Consumer Federation of America

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HOW THE REAL ESTATE CARTEL HARMS CONSUMERS AND HOW CONSUMERS CAN PROTECT THEMSELVES

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Introduction

Traditional real estate brokers perform a useful consumer service in facilitating the purchase and sale of houses and land. Moreover, they have established a "system" that is very convenient for home buyers and sellers.

Unfortunately, these traditional brokers also act as a price-setting cartel that maximizes their opportunities to charge a "fixed" commission of either 6% or 7%, depending on the local real estate market. Furthermore, in order to increase the chances of the "double-dip" – one broker collecting the entire commission – they often do not adequately represent the interests of their clients in searching for buyers or houses, or in securing the best prices on these houses – highest for sellers, lowest for buyers.

This report explains how consumers are disadvantaged by the current "system," why the system serves the interests of traditional brokers, what reforms are necessary, and what consumers can do to protect themselves. It is based on information from dozens of real estate professionals and from hundreds of articles in journals, real estate publications, and the general press.

How Consumers Are Disadvantaged

Traditional brokers harm consumers in three main ways. They try to charge a high, fixed price for their services, yet they often do not adequately represent the interests of their clients in searching completely for the best buyers or properties, or in negotiating the best price for sellers or buyers.

High Uniform Prices: A decade ago, Consumer Federation of America researchers called more than 500 real estate firms nationwide to inquire about the cost of selling a home. At that time, virtually all traditional brokers offered their services for either a 6% or 7% commission, depending on the prevailing "target rate" in their local real estate market.

Today, faced with more critical stories in the press, federal agency scrutiny, and home sellers who think broker compensation is excessive, traditional brokers are struggling to maintain targeted commission rates and the opportunity to collect this entire commission by serving as the sole broker in the sale of a home. These related goals – maintaining the 6% or 7% commission and the chance of a "double-dip" – ultimately explain almost all of a cockamamie brokerage system that traditional brokers are trying to maintain, for example, through the passage of anti-competitive anti-rebate and minimum service laws.

Can across-the-board 6% or 7% commissions be justified? We respond with a series of questions that suggest there is not one shred of a justification for this fixed price.

- Do all brokers offer services of exactly equal value? Should novice brokers who have just received their license routinely charge the same prices of highly skilled brokers who have been practicing for decades? Should listing brokers who just list houses on a multiple listing service receive the same compensation as those who look aggressively for buyers? Should buyer brokers who work hard to find the best house for a client receive the same compensation as those who just show their own listings or those of their firm? Should these brokers who persuade buyers to purchase their listings receive twice as much compensation as those who split the commission with a second broker?

- Should facilitators (often called "transactional brokers"), who do not represent the financial interests of either sellers or buyers, receive the same compensation as agents who agree to serve the interests of either party?

- Are brokerage services on a sale of an $800,000 house worth four times as much as these services on the sale of a $200,000 house?

- Are the services of brokers worth the money? Does a "double-dipping" broker deserve, for instance, $24,000 compensation on a sale of a $400,000 house? Are these services worth far more than the value of many new cars or complex, technology-dependent surgery by highly trained medical specialists?

- Why are comparable brokerage services offered in other economically developed countries much less expensively than in the United States? Why can brokers in those countries do well by charging 2-4% commissions or much lower fixed fees?

A couple of industry reports suggest that the average commission paid is closer to 5%. But this is because home sellers are beginning to negotiate price with traditional brokers, who frequently agree to give up one percent of the commission on the sale of expensive houses. Regardless, traditional brokers still work hard to maintain uniform 6% or 7% commissions.

Representation of Financial Interests: Do brokers represent the financial interests of their clients? Do they seek to gain the highest price for sellers and the lowest price for buyers? Until the early 1990s, there existed an almost universal sub agency system in which brokers, even those working solely with buyers, were legally obligated to represent the interests of sellers.

When this sub agency system, in which brokers working with buyers were legally obligated to pass on information disadvantageous to their clients to sellers, was exposed through press coverage, it collapsed almost overnight. But traditional brokers then were confronted with the challenge of representation in a double-dip situation. How could they be the sole broker involved in a sale yet represent the financial interests of both seller and buyer?

In an effort to resolve this dilemma, traditional brokers used their huge influence with state real estate commissions and legislatures to weaken the legal concept of broker representation to the point where they now can frequently serve as "dual agents" collecting an entire commission but representing the financial interests of neither buyer nor seller. Dual agency, where real estate salespeople go by different names in different states – "transactional broker," "facilitator," or "designated agent" are most commonly used – is a nonsensical concept since there is no way a broker can represent the financial interests of both seller and buyer. To begin to understand the complexity of what has happened to agency, see the excellent article by Ann Morales Olazábal in the 2003 issue of the Harvard Journal on Legislation.

The result of the watering down of the concept of agency, in which brokers used to always represent the financial interests of seller clients, is that many home sellers and buyers who think they are receiving this representation in fact are not. That is especially the case with brokers who are able to "sell their own listings" or even those of their firm. Most home sellers, whose double-dipping brokers end up facilitating a sale, are probably not aware that their "agent" is not representing their financial interests in this sale.

In a double-dip situation, buyers are naturally less likely to assume that the broker involved is representing their financial interests. Yet some buyers, confused by the whole situation, disclose potentially damaging information to brokers who in fact remain as fiduciary agents to their seller clients.

Incomplete Search for Houses or Buyers: The preoccupation, even obsession, of many traditional brokers with the double-dip also motivates many to try to limit property searches to their own listings, or failing that, to those of their firms. In the first instance, they retain the entire commission; in the second, they realize varying benefits, which range from financial considerations to preferential treatment by the firm, that they do not receive if they deal with brokers from other firms.

Typically, traditional brokers with buyer clients will try to promote their own listings. A decade ago, this was much easier because most of these clients had not attempted their own internet search of properties. But even today, most traditional brokers will still look for opportunities to sell their own listings, thus getting the double-dip.

Traditional brokers with seller clients may not advertise properties fully in order to increase chances of the double-dip. They may delay for a few days listing the property on the local multiple listing service, giving them an opportunity to find a buyer who does not have their own broker. They may also deny nontraditional brokers equal access to multiple service listings through the practice of "opting out," in which they are aided and abetted by multiple listing services usually controlled by traditional brokers. In particular, they may try to limit access to their listings by internet-based or fee-only brokers.

How Brokers Try to Maintain Their Price-Setting Cartel

Traditional brokers have structured their industry and captured its regulation in ways that maximize their chances of maintaining uniform 6% or 7% commissions in local markets. Five factors are especially important here – seller-paid commissions, discrimination against nontraditional brokers and other service providers, control of listing services, lack of consumer knowledge and flexibility, and regulation controlled by the industry.

Seller-Paid Commissions: In the current system, sellers usually ostensibly pay the full commission. In reality, a portion of that commission is added to the sale price of the home so that the seller and buyer both end up paying a portion of the commission. This system helps traditional brokers maintain high commissions through the listing of commission splits.

Typically, on either a 5% or 6% commission, 3% will be offered to brokers with buyer clients, and that commission split is disclosed to brokers on real estate firm and multiple listing service databases. This listing of the 3% split, of which buyers are rarely aware, then acts as a powerful force to discourage lower splits of 2% or even 1% because listing brokers, and their sellers, fear that properties carrying these lower splits will not be shown. If sellers and buyers each separately negotiated compensation with their brokers, uniform 5-6% commissions would quickly disappear.

Discrimination Against Nontraditional Brokers: Traditional brokers not only continue to oppose separate buyer and seller compensation but also have vigorously promoted state anti-rebate laws which prevent brokers working with buyers from rebating a portion of the 3% commission split to their clients. Despite criticism and intervention by the U.S. Department of Justice (DOJ), eleven states still maintain these anti-rebate statutes. As a result, discount brokers are prevented from competing on the basis of price with other brokers who have buyer clients.

Largely because of recent DOJ initiatives, we are not aware of states beyond the eleven that seem to be seriously considering passing anti-rebate laws. Moreover, West Virginia and South Carolina have recently effectively rescinded their anti-rebate statutes. However, traditional brokers are now pushing less controversial minimum service laws and regulations to discourage competition which threatens 6-7% commissions. In their most blatant form, these laws mandate full-service brokerage services, thus making it difficult for internet-based or other limited service firms to function because of requirements such as the maintenance of local offices or the showing of properties in person. Ten states have enacted minimum services laws or regulations which restrict nontraditional brokers.

There are also many other more subtle forms of discrimination against exclusive buyer brokers, online brokers, and fee-only brokers. Most frequently, this "informal" discrimination takes the form of traditional brokers discouraging clients from working with nontraditional brokers, their not showing listings of these brokers, or their making access to properties difficult for rebaters or fee-only brokers. This discrimination rarely benefits clients – its objective is the maintenance of 6% or 7% commissions.

Listing Services: A key factor in traditional brokers being able to maintain high, fixed commissions is their domination of home listing services – specifically the web-based listings of large firms and those of unregulated multiple listing services, which aggregate listings in an area. Since these databases are the only ones that include most listings – Realtor.com, a website controlled by traditional brokers, carries about four-fifths of these listings nationwide – most sellers want their houses listed there. But it is this monopolization of listings that allows traditional brokers to support 6-7% commissions and double-dipping.

Most importantly, most listings of the larger firms carry 5-7% commissions, typically with 3-3½% commission splits. Yet, home buyers will not have access to this information about the splits, so they cannot check to see whether their broker is steering them away from houses carrying lower splits.

In addition, some multiple listing services segregate the home listings of nontraditional brokers so that they receive second-class treatment. For example, they might display these listings at the bottom or exclude them unless a hidden box is checked. For those who might think this a trivial issue, remember the huge controversy about screen placement of flights which competed with those of United and American in the dominant databases they maintained and were used by most travel agents.

The control of all these dominant listing services by traditional brokers allows them to restrict full access to those buyers who are clients of brokers. For example, usually a buyer cannot obtain information about the original sales price, days on the market, and past sales of comparable houses for listings in a firm's database, or the local multiple listing service, without first signing an exclusive agreement (usually 2-4 months) with a broker from that firm. This control also permits exclusion of listings by sellers trying to sell their homes themselves, sometimes even with advice from a nontraditional broker.

Lack of Consumer Knowledge: Consumers purchase homes very infrequently, so do not have much if any first-hand experience to help them utilize brokers wisely (or sell themselves).

Moreover, this purchase involves much complexity relating to the saleability of the house, the features of the mortgage, ancillary services, and brokerage services. It is difficult even for well-educated, sophisticated consumers to understand and make sensible decisions about all these products and services.

First-time homeowners tend to know the least about these services and to be the most likely to trust real estate brokers implicitly. But in some ways, the challenge facing existing homeowners who are trying to sell and buy at the same time is much greater. These consumers, who are often in the middle of a major life transition, are usually preoccupied with the timing of both sales. They fear having either to pay off two mortgage loans or to arrange a transitional rent with the prospect of two moves. These homeowners feel so dependent on brokers that they often are insensitive to high, fixed commissions and other anti-competitive practices. All these factors help explain why consumers do not express as much dissatisfaction with real estate brokers as, say, used car dealers.

However, even fairly sophisticated consumers unworried about matching sale and purchase have difficulty understanding brokerage services because of the abysmal failure of required disclosures. In most states, required disclosures are inadequate: They are not required at the first substantial contact, in writing, in plain language, and/or precisely stating broker obligations. Regardless, as a recent National Association of Realtors report revealed, many homebuyers never receive the disclosures in a timely fashion: In 2005, 22% reported no agency disclosure, and only 30% said they received this disclosure at the first meeting with their broker.

Broker Dominance of Regulation: An important reason that most consumer disclosures are inadequate is because of regulatory capture. In a large majority of states, as a forthcoming Consumer Federation of America report will document, practicing real estate brokers actually serve as real estate commissioners who are supposed to regulate the brokerage industry. In these states, they pay little or no attention to consumer interests, functioning mainly to support the cartel or to adjudicate disputes between traditional brokers and their clients, and those between the brokers themselves. These commissioners take no steps to foster real price competition, to protect nontraditional brokers, to explain to consumers how the real estate marketplace really functions, or to enforce required consumer disclosures. On the contrary, many have supported anti-competitive measures such as anti-rebate and minimum service laws.

Needed Reforms

This analysis of the key factors resulting in the disadvantaging of buyers and sellers suggests the most important types of needed reforms. They are, in brief, fuller and more timely consumer information, ending of discrimination against nontraditional brokers, and effective, independent regulation.

Better Consumer Information: Traditional brokers must supply fuller, more timely information to their clients, verbally and in writing, and in plain English. At the first substantial contact, that information should include:

- whether brokers will represent the financial interests of their clients or merely serve as facilitators or transactional brokers;
- precisely what they will do to help sellers sell and buyers buy, including whether they will provide access to all listings available to the broker, including those on the local multiple listing service, regardless of commission split;
- their compensation and how it is received, especially any commission splits; and
- potential conflicts of interest such as self-identified "buyer brokers" trying to sell their own listings or those of their firms.

Elimination of Discrimination: Traditional brokers have used subtle and not-so-subtle methods of discrimination to suppress competition from nontraditional brokers who charge reduced fees, offer limited or web-based services, or provide exclusive buyer representation. All this discrimination should be prohibited by laws that are rigorously enforced. Nontraditional brokers should have the same access as traditional brokers to multiple listing services and all listings on these services. They should not be limited by anti-competitive anti-rebate or minimum service laws. And, they should be able to lodge complaints with independent regulators against traditional brokers that discriminate against them using the "informal" methods noted earlier.

Effective, Independent Regulation: An essential condition of effective consumer disclosures and elimination of discrimination against nontraditional brokers is strong, independent regulation. For a start, practicing brokers should not be allowed to serve as regulators. Ideally, even if they agree not to practice while regulating, brokers should not be allowed to easily "revolve" from practicing broker to regulator and back. Instead, as in other business areas, attorneys with relevant expertise, and few or no ties to the industry, should be favored as regulators. And, regulators should function independently of the industry, for example, being prohibited from accepting perks such as expensive meals and golf outings.

Just as importantly, regulators should shed old pro-industry functions – particularly support for traditional brokers who try to limit competition – and take on new pro-consumer functions. These include: ensuring effective consumer disclosures and their enforcement, educating consumers about brokerage services, protecting consumers against deception and fraud, and cracking down on all forms of discrimination against nontraditional brokers.

Advice to Consumers

Both home sellers and buyers can take simple steps to ensure they are treated fairly by brokers. In doing so, they will actually promote fairer, more competitive real estate brokerage services.

Most importantly, buyers and sellers should insist that brokers disclose, at the first substantial contact, orally and in writing, and in plain language, the following information about brokerage services:

- Whether the broker will represent their financial interests at all stages of the sale/purchase. If not, they should ask whether the broker will represent the financial interests of the other party, or simply serve as a facilitator or transactional broker.

- The level and method of their compensation. Consumers should never hesitate to negotiate lower fees.

    - Sellers can often persuade brokers to knock one percentage point off the standard 6% or 7% commission and possibly even two points if the home is expensive or brokerage services are limited. Moreover, they should insist that if their broker double-dips, the commission be reduced another percentage point or two.

    - While buyers are more limited in negotiating compensation, they can ask if their broker is prepared to rebate them a portion of the commission split, at least one percentage point. They can also insist on an even larger rebate if the broker double-dips.

- Any potential conflicts of interest that may arise, such as non-exclusive buyer brokers promoting their own listings or those of their firms, or listing brokers not exposing properties to all those brokers who have access to local multiple listing services.

Conclusion

Some feel that the traditional real estate brokerage industry is so entrenched and influential that it is impossible to reform. We believe, though, that pro-consumer changes are already occurring and that the adoption of significant reforms is not a question of if but when. There are too many competitive opportunities afforded by the internet, too many abuses against consumers, and too many growing criticisms from policymakers, the press, consumer advocates, and consumers themselves for the industry to resist these reforms. They will, however, be adopted sooner rather than later if these four critical groups continue to focus on brokerage abuses and call for brokerage reforms.