



NATIONAL ASSOCIATION  
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*The Voice for Real Estate®*

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**Thomas M. Stevens, CRB, CRS, GRI**  
*President*

November 28, 2005

The Honorable Alberto R. Gonzales  
Attorney General  
U.S. Department of Justice  
c/o Antitrust Division  
Liberty Place Suite 300  
Attention: Lee Quinn  
325 7<sup>th</sup> Street NW  
Washington, DC 20530

The Honorable Deborah Platt Majoras  
Chairman  
Federal Trade Commission  
c/o Office of the Secretary  
Room 135-H (Annex F)  
600 Pennsylvania Avenue, NW  
Washington, DC 20580

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RE: Competition and Real Estate Workshop—Comment, Project No. VO50015

Dear General Gonzales and Chairman Majoras:

On behalf of the National Association of REALTORS® (NAR), and the Associations of REALTORS® for all 50 states, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands, this letter conveys our organizations' comments on competition in the real estate industry as a follow-up to the October 25, 2005, workshop hosted by the Federal Trade Commission (FTC) and the Department of Justice (DOJ) on *Competition Policy and the Real Estate Industry*.

We believe that the real estate industry is extremely competitive, and that this fact is not seriously in dispute. Some policymakers, analysts, and media observers have alleged, however, that the industry lacks vigorous price competition and that there are significant barriers to

additional competition from non-traditional real estate firms. We strongly disagree. I would like to comment on three major issues about which there is considerable confusion.

### **Competition—including Price Competition—is Fierce**

The National Association of REALTORS<sup>®</sup> has more than 1.25 million members. These real estate professionals account for approximately half of all those licensed by the states as real estate brokers and agents. NAR members are affiliated with real estate brokerage firms that operate using various business models, including full service, limited service, “discount” (regardless of the level of service), Internet, and other models.

Real estate professionals compete fiercely for listings from potential sellers, for potential buyers, and many times, for both. Real estate firms compete for the best agents. Agents and firms gain their competitive edge and build their business based on all factors, including quality, reputation, service, and price. The August 2005 GAO report on *Real Estate Brokerage: Factors that May Affect Price Competition* asserts that the industry “has displayed more evidence of competition on the basis of nonprice factors, such as reputation or level of service, than on price.” There is extremely little, if any, up-to-date data available on the extent and nature of price competition to support GAO’s assertion. In fact, the GAO report itself acknowledges that “there are no comprehensive data on brokerage fees,” but then goes on to state that commissions have persisted in a range of 5-7 percent. GAO bases this statement on older studies and anecdotes. What GAO characterizes as persistent commission rates we see as market-determined rates that more likely reflect a decreasing trend in the level of commissions.

NAR does not conduct research to confirm that commissions are coming down because of concerns that such research would raise antitrust concerns. We can report, however, that our members report that consumers increasingly are negotiating lower commissions.

We also believe that price is often not the principal factor affecting a consumer’s decision on how to sell or buy a home. Buying a home is not like buying a commodity, such as an airplane ticket or a refrigerator. And while some homeowners sell their homes on their own or with minimal assistance, the vast majority—82 percent based on a recent NAR survey—enlist the skills of a real estate professional. The incentive to do this increases in slower markets. Just as patients look for the best medical care and not the lowest-cost provider, consumers buying or selling a home appear to be taking the same approach when it comes to selecting a real estate professional.

Everyone involved in this debate looks forward to someone conducting comprehensive research on a wide range of markets and reporting on price competition in the industry. NAR is confident that this research will confirm that real estate markets are competitive in every dimension, including price.

## **MLS/ILD Policies Promote Competition and Benefit Consumers**

The National Association of REALTORS<sup>®</sup> Multiple Listing Service (MLS) rules, and in particular its Internet Listing Display (ILD) policies, are also part of the debate on competition in the industry.

Through more than 900 MLSs, brokers share information on properties they have listed and invite other brokers to cooperate in their sale and to be compensated if they produce the buyer. Sellers benefit because any MLS participant, not just the listing broker, may attempt to sell the property. Buyers benefit because they can obtain information about all MLS-listed properties while working with only one broker. Brokers and their agents benefit because they have access to a wide inventory of properties to show and sell to their clients.

Despite the claims that the MLS is a “closed club” in which participation is unduly restricted, participation in the MLS is readily available. All real estate professionals engaged in the brokerage of real estate, which is the purpose for which the MLS is created and for which participants join the MLS, may have access to the MLS. In some cases participation is limited to those individuals who hold membership in a REALTOR<sup>®</sup> association. This membership requirement has been upheld in virtually all cases in which it was challenged as a violation of federal or state antitrust laws. Membership in REALTOR<sup>®</sup> associations is available on reasonable and non-discriminatory terms. Thus, real estate professionals operating all kinds of brokerage business models are entitled to participate in and enjoy the benefits offered by the MLS.

NAR’s new ILD policy will create a single set of rules for the display of MLS listing data on the Web sites of MLS participants. Consumers will have more points of access to that information than ever before, while protecting the rights of sellers and their brokers to determine how listings will be used and where they will be displayed. Like the Virtual Office Website (VOW) policy that preceded it, the ILD policy requires MLSs to permit participants to display MLS listings on their Web sites, with several minor exceptions. This enhances the ability of buyers to search for listings on the Web site of the broker of their choice.

One exception is that the ILD policy gives listing brokers the choice whether to permit their competitors to display the listing broker’s listings on the competitors’ Web sites. This opt-out feature is both blanket and reciprocal, so if a broker decides not to permit its MLS listings to be displayed on any competitor’s Web site, that broker may not display any competitor’s listings on its site. Another exception is that a home seller could elect not to permit marketing of their property on the Internet. Alternatively, a seller could opt to have the seller’s property displayed on other brokers’ Web sites even if the seller is working with a broker who has opted out of sharing listings on the sites of its competitors. We expect very few brokers and sellers to opt not to let other brokers display information about properties on their Web sites because it is ordinarily advantageous to include the property on as many sites as possible.

The ILD policy treats all MLS members equally yet respects the rights of listing brokers to market a property as they and their clients see fit. Brokers invest time, effort, and money to

obtain listings from sellers. That earns them the right to determine whether or not to allow their listings to appear on other brokers' Web sites.

One key point to keep in mind is that the MLS system is not a public utility. If it is restructured to remove the blanket, reciprocal opt-out, or to give MLS access to those not engaged in the business of listing or selling properties, there could be a significant and harmful disruption to the way real estate is marketed to the widest possible pool of sellers. One possibility is that large players could pull out and create their own systems. Competition could be significantly reduced because it would be extremely difficult for small, independent brokers to succeed if they lose access to the large inventory of listings currently made available to them through the MLS. They will also be adversely affected by the inability to share their listings with other brokers in the market. It also would harm sellers by reducing the number of potential buyers exposed to their properties, harm buyers by making it difficult to readily identify the properties on the market, and destroy the system that now gives consumers national access to all local markets.

### **National Policy Prevents Mixing Banking and Commerce**

The question of whether banks should be permitted to engage in real estate brokerage activities was beyond the scope of the workshop. But we believe it is appropriate to touch on this subject because critics of the real estate industry argue that banks should be allowed to engage in real estate in order to “shake up” the industry, open it up to more participants, and cause commission rates to come down.

We disagree with their premise—commission rates are already coming down and there are more new competitive business models than ever before. The industry is already in the midst of a transformation brought about by its embrace of the Internet. Putting that aside, however, these critics ignore the longstanding national policy that banks should not be permitted to engage in commercial activities. Reversing this policy would give national banks an unfair advantage over commercial, especially small, businesses because of their access to cheap capital due to FDIC insurance, access to the Federal Reserve’s discount window, and other benefits of a bank charter. Moreover, letting banks engage in commercial activities would inevitably result in conflicts of interest when competitors of a bank affiliate or subsidiary seek financial services and would also raise safety and soundness concerns.

In 2001, the Department of the Treasury and the Federal Reserve Board published a proposed rule that would permit financial holding companies and financial subsidiaries of banks (but not banks themselves or their operating subsidiaries) to engage in real estate brokerage and management activities. NAR believes that real estate is an inherently commercial activity and that there is no basis for these agencies to designate real estate brokerage or management as a financial activity permissible for bank conglomerates. Congress apparently agrees and has repeatedly enacted legislation to block this rule from becoming final.

## Additional Analysis

As part of our comments, I am enclosing a paper on the Structure, Conduct, and Performance of the Real Estate Brokerage Industry that analyzes the industry and demonstrates its inherently competitive structure and nature.

Thank you for the opportunity for NAR and others in the REALTOR® family to participate in the workshop. Please let me know if we may provide any further assistance.

Sincerely yours,



Thomas M. Stevens, GRI, CRB, CRS  
President

Alabama Association of REALTORS®  
Alaska Association of REALTORS® Inc  
Arizona Association of REALTORS®  
Arkansas REALTORS® Association  
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Tennessee Association of Realtors  
Texas Association of REALTORS®  
Utah Association of REALTORS®  
Vermont Association of REALTORS® Inc  
Virgin Islands Territorial Association of REALTORS® Inc  
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Washington Association of REALTORS®  
Washington D. C. Association of REALTORS® Inc  
West Virginia Association of REALTORS®  
Wisconsin REALTORS® Association  
Wyoming Association of REALTORS®

Enclosure

# **Structure, Conduct, and Performance of the Real Estate Brokerage Industry**

**The National Association of REALTORS®  
The Research Division**

**November 2005**



NATIONAL ASSOCIATION  
OF REALTORS®

*The Voice for Real Estate®*

## Executive Summary

A number of policymakers, analysts and media observers have raised concerns about the purported anti-competitiveness of the real estate brokerage industry. They suggest that there could be collusion among real estate agents, real estate firms, and others involved in the industry to control access to information, artificially set commission rates, and block entry into the real estate business. Some argue that in order to infuse competition into the industry, other non-real estate industry players should be allowed to conduct brokerage activities. In early 2001, the Federal Reserve Board and the Department of the Treasury published a proposed rule that would permit financial subsidiaries of banks and financial holding companies to engage in real estate brokerage. To date, the Congress has blocked issuance of a final rule.

To refute those arguments and provide a true picture of the competitiveness and efficiency of today's real estate industry, this paper presents analysis using a widely accepted methodology of structure-conduct-performance. Economists generally believe that the structure of a market determines the conduct of sellers and buyers. The conduct, in turn, determines the performance or efficiency of the market. We also analyze special factors and industry practices including agent-broker relationships and multiple listing services.

Our analysis demonstrates that the real estate industry *is* competitive and efficient, and allows consumers to make informed choices when selecting a real estate professional. Among the findings:

- The residential real estate brokerage industry is fiercely competitive. It allows for ease of entry into and exit from the profession. It closely resembles a perfectly competitive industry structure with production at the lowest possible cost and consumers benefiting from competitively determined prices.
- There are approximately 2.5 million real estate professionals licensed by the states (of which more than 1.2 million are members of the National Association of REALTORS®).<sup>1</sup> Nearly all REALTORS® are self-employed independent contractors. These non-salaried entrepreneurs make decisions about marketing plans, work hours, and a host of other independent business decisions. The sheer number of independent real estate service providers means that there is continuous market testing of new business models and innovations.
- Consumers can select from a full spectrum of options that best meet their needs. Real estate brokerages operate using a wide variety of business models ranging from discount, limited service brokerages to non-discount, full service providers. The for-sale-by-owner (FSBO) option offers consumers yet another choice.
- There is no “collusion” to set commission rates. Real estate brokers compete actively for clients and sales agents. Commissions and the agents' share of the commission are set by market forces in order to attract clients and attract and retain the best agents. The sheer

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<sup>1</sup> The term REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the National Association of REALTORS® and subscribe to its strict Code of Ethics.



number of real estate agents and the number of new agents entering the industry each year does not allow for anti-competitive behavior.

- Any collusion among real estate firms is improbable. Real estate agents are non-salaried and independent decision-makers, but each agent is associated with a “broker” of a local office. There are more than 200,000 locally owned real estate offices and branches of real estate firms in the U.S. The strongest check on any anti-competitive behavior among those firms to fix the agent share of the commission is the active competition *for the best real estate agents*. Agents can readily, with virtually zero cost, change firms, and many agents are in a position to become brokers on their own.
- The performance of real estate brokerage is economically efficient where costs are forced to be minimized. At the same time, consumer surplus (consumer benefits) is maximized. Furthermore, entry barriers are low irrespective of the size of a specific market. Any excessive profit will induce new competitors into the market.
- Many non-economic goals that are considered socially desirable are also attained through the competitiveness and efficiency of the real estate brokerage industry. The national homeownership rate has increased consistently over the past five years. Homeowners have a higher level of community commitment as well as higher voter participation. The real estate industry itself benefits through its commitment to equal opportunity: Women account for more than half of brokers and broker-associate licensees, and flexible work hours allow for both full- and part-time careers
- There is little concentration in the real estate industry. The top 100 real estate firms held only 17 percent of the market’s share. The majority of agents are affiliated with independent, non-franchised firms. By comparison, concentration in the banking industry has greatly increased in recent years.
- In an unfettered, competitive market environment, service providers must be flexible and continuously innovate to meet changing consumer demand and preferences. To assure certain minimal standards and consumer protection, all states have adopted licensing requirements for brokers and agents, some of which include minimum service requirements. Nearly all of the state laws set very low requirements (such as presenting contracts to clients), and so do not appear to place discernible entry barriers to new entrants. The National Association of REALTORS® supports license laws in general but has made no recommendations regarding the inclusion of minimum service requirements.

In the discussion below, we examine the details behind these findings. We conclude that while there are constant challenges to our industry, the professionals involved in real estate brokerage compete in an open marketplace, thus affording housing and other real estate consumers efficient service at reasonable costs.

## **Competition in the Real Estate Brokerage Market**

Real estate brokerage is a \$60 to \$70 billion industry. In fact, residential real estate is one of the largest sectors of the U.S. economy. Approximately \$1.9 trillion was exchanged in 2004 in the sale of both new and existing homes. These transactions provide millions of Americans with jobs and produce hundreds of billions of dollars of economic output each year. The housing sector directly accounts for 15 percent of U.S. gross domestic product (GDP). Further, housing represents a major source of wealth for U.S. households – nearly 70 percent of American households own the home in which they reside. For most of these American families, their home is the largest component of their net worth. In addition, from 2001 to 2005, housing indirectly but significantly contributed to consumer spending from the near \$4 trillion in housing equity accumulated by the nation's 74 million homeowners.

As well as being a vital part of the U.S. economy, the residential real estate brokerage industry operates in a competitive marketplace. More than two million real estate licensees and tens of thousands of real estate brokers compete for customers' business each day. The underlying cost structure of the industry and the relative ease of entry into the market serve as checks to the concentration of market power. The large number of industry players gives homebuyers and sellers access to service providers who best meet consumers' needs at a competitively determined price. The industry cost structure also shows fairly constant economies of scale, thereby offering no cost advantages to larger firms.

### **Real Estate Agents and Brokers**

There are approximately 2.5 million real estate licensees (of which more than 1.2 million are members of the National Association of REALTORS®). These real estate brokers and sales agents provide professional services to support home buying and selling. All have their own personality, work ethic, work hours, marketing plans, and essentially their own business plans and make independent business decisions, regardless of firm affiliation. Real estate professionals are overwhelmingly non-salaried independent contractors actively competing directly with other agents – including those agents within the same office – for listings and clients. Commission rates vary depending on the scope of services an agent provides to clients and competition in the marketplace. Real estate agents also manage their own clientele. An agent can turn down any client or those referred by the broker. Because most agents receive no salary, and office profit-sharing is generally rare, there are few monetary incentives to help other agents from the same company, although agents do assist each other in return for future reciprocity.

Real estate professionals have different experiences, expertise and training. But they all have the ability to negotiate what services to provide to their clients. Real estate brokers negotiate the level of sales commission and the commission split with agents in order to build business and attract and retain their agents. This encourages competition among real estate professionals and so presents a wide range of choice to consumers. The ways in which they conduct business change, and the agents themselves are constantly tested by the market. Those who can meet consumers' needs survive; those who do not leave the real estate industry. In 2004, 849,083 REALTORS® continued to hold their membership in the National Association of REALTORS® and presumably stayed in the business while 127,877 dropped their membership. During the same year, additional 253,167 new members joined the Association.

Any collusion to set commission rates at the agent level is impossible. The reason is simple: agents do not set commission rates. The real estate broker negotiates commissions and the split with agents. The sheer number of brokers (200,000) competing for agents and clients precludes any noncompetitive behavior. Furthermore, many agents are permitted to set their own commission rates *within the prescribed limits set by their broker*. Therefore, any anti-competitive behavior is further precluded, as even a larger number of participants can often engage in commission negotiations.

Most real estate professionals are essentially small business owners. Nine out of ten real estate professionals are independent contractors who represent a real estate brokerage. As independent contractors, they do not receive a base salary; rather, they earn their income by successfully matching homebuyers with sellers. Most real estate professionals are compensated with a percentage (or even all) of the sales commission paid by the seller of the properties to the agent's real estate firm. Typically, real estate agents receive 60 percent of the commission. Since their livelihood is based on their ability to successfully match homebuyers with sellers, real estate agents have an incentive to ensure a high level of customer satisfaction from the homebuying and selling public.

While being highly motivated professionals dedicated to their clients, real estate professionals have an additional incentive to serve their customers well. Consumers tend to choose their real estate professional based on "word of mouth." While many agents choose to market their services to homebuyers and sellers through advertising, most homebuyers and sellers choose their real estate agent based on a referral or their own experience with the agent in a previous transaction. In 2004, almost 60 percent of homebuyers chose a real estate agent that they had used previously, or who was referred by either a friend or relative.

### **For-Sale-by-Owners**

Real estate agents and brokers compete actively among themselves for business. But they also compete with consumers. Homeowners can always choose the do-it-yourself route. In 2004, 14 percent of home sales were "for-sale-by-owner"-- commonly known as FSBO.

An interesting aspect of the FSBO market is that it can include REALTORS®. It is not uncommon for a REALTOR® with a homebuying client to contact the FSBO seller if the buyer client or the seller is willing to compensate the agent for a resulting sale. In addition, there are companies that assist sellers in marketing their properties for a fixed fee for limited services.

Because homes can be bought and sold without a real estate professional, agents and brokers must earn their customers' business during every step of the housing transaction. Consumers' ability to complete transactions without the assistance of real estate professionals provides agents and brokers with one of their greatest sources of competition, as well as the additional impetus to better serve their current and future clients.

### **Real Estate Firms and Brokers**

At the end of 2004, there were 236,000 active real estate brokerage office locations and branches in the United States. These brokerages are in the business of managing independent agents. They range in size from a single office with a single broker-agent to multiple-office firms that serve an entire metropolitan area or, in some cases, several states. As brokerages differ, so do their business models. For example, brokerages may choose to affiliate with a regional or national franchiser (e.g., Real Living or Century-21) or to remain independent.

All real estate brokerage offices are headed by a real estate professional holding a broker's license. Each real estate office must have at least one broker to operate, whether it is a single broker-agent firm or one with several hundred agents. An agent can obtain a broker's license, usually after having been in the business for several years, and passing the broker's license exam. The exact requirements vary by state.

Brokers are compensated by the commission typically paid by the home seller to the firm. Brokers then pay their agent through either a fixed fee or a percentage of the sales commission. The commission split and fees depend on many factors, such as on how much computer or legal support the broker provides and on the production level of the agents. If a second brokerage firm procured the buyer for the property, which can occur when the listing broker places the property into the multiple listing service ("MLS"), then frequently the listing broker shares the compensation it receives with the second brokerage. The fee received by the second brokerage is further split between the broker and the agent involved in the transaction.

Brokerages of different sizes and business models are able to compete on a level playing field because most real estate professionals and firms share their detailed property listing information with other real estate professionals in their market through the local or regional multiple listing service. Most MLSs make the listings available to their participants via computerized databases. By including a listing in an MLS, a participating broker invites other participating brokers to cooperate in the sale of the listed property and offers to compensate any other MLS participant who produces the buyer. An MLS enables real estate professionals, whether representing large or small brokerages, to access information about homes for sale that can be shown to their clients.

Both sellers and buyers benefit from this arrangement. Homebuyers do not need to visit multiple brokerages or even the largest brokerage in town to see the best selection of homes available. Buyers have choice. They are able to choose a real estate professional or brokerage that best meets their other requirements without worrying about access to listings. Sellers also gain a similar benefit from the MLS. It guarantees exposure of the seller's property to the widest possible audience of potential buyers for homes. This broad market exposure for the property results in the sale of a property at the best price possible.

### **Franchises**

Firms can differentiate themselves from their competitors by affiliating with a regional or national franchiser. In exchange for a fee that frequently is a percentage of the firm's revenues, the franchiser provides the firm with a recognized name brand and advertising capabilities, training materials, and assistance in recruiting sales agents and acquiring new technologies. Among the most widely known real estate franchises are those owned by Cendant (Century 21, Coldwell Banker, and ERA), RE/MAX, and GMAC Realty Services.

*Franchised brokerages are still independent local brokerages.* Brokerages that have an affiliation with a national franchiser are owned and operated by a local broker, who makes final decisions on firm policies and prices. Further, unlike franchised fast food restaurants and gasoline stations that purchase much of their products from the franchiser, real estate franchisers do not produce the output sold by their affiliated real estate brokerages. Franchised brokerages are truly local independent firms. Furthermore, franchisees with the same franchiser compete with each other—even within the same market.

## **Competition among Firms for Real Estate Professionals**

Real estate professionals are independent contractors of the firms they represent. Typically, they neither receive a guaranteed salary nor do they receive benefits such as health insurance or paid vacation. Agents frequently switch firms to receive a better commission split or other benefits. As agents become very successful, they often seek better compensation terms from either their present firm or from a competing firm.

To attract or keep top agents, firms may raise the commission split paid to those agents or provide additional marketing assistance. As agents gain more experience and generate a loyal clientele of buyers and sellers, they tend to earn a greater percentage of the commission earned by the broker. In some business models, agents receive 100 percent of the commission received by the brokerage firm, instead of a commission split. Under a 100 percent commission compensation arrangement, agents pay their firms fixed “desk costs” that are unrelated to business volume. .

Competition among real estate firms for market share is fierce. Because of that, any possible collusion among firms to artificially inflate commission rates is virtually impossible. In a few markets, some firms may have a larger than usual market share, but market shares are known to change measurably from one year to the next.<sup>2</sup> If a few local brokers were to collude on the commission rate or agent split, there would be less negotiating room in their dealings with clients. Clients would then gravitate to other firms. Similarly, if two or more franchise firms make a joint decision to artificially raise their franchise fees paid by independently owned and operated local franchisees, the final commission faced by the consumer would also be artificially higher because the broker would have to charge higher commissions to cover the higher franchise fees. Again, affected brokers would soon lose customers to other competitors with lower costs and the franchisers would have to lower their fees or lose franchises.

Even in those few local markets where just a couple of firms appear to predominate, there are strong market forces at work that exert competitive pressures. Many real estate agents could easily become a broker should they choose to do so if there were anti-competitive behavior among existing brokers. But many agents are satisfied with their current commission split arrangement with their existing brokers and have no need to set up their own offices. This is not surprising given that the market for agent recruitment is fierce. Successful agents are in demand. They are constantly being “wooed” to join other firms. And, as has been noted above, consumers select their real estate professional primarily based on previous experience or from a referral, so when an agent changes firms the agent brings her client base with her. There is no cost to a client to follow an agent to another firm. Unlike stock market brokerage, there is no financial asset holding or liquidation cost associated from switching a firm. A good agent can, therefore, expect client loyalty independent of the agent’s firm affiliation.

Given these market realities, collusion among firms to set artificially high commission rates or splits would be counter-productive. Firms would lose the best agents. Agents who were at a disadvantage in the marketplace from such artificially high commission rates or splits – or an artificially high franchise fee -- would generate less business and less total income, and so would gravitate to other firms. Firms with artificially high commission splits would lose their most efficient and highly productive sales agents, and thus would be less profitable. Such firms would

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<sup>2</sup> Sawyer, Steve, “Local Real Estate Market Competition: Evidence and Insights from an Analysis of 12 Local Markets”. Report for the REALTORS® National Center for Real Estate Research, 2005.

not survive in the market. Top-producing agents able to charge lower commissions will outperform the agents working within an artificially high cost structure. This in turn will drive the associated brokers and franchisers to change their policies or go out of business.

Even in small markets, a real estate brokerage firm is nearly always present even if the area suffers from a lack of competition in retail, banking, and other services. What appear to be relatively higher commission rates in some rural markets may not necessarily imply market power. It may simply reflect very low sales volume and the need for any broker in that market to charge a higher commission to make it feasible for agents and brokers to stay in business. Furthermore, entry barriers are low irrespective of the market size. If there is any excess profit, it will induce new competitors who will “bid away the profit” given low barriers to entry into the industry.

The real estate brokerage industry is disaggregated. According to data published by *Real Trends*, the top firms in 2004 had the following market shares.

- Top 10 firms -- 9.1% market share
- Top 20 firms -- 10.9% market share
- Top 100 firms -- 17.0% market share
- Top 500 firms -- 26.6% market share

NRT was the largest real estate firm, but still accounted for only a 4.1% share of the market. Homeservices.com was second with 1.7%. Since the large firms account for a relatively small proportion of the market, consumers have a wide choice of firms to choose to find the one that best suits their specific needs.

## Economic Theory of Industry Structure

To help assess the structure of the real estate brokerage market, we examined the theoretical aspects of industry structure. This discussion also provides a framework in which to compare the banking industry with the real estate industry.

Economists have broadly classified industries into four categories: perfect competition, monopolistic competition, oligopoly, and monopoly. Perfect competition is said to yield “good” economic outcomes, while an unregulated monopoly is said to yield “bad” outcomes due to resource misallocation. Many industries do not fall neatly into one of these categories. Nonetheless, they provide a valuable reference point on which to compare industry performance.

### Structure

For a market to be characterized as being perfectly competitive, certain pre-set conditions must be met. They include:

- (a) many buyers and many suppliers
- (b) no barriers to entry
- (c) identical products and services
- (d) perfect information
- (e) consumers are able to maximize their well-being by seeking the lowest possible price and firms are able to maximize profit by seeking the highest possible price.

These conditions assure that all market players have limited impact on the overall market and have no control over the price. They also assure that the goods-and-service provider operates at a point where the marginal cost equals the average cost. This point corresponds to the point at which the long-run average cost is the lowest.

Furthermore, easy entry into the industry assures that the suppliers will have profit no higher than that earned by others in the industry. So the end result of the market process is that firms have to operate at the lowest average cost point (where marginal and average costs are equal) and consumers are getting the lowest possible price. Any deviation from this desirable result induces entry and exit of suppliers until such point is reached.

An absence of barriers to entry is a key requirement to achieving a competitive outcome. Sometimes, a barrier to entry can be overt, such as selling of a patented product or high costs of inventory. It could be a legal barrier where government grants exclusive production rights. Sometimes the entry barrier can be subtle. In the case of permitting financial subsidiaries of banks and financial holdings companies to engage in real estate brokerage activities, they would benefit from a cost advantage enjoyed by bank affiliates, and so the barrier to entry would be higher for other potential entrants

If input prices, such as material costs or worker wages, rise as more new players enter the market, then the long-run average cost curve will rise proportionally. The opposite result occurs if input prices fall. If there is no change, then the long-run average cost will show constant economies of scale. That is, there will be no cost advantage between large or small firms.

Technology innovations over time bring a lowering of the cost curve. Such a situation will lead to higher than normal profit among existing suppliers. But again, easy entry into the industry assures declining prices until no abnormal profits are earned.

The consumer in this case benefits from what is called a consumer surplus. The consumer surplus is the difference between the amount that consumers *value* the product or output, and the amount they actually *pay* for the product. Monopoly firms and colluding oligopolists would be able to extract consumer surplus. The surplus extraction can be subtle as using a loss-leader strategy to mask the profit growth in other lines of business.

A perfectly competitive industry is desirable in terms of producing the best social outcome (in the absence of externalities such as producing pollution). Economic forces operate unimpeded with no player able to exert any market power. The market outcome is said to be the “best” if these conditions are met.

### **Conduct**

Market Conduct is the actual behavior of buyers and sellers (in our case, of real estate service providers) in a market. It includes pricing policy (collusive or predatory and discriminatory), activities to raise entry barriers, and “rent seeking” activities to establish regulation to limit competition.

Industries considered to be a monopoly or oligopoly can exercise market power to raise consumer prices. Predatory pricing (cutting prices below costs in order to drive out the rivals from the market) and limit pricing (setting a price low enough to discourage entry, to guarantee lower profits for a longer time without innovations) are other options in the hands of firms in a concentrated industry. Pricing power does not exist in perfectly competitive markets. Firms are forced to charge the prevailing market price for fear of losing market share. Therefore, a perfectly competitive industry is preferred from the point of view of consumers over a monopoly or oligopoly.

As to barriers to entry, an oligopoly or even a monopoly may not have strong pricing power if there is relatively low-cost potential entry by a rival. Such a market is said to be contestable. The airline industry is often mentioned as an example of a contestable industry. A flight-route currently carried by a single carrier would not be able to raise the price above “normal” for fear of a quick re-working of schedules by competitors to enter that flight market. Therefore, from a company profit point of view, it is in the interest of the incumbent firm to raise entry barriers. From an economic point of view, entry barriers lead to misallocation of resources, higher prices for consumers, and production inefficiencies.

Price discrimination refers to charging different prices for the same product or service. An example would be senior discount pricing or a last minute air ticket purchase. Such power to price discriminate only exists in monopoly/oligopoly industries. Price discrimination *per se* is not considered inefficient in terms of resource allocation, but it does, for the most part, *transfer wealth* from consumers to producers.

Managerial theory of industrial organization implies that managers can pursue policies that are not in the best interests of their principal (i.e., some CEO goals and decisions may not necessarily benefit stockholders). But such policies can be pursued and yet survive in the marketplace because of high barriers to entry and resulting monopolistic and oligopolistic pricing power.

Finally, a rent-seeking activity – an allocation of resources for the purpose of protecting profits and *not* for production of goods and services – is socially wasteful. A regulated industry pursues



activities to “capture” the regulating agency. For example, agencies created to protect society from industry misconduct might become the captives of the industries they were supposed to oversee, furthering the industries' interest at the expense of the consumer. The regulated airline industry in the 1970s is one such case with airfares being high and airlines enjoying profits without having an incentive to lower costs.

### **Performance**

Performance looks at the end result. Does the industry produce goods and services in an efficient manner and promote other socially desirable goals? The most important characteristics include efficient resource allocation, equity (generally viewed as low consumer prices), employment, technical progress, a generally higher standard of living, and some special social goals, such as promotion of minority and women entrepreneurship or flexible work hours.

## **Is Real Estate Brokerage A Perfectly Competitive Industry?**

The five criteria required of perfect competition are fully met rarely in any industry. The question is a matter of degree in assessing whether a market is perfectly competitive or, at the opposite extreme, a monopoly.

### **The Structure of the Real Estate Brokerage Industry**

The real estate brokerage industry, by any objective measure, is one of the few industries that comes close to meeting all of the criteria of a perfectly competitive industry.

- (a) There are many buyers and suppliers: 8 million homebuyers and 8 million sellers and more than 2 million real estate agents.
- (b) Entry into and exit out of the real estate industry are easy. In 2004, 253,167 new members joined the National Association of REALTORS® while 127,877 dropped their membership.
- (c) The service provision differs from full to minimum service. But within a category, the sheer number of service providers assures that there will be plenty of competitors for a given service level provision. Furthermore, a single real estate broker is flexible in providing different levels of service at negotiated prices
- (d) Consumers have wide access to information on the selection of real estate agents – in the yellow pages, local newspapers, through referrals, and now via the Internet. Information about 95 percent of the homes for sale can now be found on a real estate firms' web sites, an aggregator site such as REALTOR.com, or other Internet sites.
- (e) It is reasonable to assume that consumers seek out the lowest possible price for a given level of service and for agents/entrepreneurs to maximize profit.

The real estate brokerage market outcome is quite remarkable in that it matches not only the conditions required but also the outcome of a perfectly competitive market.

With little capital or raw material input required to become a real estate agent, the cost structure reflects constant economies of scale (see Appendix). Mergers and acquisitions among large real estate firms do not deter individuals from creating small businesses. The main reason is because the industry is a person-to-person business requiring the highest level of trust and because even a small firm can compete with a large firm because the MLS levels the playing field.

### **The Conduct of the Real Estate Brokerage Industry**

Competition among real estate agents and firms enables consumers to demand the best service for the best price. A real estate firm that charges an above-market commission rate will have limited business. Therefore, the highest quality brokerage service providers cannot set their own price but must offer competitive pricing. There will be more discussion about this issue below.

Also price discrimination is unheard of in the real estate industry. There are no advertised discounts to seniors or during “slow” seasons. Certainly there are business models that charge lower commission rates, but they are not the same as price discrimination. Price discrimination

can occur due to personal bargaining strengths between a client and an agent. Overall, agent pricing power is consistent with that of a price taker.

With approximately 2.5 million real estate licensees (of which more than 1.2 million are REALTORS®) and well over 200,000 local real estate brokerage offices competing for the business of home buyers and home sellers, today's residential real estate brokerage industry provides a vast array of choice for consumers. Real estate agents compete for consumers' business against each other and with other methods of buying or selling homes. Real estate firms compete each day for agents. Finally, the relative ease of entry into real estate brokerage acts as a check on market power that may be generated through market concentration. The current free-enterprise system provides a wide array of choices and a high level of service to both buyers and sellers.

### **The Performance of the Real Estate Brokerage Industry**

The result of this fierce competition is relatively low profit margins for real estate brokerages. The real estate brokerage industry faces continued low profitability, as revenues are not able to rise as quickly as expenses. The two largest areas of expenses paid by firms are sales commissions and bonuses.

The typical firm earned profits of just 2.3 percent of the firm's gross revenue in 1996 (the latest data available from the National Association of REALTORS®). Though data on profitability are no longer being collected by the Association, there does not appear to have been any significant changes to the profit margin in recent years. First, market trends on commission-splits have moved in favor of agents in recent years. Second, qualitative responses on firm profitability in 2003 showed 60 percent of the firms reported their profitability increased from the previous year. In addition, 12 percent reported profitability was at or about the same level, and 24 percent reported it decreased (5 percent of respondents either did not know or did not respond). The fact that one out of three firms reported no increase in profitability in 2003 -- the year in which overall home sales rose by 9.8 percent and sales dollar volume increased by 17.6 percent -- does not definitively imply a measurable rise in profit margins in 2004. The result does not preclude the possibility of a lower profit margin either.

### **Commission and Income of REALTORS®**

The latest research from *Real Trends* indicates that commission rates decreased 16 percent from 1991 to 2004. It is unclear how commission rebates or other consumer benefits (such as free moving trucks or payment by the broker of various closing costs) are computed into the overall calculations. If one assumes a \$60 to \$70 billion brokerage industry and an existing home sales volume of \$1.3 to \$1.4 trillion (excluding FSBOs), average commission rates range from 4.3 percent to 5.4 percent. NAR cannot confirm the 5.1 percent industry average commission rate. (The National Association of REALTORS® does not conduct research on commission rates out of concerns that the research results have the effect of setting a "focal point" for practitioners to set their commissions.)

Meanwhile, the typical income of REALTORS® fell from \$52,000 in 2002 to \$49,300 in 2004. Income of sales associates, who make up two thirds of the membership of NAR, also decreased, from \$41,600 (2002) to \$38,300 (2004). This decline in income occurred despite a booming housing market and can be attributed to the competitive nature of the industry. The National Association of REALTORS® experienced an increase in its membership of 225,000 (26 percent)

over the same time period. And because REALTORS® work as independent contractors, there are generally no fringe benefits in addition to the commission income.

The income of the typical REALTOR® at less than \$50,000 in 2004 certainly would not qualify as a monopoly profit. The typical agent works 45 hours per week. For a comparison, the incomes of other occupations are below.

Engineer	\$70,300
Financial services sales	\$62,000
Real estate agent	\$49,300
Elementary school teacher	\$40,300
Nurse	\$43,661
Auto sales	\$47,670
Electrician	\$41,000
Social worker	\$30,700

*Sources: Bureau of Labor Statistics, National Association of REALTORS®*

Any analysis of REALTOR® income also needs to factor in the business cycles that occur in the housing sector. The industry has been subjected to harsh business cycles in the past (sales falling 50 percent in the early 1980s and falling 20 percent in the early 1990s). So a high average income in one particular year may not signal excessive profit wrought through market power. It may simply imply compensation in up and down years. REALTORS® undertake business risk for the chance of profit, and profit by its nature will fluctuate from one year to the next. This profit opportunity is open to all.

### Homeownership and Mobility

The U.S. housing market is clearly one of the most dynamic in the world. Total home sales reached 8 million in 2004, representing one home sale for every nine homeowners. Undoubtedly, the efficient real estate brokerage market has been a contributing factor in this high rate of mobility (usually an upward economic mobility). Most would consider a mobile society to be a positive social outcome.

### Federal Bailout

Federal bailouts imply too much risk taking and misallocation of resources by the private sector. The real estate brokerage industry has never sought nor received federal subsidies - even during hard times. It has never asked for temporary measures to reduce valid competition. The industry has always worked very similarly to the textbook example of a perfectly competitive industry. Bad times were self-correcting through exit by market participants.

### Technological Advancement

The growing use of the Internet by consumers and real estate agents and firms has dramatically reduced informational search costs. The entrepreneurial nature of the industry has engendered continuous innovations to the homebuying process. (REALTOR.com alone invested approximately \$500 million in the technological infrastructure to bring to consumers the benefits of searching of 24/7.) Many REALTORS® display property ads on their websites or provide links to property information (not the actual MLS) with property addresses so that those buyers who are interested in specific homes can just “drive by” before contacting a REALTOR®. The

ability to view available properties on line makes the home search process more efficient. These innovations also compel real estate professionals to compete actively with each other because through the Internet consumers have a greater choice in both properties and agents. The National Association of REALTORS® *2004 Profile of Homebuyers and Sellers* shows that those homebuyers who used the Internet in their home search actually *visited* a median of 11 homes versus a median of 6 homes visited by non-Internet searchers.

### Social Goals

American society recognizes the importance of women's participation in the workforce and their increasing entrepreneurship to be socially desirable goals. The real estate industry has done a superb job promoting and realizing such goals. According to the latest NAR survey of its members, 54 percent of all REALTORS® are women.

Another socially desirable aspect of the real estate brokerage industry is its flexible labor market and flexible work hours. It suits people seeking part-time employment and non-traditional hours. Because agents are independent contractors, there are virtually no labor grievances between agents and brokers, unlike between unions and management of large companies. There are no work stoppages. There are no complaints of low pay. Agents fully understand the risk-reward nature of the commission-based business. Dissatisfied agents simply leave the field. The real estate brokerage labor market reflects the best features of a market economy. It is helping the economy. Agents switch brokerages; some even establish their own brokerage firms. This labor market epitomizes the free-enterprise, entrepreneurial American economy.

### **Special Issues Specific to the Real Estate Brokerage Industry**

#### VOWS/ILD Policies

In 2003, the National Association of REALTORS® adopted a policy governing the display of listings derived from the MLS on brokers' websites (the VOW – Virtual Office Website -- Policy). The U.S. Justice Department expressed concerns that certain aspects of the VOW policy restrain competition from brokers who use the Internet to serve home sellers and buyers. In response to these concerns, NAR rescinded its VOW policy and adopted a new Internet Listing Display policy (ILD). The Justice Department has sued the National Association of REALTORS®, claiming both the defunct VOW policy and the ILD policy unreasonably inhibit competition. NAR does not believe either policy has any anti-competitive effect on the industry and, in fact, has many effects that promote competition, the most important of which is maintaining the effective functioning of the MLS. The case is pending in United States District Court for the Northern District of Illinois

#### Minimum Service Requirements

Some states have enacted laws requiring those real estate licensees to provide consumers with a minimum level of service. Some have criticized these laws as being anti-competitive because some consumers would be required to pay for services that they do not want. But the minimum service requirements are quite basic. Typically, the agent must present offers and counter offers and answer questions being asked by the consumer the agent represents.

The National Association of REALTORS® generally defers to its state associations on matters involving state law, and NAR has done so on this issue. While some state associations have adopted positions favoring the adoption of minimum standards, other state associations have recommended legislation imposing disclosure requirements on licensees. Regardless of the

approach, the goal of these laws is to protect consumers. When one party to the transaction is represented and the other is not, the unrepresented party often finds that they need more assistance than they anticipated and they find themselves at a disadvantage. And the deal may collapse, to the detriment of both parties.

### State Rebate Laws

The National Association of REALTORS® Code of Ethics expressly states that the offering of premiums, prices, rebates or other inducements is not unethical provided the REALTOR® makes clear any terms and conditions of the offer.

### Real Estate Service Is Not a Commodity

Some question why, unlike the buying and selling of stocks and airline tickets, the Internet has not brought comparable low transaction costs to the purchase and sale of real estate. The key difference is that real estate is not a commodity. Each home has its unique features and location. Each home requires a different marketing presentation. Homes are the largest transaction that a person will likely make in one's lifetime and most buyers do not want to use a "do-it-yourself" route. The process is extremely complex and time-consuming. While the purchase of an airline ticket over the Internet may take 10 minutes, the home purchase transaction – including all the real estate related services necessary for settlement – usually require over two months of work. It is therefore not surprising that an industry that requires person-to-person, case-by-case service has not seen costs reduced to a small fraction of the pre-Internet era. Examples of other businesses where the Internet has not resulted in huge (or in some cases, any) price reductions for consumers include estate planning, financial planning, accounting, legal, and medical services.

### Comparisons with Other Nation's Real Estate Industries

Some have asserted that other industrialized countries offer lower commission rates for real estate transactions. However a caution is in order for any empirical comparisons among countries. There are too many factors involved to permit simple commission rate comparisons.

- Were the commission rates adjusted to account for differences in services? Do agents in other countries normally provide a walk through with a home inspector, advise on mortgage products, assist through the settlement process, and perform other services typical in the U.S.?
- Do agents in other countries (or their parent companies) earn income from non-brokerage services (such as from title search or mortgage origination)?
- Are there barriers to entry into the profession that make the market less dynamic, which would allow for lower commission rates but more customers per agent?
- Is dual agency more prevalent in foreign countries and, if so, does dual agency serve consumers' best interest?

There are just too many unknowns about the intricacies of each of the foreign markets. Given the nature of the dynamic U.S. market and the incomplete description of the foreign markets, the assumption that U.S. commission rates are artificially high is totally misplaced.

### **Subsidies to the Real Estate Industry**

Government subsidies bestowed upon the real estate industry influence both the demand for homes and the supply of homes, but do not interfere with the competitive business environment. The list of tax benefits include:

- Mortgage interest deduction for federal income tax
- Local and state property tax deduction for federal income tax
- Home equity loan interest deduction
- Capital gains exemption from home sale
- Large allowance before the estate tax
- Down-payment assistance
- GSE interest rate “subsidy” (from perceived backing of GSEs by the federal government)
- VA loans for veterans
- FHA loans for moderate income households

Some economists have contended that there is over-investment in residential real estate due to many favorable tax treatments in owning a home. Due to these favorable tax treatments, it could well be that there is more investment in real estate and homeownership than would otherwise be present. However, the costs to the government (in terms of foregone tax revenue) must be balanced against many social benefits of homeownership.

### **Social Benefits of Homeownership**

The competitive nature of the real estate industry has helped boost the nation’s homeownership rate to 70 percent, and in doing so has had beneficial effects on our society as a whole. Homeownership makes positive social and political contributions to American society. Research shows that homeownership raises the owners’ sense of commitment to community and their willingness to invest in both the home as an asset and as a place to live and raise a family. Furthermore, a higher overall quality of life among homeowners is believed to contribute to the well-being of both homeowners and their children in a number of ways. For example, children of homeowners tend to have higher levels of achievement in math and reading and fewer behavioral problems. These factors, as well as many others, help explain increased educational attainment and higher lifetime annual incomes of homeowners’ children.<sup>3,4</sup> In addition to being *more* satisfied with their own personal situation than renters,<sup>5</sup> homeowners also enjoy better physical and psychological health.<sup>6</sup>

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<sup>3</sup> Haurin, Donald R., Toby L. Parcel and R. Jean Haurin 2001. *The Impact of Homeownership on Child Outcomes. Low-Income Homeownership Working Paper Series LIHO-01.14, Joint Center for Housing Studies of Harvard University.*

<sup>4</sup> Green, Richard K. and Michelle J. White 1997. *Measuring the Benefits of Homeowning: Effects on Children. Journal of Urban Economics* 41(3): 441-461.

<sup>5</sup> Rohe, William M, and Michael Stegman 1994. *The Impacts of Home Ownership on the Self-Esteem, Perceived Control and Life Satisfaction of Low-Income People. Journal of the American Planning Association* 60(1): 173-184.

<sup>6</sup> Rohe, Willam M., Shannon Van Zandt and George McCarthy 2001. *The Social Benefits and Costs of Homeownership: A Critical Assessment of the Research. Low-Income Homeownership Working Paper Series LIHO-01.12, Joint Center for Housing Studies of Harvard University.*

Although the extent of community involvement and the benefits that accrue to society are hard to measure, several researchers have found that homeowners tend to be more involved in their communities than renters. For example, owners participate in a greater number of non-professional organizations. They also have higher voter participation rates. In addition to higher civic participation, owners also tend to remain in their homes longer, adding a degree of stability to their neighborhood. Since homeowners reap the financial gains of any appreciation in the value of their home, they also tend to spend more time and money maintaining their residence, which also contributes to the overall quality of the surrounding community.<sup>7,8</sup>

Research also confirms that adverse social outcomes are less frequent in neighborhoods with high rates of homeownership, community involvement, and access to economic and educational opportunities.<sup>9</sup> There also is some evidence that homeownership programs may result in increased property values near subsidized or locally assisted homeownership sites and can, under the right circumstances, draw other non-housing investment to the community.<sup>10</sup>

### **Comparisons to Banking Industry**

Many argue that in order to infuse competition into the real estate industry, financial holding companies and financial subsidiaries of national banks should be permitted to conduct brokerage activities. The arguments against banks entering into the real estate business range from conflicts of interest to Congress's intent to separate banking from commerce to advantages that government subsidized banks would have against non-subsidized real estate companies. Acknowledging this policy debate, it is appropriate to examine the competitiveness of the banking industry against the backdrop of the competitiveness of the real estate industry.

The banking industry is one of the most highly concentrated industries in the country. A wave of mergers in the past decade has yielded a concentration where the top 5 banks hold 45% of the industry assets totaling \$3.4 trillion at the end of 2003. The top bank, JP Morgan Chase, held 13.3% of the market and \$1.01 trillion in assets.

In the words of two FDIC analysts "[d]ue to such a high concentration of assets among a handful of megabanks, FDIC now faces a situation in which the failure of even a single megabank could

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<sup>7</sup> Rossi, Peter H. and Eleanor Weber 1996. *The Social Benefits of Homeownership: Empirical Evidence from National Surveys*. *Housing Policy Debate* 7(1) 1-35.

<sup>8</sup> Rohe, William M. and Leslie S. Stewart 1996. *Homeownership and Neighborhood Stability*. *Housing Policy Debate* 7(1): 37-81.

<sup>9</sup> Ellen, Ingrid Gould and Margery Austin Turner 1997. *Does Neighborhood Matter? Assessing Recent Evidence*. *Housing Policy Debate* 8(4): 833-866.

<sup>10</sup> Ellen, Ingrid Gould, Scott Susin, Amy Ellen Schwartz, and Michael Schill 2001. *Do Homeownership Programs Increase Property Value in Low Income Neighborhoods?* *Low-Income Homeownership Working Paper Series LIHO-01.13, Joint Center for Housing Studies of Harvard University*



overwhelm the resources immediately available to the deposit insurance system and expose both the banking industry and the government (i.e., taxpayers) to huge potential liabilities.”<sup>11</sup>

Permitting financial holding companies and financial subsidiaries of mega-banks to enter the real estate brokerage industry raises many complex issues. Permitting heavily regulated banks, some of which are subject to foreign regulation as well, to engage in the free-enterprise, dynamic real estate brokerage market creates risks for consumers, taxpayers, and the overall economy. The LCBOs – Large Complex Banking Organizations – have significant on- and off-balance sheet risk exposures. The FDIC now faces an “uninsurable risk” in which a failure of even a single LCBO could overwhelm the deposit insurance fund and expose the nation’s taxpayers to huge liabilities.

LCBOs are subject to managerial hubris X-inefficiencies. The market outcome in such a case will be an unnecessary higher cost structure, yet continued survivability. Economic resources will be misallocated. Consumer will face higher net price while receiving lower quality of service for home transaction.

Certain legal and regulatory benefits accrue only to LCBOs. The unbalanced competitive advantage enjoyed by LCBOs, as economic theory would say, could easily lead to predatory pricing and then substantially raise barriers to entry. Furthermore, banks are subsidized and their entry into the real estate brokerage business would create an unlevel playing field in which small, entrepreneurial real estate companies would face numerous obstacles that would ultimately reduce or eliminate the benefits of a competitive marketplace for homebuyers and sellers.

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<sup>11</sup> Jones, Kenneth D. and Nguyen, Chau, "Increased Concentration in Banking: Megabanks and Their Implications for Deposit Insurance." *Financial Markets, Institutions & Instruments*, Vol. 14, No. 1, pp. 1-42, February 2005

## Comparison of Real Estate Brokerage and Banks

	<b>Real Estate Brokerage</b>	<b>Banks and Bank Holding Companies</b>
Market Structure	Nearly perfectly competitive	Oligopoly among market leaders
Number of Firms	98,000 *	8,000 to 10,000
Number of Independent Business Decision Makers	Over 2 million	8,000 to 10,000
Concentration Ratio	Near zero at the agent level.  Top 10 firms had 9.1% market share  Top 100 firms account for 17.0% of market.	Very High  Top 5 firms control 45% of industry assets.  Top 10 firms control more than half of industry assets.
Barriers to Entry	Minimal  Usually less than \$1000 and few weeks of studying time to get a real estate license	Large capital requirement
Predatory Pricing	None	Possible
Collusion	Impossible (or very short-lived)	Possible
Taxpayer Risk	No	Yes
Historical Experience of Seeking a Government Bailout	No	Yes
Subject to regulation by foreign countries	No	Yes
Ability to raise price	None	Yes
Consumer data on buying habits	Limited at best to relatively few home transactions in a local market	Vast, including data mining of credit card purchases
Price Discrimination	None	Vast, often based on data mining results of consumer buying habits and assessing willingness to pay
Social Promotion of Entrepreneurship and Self-Reliance	Yes	Yes, for owners of the many community banks
Social Promotion of Women and Minorities in Entrepreneurship	Yes	Yes, for owners of the many community banks

\* According to the Association of Real Estate License Law Officials (ARELLO). The National Association of REALTORS® membership records indicate 236,000 locally owned real estate brokerage offices and branches of those firms.

	<b>Real Estate Brokerage</b>	<b>Banks and Bank Holding Companies</b>
Social Promotion of Small Business	Yes	Yes, for owners of the many community banks
Offer to cooperate with competitors in the sale of products?	Yes, via MLS	No
Contestable Market	Yes	No
Degree of regulation	Minimal	Heavy
Managerial hubris induced X-inefficiencies at the expense of owners (stockholders)	No	Yes
Promotes flexible working hours	Yes	No
Potential for work stoppage	No, agents are independent contractors	Yes, through labor grievances or unionization

## **Conclusion**

The real estate industry is a highly competitive one. The sheer number of participants – approximately 2.5 million licensees and over 1.2 million REALTORS® – means that those real estate professionals must compete every day for clients and property listings. Through the more than 900 MLSs, real estate brokers list properties and invite other brokers to cooperate in the sale of those properties. Home sellers benefit because any MLS participant, not just the listing broker, may attempt to sell the property. Buyers benefit because they can obtain information about all MLS-listed properties while working with only one broker. Brokers and their agents benefit because they have access to a wide inventory of properties to show and sell to their clients.

In addition, the more than 200,000 locally owned real estate offices and branches of real estate firms compete for the best agents in order to serve homebuyers and sellers in their communities. This highly competitive environment provides consumers with the widest possible choice of both real estate agent and real estate firm in their home sales transactions.

## Appendix 1: Real Estate Cost Structure

The current structure of the brokerage industry – large numbers of relatively small, local firms – is quite efficient. Analyses of the underlying cost structure of the real brokerage function reveal that there are few, if any, efficiencies to be gained by the entrance of larger, more highly capitalized firms, including commercial banks. This could explain why the brokerage industry has seen relatively little movement towards increased concentration over the past 20 years.

### Average Costs

One way to measure the efficiency of the real estate brokerage business is to examine its underlying cost structure. Zumpano<sup>12</sup> describes a study that used financial data from 279 real estate brokerage firms to estimate a cost function relating the average unit costs of the brokerage to its number of sales agents (see below). For the most part, the curve was relatively flat.

Although Zumpano found modest economies of scale for smaller brokerages, he also found that average costs begin to rise once the firm has reached a certain size (in this case, 1,800 transaction sides). The analysis suggests that real estate brokerage firms can operate over a broad range of sizes without experiencing an appreciable change in average costs. More important, his findings suggests that "large [real estate brokerages] do not command any competitive advantages over smaller [brokerages], at least as far as unit costs are concerned." If anything, very large brokerages are less efficient than their smaller competitors.

These findings are not surprising given the composition of the typical real estate brokerage's operating costs and the contractual relationship between the agent and the brokerage. The single largest component of operating costs is salesperson compensation, which accounts for over 60 percent of total expenditures. Since the majority of sales personnel are essentially independent contractors who work on a commission basis, unit costs remain relatively constant with increases in output, or sales.

These general results were corroborated in a study that drew upon a sample of real estate firms to measure what economists call "X-efficiencies." Such efficiencies are related to the management of resources used in the production of a product or service, such as offices, agents, and administrative support. The study found that the average real estate brokerage operates close to its "efficient frontier," confirming that today's brokerage firms are quite efficient in managing their resources. In fact, smaller brokerages appear to be somewhat better in this regard than either their medium-size or larger counterparts. Again, this finding is consistent with the conclusion that the real estate brokerage industry would have little to gain from the entrance of large-scale organizations like commercial banks.

### Indirect Cost Measure

Another way to test for the existence of economies of scale, which is used by the Federal Trade Commission and the Department of Justice, is through a simple tool called the "survivor technique." In principle, the ability of a firm to survive over time can be viewed as *de facto* evidence of its efficiency. For example, if firms of a given size continue to operate over an extended period of time while others lose market share, the size of the surviving firms can be

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<sup>12</sup> Zumpano, Leonard, The Possible Consequences of Bank Entry into the Real Estate Brokerage Market: What the Research Tells Us, *Journal of Real Estate Literature*, 10(2), 2002. 243-261.

considered optimal. Likewise, if the firms that survive are the ones that grow while smaller firms decline, then economies of scale are most likely present.

Despite this important caveat, an analysis of trends in the size of real estate brokerages over the last 20 years suggests that the industry does not have significant economies of scale. For the most part, the size distribution of brokerages has remained relatively constant since 1983. Brokerages with a sales force of five or less currently hold 60 percent of the real estate market, up from about 55 percent in 1983. In contrast, brokerages with a sales force of more than 50 agents have yet to reach even a five-percent market share. These patterns are consistent with the analyses of unit costs described above, and again suggest that the real estate industry has little, if any, to gain from potential economies of scale, as some large banks wanting to enter the industry argue.