, may feel coerced to use a bank's brokerage services (which may be substandard) to secure a loan. Also, bank-affiliated brokers may steer lending business to the affiliate's bank when the consumer may be better served at another financial institution. While the consumer may benefit from the one-stop shopping offered by a bank, the ease of this service may blind the consumer of the benefits available elsewhere in the market.

Not all real estate trade associations support CCREA. The Real Estate Services Providers Council and the Realty Alliance have indicated that they do not endorse CCREA. The Council is a national group of residential real estate brokers, mortgage services executives and home builders, while the Alliance is composed of 55 large regional residential real estate brokerage firms. The two groups assert that they do "not fear competition by nationally chartered banks" and believe that one-stop shopping for real estate services is important for consumers.

Evidence from the Insurance Industry

The GLB Act provided for bank entry into the insurance field, as well as allowing possible bank entry into real estate brokerage. Under the GLB Act, financial holding companies were permitted to underwrite and sell insurance and annuities. National banks and their subsidiaries, on the other hand, were permitted to sell insurance and annuities, but not to underwrite insurance. The effects of bank entry into the insurance field have been the subject of several recent academic studies, which may be suggestive of the possible impacts of bank entry into real estate brokerage.

Empirical work in this area is based on the theory of contestable markets set forth by Baumol (1982) and others. The theory asserts that no industry earns economic profits over an extended period of time unless barriers to entry like regulatory constraints limit potential competition. The effects of the removal of entry barriers can be assessed by observing the path of industry cash flows and profits over time. If entry barriers have restrained competition, the removal of such barriers will increase competition in the protected industry; thus, the profits of existing firms in the industry can be expected to fall. And according to Fama and MacBeth (1973), the change in expected profits will be quickly reflected in the stock prices of existing firms in the industry. Alternatively, if the regulatory changes create new profitable opportunities, stock prices can be expected to rise.

Three studies have examined the path of stock prices of insurance and banking companies following the removal of entry barriers separating the industries. Carow (2001) focuses on the effects of a series of rulings by the Office of the Comptroller of the Currency (OCC) and the Supreme Court beginning in 1985. These rulings opened the door to allowing banks to sell insurance products, starting first with selling annuities and then insurance. He finds overall negative returns for insurance companies. The largest negative returns accrue to insurance companies that have insurance agencies and those that sell life and health insurance. Carow suggests the barriers to bank entry protected the insurance companies and removal of the barriers hurt their profit prospects. In contract, he reports there was no effect on the stock returns recorded by banks. Thus, the market anticipated few new profitable opportunities for banks concomitant with the removal of the regulator barriers.

Johnston and Madura (2000) observed the effects of the 1998 Citigroup/Travelers merger on banking, insurance and brokerage firm stock prices. They reported that the announcement of the merger was associated with positive and significant increases in the stock prices of banks, insurance companies and brokerage firms. They interpreted their results as suggesting that financial services companies could extract substantial efficiencies from diversification across financial services. They found that the largest companies registered the biggest gains in stock valuation, which indicated that bigger firms obtained greater benefits.

Akhigbe and Why te (2001) examined the impact of events leading up to the passage of the GLB Act on the stock returns of banks, brokerage and insurance companies. They reported that the passage of the GLB Act was associated with positive and significant returns for all classes of firms. They concluded that the market anticipated that passage of the GLB Act created new, positive opportunities for all institutions.

The foregoing three studies are suggestive of the effects that might result from the entry of banks into the real estate brokerage market. The Carow (2001) study found that insurance company profits were hurt by deregulation, suggesting that regulatory barriers hindered competition. Similar effects may arise with bank entry into the real estate field; however, lower profits for real estate brokerage firms do not equate to lower consumer welfare. The Johnston and Madura (2000) and the Akhigbe and Whyte (2001) studies reported strong positive returns to all categories of financial service companies concomitant with deregulation. These two studies indicate that the cross-selling of financial service products creates strong potential benefits for firms and consumers.

Evaluation of the Issues
The two most compelling arguments against permitting financial holding companies and national banks from engaging in real estate brokerage relate to an unfair advantage afforded to banks as compared to existing real estate brokerage firms and the potential of a moral hazard for consumers.

The NAR scenario of domination by the banking entities seems somewhat remote considering that the state-chartered banks in 26 states control 18% of the nation's banking assets, and these banks are currently allowed to engage in real estate brokerage, yet have thus far had so little impact on the brokerage industry. The differential advantage of national banks or financial holding companies operating in real estate brokerage appears minimal or perhaps nonexistent. To the contrary, if such banking entities decide to engage in real estate brokerage activities, they may do so at the risk of losing referral loan business from real estate brokerage firms. Therefore, banks must weigh the potential benefits against the costs.

The question of whether large banking entities would shift the cost structure in their favor relies on the presence of economies of scale in the real estate brokerage industry. Zumpano (2002) argues that real estate brokerage firms confront U-shaped average cost curves. His research reveals that brokerage firms have only modest economies of scale and that brokerage firms currently operate reasonably efficiently. Thus, entry of banks into the industry would not generate substantial gains for consumers. This argument, however, suggests that if traditional brokerage companies indeed are efficient, then they should have little to fear from bank entry. The entry of banks into the brokerage industry may result in some departures from the industry, but traditional brokerage firms should be able to continue to thrive as long as they remain low cost producers. And consumers certainly would not be hurt by heightened competition even if it proved only temporary and resulted in little change in brokerage service costs.

The moral hazard argument is diminished when it is recognized that that real estate lenders such as insurance and finance companies already are allowed to operate in the brokerage services market. Firms such as Prudential and GMAC currently own and operate real estate brokerage affiliate networks nationwide, and broker affiliates of these firms face the same moral hazards that would confront bank-affiliated brokers. In addition, large real estate brokerage companies have begun to offer consumers the convenience of one-stop shopping for services.3 For example, two of the biggest real estate companies in the Washington, DC area (Weichert and Long & Foster) provide consumers the full range of brokerage, appraisal and financial services.

The most compelling arguments in favor of entry to real estate brokerage by financial holding companies and national banks are the potential reduction in consumer costs, the increase in consumer conveniences (such as one-stop shopping) and the development of new and innovative fee structures.

The real difficulty confronting those who assert that consumers are well-served by the current cost structure of the brokerage industry is the level of commission rates extant in the industry. The survey results presented in this paper of the commission rates in the United States draws on information available from homegain.com, which documents an average commission rate of 5.4%. Comparing this rate to those in other developed countries, as reported in a recent paper by Delcoure and Miller (2001), reveals that commission rates in the U.S. are higher than in any other developed country. The authors report, for example, that rates are 1% to 2% in the United Kingdom, 3% in Japan, and 3% to 6% in Canada.

Bank advocates argue that consumers would benefit from the greater convenience that one-stop shopping offers. However, as discussed above, one-stop shopping already is an on-going industry trend, without the entry of banks. Nevertheless, bank entry might accelerate the trend because opinion surveys consistently show that consumers trust their banks.

Regarding the moral hazard issue, bank supporters assert that the financial services industry is subject to more privacy restrictions and consumer protections than any other industry. Bank-affiliated brokers will become subject to the same restrictions. The proposal advanced by the Fed and the Treasury protects consumers by providing that all rules applicable to real estate brokers (license laws and sales practices) would apply equally to bank-affiliated brokers. It also increases the protection for consumers that deal with bank-affiliated brokers since they will be subject to the "anti-tying" provisions of the BHCA, which prohibit the tying of credit and other services.

Banking advocates argue that bank entry into the real estate brokerage business may speed the development of new and innovative fee structures that will provide consumers with alternatives to the high commissions charged by most real estate brokers. If the proposal is defeated, consumers will have fewer options. While this point may have merit, it should not be overlooked that discount brokerage services are widely available in most major cities already.4

A Survey of Banks in the Real Estate Brokerage Business

In 2002, Mr. Martin Edwards, Jr., President of the NAR, testifying before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee, listed 18 state banks involved in the business of real estate brokerage.5 These banks formed the initial sample for the survey presented in this paper. In February 2004, contact information was obtained for 14 of the 18 banks through website searches, electronic bank directories and other searches on the Internet. Four of the 18 banks could not be located. In addition, survey respondents identified one additional bank engaged in real estate brokerage. Telephone interviews were conducted with personnel knowledgeable about real estate brokerage services offered by the banks. Of the 15 banks contacted, only 7 (47%) reported current involvement in the real estate brokerage business. As reported in Exhibit 2, the other eight banks had no real estate brokerage activity.6

Exhibit 2 reveals that among the seven banks in the brokerage business, all were located in the Midwest or the South. Three were in Iowa, and one each in Georgia, Nebraska, North Carolina and Wisconsin. Only three were in metropolitan areas with populations above 100,000. The others were all in small, rural communities. All of the seven institutions were state chartered. Five were non-member state banks. One was a state-chartered savings association, and one was a state-chartered Fed member bank. All were private stock-owner institutions.

It is interesting to note that during the bank interviews, the contacts were asked if they were aware of other banking institutions in the brokerage business. Of the original list of 18 banks, only one bank was able to name another bank offering brokerage services. The eight banks that were not engaged in real estate brokerage suggested that a principal reason for avoiding entrance into the brokerage business was the potential loss of loan referrals from practicing real estate brokers. Some banks further expressed the view that their bank chose not to engage in the brokerage business because it was too competitive and unprofitable.

Exhibit 2
List of Banks Surveyed

No.	Institution	Location	FDIC No.	Real Estate Brokerage
1	Tama State Bank	Marshalltown, IA	252	No
2	Northwest Federal Savings Bank	Storm Lake, IA	32647	No
3	Sac City State Bank Real Estate	Sac City, IA	n.a.	n.a.
4	Mercantile Bank of Rock Rapids	Rock Rapids, IA	n.a.	n.a.
5	United Bank of Iowa	Odebolt, IA	958	Yes
6	First Central Bank	Dawitt, IA	n.a.	n.a.
7	Maquoketa State Bank	Maquoketa, IA	17903	No
8	Hardin County Savings Bank	Eldora, IA	5817	No
9	St. Ansgar State Bank	St. Ansgar, IA	17259	Yes
10	First Federal Bank	Sioux City, IA	27732	Yes
11	Tranor State Bank	Tranor, IA	n.a.	n.a.
12	Community Bank & Trust	Cornelia, GA	5702	Yes
13	Bank of Alma	Alma, WI	26689	No
14	Anchorbank, FSB	Madison, WI	29979	No
15	Union State Bank	Kewaunee, WI	14790	Yes
16	First Bank, Upper Michigan	Escanaba, MI	14276	No
17	Peoples Bank	Newton, NC	5956	Yes
18	Security FS	Lincoln, NE	32325	No
19	Security 1st Bank	Sidney, NE	5415	Yes

Note: The source is the Hearing before the Subcommittee on Commercial and Administrative Law (Committee on the Judiciary House of Representatives), 107th Congress, 2nd session, May 16, 2002, Serial No. 77, p. 24.

Exhibit 3 shows key statistics of the seven brokerage banks. In 2003, the brokerage banks had average assets of $416 million, and an average of 165 full-time employees. The average length of time that these banks had offered brokerage services was 13 years. Two of the banks entered the business as recently as 2002, while one reported operating a brokerage business for 40 years.

In 2003, the seven banks brokered an average of 125 real estate transactions; the median number was 60. Compared to their total number of full-time employees, the number of persons doing real estate brokerage business in the banks was small. The average number of persons engaged in the brokerage business was 10; the median number was six. Not all of these persons were involved in brokerage full time. In five of the seven institutions, salaried employees with real estate licenses were assigned to engage in marketing properties as a part of their regular duties. At other times, these employees made loans or engaged in other banking business. In two of the seven cases, the banks had purchased a real estate brokerage subsidiary, and the individuals engaged in real estate brokerage were licensed, independent contractors with the real estate subsidiary.

Fifty-seven percent (four of the seven institutions) were affiliated with a Multiple Listing Service. Twenty-nine percent (two of the seven institutions) were franchise affiliated. In each case, the franchise was Century 21. All of the institutions (100%) engaged in both buyer- and seller-brokerage.

The range of commission rates charged by the banks was wide, ranging from a low of 3% to a high of 7%. One of the banks had adopted a flat-fee pricing strategy. This bank would buy or sell homes for a flat fee of $2,500. For $2,500, the bank offered "barebones" services, limited advertising, no open houses, etc.

Exhibit 3
Survey of Banks in Real Estate Brokerage

Average Total Assets	$416 million
Average Number of Full-Time Employees	165
Number of Brokerage Employees	10
Years in the Brokerage Business	13
Number of Sales in 2003	125
Own a Real Estate Brokerage Affiliate	29%
MLS Affiliated	57%
Franchise Affiliated	29%
Buyer/Seller Brokerage	100%
Number of Brokerage Banks	7

Notes: The source is the Federal Deposit Insurance Corporations. Calculations by the authors.

All of the seven institutions expressed the view that their brokerage business was a successful line of business for their bank. Most expressed the view that real estate brokerage generates additional banking business and customer contacts in addition to the extra fee income it generates. One bank reported a strong appraisal business with brokerage activities limited to foreclosures. In some of the smaller communities, the banks were principally doing brokerage business as a service to their customers because the market was very thin and few traditional real estate brokerage firms operated in their area. The biggest downside for the banks was the possible loss of loan referrals and other business from traditional brokers.

Exhibit 4 compares the financial performance of the seven brokerage banks with all insured state banks for 2003:3, using annualized measures of performance. In 2003: 3, there were 6,388 state-chartered banks with average assets of $574 million.

Looking first at overall profitability, the average performance of the seven brokerage banks is below the average of all state-chartered banks. The return on assets (ROA) of the seven banks is

0.9%, compared to 1.2% for all state banks. Likewise, the return on equity (ROE) of the seven banks is 9.9% compared to an average of 13.1% for all state banks.

Exhibit 4
Financial Performance of Brokerage Banks: 2003:3
(annualized data)

	Brokerage Banks	All State Banks
Size		
Number	7	6,366
Average Total Assets	416,019,286	573,552,969
Average Number of Full-Time Employees	165	132
Profitability Ratios		
Return on Assets	0.9%	1.2%
Return on Equity	9.9%	13.1%
Income and Expense Ratios		
Salaries/Total Revenue	25.0%	22.3%
Total Non-interest Income/Net Income	151.2%	166.0%
Additional Non-interest Income/Net Income	110.4%	97.8%
Growth and Dividend Payout		
Payout Ratio (Dividends/Net Income)	89.7%	75.6%
Growth Rate [ROE*(1 − Payout Ratio)]	1.0%	3.2%
Debt Management		
% Equity	9.4%	9.2%
Tier I Capital/Total Assets	8.1%	7.9%
Provision for Loan Losses/Net Income	49.7%	26.3%
Net Loan Charge-Offs/Net Loans & Leases	0.3%	0.4%

Note: The source is the Federal Deposit Insurance Corporations; calculations by the authors.

The lower profitability of the seven brokerage banks can be attributed to a higher level of operating expenses. The seven banks have higher salary expense as a fraction of total revenue and higher provisional loan losses as a fraction of net income.

The dividend payout ratio (dividends/net income) for the seven brokerage banks averaged 89.7%, while the payout ratio for all state banks was 75.6%. The higher payout ratio and the lower ROE of the brokerage banks suggest that their prospects for future growth are substantially less than that for all state banks. The calculated growth rate for the seven brokerage banks is 1.0%, while that for all state banks is 3.2%.

The brokerage banks operate with somewhat less leverage risk. As a group, they have higher percentages of both equity and tier I capital. These higher capital ratios suggest a somewhat more conservative management style for the seven brokerage banks. Accordingly, the higher provision for loan losses indicates that bank management is aware of the need to guard bank capital from losses stemming from future chargeoffs. Net loan charge-offs as a fraction of total loans and leases was only 0.3% for the brokerage banks compared to 0.4% for all state banks.

From the operating results of the seven brokerage banks, part of the motivation for their entry into the brokerage business is inferred to be a search for more profitable lines of business. The bank interviews confirm this motivation. The financial data in Exhibit 4 suggest that brokerage business is enhancing the profitability of the brokerage banks to a modest degree. These banks have a ratio of total non-interest income to net income of 151% compared to 166% for all state banks, but their ratio of additional non-interest income (this is, total non-interest income less fiduciary activities, service charges on deposit accounts, and trading account gains and fees) is 110.4%, compared to 97.8% for all state banks. Since brokerage income would be included under additional non-interest income, the higher performance of this ratio likely reflects the contribution of brokerage fee income.

Evaluation and Conclusions

Since the passage of the BLB Act in 1999, a sustained controversy has arisen over whether nationally-chartered banking institutions should be permitted to conduct real estate brokerage business. The NAR has argued strongly that banks should not be allowed into the brokerage business because they will drive out traditional brokerage firms and monopolize the business, lessening the quality of service and the range of consumer choice.

At the current juncture, state-chartered banking institutions in 26 states are permitted to conduct real estate brokerage business. The state-chartered banking institutions in these states comprise 51% of all banking institutions in the nation and hold 18% of the nation's banking assets. Given the number of banking institutions that already are permitted to conduct brokerage business, it is interesting that so few have chosen to do so.

Starting with a list of 18 banks from a congressional testimony in 2002, only seven banking institutions were identified that are involved in real estate brokerage. As a group, these seven institutions are smaller, less profitable and growing more slowly than the average state-chartered bank. Their entry into the brokerage business was likely motivated in part by a search for more profitable lines of business. But given that so few other state-chartered institutions have chosen to enter the brokerage business, it does not seem that real estate brokerage offers banks a profit bonanza or a quick path to faster profit growth. The survey results reveal that most banks are concerned that entry into the brokerage business will lead to a substantial loss of loan referrals and other business from Realtors®. With 1.3 million members, NAR's apparent hostility to banks engaging in brokerage appears to be a significant barrier to bank entry.

If banks do select to engage in the brokerage business, the survey results indicate that they will likely pursue two basic business strategies. Perhaps the easiest path to entry is the purchase of an existing brokerage business or franchise. Following this path, the bank would hope to capture the profits from brokerage operations and the spillovers from loan referrals and other business. However, given that few statechartered institutions in the 26 states that permit this kind of activity have chosen this path, it seems that the profit potential is not very appealing. The spillovers from loan referrals and other business may be obtained by actively and widely courting existing brokers, without investing directly in the industry. Direct investment could become more appealing in the future as a defensive measure, however, if non-bank financial conglomerates begin to take a larger market share and one-stop shopping proves to provide a clear competitive advantage.

Incorporating brokerage business directly into bank operations by allowing bank employees, who may also have lending and other duties, to operate as brokers is a more risky strategy. In this case, bank employees will compete directly with traditional brokers, and the bank is sure to suffer the loss of loan referrals and other business. For this strategy to prove successful, the bank must be able to capture a substantial market share to compensate for the loss of referrals. To accomplish this, the bank may opt to offer discount brokerage or a fixed-fee schedule; however, this tactic will require a substantial up-front advertising campaign to launch the new service and generate sufficient transaction volume and market share. This is a risky strategy that will likely appeal only to those institutions with ample financial resources and name recognition.

The evidence to date suggests that entrance of banks into real estate brokerage will be neither quick nor easy. However, it may ultimately depend on the consumers' desire for one-stop shopping in home buying to spur the banking industry into more quickly pursuing real estate brokerage opportunities. However, the opposition by NAR and other industry groups is likely to continue to be fierce. While national banks and bank holding companies are currently prohibited from the real estate brokerage business, these larger entities probably pose the greatest threat to the traditional brokerage business for several reasons. First, real estate brokerage could be viewed as a secondary versus a primary line of business profitability; therefore, they might be willing to accept lower profits, especially in the short run. In addition, if they are granted access to the MLS, or alternatively, establish a competing mechanism, it would reduce the barrier to entry and increase the attractiveness to consumers of using a banking entity's real estate brokerage business. To provide an enticement to potential customers, bank entrants might offer a flat-fee alternative for consumers, or perhaps offer consumers the possibility purchasing selected services individually.

In the long run, the benefit of banks entering real estate brokerage is the potential for reduced fees to the consumer. A "downsizing" in the number of real estate agents might also occur, particularly if fees decline. Also, the personal service relationship of agents and clients might also change, especially if banks offer "discount" services. What is relatively certain is an intense struggle by NAR and national banks to define the future of the real estate brokerage industry.

Endnotes

1. Our estimate of the average commission rate is based on a weighted average of 2003 home sales in the 50 states. The average commission rate in each state is taken from homegain.com. see Appendix Table A.1.
2. The Bureau of Economic Analysis (BEA) estimates that real estate commissions on the sale of residential structures has risen from $24.0 billion in 1990:3 to $100.0 billion in 2004:3, an annual increase of 10.7%.
3. Re/Max International Inc. of Greenwood, Colorado, a franchiser of local real estate brokerages, announced an alliance on August 18, 2003 making Bank America Re/Max's preferred mortgage and home equity lender (Shenn, 2003).
4. A prominent example of discount brokerage services available in the New York/New Jersey area is Foxtons (an international brokerage firm with operations in the United Kingdom and the

U.S.). It charges a 2% commission and provides brokerage and mortgage loan services. see, foxtons.com.

5. Hearing before the Subcommittee on Commercial and Administrative Law (Committee on the Judiciary House of Representatives), 107th Congress, 2nd session, Serial No. 77, May 16, 2002.

6. We relied on the survey respondent to provide us with accurate information about a bank's real estate brokerage activity. In a few instances, the respondent indicated that the owners of the bank might be selling foreclosed properties outside of the business activities of the bank. In this case, the bank was considered not to be engaged in real estate brokerage.

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