

# Southwest Economy



## California's Electricity Woes: A Vision of the Future?

California has long been in the vanguard of national trends. Since mid-2000, California has experienced a considerable number of problems with its electricity market, including fluctuating prices and shortages. California's electricity woes give us reason to pause and consider the future of U.S. electricity markets and of energy policies in general.

Electricity is an important part of the U.S. energy infrastructure, accounting for more than one-third of U.S. energy consumption. If other states experienced problems with their electricity markets similar to those in California, the effects would be felt throughout the economy.

Nearly half the states are restructuring their electricity markets, and many more are considering doing so. As Chart 1 shows, eight states have already implemented restructuring of their electricity markets. Sixteen states and the District of Columbia have enacted legislation or issued regulatory orders that will restructure their electricity markets, while 18 states are investigating the possibility of restructuring. Only eight states are not currently taking any steps toward electricity market restructuring.

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## Banks as Real Estate Brokers— Letting Free Enterprise Work

A proposal that would open real estate brokerage and management to banking organizations has generated a maelstrom of controversy, as evidenced by more than 44,000 comment letters and e-mails that have deluged the Federal Reserve Board.

The major banking industry trade groups have joined forces as proponents of the proposal, squaring off against the National Association of Realtors, which spearheaded a write-in campaign opposing it. The realtors' arguments caught the attention of Congress, which prevailed upon the Fed to extend its deadline for submission of comments to May 1, 2001, and prompted the House Financial Institutions and Consumer Credit Subcommittee to hold hearings on the proposed regulation.

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# Banks as Real Estate Brokers

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The controversy extends beyond the mere self-interest of competing business groups to include the core issues of enhancing the competitive marketplace and protecting the safety and soundness of the financial system. Indeed, Federal Reserve Board Governor Edward W. Kelley Jr. expressed some concern at the outset that as banking organizations engage in more activities related to real estate, it could become more difficult in the future to rule them out as real estate investors and developers.

His reservations echoed a long-running debate. For many years, consideration of expanded bank participation in real estate activities, including a 1987 proposal that would have allowed limited real estate investment activities, has been stymied by concerns that it may pose unacceptable risks for banks and lead to a highly concentrated and, therefore, less competitive industry.

The latest proposal is once again testing the changing divide between banking and commerce. Given the existing regulatory safeguards, along with the market forces and technological applications that are reshaping the financial services industry, the big winner—if the proposal were adopted—stands to be the consumer.

## Laying the Groundwork

Specifically, the current proposal put forth jointly by the Federal Reserve Board and the Treasury Department seeks public comment on whether real estate brokerage and real estate management should be determined as activities that are financial in nature or incidental to a financial activity and, therefore, permissible for financial holding companies and financial subsidiaries of national banks. (See box titled “Real Estate Brokerage and Management Activities Defined.”) The proposal would not allow financial holding companies to engage in real estate investment or development.

The legislation underlying the proposal is the Gramm–Leach–Bliley Act, which, in 1999, authorized a platform upon which the next generation of

financial institutions would be built. At its foundation was the existing financial system, whose structure had been shaped by years of incremental deregulation brought about by market developments and technological advancements. (See box titled “A Brief History of Bank Regulation.”)

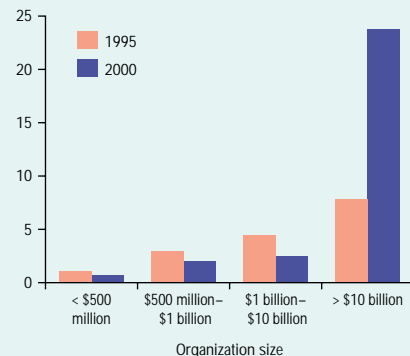
Some sections of the historic act were drafted in fine detail. The legislation contains, for example, an explicit list of financial activities in which financial holding companies may engage, including insurance and securities underwriting and agency activities, merchant banking and insurance company portfolio investment activities. It also allows national banks to engage in a broad range of new financial activities through financial subsidiaries, with certain exceptions. Banking organizations have already made substantial inroads into nontraditional activities. As seen in Chart 1, the largest banking organizations have nearly tripled their involvement in nonbanking activities in the last five years.

Other sections of the act were, by design, sketched broadly enough to leave room for future interpretation by the regulatory agencies. While the outright mixing of banking and commerce

Chart 1

## Assets in Nonbank Subsidiaries of Bank Holding Companies

Percent of organization assets



SOURCE: Bank holding company financial statements.

was rejected, one provision gives the Federal Reserve Board and the Treasury the authority to define new activities that are financial in nature or incidental to financial activities. Nonfinancial activities determined to be “complementary” to financial activities are also permitted. These standards represent a significant expansion from the previous requirement that bank holding company activities must be “closely related to banking.” By delegating to the regulatory agencies the responsibility to resolve certain issues, Congress recognized the need to keep financial regulation responsive to

## Real Estate Brokerage and Management Activities Defined

### Real estate brokerage:

- ▶ is the business of bringing together parties involved in a real estate transaction (purchase, sale, exchange, lease or rental) and negotiating a contract.
- ▶ includes acting as agent; listing and advertising; locating buyers, sellers, lessors and lessees; conveying information; providing advice; negotiating price; and administering the closing.
- ▶ does not involve purchasing or selling real estate as principal and may only be conducted pursuant to state licensing laws and regulations.

### Real estate management:

- ▶ is the business of providing for others daily management of real estate. This can include procuring tenants; negotiating leases; maintaining security deposits; billing and collecting rents; accounting; making principal, interest, insurance, tax and utilities payments; and overseeing inspection, maintenance and upkeep of real property.
- ▶ does not involve purchasing, selling or owning real estate as principal.
- ▶ is subject to the same state licensing laws and regulations that apply to real estate brokers.

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the changing environment and acknowledged the agencies' technical expertise in this area.

The repeal of the outdated restrictions on commercial bank activities and affiliations with securities and insurance firms was expected to accelerate the integration of financial conglomerates. Before Gramm–Leach–Bliley, only a few banking organizations were able to develop into diversified financial services providers by working their way through a maze of regulatory loopholes. As the act's reach is tested by proposals such as this one, the concept of full-service financial institutions will move closer to becoming a reality.

### Do the Proposed Activities Fit within Gramm–Leach–Bliley?

Supporters of the proposal contend that real estate is financial in nature and that real estate brokerage falls into the statutorily listed financial activity of lending, exchanging, transferring, investing for others or safeguarding financial assets other than money or securities. This group also argues that the purchase, sale or lease of real estate is a financial transaction and, thus, brokerage should be categorized under the permitted activities of arranging, effecting or facilitating financial transactions for third-party accounts. A home purchase could be considered financial in nature since a house is many people's largest asset, real estate supports a significant amount of mortgage-backed securities and real estate investment serves as a means of wealth creation.

Opponents argue that these attributes could apply to other assets that are not generally thought of as financial in nature. For example, automobiles are also a major asset for many people, and collectibles may be used to build wealth; but that may not make the purchase of a sedan or an antique desk financial in nature or incidental to a financial activity. Therefore, opponents feel that these attributes are insufficient to make an asset financial in nature.

In any case, there are a number of other reasons one might consider real estate brokerage and management to be financial in nature or incidental to a financial activity. First, bank holding companies and their subsidiaries are

routinely involved with various real estate-related activities and most aspects, other than brokerage, of the typical real estate transaction. Bank trust departments, for example, work with real estate assets belonging to trust estates. Second, thrifts and some state banks already provide these very services, with approval from their primary regulators. Third, some aspects of real estate brokerage are similar to permissible finder activities in which national banks and financial holding companies work to match buyers and sellers.

Perhaps the most cogent argument is that real estate brokerage may have become a necessary activity for banks to compete effectively with other companies that provide bundled financial services.<sup>1</sup> Gramm–Leach–Bliley expands significantly the agencies' capacity to consider the competitive realities of the financial marketplace in determining an activity's permissibility. Critical issues include changes in the marketplace and new technology. The act specifically instructs the Federal Reserve Board to determine whether the activity is necessary or appropriate to allow a financial holding company to compete effectively with other financial service companies operating in the United States. Since other non-bank providers of mortgage financing offer real estate brokerage services, it could be argued that banks are at a competitive disadvantage by being prohibited from offering consumers the convenience of one-stop financial shopping as well.<sup>2</sup>

### Consumers Should Decide the Issue

In our free-market economy, business firms are generally at liberty to decide for themselves the scope of activities in which they participate. If the firm offers consumers an attractive package at the right cost, it will be rewarded with profitability. For example, a grocery store might find that expanding its merchandise to include pharmaceutical goods would increase overall profitability. Conversely, a bowling alley might decide that a foray into computer sales would not be a profitable business combination. Successful expansion into a new activity rests on synergies between the new activity and existing ones. These synergies may come



on the production side from shared fixed costs, for example, or on the demand side from the convenience of one-stop shopping.

While banks have not had these same freedoms, Gramm–Leach–Bliley provides a way for them to move closer to becoming full-service financial providers. If banks can combine products and services in a way that creates value for their customers at a reasonable cost, bank expansion into the new arena will be profitable. If they cannot provide the new services at a price customers are willing to pay, the new activity will be unprofitable and banks will likely retreat from it. Without regulatory restrictions, the market will determine whether a new activity is a worthwhile venture for banks.

Entry barriers, such as those imposed by the old banking regulations, reduce competition, thereby allowing prices to climb higher than what would otherwise prevail. Hence, should the proposed real estate activities be approved for banks, the primary beneficiary of the heightened competition would be the consumer.

## Potential Concerns

By limiting banks to activities that are “financial in nature,” “incidental to such financial activity” or “complementary to a financial activity,” Gramm–Leach–Bliley maintains the long-standing separation of banking and commerce. The costs and benefits of maintaining that separation are the subject of much discussion.<sup>3</sup> The real estate proposal raises the question of whether the potential concerns about allowing participation in commercial activities might apply to real estate brokerage and management.

One such concern is that bank involvement in real estate brokerage and management could create conflicts of interest. A bank might, for example, potentially tie the provision of credit to the use of the bank’s real estate brokerage services. Or a bank might extend credit to borrowers who are not credit-worthy to gain commissions or fees on real estate brokerage or management.

With thousands of bank and non-bank financial services providers competing for business, the high degree of competition in the marketplace should

## A Brief History of Bank Regulation

Regulation has long limited the range of activities banks can conduct. At the root of these restrictions is the idea that banking and commerce should be separated. Prior to the Civil War, bank charters commonly prohibited banks from dealing in merchandise; likewise, states prohibited commercial firms from issuing banknotes.<sup>1</sup>

Bank charters continued to limit the scope of banks’ activities in the early 20th century, but determining exactly what was permissible was not a simple matter. National banks engaged in investment banking under the assumption that it was a permissible activity, but the Comptroller of the Currency ruled investment banking to be contrary to the National Bank Act. The national banks circumvented this ruling by establishing securities affiliates.

The Banking Act of 1933, also known as the Glass–Steagall Act, reestablished the separation of commercial and investment banking. Fears that bank funds would be used to support weak investment issues, that commercial banks would be exposed to excessive risk from investment banking, that bank borrowers would be harmed because of the relationship between banks and the firms they financed, and that commercial banks might foist weak securities on unsuspecting depositors were seen as justification for Glass–Steagall restrictions. Kroszner and Rajan (1994) provide evidence to debunk these fears, however.

The product restrictions embodied in Glass–Steagall were just part of the panoply of banking regulations. Regulation Q limited the interest rates banks could set on deposits. Branching restrictions under the McFadden Act limited the locations in which a bank could conduct business. Advocates of such regulations claimed they were necessary to counteract perceived shortcomings of market forces.<sup>2</sup>

Product restrictions extend beyond the separation of commercial and investment banking to the separation of banking and commerce. Some argue that allowing a firm to engage in both banking and commerce raises concerns over the possible emergence of large, powerful, monopolistic banking–commerce conglomerates. Such a Darwinian scenario could result in adverse effects on competition, unsafe or unsound banking practices, and conflicts of interest. A bank might limit credit to competitors of its commercial operation. A bank might extend credit to its commercial operation, even if lending to the commercial operation entailed excessive risks. A bank might tie its credit decision to the purchase of products or services from its commercial operation. A bank might use information gained in its banking operation to assist its commercial operation. A bank might be exposed to excessive risk from its commercial operation. Finally, some aspects of the regulatory safety net might be transferred to a bank’s commercial operation.

However, by themselves, these concerns ignore the potential benefits that might result from mixing banking and commerce. A bank might achieve economies of scope by mixing commercial activities with its traditional banking activities. A bank might earn additional revenues by cross-selling financial and commercial services, an opportunity created by the concept of one-stop shopping. A bank might more effectively diversify its income stream. Commercial firms could bring additional capital to the banking industry. Finally, allowing a bank to own the firms to which it lends could improve the flow of information between a bank and its borrowers.

The relative merits of both sides of the issue are still being debated. While banking laws and regulations continue to maintain the separation between banking and commerce, the trend in regulatory policy has been to increase the range of activities permissible for banks.

Interest rate restrictions were phased out in the 1980s after they had been undermined by technological and financial innovations. Similarly, geographic restrictions were dismantled incrementally for decades, culminating in the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994. Glass–Steagall’s severe restrictions on underwriting and dealing in securities were relaxed piecemeal over the years, beginning in the 1980s and culminating in the Gramm–Leach–Bliley Act. Restrictions on bank participation in insurance, too, were gradually reduced and then broadly liberalized by Gramm–Leach–Bliley.

This liberalization reflects the extinction of regulations that may have once been appropriate but that are not adapted to the competitive realities of the modern financial services marketplace. Once cumbersome regulations limited where a bank could do business and how much it could pay on deposits and narrowly defined what products it could offer. Today’s more streamlined regulatory environment allows a heightened role for market forces in banking. Consumers have the freedom to choose to do business with banks headquartered around the block or across the nation. These banks are free to compete on rates and terms. A banking office can provide traditional banking services as well as investment and insurance products.

Under the aegis of Gramm–Leach–Bliley, the scope of products offered at a banking office may continue to expand and further promote consumer choice and well-being.

## Notes

<sup>1</sup> Much of the historical analysis here is drawn from Shull (1994).

<sup>2</sup> Research shows these fears were unfounded. Kane (1978) finds that competition without Regulation Q did not threaten banks. Jayaratne and Strahan (1996) find that removal of branching restrictions promotes economic growth.

allay any concern about conflicts of interest. If a bank attempted to tie the provision of credit to the use of its brokerage services, the consumer could thwart the bank by turning to one of the many other mortgage credit providers. Moreover, antitying statutes already in place supplement the market-based check against tying.<sup>4</sup> Competition in the real estate brokerage business—from both existing brokers and bank entrants—would eliminate the incentive banks might have to risk lending to an uncreditworthy borrower to earn fees on the brokerage transaction. Competition in the mortgage market would cause the lender to lose money on the loan if it lowered its lending standards. Competition in the brokerage market would prevent the lender from charging high fees on the brokerage transaction to recoup that loss.

Another concern is the possibility of concentrated market power to the point of domination. If banks' entry into the real estate brokerage and management business caused the existing firms in that industry to fail or to otherwise exit the industry, the banks could then use their dominance of the industry to earn monopoly profits.

Here, too, competitive realities allay this concern. First, because the real estate industry is well established, it is unlikely that banks could drive out all the current providers of real estate brokerage and management services. Second, competition among the banks themselves would make monopoly profits in the industry unattainable. Any extraordinary profits a bank might earn from real estate brokerage would attract other banks, and the ensuing competition would drive down prices. Further, today's market is highly competitive, not only because of the sheer number of firms, but also because advances in technology and the removal of geographic branching restrictions have given banks new opportunities to do business in remote locations. This environment has shattered the old paradigm that the existence of only a few banks in a market leads to anticompetitive practices. When technology and deregulation allow easy entry into all markets, all markets become competitive.<sup>5</sup>

A final concern is that allowing banks to provide real estate brokerage and

management services may compromise safety and soundness. If these new business lines involved large risks, large losses in these lines could threaten the financial soundness of banks themselves.

Because government guarantees on deposits might weaken the incentive the market would provide for banks to maintain safe and sound practices, market forces may not completely allay potential safety and soundness concerns stemming from bank participation in real estate brokerage and management. In addition, the bank safety net might confer competitive advantages to banks that they could apply to these activities. The regulatory framework behind the bank safety net, however, contains provisions to ensure that activities such as real estate brokerage and management would not endanger bank safety and soundness and to limit the spread of the safety net to new activities. Among these provisions are sections 23A and 23B of the Federal Reserve Act, which would limit the bank's exposure to the real estate brokerage affiliate. Moreover, the proposal could actually reduce risk by enabling banks to diversify into new product lines and provide another source of noninterest income.

## Conclusion

By loosening the strictures that had prevented banks from moving into nontraditional business lines, the Gramm–Leach–Bliley Act allows banks to offer new combinations of products and services. These freedoms will allow the market to play a greater role in determining the services banks will provide.

Reducing regulatory restrictions to allow market forces to operate more freely in banking provides benefits to consumer and business users of bank services. In a free-market economy, businesses—including banks—that offer desirable services at a reasonable price are rewarded by profit. When banks have the freedom to choose the services they offer, the quest for profits will result in consumers getting the services they value.

Market forces will play a major role in allaying potential concerns about banks' entry into real estate brokerage and management services. The Gramm–Leach–Bliley provisions that allow banks

to move into nontraditional business lines can benefit consumers by providing additional choices and reducing impediments to competition among various financial service providers. Given the opportunity, free enterprise works for banks, too.

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## Notes

<sup>1</sup> For simplicity, we use the term "bank" throughout the rest of the article, although the proposal technically applies to financial holding companies and financial subsidiaries of national banks.

<sup>2</sup> The proposal under consideration at the time of this writing deals with whether real estate brokerage and management are financial in nature or incidental to a financial activity. If that proposal is not adopted, real estate brokerage and management could still be deemed permissible for banks under the Gramm–Leach–Bliley Act if real estate brokerage and management were ruled to be complementary to a financial activity.

<sup>3</sup> For a review of the issues and literature in the debate, see Saunders (1994).

<sup>4</sup> "Tying" involves making the terms or availability of credit or other services dependent on the purchase of another product or service from the bank or its affiliates.

<sup>5</sup> Guzman (2001) discusses the distinction between concentration and competition in banking markets.

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