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## TESTIMONY OF THE NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING AND FINANCIAL SERVICES

MARCH 29, 1995

### Introduction

Mr. Chairman, members of the committee, my name is Edmund G. Woods. I am a **Realtor®** from Holyoke, Massachusetts. I am the owner and president of Edmund G. Woods Company. I have been a **REALTOR®** since 1965. I am the 1995 President of the National Association of **Realtors®**. On behalf of the National Association of **Realtors®**, I appreciate the opportunity to present our views on H.R. 1062, the Financial Services Competitiveness Act of 1995 and revisions to laws governing the banking industry.

Mr. Chairman, the National Association of **REALTORS®** shares your strong reservations about removing barriers between banking and commerce. While we accept the prospect that some revision to the current structure may be needed to modernize the financial services industry, radical restructuring as proposed by other lawmakers and some industry proponents does not seem appropriate. Our Association would prefer the more measured approach that underlies the

thrust of H.R. 1062, with the assurance of strong firewalls intended to protect the safety and soundness of the nation's banking system. With clarifications regarding real estate activities discussed further in our testimony, NAR could support the direction of H.R. 1062 because, in our view, your proposed legislation recognizes the dangers of mixing banking and non-financial services.

The financial services industry has been changing in the last several years, and banks should be able to compete on a level playing field with those financial services providers offering competing products that have eroded the traditional core deposit base of banks. Safety and soundness, unfair advantage and conflicts of interest enter into the equation when banks and financial services holding companies are permitted in non-financial services, such as real estate.

### **REAL ESTATE IMPLICATIONS IN H.R. 1062**

In general, H.R.1062 would recast the Bank Holding Company Act (BHCA) to the Financial Services Holding Company Act (FSHCA). Bank Holding Companies would be renamed Financial Services Holding Companies (FSHC). Financial services company could choose between two structures for the affiliation of banking and securities firms. Under the first structure, companies owning an insured depository institution and a securities affiliate would become a financial services holding company. Under the second, companies without any insured depository institution affiliates may become an investment bank holding company. An investment bank holding company would be any FSHC that controls an uninsured wholesale financial institution and a securities affiliate. The proposal places firewall protections between insured depository institutions and securities affiliates owned by financial services holding companies (FSHC).

Section 150 of H.R.1062 -- Financial Activities -- modifies the "closely related to banking" test under the Bank Holding Company Act to a "financial in nature" test for purposes of authorizing non-banking activities for financial services holding companies. Section 151 provides for expedited approval of new activities for well managed and capitalized FSHCs to engage in non-banking activities that are permissible under subsection (c)(8), as determined by the Federal Reserve Board and such other activities as are otherwise permissible under another subsection of H.R. 1062.

The National Association of **REALTORS**<sup>®</sup> has no objection to H.R. 1062 or these sections of the proposal, **provided** current and long-standing prohibitions on bank holding company involvement in real estate activities (12 C.F.R. 225.126; attached) continue to apply to any financial services holding company. This ban must cover the FSHC structure as contemplated by H.R.1062, or the other various financial services reform proposals being debated in Congress. It is our understanding, from prior testimony before this Committee, that such prohibitions on real estate activities would continue to apply to financial services holding companies under the financial services holding company framework as proposed in H.R. 1062.

## **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 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 and financial services 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. Under present permissible activities, 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.

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 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, prohibit bank holding companies from owning entities engaged in such activities (12 C.F.R. 225.126).

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 is 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. NAR believes 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 institutions' involvement in real estate activities, as well as bank affiliates and operating subsidiaries. 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 to 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. 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 for policy-makers to use when framing their concerns about removing the barriers between banking and non-financial services.

## **REALTOR<sup>®</sup> POSITION**

The National Association of **REALTORS<sup>®</sup>** 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.

## **CONCERNS ON MIXING BANKING AND NON-FINANCIAL SERVICES**

The National Association of **REALTORS<sup>®</sup>** strongly opposes any proposal which allows 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 combinations 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 by 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, has 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 banking and commerce are mixed, we believe that effective banking and independent credit decisions based on objective evaluation of creditworthiness, 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, and corrupt the normal contractual presumptions underlying debt obligations and foster economic inefficiencies.

The National Association of **REALTORS**<sup>®</sup> is especially concerned about the deleterious effects of 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, the need to restructure the powers of financial institutions 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 mixing banking and non-financial products directly or via financial services holding companies.

## **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 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 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 exercise caution before entering these new uncharted 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. 1062 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 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 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 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 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.

## **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<sup>®</sup> are not afraid of competition. 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<sup>®</sup> 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 small 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 homebuying 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 financial institutions would have over the 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-owned 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 purposes. 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 provide a real estate subsidiary valuable access to the leadership of the financial institution and an ability to develop economies of scale.

## **Conclusion**

Thank you for holding these hearings on H.R.1062. We appreciate the approach you are taking to financial services reform. We believe the cautious interjection of banking into legitimate financial services is the correct approach in order to create a level playing field in the financial services industry. Mr. Chairman, many of our members, especially those involved in mid-sized firms are concerned that the provisions in some banking reform proposals will give unfair competitive advantage to financial service holding companies and potentially create great systemic risk within the financial institution system. The benefits that would accrue to the consumer if banks or FSHCs are permitted to become involved in real estate industry would be imperceptible and would be far outweighed by placing those already serving the real estate market at an unfair -- government created -- competitive disadvantage.

Mr. Chairman, thank you for permitting the National Association of **REALTORS**<sup>®</sup> to testify before this committee. I am happy to respond to questions.