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REALTORS® Commercial Alliance Series

HOT TOPICS—

ANSWERS TO CURRENT BUSINESS ISSUES

**NATIONAL POLICY AGAINST
MIXING BANKING AND COMMERCE**

REALTORS® Commercial Alliance
The commercial division of the
National Association of REALTORS® and its affiliates



NATIONAL ASSOCIATION OF REALTORS®

The Voice for Real Estate®

**Real Strength.
Real Advantages.**

NATIONAL POLICY AGAINST MIXING BANKING AND COMMERCE

The economy of the United States depends in large part on the health of the banking and real estate industries. Several regulatory actions are putting both of these industries at risk by challenging one of our nation's most fundamental economic policies—the separation of banking and commerce.

Since the Federal Reserve Board and the U.S. Department of the Treasury published a proposed rule in 2001 to permit banking conglomerates to engage in real estate brokerage and management, NAR has successfully advocated that Congress block implementation of a final rule. In December 2005, the Office of the Comptroller of the Currency (OCC) issued three legal opinions expanding the authority of banks to engage in real estate development, including speculative condominiums, luxury hotels, and a windmill farm. In 2006, applications from Wal-Mart and Home Depot to acquire a special kind of state-chartered, federally-insured bank—known as an industrial loan company (ILC)—drew attention to the existing statutory loophole that permits commercial firms to own these banks.

This edition of “Hot Topics” gives you an overview of each of these three public policy debates and discusses their impact on commercial brokers.

THE FEDERAL RESERVE-TREASURY “BANKS IN REAL ESTATE” RULE

What is Happening?

In early 2001 the Federal Reserve Board and the U.S. Treasury Department proposed a regulation that would let national bank holding companies and financial subsidiaries of national banks themselves engage in real estate brokerage and management. Although the Bank Holding Company Act of 1956 and the Gramm-Leach-Bliley Act (GLB Act) of 1999 permit the Federal Reserve and the Treasury Department to identify new categories of financial activities permissible for bank conglomerates to engage in, the regulators do not have authority to

designate inherently commercial activities, such as real estate brokerage and property management activities, as financial.

By enacting annual restrictions as part of the appropriations legislation for the Treasury Department, Congress has blocked the two agencies from issuing a final rule, one year at a time. Congressional support for the “Community Choice in Real Estate Act” (H.R. 111/S. 98), which removes the powers of these agencies to regulate these real estate activities, is at an all time high.

NAR's Policy Response

NAR favors retaining and strengthening the long-standing national policy against mixing banking and commerce. Accordingly, NAR has strongly opposed the proposed regulation and has successfully urged Congress to block it. We also strongly support enactment of the “Community Choice in Real Estate Act” and continue to advocate for a permanent solution.

In January 2007, there will be a new Congress. And while there are no certainties when dealing with Capitol Hill, we are optimistic that a permanent fix is on the horizon.

Why Should Commercial Brokers Care?

If banks were allowed to engage in real estate activities, it would create an unlevel playing field and inherent conflicts of interest and put the nation's banking system at risk. Banks benefit from federally chartered advantages not available to their real estate brokerage and management competitors. Banks could also cross-subsidize their activities by taking a loss on their real estate operations in order to capture customers for their banking services. For example, a bank that manages or owns commercial property could offer lease incentives for tenants who are or become customers of the bank. That will make it hard, if not impossible, for you to compete if big banks move into your market.

Permitting banks to engage in commerce would also compromise bank lending decisions and create conflicts of interest while restricting consumer choice and competition among mortgage lenders. A bank cannot be an “honest broker” of financial services if it is also a competitor with its commercial customers. Why should you have to worry whether the bank you apply to for a loan might base its decision on whether your project will compete with one of the bank's?

The real estate industry is already characterized by fierce competition, market efficiencies, and ease of entry so that there is nothing gained for consumers by permitting banks to enter real estate. Allowing banks with inherent advantages to own real estate brokerage and management companies would stifle competition, limit consumer choices and, most likely, raise consumer costs.

Finally, banks already have enough on their plates. For example, after taking a look at the most recent data submitted under the Home Mortgage Disclosure Act—HMDA—consumers groups have raised serious questions about whether banks are providing mortgage loans on a nondiscriminatory basis. The Federal Financial Institutions Examination Council (FFIEC)¹ issued a press release on September 8, 2006, acknowledging that the HMDA data has “led to concerns” about bank lending. Banks should spend more time making sure their loan officers are complying with fair housing laws and less time expanding their reach into non-banking activities. In addition, as the housing market slows, banks are likely to face problems managing their loan portfolios, including their portfolios of nontraditional mortgages such as payment option ARMs, and will need to pay more attention than needed in recent years to manage their risk profiles. These examples illustrate why banks should “stick to their knitting” and avoid risking the safety and soundness of the banking system by expanding banking activities to include commercial real estate or real estate brokerage.

¹ FFIEC's member agencies are the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration

Consequences for Independent Real Estate Companies

What would the impact be on independent real estate brokerage firms—those not owned by banks—if banking conglomerates are permitted to broker and manage real estate? That question cannot be answered with any certainty, but it is fair to speculate.

If banks are authorized to broker and manage real estate, it is likely that they will be able to do so because those activities are determined to be financial, not commercial, activities. Of course, NAR strongly believes that this would be a significant mistake, harming both industries—banking and real estate—and that real estate is inherently commercial. But if it happens anyway, non-bank owned real estate companies would find themselves operating under a significantly different regulatory and legal environment.

Commercial real estate professionals are, for the most part, untouched by federal oversight, at least compared to banks, airlines, and drug companies, for example, and are mostly subject to state law and regulation. Of course, real estate brokerage companies with lending and other affiliates are subject to additional federal regulations by agencies that implement truth-in-lending, fair credit reporting, equal credit opportunity, and consumer privacy rules.

If real estate brokerages are treated as financial institutions, additional regulation would likely apply. Again, while entirely speculative at this point, the following illustrates a potential new environment that will apply to non-bank real estate brokerage companies.

The increased regulatory burden could come potentially from federal regulators, such as the Securities Exchange Commission (SEC), Federal Trade Commission (FTC), and the federal banking regulators, to oversee financial services-related business and commercial activities. As

financial institutions, real estate companies could be subject to:

- Consumer financial privacy regulation under Title V of the GLB Act.
- Community Reinvestment Act (CRA) regulation.
- Patriot Act/Bank Secrecy Act regulations implementing the anti-money laundering and related requirements for financial institutions could come into play. The Internal Revenue Service (IRS) would get involved because it regulates entities not subject to banking regulators.
- State and federal privacy laws that now apply only to financial institutions.

A new federal regulator could even be established to oversee the new financial activities as defined by the Federal Reserve and Treasury under the GLB Act. For example, a new SEC-type regulator created to regulate the real estate industry could impose extensive and burdensome reporting and disclosure requirements on the entire industry.

If real estate brokerage and management activities are treated as financial activities and a new SEC-type regulator is established, federal preemption of state regulation and laws for all real estate brokerage and management firms could be expected—for independent firms and those affiliated with a bank. This not only puts real estate under federal regulation, it could do so unevenly with bank-affiliated firms being treated more favorably, to the competitive disadvantage of independents.

Finally, no matter what happens, it is safe to say that additional paperwork and technology costs associated with any additional regulation are inevitable.

RULINGS BY THE OFFICE OF THE COMPTROLLER OF THE CURRENCY EXPANDING BANK POWERS TO ENGAGE IN REAL ESTATE DEVELOPMENT

What is Happening?

In December 2005, the OCC announced it had expanded the authority of national banks to engage in real estate development and ownership through three separate interpretive rulings. The first decision allows PNC Bank to develop a project involving retail space, offices, a hotel, and 32 condos (for immediate sale to make the rest of the project economically feasible). The second decision lets Bank of America develop a Ritz-Carlton luxury hotel in which less than half of the rooms will be used for its own business purposes. And the third decision authorizes Union Bank of California to own 70 percent of the equity interest in windmills and the associated real estate, under the pretext that the ownership interest was taken in connection with financing the project.

NAR's Policy Response

NAR is extremely concerned that the OCC's December 2005 decisions weaken the national policy against mixing banking and commerce and are inconsistent with the National Bank Act, OCC rules, and legal precedent. Since these OCC interpretive letters became public, NAR and other industry participants have urged Congress to conduct oversight hearings on the Comptroller's decisions as well as examine whether or not the OCC has become too beholden to the banks they regulate—the same banks that fund the agency's operating budget—without any real accountability to the Treasury or to the U.S. Congress. NAR is concerned that the OCC is expanding congressionally established bank powers—in essence, creating law – without public notice and comment, without public participation, and without publication in the Federal Register or the Code of Federal Regulations.

On September 27, 2006, NAR President Tom Stevens and Cynthia Shelton, CCIM, CRE, commercial broker with

the firm Colliers Arnold in Orlando, FL, testified before the House Subcommittee on Government Management, Finance and Accountability on the OCC rulings. Mr. Stevens explained NAR's concern that the OCC rulings stretch the National Bank Act to the breaking point and will lead inevitably to an irreparable breach in the wall separating banking and commerce. Banks have statutory authority to develop and own real estate necessary to accommodate their businesses. But PNC Bank's multi-use project includes 32 speculative condominium units that the bank must sell off immediately in order to help finance the rest of the project. The Bank of America's Ritz-Carlton project is in an area that already contains hundreds of hotel rooms operated by highly reputable national hotel chains. There is no explanation of why the bank needs to own its own hotel to accommodate its business in these circumstances and the precedent it establishes is very troubling.

Why Should Commercial Brokers Care?

Federal subsidies give banks access to cheap sources of capital, which gives them an unfair advantage over REALTORS® and others involved in real estate development. Expanding the authority of banks to develop real estate could lead to the OCC giving banks the authority to broker and manage other real estate as well.

In her September 27 House Subcommittee testimony, Ms. Shelton pointed out concerns from the standpoint of the commercial real estate practitioner. She explained how the OCC's rulings create a conflict of interest within the bank and complicate a mutually beneficial relationship that exists between banks as lenders and their real estate developer customers. When a bank is allowed to compete in the business of real estate, it could take unfair advantage of information submitted as part of a loan application to make the bank's own business decisions or offer favorable financing terms to developments in which the bank has an equity stake.

Ms. Shelton explained in her testimony that under the rulings, she must now ask whether she is dealing with a financial service provider as part of her team or as a potential competitor. Banks have a unique role in our economy as honest brokers of financial services. They should not be competitors with real estate developers or other commercial businesses.

In addition, investing in real estate can be a risky venture as markets change. The OCC should not expand the authority of banks to invest in real estate development because it creates the risk that, as in the savings and loan scandal in the 1980s, REALTORS® and all other taxpayers will be forced to bail out the banks.

Congress: Define What We Do

By David Lereah

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Is real estate brokerage a financial or a commercial activity? The importance of this question was highlighted once again when the U.S. Office of the Comptroller of the Currency released its now well-known letters permitting Bank of America to build a hotel, PNC Bank to build a mixed-use project, and Union Bank to take an equity position in a wind energy facility.

NAR has taken a stand against these OCC opinions, arguing they blur the line between banking and commerce, just like Wal-Mart's attempt to move into banking. Wal-Mart is seeking FDIC approval to own what's known as an industrial loan company.

Consistent with its stand against bank-owned development and bank-owned brokerages and property management companies, NAR has asked the FDIC to oppose Wal-Mart's plan.

Funny, but the banks oppose Wal-Mart, too. I guess in their view it's OK for banks to own commercial businesses but not for commercial businesses to own banks.

What's really at stake in this debate over banking and commerce is nothing less than the definition of what you do.

Consider how the U.S. economy is organized. At one end is the banking system, with its subsidies like the banks' access to the Federal Reserve discount window. At the other end is the commercial sector, with companies like car makers and real estate brokerages. Between the two is a category called financial services.

It's in this third category that banks and commercial companies compete. Banks engage in financial services, including making home loans, and so do commercial companies. That's why consumers can borrow money from General Motors to buy a car or from brokerage-owned mortgage companies to buy a house.

But the line stops at financial services. Real estate brokerage companies, as commercial businesses, are not able to offer banking services, and banking companies, as banks, are not able to offer real estate brokerage services.

Clearly, this separation has worked. The 1980s savings and loan crisis and the 1990s collapse of the Japanese banking system remind us of the toxicity of mixing banking and commerce.

Of course, banks claim that real estate brokerage is a financial service. That's why they asked the U.S. Treasury Department and the Federal Reserve five years ago to declare brokerage and property management financial activities and thus permissible lines of bank business.

Congress needs to settle this matter. With your continued help, our federal lawmakers will have every reason to say in no uncertain terms that brokerage, property management, and development are commercial activities. When NAR President Tom Stevens asks you to help by writing letters to Congress, I hope you'll answer his call.

David Lereah is NAR Senior Vice President and Chief Economist

OWNERSHIP OF INDUSTRIAL LOAN COMPANIES BY COMMERCIAL FIRMS

What is an ILC?

An industrial loan company, or ILC, is a special type of state-chartered, federally insured bank. As of March 31, 2006, there were 61 insured ILCs chartered by seven states (California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah). About half of all ILCs are chartered by Utah. ILCs can trace their origins to the early 1900's. Once federal deposit insurance became available in 1934, these banks began expanding their operations to include some commercial and collateralized real estate lending and have now evolved into today's ILC.

The ILC charter has two features some firms have found attractive. First, unlike bank holding companies, companies that own ILCs are only subject to federal regulation by the Federal Deposit Insurance Corporation (FDIC), not the Federal Reserve Board. Second, they may be owned either by financial or commercial firms.

In recent years, there has been a large increase in total ILC assets. According to the Government Accountability Office², ILC assets grew from \$3.8 billion in 1987 to more than \$155 billion by March 31, 2006. Most ILCs remain small. In fact, six ILCs own more than 80 percent of the total assets for the ILC industry.

As a general matter, ILCs may carry out the same activities as other federally insured financial institutions, except they generally may not accept demand deposits, such as checking accounts.

What is Happening?

In 2006, in response to applications from Wal-Mart and Home Depot to become owners of ILCs, NAR, bank trade associations, and many others voiced concerns with the FDIC and with Congress about mixing banking and commerce through the ILC loophole that permits commercial firms to own an ILC.

NAR supports legislation to tighten this loophole. The "Industrial Bank Holding Company Act of 2006"

²GAO testimony before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit (GAO-06-961T (July 12, 2006)).

(H.R. 5746), sponsored by Reps. Gillmor (R-OH) and Frank (D-MA), would only permit financial firms (those with no more than 15% of their revenues derived commercial activities) to own ILCs, but it would grandfather existing ILC ownership structures. The bill would also enhance regulation of ILC parent companies by the FDIC.

On July 28, 2006, in response to concerns raised by NAR, Members of Congress, and many others, the FDIC announced a six-month moratorium on all ILC applications. This means that Wal-Mart's and Home Depot's applications are put on hold, along with about a dozen other pending applications.

What FDIC does when the moratorium expires on January 31, 2007, is anyone's guess. NAR and others have asked for the moratorium to be extended.

NAR's Policy Response

On April 11, 2006, NAR President Tom Stevens testified before the FDIC to explain that approval of Wal-Mart's application for federal deposit insurance for its proposed new ILC would establish a dangerous precedent leading inevitably to an erosion of the national policy against mixing of banking and commerce and have serious consequences for the continued stability and growth of the nation's financial system.

In a letter to the FDIC on June 5, 2006, NAR wrote to oppose an application by Home Depot to acquire an existing Utah-chartered ILC, EnerBank, USA. EnerBank specializes in making unsecured home improvement loans offered by home improvement contractors to consumers. The Home Depot business plan creates an inherent conflict of interest because it will have an incentive to encourage EnerBank to provide financial services to home improvement contractors that are Home Depot customers and not to other contractors. An unlevel competitive playing field is a significant risk because the ILC may be pressured to provide loans on favorable terms to prospective borrowers. The Home Depot plan, therefore,

has the potential to expose the ILC to substantial risk of losses because of this inherent bias and conflict of interest.

NAR submitted a statement on July 12, 2006, in connection with a hearing held by the House Financial Services Subcommittee on Financial Institutions and Consumer Credit on "ILCs—A Review of Charter, Ownership, and Supervision Issues." NAR's statement explained in detail why we oppose the Wal-Mart and Home Depot applications to become owners of an ILC.

NAR has also written to Treasury Secretaries Snow and Paulson, acting FDIC Chairman Gruenberg and the new FDIC Chairman Bair, and Chairman Bernanke of the Federal Reserve Board to express our concerns.

Why Should Commercial Brokers Care?

Banks must be "honest brokers" of financial services and not be swayed into making credit and other business decisions based on their affiliation with commercial firms. When commercial firms are allowed to engage in banking, the bank functions under an inherent and irreconcilable conflict of interest. The bank's commercial parent will be tempted to use the bank in a way that furthers its own corporate objectives, which may be at odds with what is in the best interests of the ILC, customers, competitors, REALTORS®, and the safety of our financial system.

While ILCs are subject to federal law limiting the amount and type of transactions that an insured depository institution may have with its parent or affiliates, there is still potential for abuse. For example, an ILC could provide loans that favor companies with ongoing relationships with the parent and that are developing a new commercial facility for the parent of the ILC. This would put other developers competing for business at a disadvantage.

The REALTORS® Commercial Alliance would like to thank the following people for sharing their expertise.

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