Link to Index Entry:

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TESTIMONY
of
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Midvale, Utah

1997 President
of
THE NATIONAL ASSOCIATION OF REALTORS®

SUBMITTED TO
THE SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES

CONCERNING

H.R. 10, THE "FINANCIAL SERVICES COMPETITIVENESS ACT OF 1997"

July 30, 1997

NATIONAL ASSOCIATION OF REALTORS®
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Washington, D.C. 20001- 4507

Financial Services Modernization Testimony

Mr. Chairman, I am Russell K. Booth, 1997 president of the **NATIONAL ASSOCIATION OF** REALTORS®. I am president of Mansell Commercial Real Estate Services, Inc. in Midvale, Utah. Our company is a full-service commercial, investment, property management and development company. We also have residential offices throughout Utah.

On behalf of the more than 720,000 professional members of the **REALTORS**® , we are pleased to submit our association's views on the legislation proposing comprehensive modernization of the federal banking laws. This is a critical issue for the real estate industry because we, like so many other industries, rely on the supply of credit from the nation's financial services industry.

REALTORS® are naturally concerned about the involvement of financial institutions in various aspects of the real estate industry. Consequently, the basic issue of whether or to what extent banking and commerce should be mixed is a question for our association's membership. Like all dynamic industries we, too, are contending with change and consolidation within the industry, and with the expressed desires of non-real estate entities for opportunities to enter the business. The fundamental question of modernizing the Glass-Steagall Act and the Bank Holding Company Act, which are admittedly becoming dated as are some other federal finance-related laws, comes in the face of rapid technological change and the drive for diversified product lines and income streams in current markets.

Necessarily, our concern is with how real estate activities might be treated in any schema to modernize the Glass-Steagall Act and the Bank Holding Company Act. Our comments, except for pertinent general principles, will be confined to banks becoming involved in real estate. Our testimony will review the implications that the pending bill has on the real estate industry. Specifically, we will focus on provisions that permit financial service holding companies via a subsidiary corporation to engage in real estate development, investment, management and brokerage.

Commerce and Banking

At the outset let it be known that the **NATIONAL ASSOCIATION OF** REALTORS® strongly opposes the legislative or regulatory definition of real estate as “banking in nature, or incidental thereto.” The practical test is clear. Real estate business practices are much more akin to commerce than to banking, and claims to the effect that real estate is banking, or incidental to banking simply push the broadest interpretation of a legal definition to extremes. Real estate brokerage, development, investment and management are all commercial, purely and simply.

Indeed, it is the extension of credit — the core business of commercial banking — that makes the real estate industry possible, as with any other commercial or business venture.

It is our observation that an important shift occurred in the terms of the debate regarding the mixture of commerce and banking. As recently as last year the debate seemed to turn, in large measure, on *whether* commerce and banking should be mixed; or should the Glass-Steagall Act restrictions be removed at all. Now it seems, the debate is focused more on to *what extent* commerce and banking should be mixed. Certainly recent U.S. Supreme Court decisions, market forces, and technological applications are reshaping the debate.

Pending Legislation

Are the stars actually aligning? Perhaps. If legislative action is to proceed, **REALTORS**® believe that H.R.10, the "Financial Services Competitiveness Act," as reported by the House Banking Committee, contains provisions that are a badly flawed starting point for Congress to address financial services reform issues. We believe reasonable, moderate Glass-Steagall Act reforms could follow from a framework that is narrowly focused on integrating commercial banking and investment banking, but not extending financial services reform to include a mixture of banking and commerce as envisioned by the current version of H.R. 10.

We prefer the real estate-related provisions of H.R.10 to those of other bills. We strongly support the H.R. 10 prohibition on operating subsidiaries investing in real estate and the limitations on inter-affiliate transactions, credit and credit enhancement of this bill. Further, we support the regulatory framework generally proposed by H.R. 10., *as introduced* earlier this year.

From our perspective H.R. 10, taken *en toto*, erects a framework for the financial services industry that would bend the market to a preconceived set of relationships, without the restraints that should protect the public and ancillary industries that rely on commercial banking from the threats of concentrated economic and business power or the potential conflicts of interests affecting the assessment of business risks and lending decisions. The logical extension of H.R. 10 would be a financial Darwinism, providing all the benefits to the most aggressive banking and commercial organizations with the deepest pockets. Admittedly, H.R. 10 pushes expanded and risky activities into new entities that presumably would not have the protective cover or benefits of the current financial system. But H.R. 10 currently envisions a bold experiment, which could result in the fulfillment of unintended consequences. We do not support statutory experimentation in the financial services industry, and we also have deep concerns about provisions of H.R .10 that seem to preempt state laws in the area of real estate. Such a preemption opens the way for full involvement in real estate brokerage by all state-chartered banks and savings institutions.

We cannot overstate the point, however, that this proposal could have far reaching and not necessarily positive consequences on our nation's financial markets by consolidating assets and credit decision power. For these reasons, we urge Congress to be cautious of the impact such changes could have on the continued viability of the real estate industry.

General Overview of Banks Involvement in Real Estate Activities

Historically when enacting the various laws governing the permissible activities of banks and bank holding companies, Congress was more restrictive regarding bank and bank holding company involvement in real estate activities than other non-banking activities. We believe Congress took this approach based on a general desire to require banks to concentrate their resources on banking activities rather than areas of commerce.

While national banks have been allowed to engage in real estate lending, they are all but prohibited under the National Bank Act from engaging in other real estate activities. Generally, national banks are permitted to own and manage the buildings in which they operate and to hold temporarily other real estate assets received in connection with debts owed to the bank.

While there may be a growing consensus among some observers that the Glass-Steagall Act prohibitions on mixing banking and commerce should be modified, the **NATIONAL ASSOCIATION OF REALTORS®** does not support unfettered or broadly experimental efforts in this regard. For more than a decade now, **REALTORS®** have opposed the direct involvement of financial institutions in real estate activities. We recognize that some states, as part of the dual banking system, have permitted banks and thrifts to engage in some real estate activities. These activities cannot be undertaken without restrictions because of the risks and potential for conflicts of interest entailed in real estate operations where financial institutions are involved.

Traditionally banks do not perform well in the real estate arena when they venture beyond lending. Ricki Helfer, "Testimony of the Federal Deposit Insurance Corporation On Financial Modernization," U.S. House of Representatives Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, March 5, 1997. pp. 4; 2-5, *passim*. Several factors have bearing on this issue, but certainly "the rapid expansion of [banks] into unfamiliar activities, without adequate supervision, [had] undesirable consequences."Helfer, p. 3. Real estate is a significantly different business compared to the securities or insurance businesses.

It should be noted that in 1987 the Federal Reserve Board proposed allowing bank holding companies to engage in direct real estate investment, subject to fire walls similar to those later applied to Section 20 securities affiliates.52 <u>Federal Register</u> 453, (January 7, 1987). These proposed firewalls restricted inter-affiliate transactions and separate capitalization. Significantly, the Federal Reserve Board never adopted the proposal in the face of Congressional opposition, which included the threat of a legislative moratorium.

Although it is early in the game, there is evidence that banks are not integrating the sale of insurance products as smoothly as was originally anticipated. Banks using third-party marketing companies were not reporting the sales successes that the industry believed would naturally follow from new powers. Howard Kapiloff, "Insurance: Study Indicates Banks' Third-Party Sales Have Yet to Take Off," <u>The American Banker</u>, April 1, 1997, p.11. Indeed, banks are finding that selling life insurance is not as easy as believed. The same or an even more urgent concern, could be raised regarding real estate development, which is one of the more difficult and riskier enterprises for experienced professionals.

The **National Association of** REALTORS® strongly opposes any proposal allowing the mixture of commerce and banking because economic power will be too concentrated, especially in the financial system, and the interference of noncredit worthiness factors in credit decisions. This prospect was summarized several years ago by noted economist Henry Kaufman, when he observed (and I paraphrase here) that over time, joining industry and banking will produce mammoth conglomerates that will strongly influence the flow of credit and affect business competition. Dr. Kaufman further observed that a large corporation controlling a bank would be tempted to use the bank for extending credit to borrowers who could benefit the whole organization. The captive bank could attract low-cost funds through insured deposits and could use these funds to finance borrowers and corporate entities who would further the distribution of the parent corporation's products and services. The bank would likely withhold credit from those who are, or could be, competitors to the parent corporation.

If banking and commerce are mixed, we believe that effective banking and independent credit decisions based on objective evaluation of credit worthiness, will be undermined. Bank and financial services holding company involvement in non-financial entities will create a situation where credit decisions will be subordinated to the broader business interests of the parent
corporation. This process will chip away at the transactional arms-length relationship between creditor and debtor, corrupt the normal contractual presumptions underlying debt obligations, and foster economic inefficiencies.

REALTORS® are not alone in this opinion. Federal Reserve Board Governor Laurence H. Meyer pointed out that although there were "gray areas" regarding the separation of banking and commerce, he said, "I think is fair to say that to a very substantial extent banking and commerce are essentially separate activities in the United States. Thus, we need to think carefully about whether we want to go even further down the road of combining banking with non-financial activities."Laurence H. Meyer, Governor of the Federal Reserve Board, "Remarks at the Seventh Annual Conference on Financial Structure," Annandale-on-Hudson, New York, April 10, 1997. Governor Meyer urged caution against broad change in combining banking and commerce. Central to this cautionary advice is the matter of how to supervise and regulate these resulting new combinations. Governor Meyer goes directly to the point:

> An additional reason for caution is the necessity of modifying supervisory techniques. I believe that all of the banking agencies can meet the challenges of expanded *financial* activities. But adding commercial firms before we have digested the financial side of the business could well be a bridge too far.*Ibid.*

The National Association of REALTORS® is especially concerned about the deleterious effects of the potential concentration of power on small businesses — our nation's economic backbone-- by mixing bank and financial service holding company with commerce. The majority of our members are small business men and women. The average real estate firm has 23 residential sales persons. These small business owners will be at a competitive disadvantage if large financial services holding companies are permitted in non-financial services activities because of the possibility of predatory pricing, possible cost shifting to other areas within the FSHC structure, and conflicts of interest. Our nation's small businesses are the very cornerstone of America, and these small businesses create jobs and economic opportunity for all Americans. These proposed economic conglomerates will concentrate capital to the detriment of small business and the American people.

To many advocates, the need to restructure the powers of financial institutions stems from the disintermediation of funds from banks to insurance and securities firm products that are the functional equivalent to bank checking and savings accounts. Restructuring in order to correct or make a level playing field between equivalent financial products is understandable. However, we are opposed to mixing banking and non-financial products directly, or via financial services holding companies, with strong firewalls and other safeguards.

Fire Walls and Safeguards

Integration of banks, real estate development, investment, property management and residential and commercial brokerage under one financial service holding company (FSHC) would interfere with the financial institutions' primary purpose of channeling funds based on credit worthiness. We believe placing all aspects of real estate under an FSHC would create conflicts of interest that interfere with a financial institution's central purpose of supplying credit to markets. Such an integration would create a limitation of sources of funds, conflicts of interest, confidentiality concerns, unfair advantages, and expose the banking system to high risk real estate market fluctuations. We are concerned with the potential effects on the natural real estate business cycle if financial institutions holding companies are permitted in the real estate development industry. We urge the Congress to exercise caution before entering these new unchartered waters. It was not long ago that the savings and loan regulators opened the floodgates for new investment avenues for savings and loans. We are all well aware of how that venture ended. Congress and the country cannot afford to make the same mistake again. The $220 billion dollar taxpayer paid bailout of financial institutions should not occur again.

In Section 4(c)(8) of the Bank Holding Company Act, the Board of Governors of the Federal Reserve may decide whether an activity is closely related to banking and is a proper incident thereto. The closely related test generally requires the proposed activity to meet one of the following criteria:

(1) Banks generally have provided the proposed services.
(2) Banks generally provide services that are operationally or functionally so similar to the proposed services as to equip them particularly well to provide the proposed service.
(3) Banks generally provide services that are so integrally related to the proposed services as to require their provisions in a specialized form.

Permission under Section 4(c)(8) also requires a finding that there is a benefit to the public, such as greater convenience, increased competition, or gains in efficiency. The benefits must far outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. We believe present restrictions on bank holding company involvement in real estate activities should continue.

Real Estate Investment

Real estate investment and development are potentially risky ventures that require a level of acumen that may be outside the experience of the new financial services holding company envisioned by some proposals in Congress this year. H.R. 10 retains current restrictions on bank and FSHC involvement in real estate investment. Market volatility, inherent business risk and competition require that new entrants into these activities have the capacity to adequately anticipate and account for these risks.

Consider: One of the principal objectives of the 1986 Tax Reform Act was to end abusive tax shelters. But the most obvious result was a precipitous decline in real estate markets. During the period 1989-1992, some locations around the country experienced as much as a 30 percent decline in the value of real estate in their markets. These risks of market downturn could create a long-term stagnation in the real estate industry if FSHCs are permitted widespread involvement in real estate investment. Where today non-performing real estate investments are partially or fully written off the books of financial service entities, a FSHC's investment via an affiliate could tend to languish on the books and in the market for years, interrupting the real estate market cycle. Congress should seriously consider the potential harm FSHC involvement in real estate could have on the overall real estate market before permitting such affiliations.

Real Estate Development

NAR is opposed to banks or bank holding companies engaging in real estate development. Risk-based capital requirements already create a *de facto* limit on real estate development loans. We are concerned that loans for third-party real estate development could be limited since the real estate development loans in the financial institution could be concentrated or weighted toward development projects of the financial institution's real estate development affiliate corporation.

We are also concerned that financial institution lending to third-party developers would require the real estate developer to give the bank's real estate investment affiliate an equity position in the proposed real estate project. Such a forced marriage would interfere with the original economics of the development.

Additionally, a potential safety and soundness concern is raised by the possibility that a financial institution could be tempted to extend credit to a troubled development that one of its subsidiaries sponsored, despite the fact that such a loan would be considered of questionable prudence were the borrower a an outside third-party. Such a conflict of interest would pit the financial safety of the lending institution against its incentive to ensure a profitable operating subsidiary. No degree of firewalls could entirely mitigate against this risk. This problem stems from competing priorities inherent in any business endeavor — the quest for financial return versus concern about potential losses. The banking industry cannot claim to be immune from this conflict of interest.

Recently the **NATIONAL ASSOCIATION OF REALTORS**® provided public comments to the Comptroller of the Currency (OCC) regarding two NationsBank applications to engage in real estate lease financing and real estate development through operating subsidiaries under the Part 5 regulation affecting operating subsidiaries. **REALTORS**® generally opposed approval of these applications because we wonder just how effective the OCC's firewalls and safeguards will be over time. We are concerned that the OCC is overreaching in its regulatory authority and usurping Congressional intent and prerogative in establishing where the line between banking and commerce should be. Extending the operating subsidiary authority to include activities forbidden to national banks is experimental and overreaching, particularly when these prohibited activities include real estate development and management.

Real Estate Management

We believe permitting FSHC's to engage in real estate management would also lead to conflict of interest and confidentiality concerns. This situation could occur where a real estate developer seeking funds would be required during the loan evaluation process to divulge the underlying economic assumptions of the real estate project to the financial institution. Such proprietary information could eventually end up in the hands of the real estate management firm affiliate. This information could then be used to undermine tenants of the project. The information from the financial institution concerning the termination rights and length of lease terms of tenants could be used by the financial institution's affiliate management company in order to market to those tenants when lease terms expire. This is an unfair advantage to other management firms in the market and could further the economic concentration of power in a few large financial institution holding companies.

Real Estate Brokerage

Mr. Chairman, as you know, REALTORS® are not afraid of competition. We deal with it every day. Our industry, because of its relative ease of entry, is one of the most competitive businesses in America. Nevertheless, the members of the NATIONAL ASSOCIATION OF REALTORS® are deeply concerned about the unfair competitive advantages financial institutions could possess if allowed into our line of business. Central to this unfair competitive advantage is the aura of federal deposit insurance. This umbrella of protection extends beyond the deposits that are actually insured. A real estate brokerage company as part of a bank or financial services holding company will have the aura of respectability and safety that is provided by federal deposit insurance. We believe, just as people prefer to deposit their money in a federally insured depository institution, they will prefer to deal with a brokerage that is connected with a federally insured entity via a FSHC.

The real estate industry consists of independent business people, who, by their own determination and energy, earn a living by performing certain real estate services. The bulk of our members work on a straight commission basis with no guaranty of any minimum income. To the extent that a new person, or company, enters into our industry, the competition that evolves takes place among equals.

The business of real estate brokerage is one of customer service and the result of competition within our industry is better service to the home buying public. This situation involves competition equity. Our concern is that financial affiliates would not compete as equals in the real estate broker, management, or development industries.

Holding Company Regulation

When Congress enacted the Bank Holding Company Act (BHCA) in 1957, as part of the general effort to continue the separation of banking and commerce and to prevent the undue concentration of control of banking resources, it essentially reaffirmed the policy embodied in the National Banking Act of separating the banking and real estate business. Again, with very few exceptions, under Section 4(c)(8) of the BHCA, the Federal Reserve has adhered quite closely to the BHCA's policy of separating banking and commerce, by finding that real estate investment, development and brokerage are not closely related to banking and, therefore, prohibited bank holding companies from owning entities engaged in such activities.

In recent years, the Federal Reserve Board has on several occasions solicited public comment on whether or not real estate brokerage should be deemed to be "closely related to the business of banking" and, therefore, a permissible activity for bank holding companies. To date, however, the Federal Reserve has not made that determination. Indeed, our insistence would be that federal statute should affirmatively declare that real estate activities are not financial in nature, or closely related to the business of banking.

Thrift Charter Conversion

The **NATIONAL ASSOCIATION OF REALTORS**® has long viewed savings and loan associations as significant participants in the real estate finance delivery system. Most importantly, **REALTORS**® support thrifts in their role as major credit sources for residential mortgage financing. Thrifts have a depth of expertise in real estate lending and the secondary mortgage market that is unrivaled. This expertise should not be taken for granted by the industry itself or by those who would criticize the thrift charter as either unnecessary or antiquated.

We point out, however, that certain changes made to the savings and loan association charter last year regarding investment authorities should not be overlooked. Consequently, the **NATIONAL ASSOCIATION OF REALTORS**® believes that no thrift institution should be forced to give up its mortgage finance expertise or mandate when the issue of converting charters is debated and resolved.

Conclusion

Mr. Chairman, for more than a decade now Congress has debated in some fashion or the other the need for and potential revisions to the Glass-Steagall Act prohibitions on mixing commerce and banking. Last year the House Banking Committee leadership struggled mightily to devise a legislative formula that could anticipate the evolution of the marketplace while creating competitive equity for the various financial entities affected by Glass-Steagall provisions. The constant themes in these efforts were moderation, containment of systemic risk in the banking system, and prudent regulatory and supervisory safeguards and parameters. Meanwhile, the market continued to evolve driven by technological applications and a strong economy with record profitability for banks and savings institutions, and securities and insurance firms.

The marketplace *is* evolving, despite the apparent 60-year impediments of the Glass-Steagall Act that some advocates maintain must be eliminated. Neither I nor the NATIONAL ASSOCIATION OF REALTORS® can declare with certainty that no change is needed. Our association recognizes that there may be some need for Glass-Steagall Act reforms, but we firmly believe that these reforms should be cautiously executed. Studies by the Government Accounting Office (GAO) give us reason to consider just how radical or even necessary the separation of banking and commerce should be, however.See James L. Bothwell, "Testimony before the House Committee on Banking and Financial Services [regarding] Financial Regulation and Bank Modernization Legislation, May 7, 1997." See also **Financial Regulation: Modernization of the Financial Services Regulatory System** (GAO/T-GGD-95-121, March 15, 1995); **Separation of Banking and Commerce** (GAO/OCE/GGD-97-61R, March 17, 1997); and **Bank Oversight: Fundamental Principles for Modernizing the U.S. Structure** (GAO)/T-GGD-96-117, May 2, 1996). Over time, Congress responded to financial marketplace crises and federal regulators followed with revisions to regulatory and supervisory practices and guidelines. It is understandable that overlaps and anomalies, the "gray areas" the Federal Reserve Governor Meyer referred to, developed. Yet, Mr. Bothwell's testimony and the GAO studies are persuasive: "...the goal of financial modernization should not be achieved at the expense of other important goals, such as maintaining the safety and soundness of the financial system and the deposit insurance funds, preventing undue concentrations of economic power, and protecting consumers form potential conflicts of interest."Bothwell, "Testimony," May 7, 1997, p.2.

Our association supports the incorporation of safeguards and firewalls to protect consumers and taxpayers against conflicts of interest and spreading the federal safety net for banks to commercial activities. Regulation of banks and their subsidiaries should be comprehensive and coordinated such that firewalls and other safeguards will not be breached or collapse under financial stresses that inevitably will come.

REALTORS® also believes that real estate should not be considered banking or incidental to banking. Critical concerns are maintaining the financial system's safety and soundness and assuring that the integrity of the lending decision should be protected. Conflicts of interest should not be permitted.

We are fully willing to work with the Congress to devise reasonable, cautious reforms that include firewalls and safeguards to protect the bank from any risks associated with non-banking business ventures. But we insist that the merging of banking and commerce should proceed in a cautious, measure framework.

Thank you for the opportunity to present our views, Mr. Chairman.