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Potential cost synergies from banks acquiring real estate brokerage services

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Abstract

National banks and Financial Holding Companies (FHC) solicited permission from the Federal Reserve Board and the Treasury Department to add real estate brokerage and management services to list of permissible business activities under the 1999 Gramm–Leach–Bliley Act (GLB). To date, permission has been denied due to the Community Choice in Real Estate Act, HR 111 and S 98.

This study offers a method of combining the financial data of two independent industries. Additionally, this study identifies the scale returns and cost complementarities that may occur if banks offered real estate brokerage services under a single organization. Considerable evidence suggests that joining bank and real estate activities under a single organization would continue to generate increasing returns to scale for banks even when large levels of real estate brokerage services are offered by the joint institution. In addition, the results indicate evidence that bank acquisitions of real estate brokerages do create some cost saving synergies from cost complementarities between product lines. Finally, complementarities exist between traditional bank services and real estate services most at low levels of real estate outputs.
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1. Introduction

Congress has temporarily blocked efforts by national banks and financial holding companies (FHC) to expand their services to include real estate brokerage activities. Banking conglomerates have asked permission from the Federal Reserve Board and the Treasury Department to sell and manage real estate under the 1999 Gramm–Leach–Bliley Act (GLB). However, Congress has denied national banks and FHCs from offering real estate brokerage and management services by passing the Community Choice in Real Estate Act (CCR).

The Fair Choice and Competition in Real Estate Act (FCCR) of 2005, recently introduced to the House of Representatives, is a rival bill to the CCR. In contrast, FCCR would amend the Bank Holding Company Act with the purpose of clarifying that real estate brokerage and real estate management activities are authorized "financial" activities for FHCs and financial subsidiaries of national banks. If passed, this bill would allow bank conglomerates the right to acquire real estate brokerage activities as a service that they offer under the same roof as lending, insurance, and investment services.

Researchers have identified four drivers in the decision to acquire target firms, aside from financial distress: scale economies; scope economies; agency issues relating to the conflict of interests between management and shareholders; and risk diversification. For an acquisition to be successful, the newly acquired activities should possess synergies with the existing ones. These synergies could come on the demand side from the shopping conveniences, newly acquired market power and revenue diversification or on the supply side from shared fixed costs, such as scale and scope economies.

One of the contributions that this study makes is the hypothetical combination of financial cost data from two independent industries before a merger or acquisition occurs with the purpose of estimating cost synergies. First, this study will directly estimate the benefits of producing a larger scale of real estate transactions called revenue units in a combined industry (returns to scale). Based on a number of studies that show evidence that the real estate brokerage industry is operating near its optimal scale, Zumpano (2001) asserts that the real estate brokerage industry may face diseconomies of scale if large bank conglomerates are allowed to offer real estate services. We argue that a joined industry would face an entirely different cost frontier and that the existing research would tell little about a new industry with a combined product line.

Second, this paper estimates the cost synergies between banking and real estate services due to cost complementarities. This study provides empirical evidence of cost saving synergies that may exist when a single firm blends traditional banking services with real estate brokerage services. Cost synergies exist when the joint cost of producing complementary services is less than the combined costs of producing the services separately. This paper breaks out specific services and analyzes the synergies between each service. We use simulated Bayesian stochastic cost frontier analysis ex ante by taking each possible, albeit hypothetical, bank acquisition of a real estate brokerage in our data samples.

We find considerable evidence suggesting that joining bank and real estate activities under a single organization would continue to generate increasing returns to scale for banks even at large levels of real estate brokerage production. We find significant evidence that bank mergers with real estate brokerages do create some cost saving synergies between product lines. Depending upon the level of services provided, cost complementa-

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