The role of the age pension in your retirement plan

■ The age pension is a valuable safety net and source of income for retirement that, for eligible retirees, pays an inflation-adjusted income stream for life.

■ The size of the benefit a retiree receives is dependent on means-testing, adding to the complexity of the age pension and underscoring the importance of sound financial planning.

■ Retirement is highly personal, and understanding the interaction of the age pension with a retiree's unique goals, risks, and other financial resources will help give retirees the best chance for financial success in retirement.

For most Australian retirees, the age pension is a meaningful portion of their retirement income, and for all retirees it should be considered as part of the retirement planning process[1]. Two key features of the age pension – it is payable until one's death, and it adjusts for inflation over time – make the age pension a very valuable benefit as well. Given this, a thorough understanding of how the age pension works, what benefits should be expected, and its role in planning for retirement is critical.

As described above, the age pension acts like an inflation-protected, lifetime-income safety net for retirees. This means that Australian retirees who are eligible for the age pension can expect to receive a fortnightly pay packet that maintains its purchasing power for as long as they are alive, making it a great resource to help meet "basic living expenses" in retirement[2].

However, the benefits a retiree receives are adjusted based on means testing (the amount of other wealth or income a retiree has impacts the age pension benefit received) adding to the complexity of planning. In this note, we review the basic rules of the age pension, considerations on the length of one's retirement, key points in the means test process, and the interaction of the age pension with superannuation to meet retirement spending needs.

Figure 1: Age pension eligibility age requirement

Date of birth	Qualifying age
Before 1 July 1952	65 years
1 July 1952 to 31 December 1953	65 years and 6 months
1 January 1954 to 30 June 1955	66 years
1 July 1955 to 31 December 1956	66 years and 6 months
1 January 1957 or after	67 years

Source: Department of Human Services.

There are key rules that determine eligibility and benefits

The minimum commencement age to receive an age pension benefit is being gradually increased from 65 to 67 years for those born in 1957 or later.[3] **Figure 1** sets out the schedule for adjustment.

The full age pension that may be received is set out in **Figure 2**. The amount is adjusted every six months, in March and September, in response to rising costs of living. The maximum base rate is added to the pension and energy supplements to determine the full pension that may be received, which is over $23,000/$35,000 per year for a single person/couple respectively.[4]

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1 73.4% of retired Australians receive some form of government benefit (Australian Bureau of Statistics 6238.0 Retirement and Retirement Intentions Australia, 2017).
2 See Vanguard's Roadmap to Financial Security: A framework for decision making in retirement.
3 Additionally, you must have 10 years of residence in Australia with at least 5 consecutive years at some point.
4 For those eligible, a rent assistance supplement is also available.

Figure 2: Full age pension payment rates

	Maximum base rate	Maximum pension supplement	Energy supplement	Total full pension per fortnight	Total full pension per year
Single	$826.20	$67.30	$14.10	$907.60	$23,597.60
Couple each	$622.80	$50.70	$10.60	$684.10	$17,786.60
Couple combined	$1,245.60	$101.40	$21.20	$1,368.20	$35,573.20
illness separated couple, each	$826.20	$67.30	$14.10	$907.60	$23,597.60

Note: Fortnightly rates as at 20 March 2018. Payment rates are updated in March and September each year. Rent assistance is not included in the above table and is dependent on eligibility and rent paid by the individual or couple.

Source: Department of Human Services

As noted, the age pension is adjusted by means testing. Two means tests, the assets test and the income test, are used, and the level of pension received is based on whichever test produces the lower result.

The assets test considers the value of assets that a single or couple owns, including home contents, financial assets such as shares and bank accounts, and investment properties. Some assets, such as the primary residence and any funds held in a super accumulation account by the retiree's partner who is below age pension eligibility age, are excluded from the assets test. Once asset balances surpass the lower threshold (see **Figure 3**), the amount of the fortnightly

age pension received is reduced by $3 for every $1,000 of assets – the taper rate – until the upper threshold is reached at which point no age pension is received.

The income test considers both income actually received – from employment, foreign pensions and income generating assets, such as rental property – as well as "deemed" income from financial assets. Deeming works by assuming that financial assets earn a certain rate of income, which simplifies administration. A lower deeming rate is applied to assets up to a certain threshold with a higher rate applied to any excess financial assets (see **Figure 4**). Deeming only applies

Figure 3: Asset test thresholds

Asset test lower thresholds Full Age Pension eligibility decreases for assets above:			Asset test upper thresholds No age pension eligibility if assets exceed:		
	Homeowner	Non-homeowner		Homeowner	Non-homeowner
Single	$253,750	$456,750	Single	$556,500	$759,500
Couple	$380,500	$583,500	Couple	$837,000	$1,040,000
illness separated couple, combined	$380,500	$583,500	illness separated couple, combined	$986,000	$1,189,000
one partner eligible, combined	$380,500	$583,500	one partner eligible, combined	$837,000	$1,040,000

Note: Asset test thresholds as at 20 March 2018. Payment rates are updated in March and September each year.

Source: Department of Human Services

5 Account-based pensions started before 1 January 2015 may be grandfathered under the previous rules and consider actual income earned.

Figure 4: Deeming rules in determining income

	First portion of assets	Rate applied to the first portion	Rate applied to assets above the first portion
Single	$50,200	1.75%	3.25%
Couple and at least one gets a pension	$83,400	1.75%	3.25%
Couple and neither gets a pension	$41,700	1.75%	3.25%

Note: Deeming rules as at 20 March 2018. Rates are updated in March and September each year. Deeming rates are set by the Minister for Social Services and reflect expert advice on market conditions. The rates are subject to change.

Source: Department of Human Services

to financial assets such as superannuation, shares, bonds and cash[5]. The income test then only considers income (deemed and received) above an income test free area (see **Figure 5**)[6]. Each dollar of income earned above this area reduces the fortnightly age pension received by $0.50.

Partnering with a financial adviser can help to clarify the age pension rules, other associated benefits, and what an investor can expect to receive in retirement.[7]

With long life expectancies, retirees may need to plan for a long time horizon

The availability of the age pension to be paid for the entirety of someone's retirement years is one of its key features, particularly given the potential for a long retirement. Australians enjoy the 4th longest life expectancy in the world[8], which means that while there will likely be many years to enjoy in retirement, there are many years to plan for as well. For example, a male/female couple both aged 67 today has a 50% chance that at least one of the couple makes it to age 90 and a 5% (1 in 20) chance that one of them makes it to age 99! (**Figure 6**)

Figure 5: Income test thresholds

	Income test free area
	Minimum income received before the full age pension is reduce
Single	$ 168 per fortnight
Couple	$ 300 per fortnight

Note: Income test thresholds as at 20 March 2018. Rates are updated in March and September each year.

Source: Department of Human Services

6 Additional exemptions are made for work income.

7 Rules on the treatment of annuities for means testing, pension loan schemes to increase age pension using home equity, and links between age pension and ancillary benefits, such as Commonwealth Seniors Health Card, amongst other rules require additional planning.

8 World Health Organisation (2015)

Figure 6: Planning for a lengthy retirement is prudent
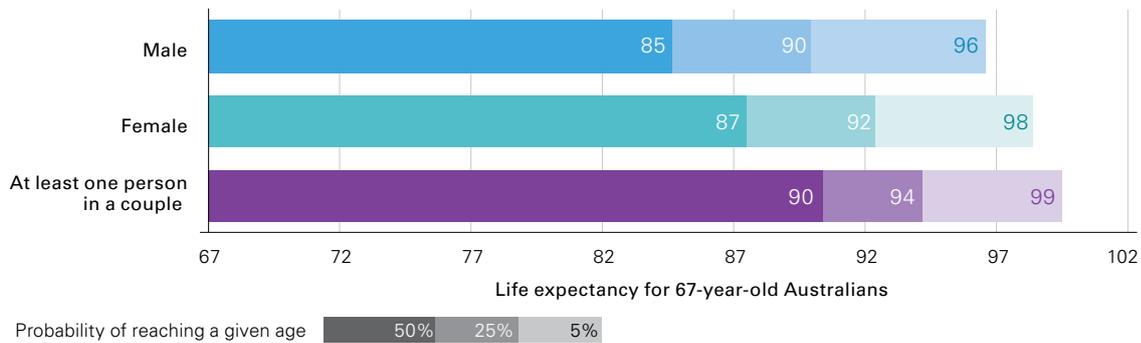
Note: Life expectancies assume no mortality improvements. See Australian Bureau of statistics 3302.0.55.001 – Life Tables, States, Territories and Australia, 2014-2016 (http://www.abs.gov.au/AUSSTATS/abs@.nsf/Latestproducts/3302.0.55.001Feature%20Article12014-2016?opendocument&tabname=Summary&prodno=3302.0.55.001&issue=2014-2016&num=&view) for a discussion on mortality improvements in Australia

Source: Australian Bureau of Statistics Mortality Table 1.9 2014-2016. http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/3302.0.55.0012014-2016?OpenDocument

While the dollar amount of benefits received from the age pension depends on the results of the means test, the fact that the benefits, however small, will be paid for the entirety of someone's retirement years underscores the importance of a diligent understanding and thoughtful planning for the age pension. As we'll see later, how one spends down their assets and age pension benefits has a great impact on retirement success and should be done thoughtfully and with great care.

How should I consider the interaction of my assets and the age pension?

In addition to the potential for a long time horizon in retirement, the means testing process adds a great deal of complexity to the task of determining the role of the age pension in the retirement planning process. In particular, understanding the significance of break points at which benefits are reduced and potentially no longer received at all, impacts both near term and long term planning[9]. Additionally, because other benefits, such as the Commonwealth Seniors Health Card, are only eligible to retirees receiving at least a partial age pension, the financial impact of the break points goes beyond the age pension benefit itself.

In **Figure 7**, we examine the impact of the breakpoints for 4 cases – a single homeowner, a single non-homeowner, a couple homeowner, and a couple non-homeowner[10]. Focusing on the couple homeowner (point A), if they have financial assets much beyond $800,000, then they will be ineligible to receive any age pension benefits (until they deplete their private assets below the relevant threshold). For a single homeowner (point B) with $200,000 in financial assets however, they can be seen to receive almost the full age pension, though slightly reduced by the income test.
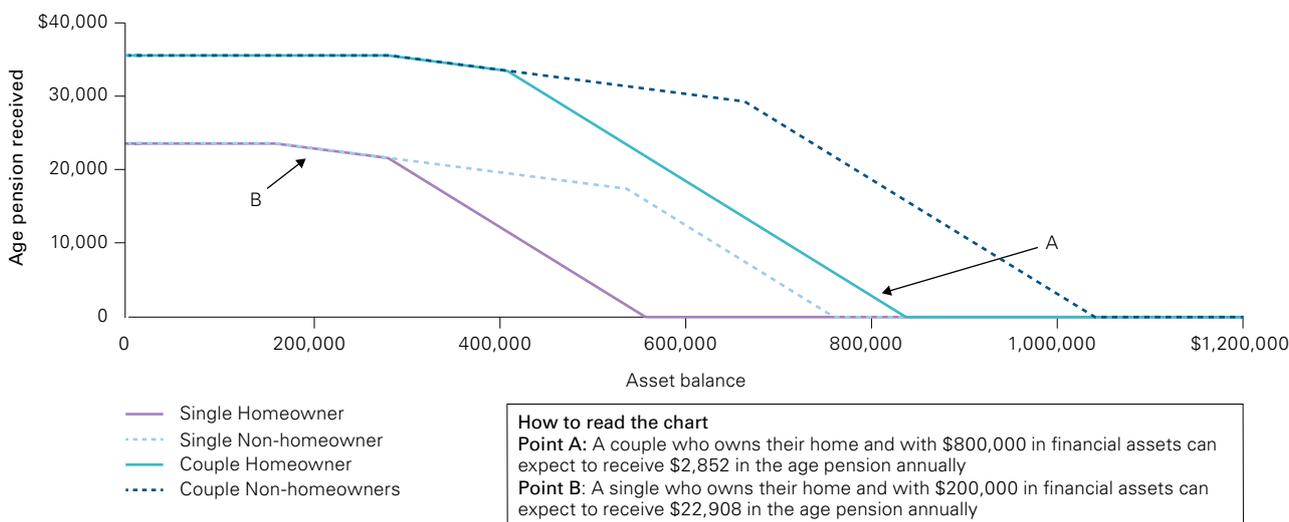
For retirees with wealth levels near these breakpoints, planning is necessary to consider the trade-offs between financial asset drawdowns and age pension and other ancillary benefits received.

The breakpoints and interactions of the means tests will also influence strategies over time. For example, should the couple at point A start spending down their assets to increase their annual spending or make a one-off purchase, they will also start to receive more of the age pension each year. While this may appear to be a superior strategy at first to increase age pension benefits, it is not quite that clear-cut. The couple may instead prefer to use the assets to meet contingency or legacy goals which might mean that maintaining (or growing) assets is of greater importance than

9 For a more information on spending strategies see Smart, Zahm, Geysen & Jaconetti (2018)

10 Figure 7 makes the assumption that only financial assets are held and no additional income is earned.

Figure 7: Understand the impact of wealth on the age pension received

How to read the chart
Point A: A couple who owns their home and with $800,000 in financial assets can expect to receive $2,852 in the age pension annually
Point B: A single who owns their home and with $200,000 in financial assets can expect to receive $22,908 in the age pension annually

Note: age pension as at 20 March 2018. It includes both the asset test and deemed income from financial assets. The steeper line is the binding of the assets test, the shallower line is the binding of the income test. This chart only considers financial wealth and therefore does not consider assets that would not be deemed to earn an income (i.e. home contents) or additional income (i.e. employment income) which would shift eligibility. It also assumes that the retiree is not eligible for rent assistance if they are not a home-owner. This would increase the maximum pension received by up to $3,504.80 a year.

spending down assets and increasing age pension benefits. The decision on how to best incorporate the breakpoints and means tests in a retirement strategy is therefore a personal one for each retiree and working with a financial advisor can provide valuable guidance in this process.

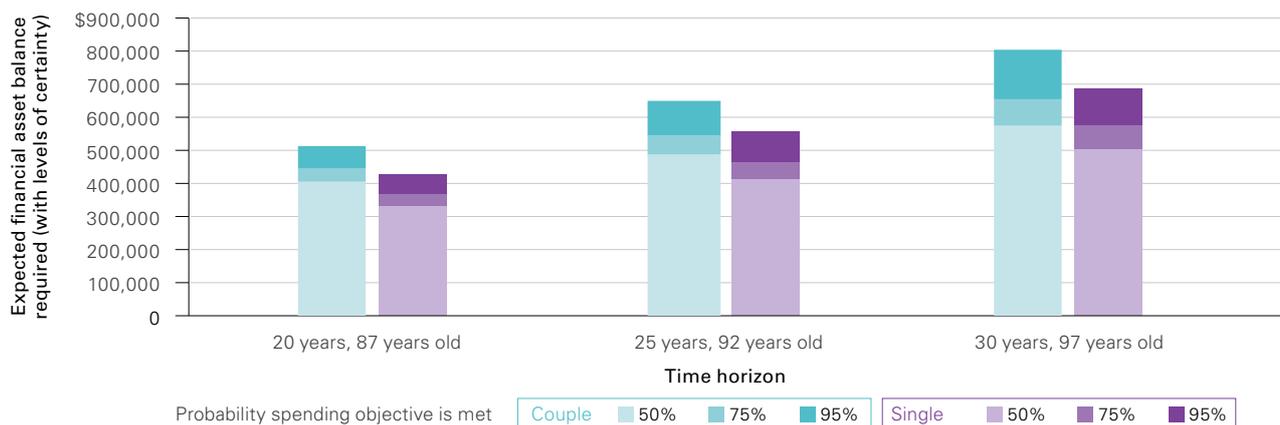### How large a balance do I need to live comfortably?

A common question nearly everyone asks is, "how much do I need to retire?" This question is highly personal, dependent not only on life expectancy, health, and demographic characteristics but also personal preferences on spending, desired lifestyle, and legacy objectives. That said, guidelines are also very useful. In **Figure 8**, we estimate the amount of wealth needed in superannuation and/or other financial assets, when combined with the age pension, to meet the ASFA Comfortable Retirement Standard for single and coupled home-owners[11],[12].

ASFA suggest that a comfortable standard of living in retirement can be maintained with a real income of $42,764 and $60,264 annually for a single and a couple respectively. This means that the full age pension meets 55% and 59% of the ASFA Comfortable Standard for retirees who are eligible. However, a retiree with an ASFA Comfortable retirement spending target may expect to receive a lower age pension in early years given that the wealth needed to meet that objective typically exceeds the minimum mean testing thresholds. For example, a couple with a balance that has a 75% chance of sustaining total spending (age pension plus asset drawdowns) for 30 years at the ASFA Comfortable level will receive a part pension ($13,860) in their first year that meets 23%, rather than 59%, of their spending target.

11 See the Association of Superannuation Funds of Australia, ASFA Retirement Standard for detailed budgets at https://www.superannuation.asn.au/resources/retirement-standard.

12 Retirees and their financial planners face a series of product selection decisions, all of which involve trade-offs between different features and benefits. In our simulations we have assumed a constant asset allocation split of 50% each between equities and bonds, but of course different combinations of assets – both more conservative and more aggressive – may yield different results.

Figure 8: Balance needed at age 67 to meet the ASFA Comfortable Retirement Standard as at March 2018 for given time horizons and probabilities

Note: The ASFA Comfortable Retirement Standard as at March 2018 is $42,764 per year for a single and $60,264 per year for a couple. We have assumed 0.5% annual investment fees, the retirees are homeowners and a balanced (50% equity/50% bond) portfolio. The model incorporates the age pension as at 20 March 2018 and only considers financial wealth and therefore does not consider assets that would not be deemed to earn an income (i.e. home contents) or additional income (i.e. employment income) which would shift eligibility. The model treats superannuation and non-superannuation assets as one pool of financial assets and therefore we have assumed that any minimum withdrawals from super that exceed what is needed to meet the ASFA retirement standard are reinvested in a non-super account. A non-homeowner would need to consider rental costs in addition to the Retirement Standards. All values are in real terms. The examples used here are general only and do not consider any personal information. Actual age pension received may differ from that represented by the charts due to a range of legislative and personal factors.

Source: Vanguard, March 2018 VCMM Simulation

IMPORTANT: The projections or other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class in AUD. Results from the model may vary with each use and over time.

As we saw when reviewing longevity, the chance of a 25 or even 30 year retirement is quite high, and although a 20 year retirement might be "average" for someone retiring at 67, the risk of being underprepared is roughly a "coin flip." Rather than leaving things to chance, planning to meet a realistic retirement horizon and have the probability of meeting your objectives that suits your risk tolerance is key. For example, a 67 year old couple might only need $400,000 combined in superannuation to have a 50% chance at meeting the comfortable living standard until age 87, but if they are planning more conservatively, aspiring to have a 95% certainty until age 97, then they would need over $800,000 in superannuation.
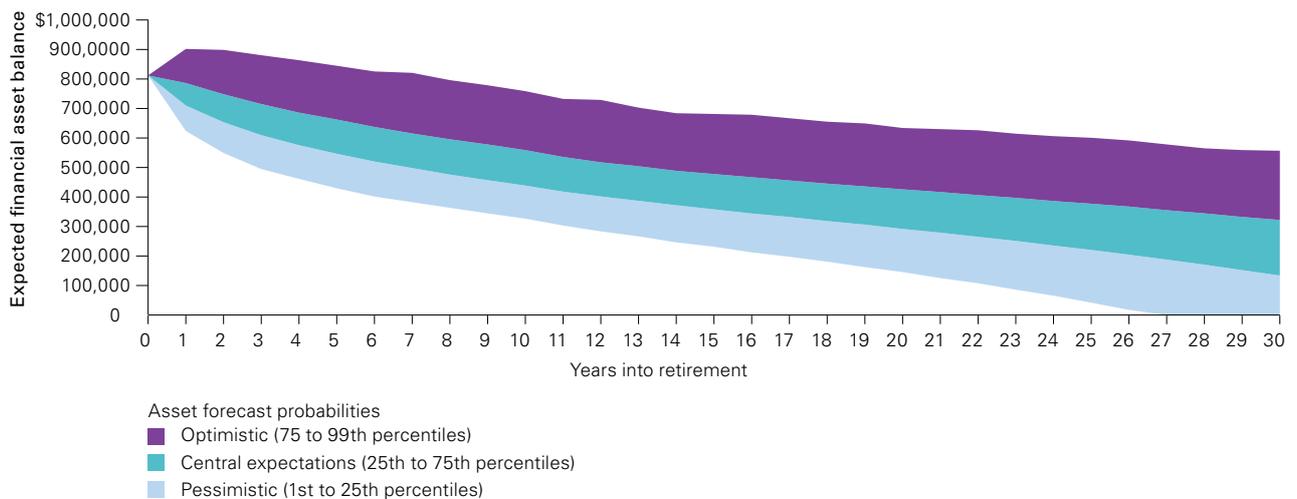
The balance required will, of course, depend on the level of income targeted in retirement. A real income target that differs from the ASFA Comfortable Standard will require a different balance to meet the target for a given

level of certainty. The trade-off between an income target and required balance is not linear, however, because of the means test. An income target that is just above the full age pension will require only a minimal amount of assets since the age pension will fund the majority of retirement spending. A very large income target will need to be supported mainly through financial assets, however, since the balance may exceed age pension upper asset test thresholds until late in retirement.
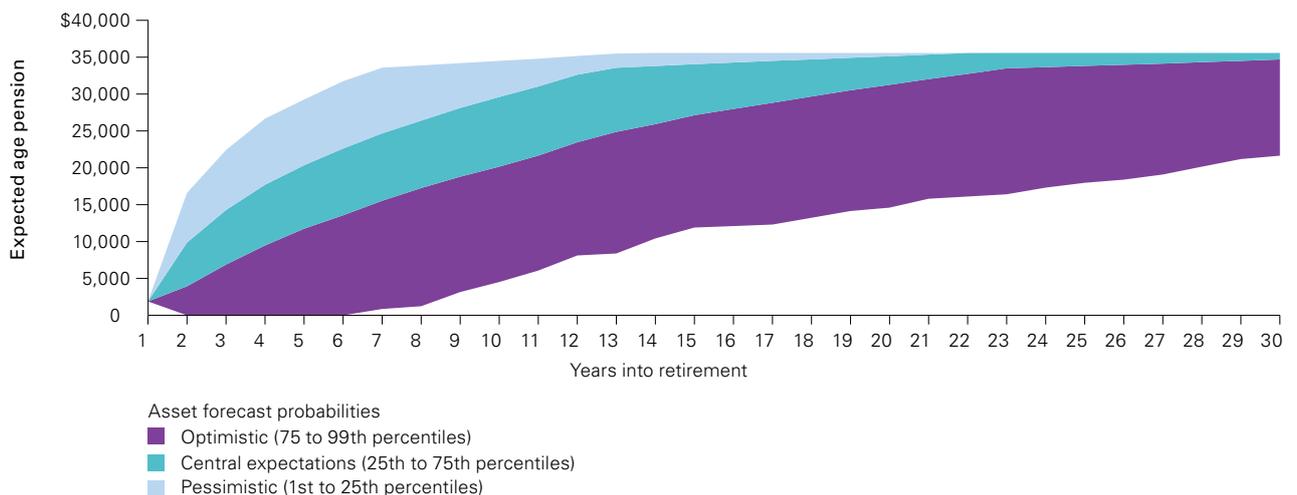
When planning for retirement it also helps to have an idea how one's account balance could change over time. In **Figure 9a**, we look at how our couple with over $812,000 starting retirement at age 67 might fare over a 30 year horizon while spending at the ASFA comfortable retirement standard each year. What we see is by age 97, there is still a roughly 75% chance that they will have

Figure 9a and b: Expected account balance and age pension received for a couple starting with $812,000 at age 67 spending the ASFA Comfortable Retirement Standard for 30 years

a. Expected account balance

Asset forecast probabilities
- Optimistic (75 to 99th percentiles)
- Central expectations (25th to 75th percentiles)
- Pessimistic (1st to 25th percentiles)

b. Expected age pension received

Asset forecast probabilities
- Optimistic (75 to 99th percentiles)
- Central expectations (25th to 75th percentiles)
- Pessimistic (1st to 25th percentiles)

Note: The ASFA Comfortable Retirement Standard as at March 2018 is $42,764 per year for a single and $60,264 per year for a couple. We have assumed 0.5% annual investment fees, the retirees are homeowners and a balanced (50% equity/50% bond) portfolio. The model incorporates the age pension as at 20 March 2018 and only considers financial wealth and therefore does not consider assets that would not be deemed to earn an income (i.e. home contents) or additional income (i.e. employment income) which would shift eligibility. The model treats superannuation and non-superannuation assets as one pool of financial assets and therefore we have assumed that any minimum withdrawals from super that exceed what is needed to meet the ASFA retirement standard are reinvested in a non-super account. A non-homeowner would need to consider rental costs in addition to the Retirement Standards. All values are in real terms. The examples used here are general only and do not consider any personal information. Actual age pension received may differ from that represented by the charts due to a range of legislative and personal factors.

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over $100,000 remaining in superannuation, but there is also the possibility they will have run out of financial assets (i.e. be wholly dependent on the age pension) 2-3 years prior in some of the more pessimistic scenarios.

In **Figure 9b**, we observe how the expected age pension benefit changes over time as well. We can see in scenarios where investment returns are poor (pessimistic scenarios), the age pension benefit rapidly increases to its full value over time. On the other hand, when market returns are strong, it is likely a reduced benefit will be received for most of retirement. In general though, for most retirees as assets are spent down, they can expect their age pension benefit to increase over time.

Another important consideration when planning the wealth needed to meet retirement objectives is cost. In **Figures 8** and **9**, we have assumed an investor is paying 0.50% (50 bps) for investments, but if the same investor were paying 1% (100 bps) to 1.5% (150 bps) in fees, they would need roughly 10% to 20% more in wealth at the start of retirement to have the same probability of meeting their goals. For example, in the case of a homeowner couple planning for a 30 year horizon with 95% probability of success, they would need over $80,000 or $160,000 more respectively in assets at commencement if they are paying the higher fees.

It should be noted that the age pension is subject to change, and this "policy risk" exposes retirees to some uncertainty of their future benefits. For example, the recent taper rate change that tightened the age pension assets test emphasises the possibility of additional adjustments in the future. This encourages retirees to plan to include something of a margin of safety rather than to barely meet their goals with the age pension in its current form. This could be achieved by the retiree targeting a higher asset balance at retirement and/or maintaining a higher contingency reserve to mitigate any negative changes.

At the extreme, single and coupled retirees targeting the ASFA Comfortable Living Standard, would need roughly $400,000 or $700,000, respectively, in additional financial assets beyond those shown in **Figures 8** if they assumed the age pension did not exist. While this scenario is highly unlikely, it reemphasises the value of the age pension and its importance in retirement.

Ultimately retirement planning is about making trade-offs and understanding the full scope of all financial resources and how they integrate together. In the case of the age pension, retirees have a lifetime inflation protected benefit that provides a base level of income support. Understanding the age pension benefits, how other assets impact the income received, particularly through the means testing process, and then using that knowledge to plan for one's retirement goals will help create the best chance for financial security and success in retirement.

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About the Vanguard CapitalMarkets Model

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The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based.

The VCMM is a proprietary financial simulation tool developed and maintained by Vanguard's Investment Strategy Group. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

The primary value of the VCMM is in its application to analyzing potential client portfolios. VCMM asset-class forecasts—comprising distributions of expected returns, volatilities, and correlations—are key to the evaluation of potential downside risks, various risk–return trade-offs, and the diversification benefits of various asset classes. Although central tendencies are generated in any return distribution, Vanguard stresses that focusing on the full range of potential outcomes for the assets considered is the most effective way to use VCMM output.

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Vanguard research authors

Timothy Smart
Nathan Zahm, CFA, FSA

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