The Residential Real Estate Brokerage Industry: What Would More Vigorous Competition Look Like?

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Overview

- Some background
- The experience of the securities brokerage industry
- The likely outcome of more vigorous competition
- Conclusion

Background (1)

- A house is a big ticket item
- Most households buy and sell houses infrequently
- Mistakes can be costly
- Households are likely to turn to experts/agents
- Government is likely to become involved in consumer protection

Background (2)

- Nationwide: about 2 million active real estate agents (over 1% of the U.S. labor force!), and about 100,000 active firms
- Most agents operate on both the sell-side and the buy-side
- Agents are legitimately concerned about free-riding
- The MLS is a valuable information/efficiency tool

Background (3)

- The large numbers of agents and brokerages in any community would seem to promise vigorous competition; but
  - The MLS can be and has been used as a tool for excluding fee-cutting mavericks
  - The reciprocal interaction of agents in vertically related ways (sell-side <u>and</u> buy-side) provide opportunities for freezing out mavericks
    - Also true in NASDAQ dealer interactions and IPO underwriting
  - State government regulation (in some states) impedes competition

Background (4)

- Evidence of less than fully vigorous competition
  - The prominence of 6% or 7%
  - The modal frequency of exactly 6% or 7%, regardless of home value
    - Persistence cross-sectionally and over time
    - Do the true selling costs really rise <u>proportionally</u> with house prices?
  - Surges of entry into brokerage accompany house price increases
  - The use of the MLS as an exclusionary tool vis-à-vis mavericks
  - Successful lobbying of the states

Background (5)

- State involvement
  - All states (and DC) have real estate commissions (or dept of real estate)
    - Arizona was the first (1912)
  - Mission is consumer protection
    - But some states require minimum service and prevent buyer's agents from rebating fees to buyers
  - States have not (yet?) adopted restrictive licensing

Securities brokerage (1)

- Prior to 1968 stock brokerage commissions were set collectively by NYSE members
- Commissions were $X per round lot (100 shares), with no discount for higher volume, and X varied with the price of the stock
- This rate structure contravened the actual costs of stock brokerage
  - The brokerage costs of selling/buying 1,000 shares were surely not 10 times the costs for 100 shares
  - Brokerage costs didn’t rise very much with X

Securities brokerage (2)

- The rising importance of institutions and their high-volume trading in the 1960s made the fixed commission structure anachronistic
- As a response to excessively high commissions, the institutions tried to
  - Obtain (in return) in-kind services from brokers
  - Force “give-ups” (of part of commissions) to third parties
  - Trade in “the third market”
  - Join the NYSE
  - Join regional exchanges

Securities brokerage (3)

- In 1968 the SEC (in response to institutions’ and DOJ pressures) required some volume discounts
- In 1971 the SEC mandated negotiated fees on the portion of an order above $500,000
- In 1972 the SEC mandated negotiated fees on the portion of an order above $300,00
- On May 1, 1975, all brokerage commissions became fully negotiable

Securities brokerage (4)

- NYSE’s defense of fixed commissions
  - Competition would be “destructive” and would not allow the industry to recover its fixed costs and would lead to industry dis-investment
  - Competition would lead to massive consolidation and less competition and higher commissions
  - Competition would lead to fragmentation of markets
  - Competition would mean the end of cross-subsidization that favored the small investor
  - Competition would mean that investors would not get the services that they really needed
  - The industry had served the U.S. economy well; why take chances with an untried proposal?

Securities brokerage (5)

- The consequences of competitive commissions
  - Rates fell, especially for institutions
  - Discount brokers arose
  - Electronic trading allowed even lower rates
  - The industry did consolidate, but oligopolistic coordination is not a problem
    - NASDAQ dealer problems and IPO 7% stickiness have been due to reciprocal vertical interactions
  - The introduction of competition was a major public policy success story

More vigorous competition in real estate brokerage:

- Average commissions would surely fall
- Greater variety of services
  - Unbundling, a la carte
  - Discount brokers
- New arrangements with respect to buyers' agents?
- Embrace of new technologies
- An end to surges of people into and out of real estate brokerage
- Some consolidation

How to get there from here

- Allow the banks (depositories) to enter real estate brokerage
  - Safety and soundness problems can be handled
  - The banks are unlikely to be predatory
  - The banks may well become discount brokers
  - The UK allows depositories into real estate brokerage
- Vigilant antitrust vis-a-vis MLSs as exclusionary devices
- Vigorous antitrust lobbying of the states
- Be vigilant against “the law of unintended consequences”

Conclusion

- Real estate brokerage is important
- More vigorous competition is possible
- The securities industry experience is a good model
- Public policy has an important role to play