

Index rents in residential contracts

Timo Attenhauser, 2009-04-14

Introduction

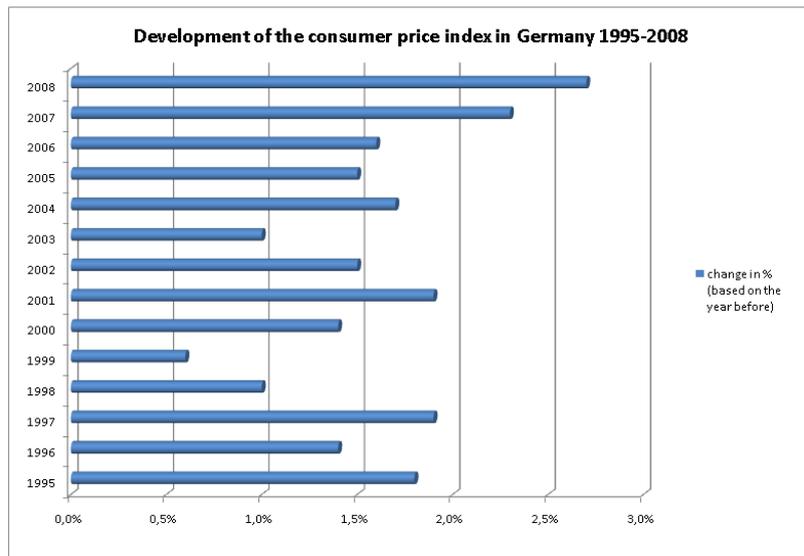
Currently there is a lot of discussion as to whether there will be a high inflation in the coming years in Europe. The author was asking himself if it makes sense or not to agree to an index rent in the recently signed rental contracts. The first part of this essay deals with a short overview of the topic inflation. This topic could fill hundreds of pages, so it is really just a very brief overview to match the given time conditions. The next sections will provide an overview of the consumer price index and the legal procedure to agree to an index rent.

Inflation

Inflation means a continuous and significant increase of the price level. The relation between money and all other goods is changing at the expense of the money. That is why inflation is understood as currency devaluation. The so-called inflation-rate is mostly measured with the consumer price index.

Development in Germany

There is a continuous increase in the consumer price index in Germany since 1995. The annual increase was between 0.6 % and 2.7 %. That means that Germany has a slight inflation (inflation between 0.0 % and 5.0 % per year). This slight inflation causes a supporting demand on the national market, because people spend or invest their money. The investors are looking for an investment where the yield is higher than the inflation-rate. A slight inflation is good for the national economy.



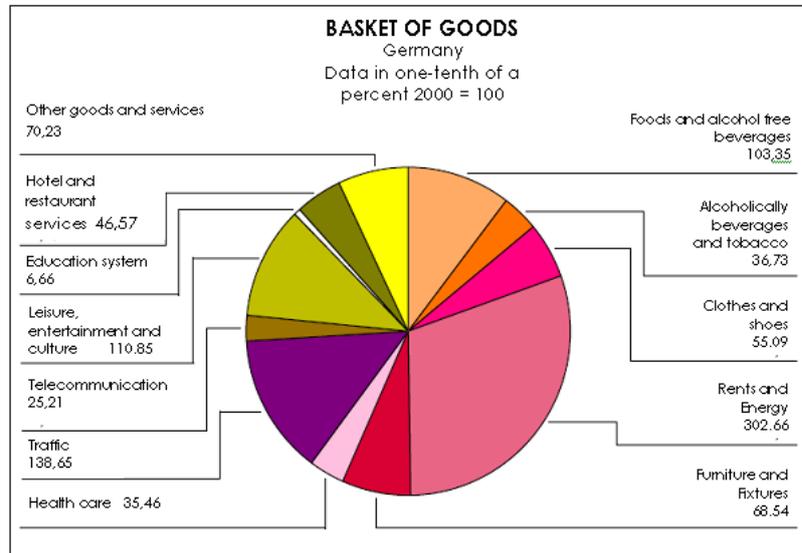
source: www.destatis.de

However, there have been other times in Germany. After the Second World War Germany had a massive inflation (more than 5.0 % per year). Money as medium of exchange lost its value faster than other goods (e.g. real estate). People are looking for a substitute to have a medium of exchange. After the Second World War the German people have chosen cigarettes as new medium of exchange, because cigarettes were more stable in value than money. The winners during a massive inflation are real estate owners, because their real estate does not lose value. Those people who have their money in saving accounts or in fixed-interest securities lose a lot of money, because the massive inflation causes high currency devaluation.

The European Central Bank tries to control the inflation by the amount of money in circulation. A decrease of the amount of money in circulation (in Germany called "M1") means that the people have to buy the same amount of products with less disposable money. The sellers of the products have to lower the prices for these products. The value of the money is increasing. The European Central Bank tries to adjust the increase of the money in circulation with the increase of the productive capacity, in order to maintain a continuous inflation-rate margin under 2.0 % per year.

Consumer Price Index (CPI)

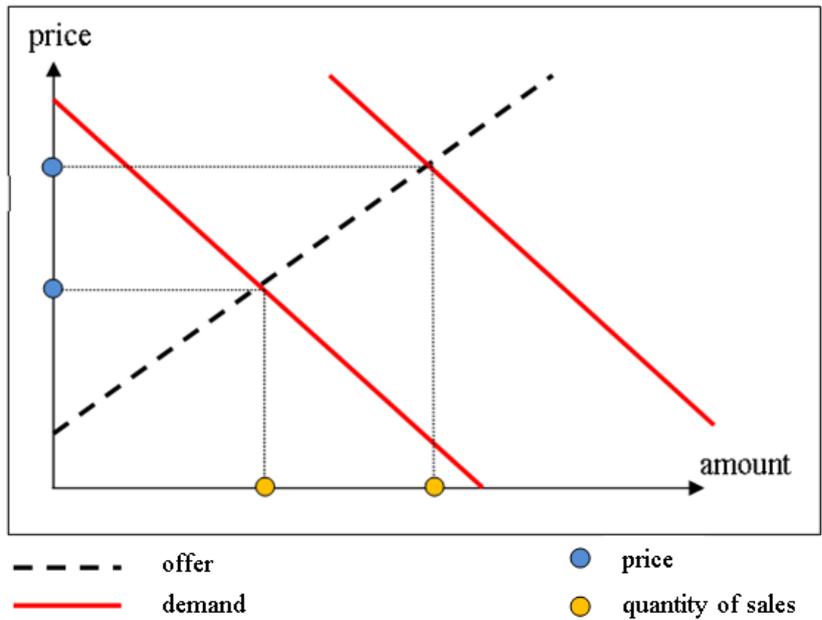
The inflation-rate is measured with the consumer price index. This index includes a basket of goods:



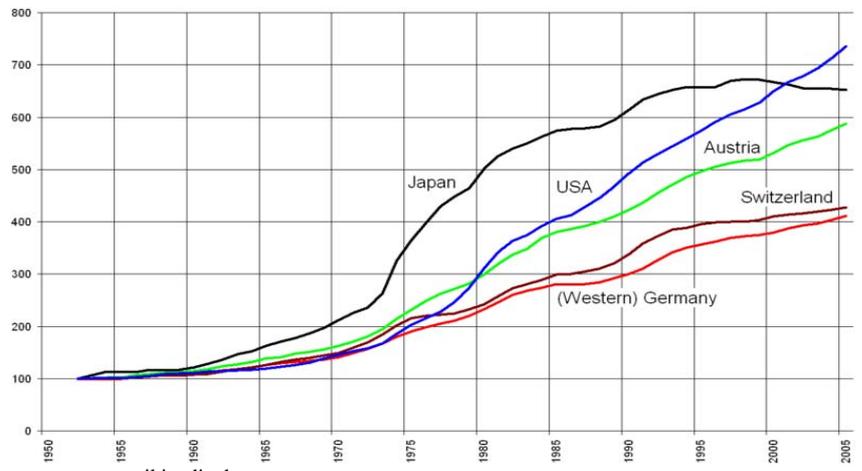
source: www.destatis.de

The above shown figure shows the basket of goods from the basis year 2000. This basket of goods has to be representative of the need of an average household (in Germany 2.3 people per household). The federal statistic office in Germany determines the price increase every month to measure the inflation-rate. This determination is based on 350.000 price quotations and 750 of the most important goods in Germany. The development of the consumer price index is released on the homepage www.destatis.de. After a few years the basket of goods has to be replaced by a new representative basket of goods, because the need of the households is changing and new innovative products are available on the market.

The reasons for the increase of the consumer price index are different. The most common one is the fast increase in the demand for some goods. The producers can not raise the production of these goods that fast, so the producers/ sellers have to raise the prices for these goods.



Other reasons for the increase in the consumer price index can be linked to higher production costs, higher energy costs, higher interests or tax increases. The increase in the price indexes varies in different countries:



source: www.wikipedia.de

Index clause in residential contracts

Property owners and tenants can include an index clause in the residential rental contract. The legal basis in Germany is § 557b German Civil Code.

Procedure

The index clause can be used in an unlimited and limited rental contract. When using the index clause both parties agree in a written rental contract to future rent increases. The rent increase will be adjusted by the increase of the consumer price index for Germany. The parties are only allowed to use this index; the usage of any other index will lead to the invalidity of the index clause or even the whole rental contract.

Example of a valid index clause:

“The parties agree, that the rent level develops according to the Federal Statistic Office determined consumer price index (CPI) (basis 2005 = 100). If the CPI increases or decreases from ... (date of the last rent increase), each party will be allowed to ask for a proportional change of the rent according to the percentage increase of the CPI. However, the rent must be unchanged for at least one year, with exception for rent increases due to modernization or because of increased operational expenses. The same applies for each new index change after an increase or decrease of the rent. Rent increases due to adjustments in the comparative rent common for the location (rent index) are excluded.”

The property owner is allowed to raise the rent of their tenant if the consumer price index has risen. The property owner has to prove if the rent of this tenant has been stable for the last 12 months. If these requirements are met, then the property owner is allowed to raise the rent of this tenant. They have to send a notification to this tenant. This notification has to include the percentage increase of the consumer price index, the monthly rent increase and the new rent. The tenant has to pay the new rent from the beginning of the second month after receiving notification. An example of a calculation for the new rent follows:

CPI 01-2007:	102.4 points
CPI 01-2008:	105.3 points
Percentage increase:	$(105.3-102.4)/102.4 = 2.83 \%$
Current cold rent:	500,00 €
New cold rent:	$500,00 \text{ €} \times 1.0283 = 514,15 \text{ €}$

Disadvantages for property owners

If both parties agree to an index clause, the property owner is limited in using other rental increase options.

The property owner is not allowed to raise the rent to the comparative rent common for the location (rent index). This is not good, if the tenant pays a rent below the rent index rent, because the inflation-rate is only 2 % per year and with the other rent increase opportunity the property owner can raise the rent up to 20% during a three year period.

The rent increase after finishing a modernization is limited. Usually the property owner could pass on 11% of the costs for the modernization, if the living conditions of the tenants have improved. If the parties had agreed to an index clause, the property owner can only pass on 11% of the costs for a modernization, in one case: there are new legal obligations and the property owner is “forced” to carry out several measures during a modernization. The property owner is not allowed to pass on the other modernization costs.

The property owner is allowed to increase the prepayment for the operational expenses.

The tenant has the right to long for a decrease of their rent, if the consumer price index has decreased. The risk in Germany is very low: Since 1951 there has only been a decrease in two years: 1953 and 1986.

Advantages for property owners

After signing the rental contract with an index clause, the property owner has an agreement with his tenant about rent increases in the future. There is no need for another written agreement, after the tenant receives the rent increase notification.

The index rent is a clear agreement for both parties. The measurement to increase the rent is an index from the federal statistic office in Germany. Both parties have access to look for the change of the consumer price index. There is no need to discuss about the rent increase. That makes the index clause very practicable. Property owners often have very long discussions with tenants when raising the rent to the comparative rent common for the location. For this increase in rent it is necessary to know the exact fittings of the apartment; property owners and tenants have often different views on that. That discussion is not necessary when using the index clause.

Both parties can stipulate in the rental contract a termination clause for a specific time period. That could lead to a lower fluctuation in the building.

If the tenant already pays a rent above the rent index, it is good to stipulate the index rent to generate rent increases in the future. It could take a long time until the rent in the rent index meet the current rent from this tenant; however, this differs from region to region in Germany. In the southern part of Germany the rent increase is higher than the increase of the inflation-rate, so it is not good to agree to an index rent. In some parts of the eastern region in Germany, the rent increase is lower than the inflation-rate, so it makes sense to agree to an index rent.

Summary

The index rent is a very good and clear instrument for tenants and property owners to stipulate rent increases in the future. However, property owners have to be careful with this index rent because other rent increase opportunities are no longer possible. If the property owner is planning a modernization they should calculate which option is better. Another important question to answer is whether the increase of the inflation-rate or the increase of the rents, common for the location, is higher and faster. After answering all these questions it could be worth agreeing to an index rent.

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