

# Index rents in residential contracts

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## Introduction

Rent increases are, at least in Germany, a sensitive issue. The right to increase the rent often needs to be enforced by lawyers or judicial assistance. Could an index clause in residential contracts be an alternative to rent increases referring to the local comparative rent? The first part of this essay deals with the issue of inflation and how it is measured. In the second part we will see how an index rent could be agreed and what the positive and negative aspects are from the property owner's point of view. The whole issue is considered with reference to the legal situation in Germany.

## Inflation

Inflation is a rise in the general price level of goods and services over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. This can also be seen as decreasing the purchasing power or of the so-called real value of money.

Low or moderate inflation may be attributed to fluctuations in real demand for goods and services, or changes in available supplies, as well as to growth in the money supply. A long sustained period of inflation is generally caused by money supply growing faster than the rate of economic growth.

Today, most economists favor a low, steady rate of inflation. This has a demand-enhancing effect on the national economy. People want to spend their money or make investments with yields significantly higher than the inflation rate. A slight inflation (between 0.0 % and 5,0 % per year) has a positive effect on the national economy.

In the European Economic and Monetary Union the task of keeping the rate of inflation low and stable is given to the European Central Bank, which attempts to ensure a rate of inflation

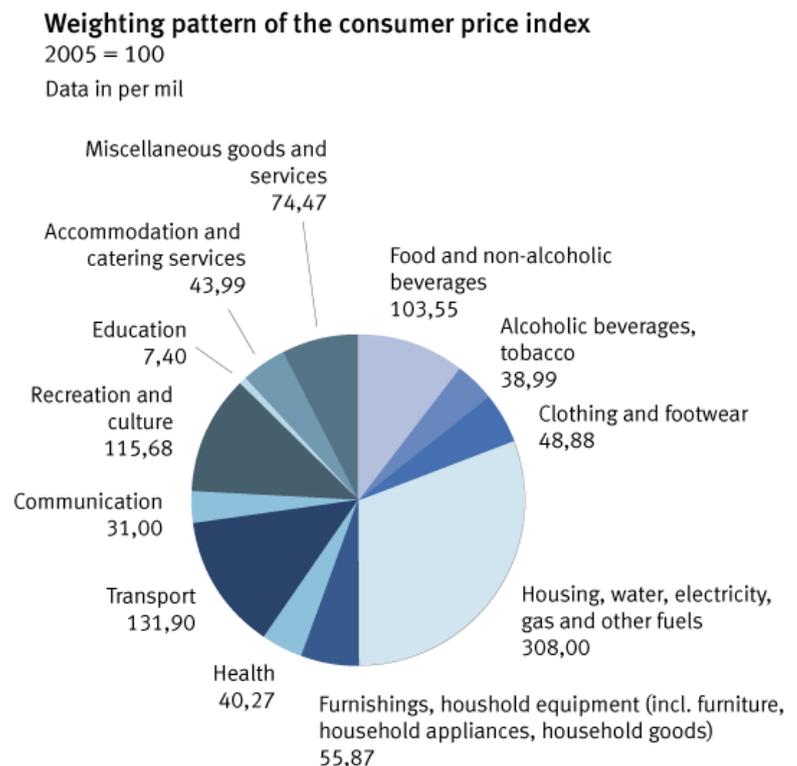
of just under 2 percent. In other countries there are national central banks. Central banks control the size of the money supply, for example through the setting of interest rates and through the setting of banking reserve requirements.

A chief measure of price inflation is the inflation rate, the annualized percentage change in a general price index (normally the Consumer Price Index) over time.

## The Consumer Price Index (CPI) in Germany

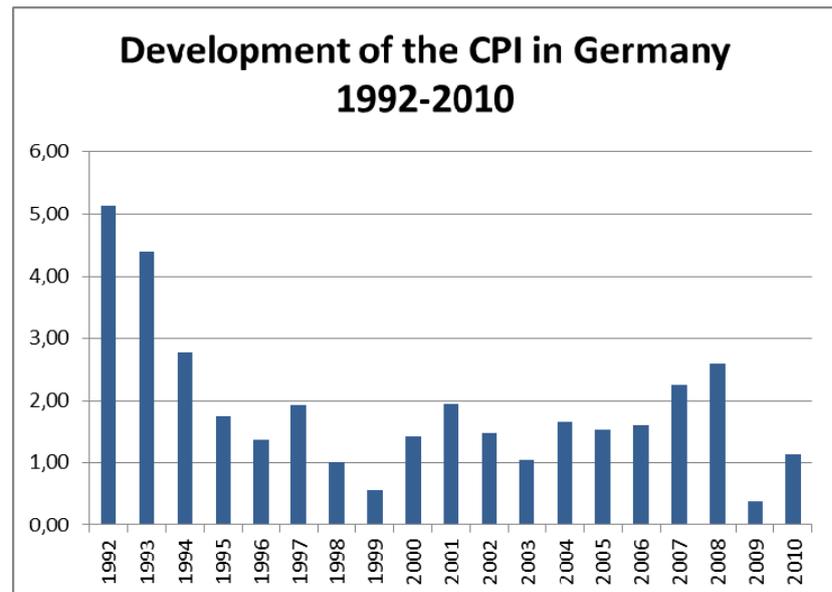
The consumer price index for Germany is determined and published by the Federal Statistical Office. The starting point is the so-called basket of 700 goods and services of the consumption of a typical household (which consists of 2.3 people in Germany). The basket is updated every couple of years because the needs of the households are changing and new products are available on the market. Currently the prices are given equivalent with respect to the base year 2005 = 100.

To calculate the overall rate of price increase, the average price trend for a type of products is weighed with the average proportion of the budget the households spend on this product type. The result is a weighted average reflecting the price trend in Germany. The weighting information is included in what is called a weighting pattern.



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To measure price trends, about 600 price collectors collect the prices of the same products in the same shops in a total of 188 municipalities in Germany every month. In addition, prices are centrally collected for many types of products, for instance, via the internet or in mail-order catalogues. On the whole, more than 300,000 individual prices are collected every month.



Source: [www.destatis.de](http://www.destatis.de)

## Index rents in residential contracts

### The legal basis

An index rent is a variable rent for a property. The rent is not intended permanently to a fixed value but will, starting from a base rent, be modified by parameters that can be comprehended by both parties. The legal basis in Germany is § 557b of the German Civil Code, which allows index clauses in residential contracts since 1993. Before that they were allowed only in commercial contracts.

## How to formulate a valid index clause.

When using the index clause both parties agree to future rent increases. The rent increase (or decrease) will be determined by the increase (or decrease) of the consumer price index for Germany. This is the only index allowed to be used. NOTE, the usage of any other index will lead to the invalidity of the index clause. The index clause will be invalid too, if the decreasing of the rent in times of a decreasing price index is excluded.

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, each party will be allowed to ask for a proportional change of the rent according to the percentage increase or decrease of the CPI. 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 if both of these conditions are fulfilled:

- the consumer price index has risen
- the rent has been stable for the last 12 months

A notification has to be sent to the tenant, including the development of the consumer price index, the monthly rent increase and the new total rent. The tenant has to pay the new rent from the beginning of the second month after receiving the notification. An agreement by the tenant is not necessary because he has already explained this in the rental contract.

Example:

02-2010	02-2011
CPI = 107.5 points	CPI = 109.8 points
Old rent = 500 €	New rent = ?

Percentage increase:  $(109.8/107.5)-1 = 2.14 \%$

Old cold rent: 500,00 €

New cold rent:  $500,00 \text{ €} \times 1.0214 = \underline{\underline{510,70 \text{ €}}}$

## Negative aspects for property owners

If an index clause was agreed, the possibilities for other rent increases are strictly limited.

### *No increase up to the local comparative rent*

If the rent has been unchanged since 15 months it is generally allowed to raise the rent up to 20 percent within three years, up to the local comparative rent. This is not allowed in case of an index rent. This is a disadvantage in such cases in which the current rent is below the local comparative rent.

### *Limited Rent increase after finishing a modernization*

The property owner could pass on 11% of the costs for a modernization to the yearly rent, if the living conditions of the tenants have improved. In case of an index rent this is only allowed if the owner has carried out building work under circumstances of which he was not responsible for, due to new legal obligations.

### *Decreasing CPI causes decreasing in rent*

If the consumer price index has decreased, the tenant may demand a reduction of the rent. The risk in Germany is very low: since 1951 a decreasing CPI was only determined twice: 1953 and 1986.

## Positive aspects for property owners

Both parties have access to the consumer price index published by the German Federal Statistical Office, there is no need to discuss and that makes the index clause *very practicable*. When raising the rent to the comparative rent common for the location there are often long debates with tenants or their representatives like tenants' associations or lawyers. Compared to this it causes significantly less effort to use the index clause.

If the currently paid rent already exceeds the comparative rent common for the location, stipulating an index clause is an useful action to *generate rent increases in the future*. However, if the expected common rent increase is higher than the expected inflation-rate, it will not be a good idea 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.

## Conclusions

The index rent is an easy to use instrument to generate future rent increases. It is especially interesting when the agreed rent level is already above the local comparative rent.

If property owners are planning modernizations they should thoroughly determine whether they would agree to index rents. In this cases they will not be able to pass the modernization costs to the tenants, except that legal obligations required the construction work carried out.

It is important to make good assumptions regarding the increase of the inflation-rate and the increase of the rents, common for the location.

After taking account of these items it may be the proper decision to agree to an index rent.

### Sources:

1. [www.destatis.de](http://www.destatis.de)
2. [www.wikipedia.de](http://www.wikipedia.de)
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