Is the Compensation Model for Real Estate Brokers Obsolete?

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Abstract

This study examines the traditional compensation model for real estate brokers under which both the listing and buyer brokers are paid by the seller based on a percentage of the property sales price. We argue that this model has not evolved to reflect contemporary legal agency relationships and technology-driven information availability. It therefore creates substantial transactional inefficiencies for buyers and sellers at both the matching and bargaining stages of a transaction. While there is evidence that market forces are pushing for a change in the status quo, there is also evidence that the brokerage industry is resisting this change by pursuing anti-competitive policies and laws. We explore the economics of the current and alternative compensation structures and suggest policy implications regarding anti-competitive behavior in the brokerage industry.

Notes

1. United States Government Accountability Office (2005), 9–10.

2. Sharing of listing information between brokers historically began to occur at the turn of the twentieth century, as brokers were encouraging sellers to enter

into exclusive rather than open listing contracts. It was not until the 1970’s however, that exclusive listing became prevalent and most brokerage firms shared information and agreed to split commissions with cooperating brokers through a multiple listing system. See Edward L. Slumber, Attorney Explains MLS–Realtor Multiple Listing Service is Discussed—Industry Overview”, *Real Estate Weekly* (April 9, 2003).

3. Information on services provided is outlined in the National Association of REALTORS®, Inc. online article entitled “Why Use a REALTOR?®”. As part of what we refer to as the matching effort, a listing broker will typically provide the following services for a seller: provide information on market conditions that would effect pricing the property, list the property on an MLS, hold broker and public open houses, place hard copy and internet advertisements, and prescreen and accompany buyers seeing the property (unless there is a buyer broker, who would then do this). On the bargaining side, a listing broker would assist a seller in evaluating potential offers and negotiating an agreement, as well as seeing the agreement through to closing of title. On the buyer’s side, a buyer broker will assist in matching a buyer with a property by helping the buyer determine what they can afford, searching for property for sale, providing information about properties for sale, and showing properties. On the bargaining side, a buyer broker assists a buyer in making an offer, negotiating an agreement, advising as to reports and inspections on the property that should be obtained, and explaining financing options, and seeing the transaction through to closing. http://www.realtor.com/Basics/AllAbout/Realtors/Why.asp?poe=realtor, accessed 02/03/06.

4. See Blanche Evans, “DOJ Doesn’t Have a Case Says MLS Attorney,” *Realty News* (March 14, 2006).

5. Federal Trade Commission (1983), 69.

6. See Pancak et al. (1997).

7. We recognize that, in theory, the buyer ultimately pays the buyer broker fee in the form a higher selling price. We also note that some buyer brokerage agreements now provide that the buyer must pay a fee if the broker can not secure a commission split from the listing broker.

8. The U.S. Government Accountability Office reports that non-traditional approaches to compensation account for only a small share of the brokerage market. United States Government Accountability Office (2005), 5.

9. Hagerty, James R. “Foxtons Redefines Its Discount Approach: New Chief Executive Raises Sales Commission to 3%, Boosts Services and Staff.” *Wall Street Journal*. October 27, 2004, p. B. 4.

10. Insight Realty website: http://www.insight-realty.com. MLS Lion website: http://www.mlslion.com.

11. Johansen, Erin. “Help-U-Sell Gains Converts.” *Denver Business Journal*, April 30, 2004. Also see Help-U-Sell website at http://www2.helpusell.com/RealtyConsultantsCT/Sellers/SaveMoney.aspx.

12. United States Government Accountability Office (2005), 13–14.

13. *United States of America v. National Association of Realtors*; complaint filed September 8, 2005 in the United States District Court for the Northern District of Illinois Eastern Division. See Department of Justice website for case filings at http://www.usdoj.gov/atr/cases/nar.htm.

14. DOJ antitrust comments can be found at http://www.usdoj.gov/atr/public/comments/comments.htm. FTC antitrust

comments can be found at http://www.ftc.gov/opp/workshops/comprealestate/index.htm.

15. This practice was found to be in violation of the Sherman Act in 1950 in *U.S. v. National Association of Real Estate Boards, et al.*, 339 U.S. 485 (1950).

16. For more on these topics, and an excellent overview of the brokerage literature in general, see Benjamin et al. (2000).

17. Yavas (1992) also considers these stages in a model that focuses on the search of buyers and sellers.

18. See Yinger (1981) for a formal search model of broker behavior.

19. See Bartlett (1981), Frew (1987), and Miceli (1991).

20. This can also be interpreted as the total number of listings attracted by broker *i*.

21. This conclusion is in consistent with Crockett (1982) and Miceli (1992), who show that when brokers engage in non-price competition, they do not minimize average costs.

22. See, for example, Mortensen (1982) and Lueck (1994).

23. Yavas et al. (2001) conduct an experimental analysis of the impact of brokers on the outcome of bargaining between buyers and sellers.

24. As noted above, since the matching and bargaining stages are sequential in time, backwards induction requires that brokers in the matching stage

rationally anticipate the outcome of the bargaining stage when choosing their search strategies. Thus, the model in the previous section implicitly assumed that A was independent of broker search, which may not be realistic in the case of a percentage commission.

25. Many of the results in this section have already been established, or anticipated, in previous literature. See Anglin (1994), Yavas (1996), and Colwell et al. (1993, 1994).

26. For other arguments against net listings, see Anglin (1994) and Yavas (1996).

27. This scheme resembles that proposed by Colwell et al. (1993, 1994), but differs in that compensation falls dollar-for-dollar with the sale price. In contrast, in their scheme, compensation falls in proportion to $\sigma/2$, where σ is the commission rate.

28. For example, the market might dictate that the gross compensation will be 5–6% of the market value of the house, in which case β and δ will be functions of the market value.

29. The values of β and δ could be tied to the assessed value of the property, V, as follows. (Our approach follows Colwell et al. 1993, 1994.) Let $V =$ \$100,000, and suppose the gross commission is set at 5% of this value, or \$5,000. Then, assuming an equal division of this "provisional commission," we have $\delta = (\$100{,}000)(1 + 0.025) = \$102{,}500$, and $-\beta = (\$100{,}000)(1 - 0.025) = \$97{,}500$. The actual commission, of course, may not be divided equally, as illustrated by the example in the text.

30. United States Government Accountability Office (2005).

31. Under the NAR Virtual Office Website (VOW) and Internet Listing Display

(ILD) policies, allows brokers to “opt out” of displaying property listed with them on a competitor’s website, claiming an ownership right in listings. See NAR press release, “Justice Sues Over Wrong Policy” September 9, 2005 at http://www.realtor.org/PublicAffairsWeb.nsf/pages/narsuedoverwrongpolicy.

32. Resultant dual agency and designated agency has many agency conflicts, not directly related to this study.

33. Cendant Real Estate Services Division (2003).

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