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Issue Area: Conventional Residential Lending
Date of Action: 03/21/95
Document Title: N A R Testimony Concerning H.R.814, Bank Reform

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TESTIMONY OF THE NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

CAPITAL MARKETS, SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE

OF THE

HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE

MARCH 16, 1995

Introduction

Mr. Chairman, Members of the Subcommittee, my name is Rick Adams I am a **Realtor**® from Corpus Christi, Texas. I own a four office firm operating in the San Antonio and Rio Grande

Valley area of Texas. I am the 1996 Chair of the National Association of **Realtors**® Public Policy Coordinating Committee. On behalf of the National Association of **Realtors**®, I appreciate the opportunity to present our views on H.R. 814, the Depository Institutions Affiliation Act of 1995.

We thank you, Mr. Chairman, for holding these hearings on the state of the financial institutions market and what is certainly one of the most significant pieces of financial services legislation contemplated in the last 50 years. 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. We continue to review and analyze other Glass-Steagall Act and Bank Holding Company Act reform proposals introduced to date.

Our testimony will review the implications H.R.814 would have on the real estate industry. Specifically, we will focus on provisions which permit financial service holding companies via a subsidiary corporation to engage in real estate development, investment, management and brokerage. We also have deep concerns about provisions of H.R.814 which seem to preempt state laws in the area of real estate. Such a preemption opens the way for all state chartered banks and savings institutions full involvement in real estate brokerage.

GENERAL OVERVIEW OF BANKS INVOLVEMENT IN REAL ESTATE

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

While national banks have been allowed to engage in real estate lending, they have been generally 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 owned to the bank.

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 this date, however, it has not made that determination.

However, in January 1995 the Office of the Comptroller of the Currency issued a notice of proposed rulemaking that would permit national banks to engage in real estate brokerage. NAR's comment on this proposal expressed our vigorous opposition to banks engaging in real estate brokerage activity. Our concern then was with the prospect that national banks could apply for an operating subsidiary to engage in activities not permitted for the bank, provided the activities were incidental to or within the business of banking. We argue that the impermissibility of real estate brokerage for a national bank should also extend to its operating subsidiary. We reiterated in the strongest terms the National Association of REALTORS® position that banks and their subsidiaries should not be permitted to engage in real estate brokerage.

The National Association of REALTORS® opposes federally insured depository institution's involvement in real estate brokerage, as well as bank affiliates and operating subsidiaries. The severe limitation in credit available for commercial real estate financing and the financial crisis precipitating the collapse of the savings and loan industry in the late 1980s loom large in the collective memory of our membership. These experiences should continue to serve as important reinforcement and object lessons for policy-makers to frame their concerns about removing the barriers between banking and commerce.

Based on prior experience, it is clear that financial service entities must carefully expand into activities that require an investment of new expertise and operating systems. The lure of new business lines, including real estate brokerage, can be appealing banks seeking to generate revenues in an era of corporate consolidations and new business opportunity. However, there may be new risks to the safety and soundness of the banking system that may unknowingly compound those that already exist in this competitive environment.

REAL ESTATE PROVISIONS IN H.R.814

In general, the Baker proposal would eliminate all restrictions on affiliations between banking and non-banking companies. H.R.814 would permit a bank or savings and loan holding company to become or start a financial services holding company (FSHC). An FSHC could control any type of financial institution or non-banking entity.

Turning to the real estate specific provision in the proposal, section 101(g)(1)(C) of the Baker proposal would require all federally insured financial institutions conducting real estate investment or development to transfer those activities to a separate subsidiary of either the bank or the financial services holding company. These restrictions also apply to any state-chartered financial institution owned by the FSHC. One major area of concern for NAR is a provision which would preempt state banking laws concerning restrictions on real estate power. Section 101(f)(2)(B) of the Baker proposal would, in general, preempt all state restrictions concerning real estate activities. Therefore, present state prohibitions on state bank or saving institutions from engaging in real estate brokerage would be preempted by federal law. In addition, the Baker proposal permits the FSHC to purchase a real estate brokerage firm provided the brokerage firm was in existence for two years prior to passage of the bill.

The Baker proposal also permits FSHC operating subsidiaries to engage in any activity which falls under exceptions found in Section 4(c)(8) of the Bank holding Company Act. Under this section, 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.

REALTOR® POSITION

The National Association of **REALTORS®** strongly opposes the authority of all financial entities, state or federally chartered, which benefit from federal deposit insurance, favorable tax treatment, and special access to credit (including their subsidiaries and divisions) to participate in the business of real estate brokerage, fee appraising, leasing of real estate development, real estate syndication, property management and other real estate services and/or activities not directly related to their primary function. Such activities may conflict with the interests of their

customers, threaten the safety and financial stability of the institution, increase the risk of taxpayer liability and pose a threat to the competitive structure of the real estate industry. NAR is opposed to long-term holding of foreclosed property by financial entities. We further urge the appropriate regulators to use their authority to restrain the expansion of real estate activities by state financial entities and their federal counterparts.

GENERAL CONCERNS and OBSERVATIONS

The Baker proposal envisions a broad commercial umbrella providing coverage for financial services holding companies which would combine banks with a whole host of financial and non-financial activities. The National Association of **REALTORS**® strongly opposes this proposal to allow the mixture of commerce and banking for the simple reason that economic wealth will be too concentrated, especially in the financial system, and the interference of non-credit worthiness factors in credit decisions. The end result of this proposal has been neatly summarized by noted economist Henry Kaufman:

> " Over a period of time, the joining of industry and banking will produce mammoth entities. These combines will have a strong influence on the flow of credit and thus on business competition. A large corporation that controls a bank will give in to the temptation to use it for extending credit to those who can benefit the whole organization. The captive bank will attract low-cost funds through insured deposits and will deploy them to finance retailers, jobbers, manufacturers and individuals who further the distribution of the parent's products and services. The bank will be inclined to withhold credit from those who are, or could be, competitors to the parent corporation."

A glimpse of this prediction can be seen in the commercial and financial interlocks permitted in the German banking system. In that country, a few banking interests dominate the market. In addition, the interweaving of financial and equity ownership has created a tense situation where many credit decisions are affected not by the creditworthiness of the borrower but the impact the successful new venture could have on other ventures of the lender bank. The German government, recognizing the long-term negative affects on the overall competitive position of the German economy, have taken steps to intercede in reining in German banks. One proposed provision would limit a German bank's equity stakes in companies to 5 percent . Attached is an article from a recent issue of *Business Week* (February 20, 1995) that summarizes this situation.

If H.R.814 is passed as proposed, we believe the cornerstone of effective banking and independent credit decisions based on objective evaluation of creditworthiness, will be undermined. Under H.R.814, 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 ineffiencies.

The National Association of **REALTORS®** is especially concerned about the deleterious effects of potential concentration of power on small businesses -- our nation's economic backbone-- by the Baker proposal. The majority of our members are small business men and women. The average real estate firm size is 49 full-time staff. These small business men and women will be at a competitive disadvantage relative to large financial services holding company because of the possibility of predatory pricing and possible cost shifting to other areas within the FSHC structure. 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.

Lastly, to many the need to restructure the powers of financial institution comes 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 the mixing of banking and commerce as we will explain later in our testimony.

FINANCIAL INSTITUTIONS INVOLVEMENT IN REAL ESTATE

Integration of banks, real estate development, investment, management and brokerage under one Financial Service Holding Company would interfere with the financial institutions primary purpose of channeling funds based on credit worthiness. We believe placing all aspects of real estate under a FSHC would create conflicts of interest which interfere with banks 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 very 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 carefully enter 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.

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 HR 814. 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.

H.R. 814 is a sweeping, even bold restructuring of the financial services industry. As witnessed by the consequences of the 1986 Tax Reform Act, and by well-meaning Congressional and regulatory actions intended to fend off the savings and loan crisis, major changes in the financial services industry can have far-reaching and unanticipated negative results.

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 which time numerous other businesses were undeservedly harmed. During the period 1989-1992, some locations around the country experienced as much as a 30 percent decline in value of real estate in their markets. These risks of market downturn could, if FSHC are permitted widespread involvement in real estate investment, create a long-term stagnation in the real estate industry. 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 market. Congress should consider the worst impact FSHC involvement in real estate could have on the overall real estate market before permitting such affiliations with FSHCs.

NAR is fully aware of firewalls present in H.R.814. We believe these measures are not adequate to remedy the acts that desperation people take in order to save an affiliate corporation. An excellent example comes from the Barings bank failure. At Barings, even management imposed checks and balances did not prevent the protection of the bank's capital base. (Please see the attached article from the Washington *Post*, dated February 13, 1995).

REAL ESTATE DEVELOPMENT

NAR is opposed to banks or bank holding companies engaging in real estate development. Risk based capital requirements 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 bank would be concentrated or weighted toward developments of the bank's real estate development affiliate corporation.

We are also concerned that bank 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 had sponsored, despite the fact that such a loan would be of questionable prudence were the borrower a third-party. Such a conflict of interest would pit the financial safety of the lending institution against its incentive to ensure an operating subsidiary was profitable. 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.

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. Our industry, because of is 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.

The real estate industry consists of small, 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 homebuyng public. This situation is one of

competition among equals. Our concern is that financial affiliates would not compete as equals in the real estate broker, management, or development industries.

The following details some of the specific advantages that a financial institution would have over the exiting real estate industry. These competitive advantages would be of concern depending on whether the authorized real estate activities were performed directly through a department of a financial institution, its holding company, or its subsidiary.

Allocation of Resources: Financial institutions enjoy benefits that would allow them to utilize a greater proportion of their resources toward competition than existing real estate companies are able. Additionally, a financial institutions real estate firm would gain a competitive advantage from the use of its corporate parent's resources, such as clerical staff, building, files, and equipment.

Access to Special Credit: Federally chartered commercial banks may obtain below-market funds from the Federal Reserve discount window and the Federal Funds Market. Federally chartered savings and loans may have the ability to obtain loans in the form of Federal Home Loan Bank advances. In both cases, the access to below market credit represents a significant advantage over other business entities. Increasingly, real estate firms are relying on commercial banks for lines of credit to finance business operations. This situation is a reflection of the volatile real estate market dynamics.

Economic Discrimination : Financial institution-owned real estate firms would competitively benefit from a corporate parent federally-insured financial institution's ability to provide discounted interest rates, fees, and/or quicken loan approval processes to its real estate subsidiary's clients.

Affiliations and Tie-ins: Financial institution-owned real estate brokerage or management firms would competitively benefit from the use of their parent federally-insured financial institution's name, trademark, or logo. The brokerage or management firm would also competitively benefit from any indication, either expressly stated or implied, of affiliation to the financial institution in public advertising by the subsidiary.

Geographic Location: Financial institution-owed brokerage or management firms would competitively benefit from their location on or near the facility of the federally-insured financial institution.

Joint Marketing: Financial institution-owned brokerage or management firms would competitively benefit from joint marketing arrangements with their parent financial institution.

Consumer Access: Financial institution-owned real estate firms would competitively benefit from access to confidential credit information, available from the parent federally-insured financial institution, used for solicitation purposed. Additionally, financial institutions already enjoy a special relationship with consumers which would provide a distinct advantage if permitted.

Management: Financial institutions would competitively benefit from sharing management and staff with their federally-insured financial institutions. This situation would afford a real subsidiary a valuable access to the leadership of the financial institution and an ability to develop economies of scale.

Conclusion

Mr. Chairman, many of our members, especially those involved in mid-sized firms are concerned that the provisions of H.R.814 will give unfair competitive advantage to well capitalized financial service holding companies and potentially create great systemic risk within the financial institution system. H.R.814 is a bold, radical vision of what the financial services industry may look like later in the next century. Congress would be wise to take observations of how the proposed system envisioned in H.R.814 is presently working in similarly structured banking systems such as with Germany. The National Association of **REALTORS**® urges caution in these unchartered waters. Mr. Chairman, thank you for permitting the National Association of **REALTORS**® to testify before this Subcommittee. I would be happy to respond to questions.