INSIGHTS

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APARTMENT OWNERS ARE NOW HIT BY INCREASING MORTGAGE RATES AND STRATA LEVIES

Double Whammy for Qld Apartment Owners

Dr. Stephen Thornton

The Reserve Bank announced today that it has increased its cash rate target by 25 basis points to 35 basis points, and expects to raise the rate much further very soon.

The RBA Governor, Philip Lowe, pointed to two considerations in the board's decision to increase the cash rate:[1]

1. The economy has bounced back quicker and better than expected from the Covid-19 measures of the last two years (e.g. lockdowns) and the unemployment rate is low (4%).
2. Inflation has also increased quicker and to a higher level than expected.

While it was not unexpected that the RBA would increase the cash rate from its historic low of 0.10%, it is not good news for Queensland apartment and townhouse owners with a mortgage.

Indeed, the Governor alluded to this in his speech today:[2]

> *It is also relevant that households have much more debt than previously, and many households have never experienced rising interest rates. So this is another aspect that we will be watching carefully.*

However, for those owners in Queensland strata buildings/complexes with management rights, today's announcement is a double whammy given the high inflation outlook will generally mean higher strata levy costs alongside paying more interest on their housing loan as the banks increase their mortgage lending rates.

What are strata management rights?

As I have previously written, strata management rights (MRs) are sold by the developer to caretaking companies, mostly small 'mum and dad' operations but increasingly corporate companies, for millions of dollars, with a maximum 25-year contract locked in for bodies corporate from the get-go.

They also typically come with 'exclusive' letting rights of apartments in the building, meaning that while investor owners are able to let their apartment with an outside real estate agent, no-one else can set up a letting service in the building. The vast majority of investor owners put their business with the onsite manager.

MRs are periodically 'topped up' to the original maximum contract term at AGMs by uninformed lot owners as the contract runs down and on-sold every three to five years via industry brokers.

These high contract prices charged by developers for the larger complexes create a barrier to entry to the industry for potentially very good managers who are unable to stump up the money to obtain bank finance to make the MRs purchase.

Obviously, the price of a 25-year contract as opposed to say a 3-year or 5-year contract is significantly higher.

Why is this a cost of living issue in a high inflation environment?

The fixed 'salary' paid by the body corporate (lot owners) to MRs holders varies but can be over $300,000/year in the larger strata complexes with mandatory CPI increases (or better) written into the contract.

This means the caretaking cost in a body corporate's budget is often the highest line item and is a significant factor in determining the levies that owners pay.

Leaving aside that the developer may have provided a generous starting contract price to the initial caretaking company, having such long contract terms makes it impossible for the body corporate to periodically test the market for gardening, cleaning and maintenance services meaning these long-term contracts stifle competition, which is the best way to ensure value for money for services is achieved.

The caretaking company on the other hand, while also being negatively affected by bank interest rate rises where they borrowed to fund the purchase of their MRs, has been provided with the ability to seek out new sub-contractors from time to time to perform the duties at more competitive prices, which in a high inflation environment is very useful.

They also have the ability to reduce their services e.g. have the sub-contracted gardeners and cleaners attend for fewer hours. They do not put their MRs contract at much risk in doing so given there have been very few successful terminations for non-performance.

The Queensland Government needs to act

Most people will be unaware, or will have forgotten, that the Bligh Government in 2012 commenced a management rights review which progressed to the public consultation stage before being abandoned by the LNP later that same year after it won government.

The new Attorney-General then announced a general property law review which included strata (by-laws, scheme terminations, etc.), but excluded a review of MRs.

The current government should cast its mind back to 2012 and complete the job that was started.

References

1. Lowe, Philip. 2022. 'Today's monetary policy decision'. Speech in Sydney NSW, 3rd May 2022 www.rba.gov.au/speeches/2022/sp-gov-2022-05-03.html

2. Ibid.

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