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Brokers' contractual arrangements in the Manhattan residential rental market ☆

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ABSTRACT

We bring new evidence to bear on the role of intermediaries in frictional matching markets and on how parties design contracts with them. Specifically, we examine two features of contracts between landlords and agents in the Manhattan residential rental market. In our data, 72 percent of listings involve exclusive relationships between landlords and agents (the remaining 28 percent are non-exclusive); and in 21 percent of listings, the landlord commits to pay the agent's fee (in the other 79 percent, the tenant pays the agent's the fee). Our analysis highlights that these contractual features reflect landlords' concerns about providing agents with incentives to exert effort specific to their rental units and to screen among heterogeneous tenants.

1. Introduction

In many markets with heterogeneous goods and agents, the idiosyncratic match value is an important component of the gains from trade. In these markets, the matching process between buyers and sellers often involve frictions, and, thus, specialized intermediaries emerge to facilitate the exchange. In this paper, we investigate the role of intermediaries in matching markets by examining contracts between landlords and real-estate agents in the Manhattan residential rental market.[1]

Our empirical analysis highlights two concerns that are key to understanding the main contractual features observed in this market: landlords' desires to provide agents with incentives to exert effort specific to their rental units and to screen across heterogeneous tenants. Specifically, more unusual rental units might require agents' specific investments, in line with a broad (primarily theoretical) literature on vertical contracting. One such specific investment requires learning landlords' preferences and tenancy requirements in order to screen tenants on their behalf. Moreover, we argue that a rather unusual contractual term—whether the landlord or tenant should pay the broker's fee—affects tenants' likely schedule of payments, thereby allowing landlords to screen between long-term and short-term tenants.

The Manhattan residential rental market provides an ideal setting in which to analyze the role of intermediaries in matching markets through their contractual arrangements. First, as in typical housing markets, there is a significant heterogeneity across housing units and across tenants. Second, it is a large market, as more than 75 percent of Manhattan households live in rented dwellings, and brokers and agents are widely used. Third, the market displays interesting variation in the way that landlords and brokers contract. More specifically, the landlord sometimes lists his unit on a

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[1] We use the terms brokers and agents interchangeably. Formally, the licensing requirements for brokers and salespersons are different, and a licensed salesbroker or associate (licensed) broker typically works for a firm owned by a licensed broker. A licensed broker will typically employ several other licensed brokers and salespersons. In common parlance, these are rental agents.

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real-estate platform directly and deals with any agent bringing a potential tenant—i.e., an "open" listing—and sometimes designates an exclusive agent to market the rental unit and through whom all tenants must approach the landlord (though co-brokered deals are possible and, indeed, provide the rationale for such listings)—i.e., an "exclusive" listing. Such exclusive relationships require the agent to agree to market the rental unit for a specified period of time (usually 2–3 months), on the owner's stated terms. One such term, which also appears in open listings, specifies whether the agent collects the fee from the tenant or from the landlord—the latter marketed as "no fee" apartments. Thus, four possible contractual arrangements exist—combinations of exclusive/open and fee/no fee.

To understand the role of these contractual features, we use several sources to bring together new data on the Manhattan residential real estate rental market. Our rental listings data, provided by an online platform for renting real estate, suggest that concern about providing incentives to brokers determines landlords' choices between exclusive and non-exclusive arrangements since cross-sectional variation in *apartment characteristics* is related to this choice. As we describe in Section 4, landlords face a trade-off when deciding to enter into an exclusive relationship with an agent. On the one hand, agents are more willing to exert greater effort when advertising exclusive apartments since they reap greater benefits from this effort. On the other hand, agents have renters looking for similar units, and granting exclusivity to one agent may dampen the incentives of others who may otherwise show the apartment. This trade-off varies according to the characteristics of the unit. More precisely, the more atypical the apartment, the less likely it is that an agent has renters looking for similar units. Thus, landlords should be more likely to use exclusive contracts when the apartment is more atypical.

Hence, following Haurin (1988), we construct an index of atypicality for each apartment and find that more-atypical apartments are more likely listed with exclusive deals. The magnitude of this effect is quite large: A one-standard-deviation increase in the value of the index of apartment atypicality increases the probability that a listing is exclusive by 4.6 percentage points, which is approximately a 6.4-percent increase in the probability that the listing is exclusive.

The data also suggest that landlords use exclusive agents for the purposes of screening or steering tenants. This is a rather delicate issue for landlords since some screening criteria would fall foul of fair housing rights in the NYC Human Rights Law[2] (for example, screening families with children or applicants with particular occupations, such as lawyers who might be perceived as more difficult tenants). We find that landlords use exclusive agents for apartments for which the tenant's suitability appears to be a greater concern—for example, almost all furnished units in the data feature an exclusive agent (though this is also consistent with the unit being atypical); similarly, units in co-op and condo buildings, and units that allow pets (where there may be considerable variation in tenants) are more likely to have exclusive listings. We also find that landlords are more likely to sign exclusive agreements when local vacancy rates are lower: This would be surprising if exclusivity contracts existed solely to induce agent effort; however, it is consistent with the idea that landlords are more concerned about selecting particular types of tenants when it is relatively easy to find tenants.

Turning to the other source of variation in contractual arrangements, standard economic theory suggests that whether the landlord or the tenant pays the broker's fee should have no effect on outcomes, as landlords also set the prices at which to rent their apartments. However, if landlords face external constraints over the nominal rental price that they can charge, then which party pays the broker's fee affects the parties' share of the surplus. While the extreme case of rent control does not arise in our data, they do include many rent-stabilized apartments, as we describe in Section 3.[3] For these apartments, landlords do not have full discretion to change rental prices when leases are renewed, and since many tenants anticipate renewing the lease for a rent-stabilized unit, a landlord is likely to prefer a higher initial rent (and to pay the broker's fee).

More broadly, Genesove (2003) finds nominal rigidities in apartment rents even for unregulated apartments and greater rigidities for units housing tenants who continue from the previous year. Hence, when choosing between two identical apartments with a trade-off between the annual rent and the broker's fee—i.e., one apartment with a higher annual rent, but the landlord pays the broker's fee; the other apartment with a lower annual rent, but the tenant pays the broker's fee—tenants expecting to stay in the apartment longer-term should be more willing to pay the broker's fee directly in anticipation of even lower relative rents if they renew their lease. Landlords' desire to attract longer-term tenants varies with market conditions. In particular, future nominal rigidities in rents reduce the value of a longer-term tenant relatively more in "cold" markets—i.e., when the demand is weak relative to supply, and, thus, the vacancy rate is high—than in "hot" markets. Hence, landlords should be more likely to pay brokers' fees when the vacancy rate is high. Indeed, we find that landlords are more likely to pay brokers' fees when the apartment is in a rent-stabilized building and when the vacancy rate is higher. Again, the magnitudes of these effects are sizable: The probability that the tenant pays the broker's fee is 5.3 percentage points lower for a rent-stabilized apartment than for one that is not, corresponding to a 6.7-percent decrease in the probability that the tenant pays the fee. In addition, a one-standard-deviation increase in our estimate of the appropriate vacancy rate increases the probability that the tenant pays the broker fee by approximately 5.8 percentage points, which is approximately a 7.3-percent decrease in the probability that the tenant pays the broker fee.

2. Related literature

Our paper contributes to the literature that investigates the role of intermediaries in search markets. The theoretical literature provides useful insights into the existence and use of intermediaries (for a thorough review, see Spulber (1999)), as well as into their compensation structures and incentives (Inderst and Ottaviani, 2011; Lewis and Ottaviani, 2008; Loertscher and Niedermayer, 2012a,b). However, empirical studies of intermediaries' contractual arrangements have been hampered because data availability is usually limited and because such agreements often display little variation within an industry. Further, in most papers, the intermediary holds inventory (Rubinstein and Wolinsky, 1987; Yavas, 1992; Johri and Leach, 2002; Shevchenko, 2004; Shi and Siow, 2011). Instead, we focus on contractual arrangements between asset owners and intermediaries in a market in which intermediaries' main role is to match buyers and sellers. Finally, Inderst and Ottaviani (2011) study whether buyers or sellers should pay fees for recommendations, as well as the effects of these payments on intermediaries' incentives to misinform and mis-sell. We contribute to this literature by studying a setting in which who pays the fee is largely unrelated to the provision of incentives to the intermediaries. Instead, it affects matching by buyers and sellers

[2] See "Fair Housing NYC" at http://www.nyc.gov/html/fhnyc/html/home/home.shtml.

[3] To qualify for rent control, a tenant must have lived continuously in an apartment since July 1, 1971; once vacant, the unit becomes rent-stabilized or is deregulated.