Good news – the residential rental market is becoming affordable

by **Denis H. Camilleri**

A COMMENT in BICC's recent 2004 report outlining the state of the construction industry coerced me to delve into the present residential rental situation. The following was quoted: "Rental values have seen a steady growth between 1999 and 2003, with the largest increases being seen in the detached and semi-detached market.

"Specifically during 2003, the largest increase was seen in the terraced house market, while rental values for maisonettes and apartments were stable at the previous year' values."

What stirred this enthusiasm was that the increases mentioned above occur not in the upmarket properties but in flats and maisonettes, the type of property that first-time buyers are expected to go for. At the turn of this century various conferences were undertaken on the local housing affordability situation by the Chamber of Architects and Civil Engineers, and also the Housing Authority.

These conferences aroused an awareness on the existing affordability problem, as witnessed by a declining housing capital market annual growth rate prior to EU accession. In the previous 15-year period from 1982-1997, affordable house price increases stood at 7.9%, decreasing to 7.43% p.a. over the 20-year period from 1982-2002.

What is also interesting is that the price growth for 2002 stood at 5.5% p.a., prior to entering into the double figure unsustainable growth rates of 12.3% p.a. for 2003, 18% p.a. for 2004 and 25% p.a. for 2005.

What triggered off these unsustainable double digit annual growth rates was the EU accession market expectancy, which fizzled out after the initial euphoria. This was followed by unguided housing budgetary measures, effecting capital gains tax on inherited property, together with rightly so imposing measures to cut down under-invoicing of property transactions. This should have been followed immediately by a reduction of the high stamp duty charges imposed on affordable properties.

The table on the right shows the sharp drop in affordable property capitalisation rates that occurred from 1997-2005. At an average capitalisation rate of 3.5% for 2005 as opposed to 7% for 1997, the rental housing market is now noted to hover around market capitalisation rates assumed to vary from 3%-4%.

Considering the above residential rental capitalisation rate to hover around 3.5%, the net return to the property investor, who anticipates to achieve a 7.5% p.a. annual capital return and after deducting 0.65% pa for maintenance costs, is seen to achieve a net annual return of: 3.5% + 7.5% - 0.65% = 10.35% p.a.

This appears to be an acceptable rate of return, as this is well above a present safe Government 15-year bond issue at 5% p.a.

Modern rents for a two-bedroom apartment stand at 17% (2004) as compared to 22% (1997) of the median household income. For a three-bedroom apartment this stands at 24% (2004) as compared to 33% (1997). These are to be compared with the accepted norms that rental amount is not to exceed 25-30% of household income.

What people pay for private renting as a percentage of payments for owner occupation works out for Malta at 62.5% (2005) for a two-bedroom apartment as compared to 160% (1997), and 60% (2004) for a three-bedroom apartment as compared to 100% (1997).

This is to be compared to the respective values of advanced economies countries at 75% and 88%, outlining that it is currently better to rent out in Malta, with the added bonus of mobility than purchase of one's residence, unless it is undertaken as a form of investment.

From the above it is noted that at present, unlike in 1997, it appears more advantageous to rent out a residence than outright purchase, with the advantages obtained being superior than those achieved in the advanced economy countries.

This may be further gauged by noting that at present the mortgage rate stands at 4.75% p.a., as opposed to the rental capitalisation rate of 3.5%. In 1997 the mortgage rate stood at 7% p.a., with the average rental capitalisation rate at 7%. This may indicate that the local mortgage rates should now tend towards the EU mortgage rate average of 3.5% p.a.

Residential rental affordability

Available statistics indicate that between the two world wars rents averaged around a tenth of income. In the United States, on the other hand, 20% appeared more usual.

During the Eighties this figure for the poorest households in Germany was 30%, averaging off to 20% for average households and tapering off to 15% for the richest.

In France the rent/income ratio after housing allowance was 12.5%, for minimum wage earners it was 17%, while for households not receiving housing allowance it reached 33%.

Traditionally, 25% has been regarded as a reasonable proportion of family income to spend on housing. Great dissatisfaction has been expressed with this rather arbitrary concept of reasonableness.

A more flexible definition of reasonable rent burden provides for a sliding scale based on family size and income. An alternative method of determining 'affordability' is the market-based concept.

This approach determines first the cost of the household's basic necessities, such as clothes, food and essential services, and then finds out much income is left for housing costs.

The figures for Malta in the table stand at 17% for a two-bedroom apartment and 24% for a three-bedroom apartment were based on an average household monthly income of Lm640.

For the average two-parent household the cost of basic necessities works out at around Lm345 monthly, which at Lm76 weekly is well above the minimum wage at Lm55 weekly.

Thus it is calculated that those households earning below Lm345 monthly do not have surplus funds to make good for the assumed 25% allowance for rental payments. Thus the proportion of households earning below this threshold would still need to qualify for a rent allowance to be forked out by the Housing Authority.

Residential renting capitalisation rates of affordable properties

Locality	Rental value as % of market value – 1997	Rental value as % of market value – 2005
Bugibba – internal	8.0	3.6
Qawra – internal	8.5	4.3
Sliema front	5.5	2.0
Sliema inner	5.5	4.1
St Julian's	7.5	3.5
Swieqi	7.0	4.15

Much-awaited amendments

At present the differential existing between renting a three-bedroom apartment at Lm155 monthly as opposed to a monthly mortgage payment at Lm256 appears to tip the scales towards rented accommodation, if affordability carries a greater weight than investment building.

Studies in 1997 pointed to a sustainable home ownership rate for advanced economies at 71% over the next decade. With Malta's home ownership rate over the past years approaching the 75% mark, this conclusion appears to be very valid.

Thus, with the present efficient functioning of the residential rental market, the much-awaited amendments to the present archaic rent laws, currently being supposedly undertaken by the Rent Commission, would only further reinforce the efficiency of the rental market, helping to add to the competitiveness of the Maltese Islands.

The Maltese population has surely reached a maturity level that does not require the mechanics of a referendum to amend these laws, thus sparing the islands a traumatic and expensive experience.

A recent article in the *Economist* noted: "The worldwide rise in house prices is the biggest bubble in history. Prepare for the economic pain when it pops. Housing booms tend to be more dangerous than stock market bubbles, as people are much more likely to borrow money to purchase a house than for shares."

The earlier the rental amendments are undertaken, the lesser the economic pain to be endured.

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