Analysing the 2017 Asset Test Changes

Dr Don Hamson – 22nd November 2016

Analysing the 2017 asset test changes:
Why 7.8% p.a. earnings is the new black for pensioners

In the 2015 Federal Budget, changes were announced to the aged pension assets test. These changes have been legislated and come into effect from January 2017. The good news is that more people will be able to access the full pension while some part pensioners will receive slightly higher part pensions – in total 170,000 pensioners will be better off according to the Budget papers. The bad news is that up to 300,000 part pensioners may be worse off due to a doubling of the taper rate.[1]

Table 1 shows both the existing and new maximum asset levels needed to access the full aged pension from January 1, 2017. For a home-owning aged pension couple, for example, they can hold $78,500 more assets to qualify for the full pension from January 2017.

Table 1: ***Changes to the assets test to access full aged pension from January 2017.***

Assets Test for Full Pension	2016 Rules	2017 Rules
Single Homeowner	$209,000	$250,000
Single Non-Homeowner	$360,500	$450,000
Couple Homeowners	$296,500	$375,000
Couple Non-Homeowners	$448,000	$575,000

Source: www.humanservices.gov.au/customer/enablers/assets

Table 2 shows the maximum assets pensioners can own to access a part aged pension. Here the story is quite different, with the amount of assets significantly reduced for all categories of aged pensioners. A home-owning couple will lose access to a partial aged pension if they hold over $816,000, down more than $350,000 from the current rules. Similarly, for a single home-owner the assets test will soon be over $250,000 less than it currently is. The reason for the large declines is due to a change in the so-called taper rate. Currently, the aged pension reduces by $1.50 per fortnight for every $1000 in assets above the full pension assets test amounts in Table 1. From January the taper rate will double to a $3 per fortnight reduction in pension for every additional $1000

[1] http://www.superguide.com.au/smsfs/300000-retired-australians-to-lose-some-or-all-age-pension-entitlements

in assets. Now, $1.50 per fortnight translates into $39 per year for every $1000 in assets, or if you like, an assumed earnings rate of 3.9% p.a. The new $3 per fortnight number equates to $78 per year or an earnings rate of 7.8% p.a. So based on our calculations, the new taper rate therefore assumes pensioner assets earn 7.8% p.a.

Table 2: ***Changes to the assets test to access part aged pension from January 2017.***

Maximum assets test for part pension	2016 rules	2017 rules
Single homeowner	$793,750	$542,500
Single non-homeowner	$945,250	$742,500
Couple homeowners	$1,178,500	$816,000
Couple non-homeowners	$1,330,000	$1,016,000

Source: www.humanservices.gov.au/customer/enablers/assets

In Chart 1 we plot how the fortnightly aged pension declines as one increases the amount of assets a pensioner owns outside of the family home, for home-owner singles and couples. For home-owning singles (couples), pensioners with approximately $300,000 ($450,000) or less in assets will be better off, but above that level pensioners will have reduced part pensions. The reduction in part pensions can be quite large. We estimate that a home-owning couple with $800,000 in other assets currently receives $567.15 per fortnight in part pension and we expect this to fall to just $47.70 per fortnight, a reduction of over $500 per fortnight or $13,500 per annum. Similarly a single home-owner part pensioner with $550,000 in assets will miss out completely on a part pension, losing some $365 per fortnight or nearly $10,000 per annum.

Drawdown assets or make your assets work harder?

So what can pensioners do to offset the pension changes? The government suggested that part pensioners can make up for the loss of income by drawing down on their assets. For instance in the $800,000 couple example, the pension reduction can be offset by drawing down 1.7% of that $800,000 in assets each year. In announcing the changes, the government stated precisely that fact:

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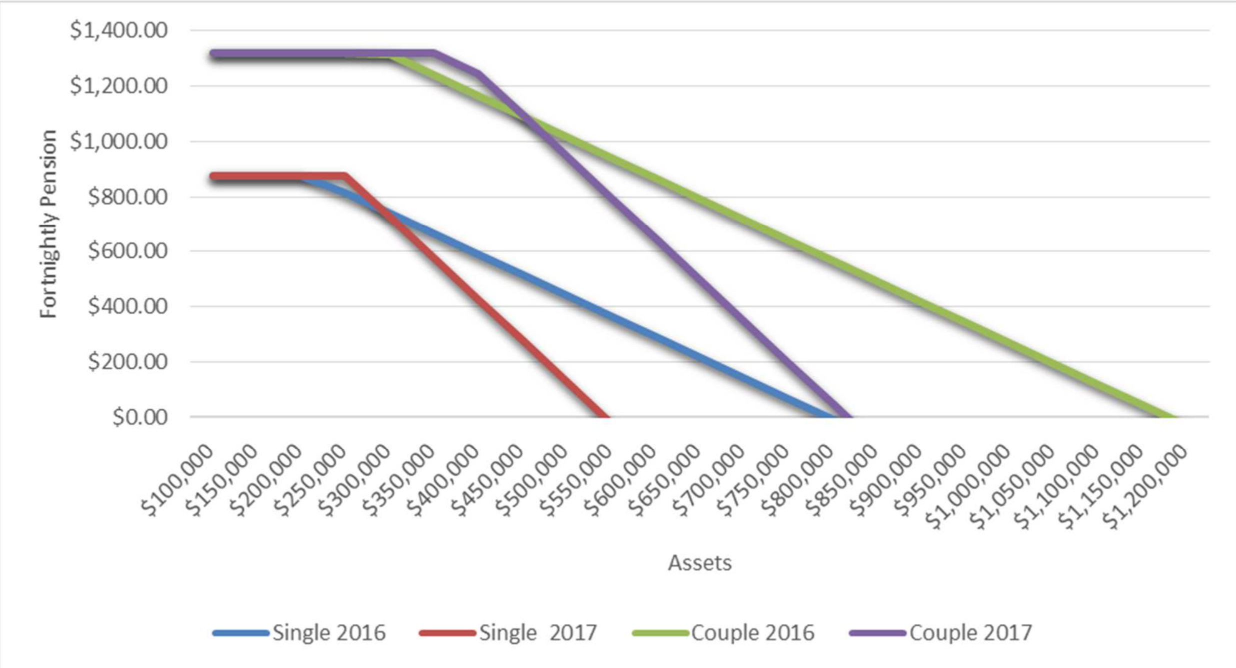
"The changes in the Budget require those pensioners with substantial means to draw on slightly more of their assets to maintain their current income levels in retirement, while the Government continues to support those who need it most. In a worst case scenario, this would mean a 1.8 per cent annual drawdown on their assets."

http://www.budget.gov.au/2015-16/content/overview/html/overview-26.htm

Chart 1. How the fortnightly aged pension falls under the current and new assets test for home-owners.



Source: www.humanservices.gov.au/customer/enablers/assets Plato

Alternatively, if the $800,000 in assets earns 7.8% p.a., then the pensioner can offset the loss in part pension which underlies the $3 taper rate assumption. We think this is a better option, and is more consistent with the way pensioners behave. We believe pensioners don't like to drawdown on their assets, rather they prefer to live off the "income" they receive from pension entitlements and investment earnings. We believe they attempt to preserve assets in an attempt to offset longevity risk. No-one knows how long one will live, but if one draws down too heavily on one's assets, longevity does become a real risk.

The question that must be asked is: is 7.8% p.a. a reasonable earnings rate? Chant West calculate that the average super fund has achieved an annualised return of 8.1% p.a. over the 24 financial years to June 2016[2]. However, the average returns have been lower over the past 10 financial years, with the average Balanced (41-60% growth assets) and Conservative (21-40% growth assets) strategies earning 5.1% p.a. in accumulation mode. For pension funds, Chant West report median Conservative strategies having averaged 6% p.a. over the last 10 years, presumably due to their lower (zero) tax rate.

So we believe 7.8% p.a. can be achieved, but in the current low yield environment with Australian official cash rates currently at 1.5% and 10 year Australian Government Bonds currently yielding less than 3%, we believe it will be difficult to do so, particularly for conservative strategies with large weightings to cash and bonds. Achieving a 7.8% p.a. return in the current environment would likely require investors to take on considerable investment risk by allocating to risky assets which are likely to appreciate in capital terms, such as equities. Thankfully, Australian equities also provide some of the strongest income opportunities available in the world today. For an Australian pension investor who gets a full refund of Australian franking credits, we currently estimate the S&P/ASX200 yields approximately 6% p.a. in income with about a quarter of this due to franking credits. We believe high yield Australian equities can earn even higher rates of income. For instance, we estimate Australian banks currently yield around 8-10% p.a. on a grossed up basis for franking. However, pension investors need to balance risk and return, and so putting all their eggs in the Australian banking sector may not be a wise strategy. We believe pensioners should consider investing at least part of their assets in well-diversified equity products (both Australian and Global) that produce the required 7.8% p.a. return, which should help preserve their capital base.

[2] https://www.chantwest.com.au/resources/super-funds-post-seventh-straight-gain