

*The Pensions Commission report has underscored the need for thoughtful, consensus-based reform of the UK pensions systems*

## The Way Ahead for Pensions...

Here, *Graham Everness* reviews the state of play in pensions reform. As the *Pensions Bill* goes through its final Parliamentary stages, the First Report of Adair Turner's Pensions Commission is a timely reminder of what is missing.

Three years ago, the emphasis was firmly on the need for de-regulation and to make pension provision easy. But things changed – the terrible losses suffered by workers at ASW and elsewhere, politically could not be ignored and the Government also had no option but to comply with the EU Pensions Directive. The focus of the *Pensions Bill* therefore shifted from de-regulation to new regulation. Irrespective of whether or not there were good reasons for this shift, the urgent need for radical simplification remains.

### The blame game

It is fashionable to seek someone to blame for any problem. 'Pensions' is no exception: the current Government, the previous Government, employers, unions, actuaries, accountants and insurance companies are some of those who have been criticised in the past. But two of the biggest reasons why pensioner incomes are increasingly being seen as inadequate are that life expectancy has risen substantially and that real earnings growth has consistently pushed up living standards for those in employment. It is silly to try to attribute 'blame' for either of these! Instead, a new culture of co-operative problem-solving is what is needed.

### Living longer

If current trends continue, the average future lifespan of a 65 year old man will have increased from 12 years in 1950 to 24 years by 2050. You don't have to be a mathematical genius to appreciate that this has a big effect on the cost of providing a pension. A rough guess that the cost would double would only be a slight over-estimate – the increase is probably about 80%.

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### Pensions: a divided nation



*A famous TV sketch re-visited, what our characters might say today....*

**Cleese:** "I look down on them (Barker and Corbett) because I have a public sector index-linked pension related to my salary and service".

**Barker:** "I look up to him (Cleese) because he's got a pension paid by tomorrow's taxpayers come what may, whilst my private sector employer struggles to meet the increasing cost of providing a funded pension. But I look down on him (Corbett) because my pension is much better than his".

**Corbett:** "I look up to him (Cleese) because he's got what I'll never 'ave. I look up to him (Barker) less 'cos his pension is a bit like mine – it could go down if shares and other things fall – but it's still better than my 'stake-burger' plan".

*Extract from 'Occupational Pensions: a divided nation' published by the ACA, May 2004 (see page 8)*

Inevitably, therefore, the average age at which pensions start to be paid must increase. Employers' preferences to replace older workers with younger ones and employees' (and their unions') aspirations of an early escape from the workplace must both be set aside, with everyone working together for change so that the employment of older people becomes mutually beneficial.

### Rebalancing consumption

But, as the Pensions Commission report says, an increase in retirement ages is unlikely to be sufficient on its own. Through savings or taxation, there needs to be a transfer of wealth from working life to later life, a re-balancing of consumption whilst in employment with consumption when retired.

If the working population systematically saved rather than spent their 'real' salary increases (i.e. the excess over price inflation) this would not only generate substantial sums for retirement income but would also help counteract one of the current drivers of relative pensioner poverty – that workers' income naturally tends to rise with earnings whilst that of pensioners is more likely to rise at a lower rate in line with prices. Of course this means that workers' standards of living will rise more slowly, but this is merely a reflection of the fact that an increase in the length of retirement relative to the length of working life must result in the 'jam' from that working life being spread more thinly.

### Encouraging saving

How can the balance of consumption between working life and retirement be changed? The options are higher taxation, more compulsory saving, and increased voluntary saving. The third of these is inherently preferable in a 'free' society, if it can be made to work.

This is where the continuing urgent need for radical simplification of the pension saving system comes in. The new protection measures in the *Pensions Bill* may well be thought to be important to bolster individuals' faith in saving, but without 'radical simplification' the opportunities for exercising any such newly-discovered faith will be sadly reduced, as employers continue the recent trend of scaling down their pension provision.

What simplification do we need? It needs to start with the State pension system. The State Second Pension (formerly SERPS) is unnecessarily complicated and, given the original intention to make it flat-rate in early course, it should be merged with the Basic State Pension to create one State-provided benefit at the minimum level considered adequate for a pensioner to live on.

The end of S2P/SERPS should be accompanied by an end to contracting-out. The concept of contracting-out may have been a reasonable one in 1978 but it lies behind a lot of the complexity that now burdens private pensions. Probably the main reason why many occupational schemes remain contracted-out is that to contract back in would require substantial scheme re-design; but scheme design is now likely to be widely reconsidered in light of the new Inland Revenue pensions taxation regime from April 2006, making this a particularly good time for the DWP to discontinue contracting-out and to make it generally much easier for employers to offer something other than a standard money purchase scheme.

### Opening up the middle ground

Final salary schemes are very expensive and the disproportionate compliance burden placed on them by the legislation further discourages employers from offering them. The limited simplification measures included in the *Pensions Bill* do not make a significant improvement here. Neither do they address the problem that the legislation is based on a simple 'final salary or money purchase' assumption and does not facilitate so-called 'middle ground' solutions where risks are much more evenly shared between employee and employer. Such schemes are increasingly being viewed as a sensible way forward and the DWP legislation urgently needs to follow the Finance Act changes in accommodating them better.

### A final consideration

There's one final suggestion I'd like to make. There is one other option that has not been widely considered, probably because, at first glance, it seems unpalatable. I am not proposing that it is adopted, without careful consideration of the consequences but the option should be given an airing.

Final salary pensions earned to date have, in many cases, ended up costing a great deal more than envisaged when the 'promise' was made. Disregarding investment returns, which have sometimes been good and sometimes bad, this is largely the result of benefit improvements imposed by successive Governments and of the big rise in life expectancy. It is often argued that some employers (although not all) took the benefit of contribution holidays when times were good and cannot complain when the tide turns, but can a case not be made for allowing schemes some scope to reduce accrued benefits to offset part of the unanticipated extra cost? The idea of permitting promises to be scaled down may not sound appealing, but the Pension Protection Fund is being set up with a facility to do this.



*Graham Everness is a member of the ACA Pension Schemes Committee*

# We Should Encourage 'Affordable' Defined Benefit Pension Schemes

**Here, *Adrian Waddingham*, Chairman of the Association of Consulting Actuaries (ACA), calls upon government and employers to jointly support the concept of 'affordable' lower-cost defined benefit (salary related) pension arrangements as a key part of the solution to the mounting crisis in UK pension provision.**

The Pensions Bill has lost its way. The original intention, when the government started its consultation process, was to simplify occupational pensions, so that more employers and employees would be keen to offer and join such schemes. These good intentions have been almost entirely lost in legislation that concentrates on adding protection.

## **An agenda for reform**

So what would the ACA have the government do? We certainly oppose further compulsion. Occupational pension schemes work best when employers want to set them up. A pension scheme that an employer has been forced to set up or which he is 'required' to join members to is likely to be modest, at best.

We are appealing as loudly as anyone – indeed alongside almost everyone aside from the Chancellor – for reform of state pensions. We believe that society should commit to a better state pension by raising state pension age. A higher pension age is a worthwhile trade for a better state pension. Making pensions – public and private – affordable is the only way we will get them back.

The state increased the pension age for women to 65, albeit with plenty of warning. That was a good move. But why cannot a company pension scheme do the same to bring costs under control? It is not the employer's fault that we are all living longer – increasing retirement age by say 2 or 3 years but with at least 15 years' prior notice would be as sensible in the private sector as it was for government and should be allowable.

Higher means tested benefits for pensioners may have helped address a short-term problem, but it has and will destroy the savings ethic. Pensioners should share in the

growing wealth of society and not be beneficiaries of the state's charity.

We need to save more and work longer. Before the legislators introduced Limited Price Indexation, revaluation of deferred pensions, spouse's pensions and before better social conditions helped improve life-spans, willing

employers across the nation doubled-up on employee pension contributions – the employee paid 5% of earnings and the employer 10%. To achieve the same pension result now means employers must pay around 20% or 25% to match the employee's 5% and, not surprisingly, that has become unacceptable in a highly competitive world where overall costs have to be kept down. It is no good wishing this were not the case and designing all sorts of regulations to protect the status-quo – times have changed and pension arrangements must keep pace with the changes in society and economics.

It is not beyond the wit of actuaries to design good schemes on the two to one model. The key is the pensionable age. If we can start planning now for schemes that will deliver benefits at, say, 70 we can once again afford good workplace-based schemes. We do not need a retirement age of 70 tomorrow. Even going for 68 in twenty years' time would help enormously.

I believe defined benefits served Britain well and can do so in the future. Employees and their employers continue to value the greater certainty in benefits that the vast majority of these schemes still provide. Employers should be positively encouraged to provide affordable defined benefit schemes.



***Adrian Waddingham***

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Could a 5% employee and 10% employer scheme provide worthwhile benefits? For example, this could fund a 1% of career-average salary per year of service payable at 68 (moving to 70 over time) with partners' benefits of 60% and discretionary pension increases. And add in a tax-free lump sum, designed for a particular purpose. The lump sum could be say 5% for each year of service and payable at 65 not 68. This would then give retirees some financial support from 65 to 68 if they are in fact no longer at work.

And add in a new government incentive, reflecting government's commitment to good schemes - a 1% reduction in employer NI for those employers offering such a model scheme (and those continuing to operate similar schemes). Over the longer-term, I suspect that this will cost a lot less than an ever-increasing number of pensioners dependant on means-tested benefits and all the indignities and bureaucracies associated with such a policy.

Such new "two to one" schemes would probably best sit on top of improved state benefits. Contracting-out currently holds few attractions to those setting up new schemes - the rebate terms are just not good enough. How pleased both we and government would be if as a result a significant proportion of the workforce retired on the higher state pension, and a work pension of say 30% of earnings.

*This article is based on Adrian Waddingham's speech to the 2004 ACA Annual Dinner.*

# PENSIONS C

The Pensions Commission published its first report on 12 October 2004. It has invited comments on a number of areas within its report by 31 January 2005. Its next report, probably in the Autumn of 2005, will make recommendations on what actions the government should take to resolve the problems in pension provision it has identified.

## Remit of Pensions Commission

To keep under review the adequacy of private pension saving in the UK, and to advise on appropriate policy changes, including whether there is a need to 'move beyond the voluntary approach'. The focus of the Commission is not on the short-term, but the need to ensure a sound pension system looking forward over the next several decades.

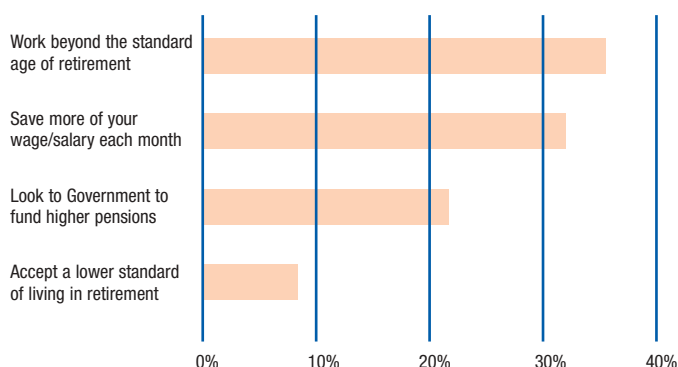
## Purpose of initial report

To stimulate debate and to ensure that the debate is fact-based and well-structured. In presenting policy options in response to the problems found with pension provision, the Pensions Commission is at pains to make clear that no final recommendations have as yet been arrived at. Hence, pros and cons of policy options are explored.

## Time to reflect

The Commission favours a debate ahead of new policies being decided. It stresses that the choices will be difficult and stresses the need for 'consensus across parties... which can be sustained across parliaments and governments'.

## Preferred Responses to the Demographic Challenge



Source: Pensions and Saving Index, Survey 1 (Sept 2003) by You Gov for the ABI

Note: Response to the question "Most people can expect to live longer and spend more time in retirement than their parents and grandparents. Bearing this in mind, and if you had to choose one of the following options which are you personally most likely to do?"

Base: working age population. Excludes those who answered "don't know".

[ Extract from: Pensions Commission Report, October 2004 ]

## Key conclusions

- **Demographic changes:** Combined with a reducing birth rate (which fell below replacement rate in the early 1970s), life expectancy is improving at a faster rate than was envisaged even only a few years ago. The percentage of the population over pensionable age will increase from 18% today to 25% by 2040. The next 50 years will see a rapid change in the dependency ratio. At present there are three people of working age for everyone over age 65. By 2050, the figure reduces to one and a half. Faced with this ageing population, the Pensions Commission says society and individuals must choose between four options:

- pensioners will become poorer relative to the rest of society, or
- taxes / NI contributions devoted to pensions must rise, or

# COMMISSION: A Summary

- savings must rise, or
- average retirement ages must rise.

As the first option ‘appears unattractive’, and there would be significant problems in relying upon one of the solutions alone (for instance raising the average age of retirement to age 70), the Pensions Commission says ‘some mix of higher taxes / NI contributions, higher savings and later average retirement is required’. Whichever option is chosen, the country will need to find £57 billion a year by 2050 for pensioners to just maintain their living standards. If nothing is done, pensioners will be 30% poorer in relation to average earnings by 2035.

As well as living longer, we are retiring earlier. Whereas in 1950 the average man retired at age 67 and lived 11 years in retirement (although far fewer reached retirement age), he now retires at age 63 and lives 20 years in retirement. The Pensions Commission describes this trend as ‘unsustainable’.

- **The UK pensions system - position and trends:** the report says the UK system appeared to work well in the past ‘because one of the least generous state pension systems in the developed world was complemented by the most developed system of voluntary private funded pensions’. However, the Commission found that the private system is now in ‘significant decline’ and is ‘not developing to offset the state’s retreating role’.

The Report says that the trend in private sector employer pension contributions have been downwards since the 1980s. As the ‘fool’s paradise’ of irrational equity markets and delayed appreciation of life expectancy increases came to an end, defined benefit schemes have closed to new members, replaced by less generous defined contribution schemes. The underlying level of pension funding is falling rather than rising.

- **Looking forward – pension adequacy if trends unchanged:** if present trends continue, many people will face inadequate pensions in retirement. The Commission estimates that 9 to 12 million people may be under-saving for retirement including 75% of defined contribution scheme members. Most public sector workers and senior executives are in a much better position.
- **Non-pension savings and housing:** only a minority of people will receive enough of a contribution from non-pension financial assets to make significant difference to their retirement income. Home ownership does not

provide a sufficient solution to the problem of pension provision given uncertainty over future house prices and other claims on this such as long-term care.

- **Barriers to a voluntarist solution:** behavioural barriers to savings and the costs of provision (particularly for low earners) have been made worse by the bewildering complexity of the UK pension system, state and private combined. The Commission says, ‘means-testing within the state system both increases complexity and reduces, in some cases reverses, the incentives to save via pensions which the tax system creates. The scope of this means-testing would grow over time if current indexation approaches were continued indefinitely’.

- **Revitalised voluntarism, changes to the state system, or increased compulsion?**

To achieve pension adequacy, the Pensions Commission says there are three possible ways forward:

- a major revitalisation of the voluntary system and / or;
- significant changes to the state system; and / or
- an increased level of compulsory private pension saving beyond that already implicit within the UK system.

*‘Analysis of these issues (above)... will be the key focus of the Pensions Commission between now and the publication of the Second Report in Autumn 2005’.*

- **Women and pensions:** women pensioners are significantly poorer than men. ‘An effective pension system for the future must be one in which the vast majority of women accrue pension entitlements, both state and private, in their own right’.
- **Issues and consultation:** The Pensions Commission wants views from interested and informed parties by 31st January 2005 that separately and explicitly identify:
  - any factual errors or relevant information that has been overlooked.
  - whether judgements of future trends are over-optimistic or over-pessimistic.
  - What organisations / individuals believe should be the appropriate responsibility of the state in ensuring adequate pension provision.

Other matters for consultation are also raised in Chapter 9 of the report – see pages 283 – 286 of *Pensions: Challenges and Choices* which can be found at [www.pensionscommission.org.uk](http://www.pensionscommission.org.uk)

# A simpler way to better pensions?



*Alan Pickering*

**This article is based on a talk given by *Alan Pickering* to the House of Commons All-Party Group on Occupational Pension Schemes.**

There are those who question the involvement of politicians in the development of UK pensions policy. I would argue that, pensions and politics are inextricably linked since they each deal with the allocation of scarce resources between conflicting priorities. It is essential that politicians take part in the debate about the allocation of resources within generations and between generations.

I do, however, have two criticisms of political involvement in the UK private pension scene. First, politicians insist on micro-managing the private pension system. If they wanted to do that, why did they go into politics and not into pensions? Secondly, UK pension policy is event driven rather than vision driven. Politicians use the rear view mirror and not the windscreen to determine how to drive policy forward. The previous Conservative Government had its Maxwell while this administration had ASW and Maersk. Maxwell, in some ways, came as a relief since the incumbent Government was under pressure to take a long look at the future of pensions at a time when we were enjoying something of a golden age. Responding to Maxwell allowed them to heed the cry “somebody must do something about it”.

The present Government came to office with a bit of a futuristic vision and subsequently came to the conclusion that the vision was right but its fulfilment was being hindered by the complexity of the system. Rather than revisit the merits of the system, therefore, the Government embarked upon a simplification strategy. Along came ASW and Maersk so that increased security overtook simplicity at the top of the political agenda. Traumatic though these events were for those directly involved, one has to question the extent to which they should form the basis upon which our future infrastructure is built. It is assumed that everyone will either do an ASW or a Maersk. In the event, even Maersk did not do a Maersk.

## **My vision**

Having criticised others for a lack of vision, it is incumbent upon me to set out my vision of the future. Having done so, it is possible to comment on the extent to which Government policy will get us from where we are now to where we ought to be in the second or third decade of this century. Three elements make up my vision.

First is a labour market which allows folk of all ages and abilities to earn an income from employment. Increased saving alone is not an adequate response to the demographic challenge. Such a challenge has an impact on the way we save but also on the way we work.

Hitherto, learning, earning and retirement have been compartmentalised. In future, lifelong learning should give rise to lifelong earning. Older workers should not be pensioned off in their prime. They should be able to mix and match work and retirement, pay and pension in ways that suit them best

Second, the state should be a proud pension provider and not an income source of last resort. I am willing to trade a higher state pension age for a much bigger state pension. The state is far better placed than is the private sector to provide a guarantee against absolute poverty in old age. The state should not be providing a retirement pension but an old age pension. The definition of “old” should have more to do with expected date of death than actual date of birth.

Thirdly, there will be a vibrant and very lightly regulated market for private pensions of all forms. No longer should there be a division between traditional second and third pillar pensions. The workplace should be the marketplace for pensions and financial products of all types. Employers and employees should determine how to allocate risk. Employers too should be willing to offer access to financial advice so that workers can determine how best to navigate around the free market for savings and protection products.

The prospect of a lightly regulated market for pensions, both defined benefit and defined contribution, should be increased once the state has accepted the responsibility for providing a guarantee against absolute poverty. One of the reasons for the interference of politicians in private pensions today is their belief that these pensions are actually providing welfare rather than an employee benefit or a commercial product. Privatising welfare and imposing benefit designs on the private sector means that this sector operates sub-optimally.

## How does the Government score?

So far as labour market modernisation is concerned, the Government scores very highly. Its employability programmes are already focusing on the employment needs of disabled people and older workers. While each of these groups is able to punch their weight in appropriate employment circumstances, some nudging from officialdom is required if old habits and mindsets are to be challenged.

It is rather strange to see captains of industry urging British workers to be flexible except when it comes to retirement age. It is for the Government to determine the age at which we qualify for our taxpayer-financed old age pension, it is for employers and employees to determine when we retire from a particular relationship. Such a retirement need not be the end of our working career. While advancing years may prevent us from doing one job, they do not prevent us from doing any job.

Any management worthy of that name should be capable of helping workers transition from one job to another. I do not accept that massive sophistication is required to facilitate a regular dialogue between employer and employee as to the relative merits of continuing in employment or calling it a day. One captain of industry suggested that what an older worker wants is a clock and not employment counselling. This gives a whole new meaning to the concept of clocking off. It is this attitude which should be retired and not productive older workers.

The Government does not score quite so highly on modernising the state pension. Contracting out may go by default and this might be by design as well if the Government is deliberately using parsimonious rebates to get rid of one aspect of complexity within the system. Hopefully, they will, before too long, acknowledge that we need one state pension and not two and that this state pension should eventually be way above the current level of the basic state pension which falls £25 per week short of what Parliament determines an individual needs to survive.

Even the increased element of flexibility which is being introduced into the state pension system adds complexity. History might say that the Government's decision to enhance the bonus for deferring a state pension was one of the more significant elements within the *Pensions Bill*. However, it would have been far better had the Government announced that there would be a progressive increase in both the level and starting date of a single universal state pension. If they wanted to have a two-tier pension, they could offer one level at seventy and another at eighty thereby making it easier for the private sector to deal with the longevity risk. Female state pension age will be

increased between 2010 and 2020. We should simply roll the process forward for men and women during the 2020 decade.

So far as the market for private pensions is concerned, there is good news and bad. The amendments to the *Financial Services and Markets Act* as they are emerging seem generally welcome. There is recognition that making a profit from selling financial services is acceptable and that employers should be able to play a more important role in bringing workers face to face with market-based products. The Inland Revenue's changes are beyond any of our wildest dreams in terms of radicalism. From now on, most people will be able to save what they want when they want and how they want through a pension scheme. Sadly, the social policy measures contained within the *Pensions Bill* are much less emancipating.

## Three themes

In "A Simpler Way to Better Pensions" three themes were identified. To what extent are these three themes emerging in the *Pensions Bill*?

The first theme called for a new Pensions Act to be policed by a new kind of regulator. Sadly, we have an old kind of *Pensions Bill* with a vengeance. It is lengthy, opaque and littered with regulation-making powers. Not at all like the principle-based enabling piece of legislation for which I had hoped. So far as the Regulator is concerned, things are a little brighter. All the noises coming out of Brighton suggest that there is a desire to operate in a risk-based proportionate fashion. Hopefully the powers that be and the media will allow the Regulator to operate in this way. There is no such thing as a risk-free pension and absolute security is not only absolutely unaffordable, it is absolutely undeliverable.

The second mantra was that "a pension is a pension is a pension". The Inland Revenue has developed this theme with alacrity. Sadly, the DWP continues to differentiate unhelpfully between those schemes where all of the risks are transferred to the employee and those where the employer is prepared to take part in risk sharing. The going remains disproportionately tough for the latter – surely a disincentive to further risk sharing?

Finally, we identified the heavenly twins of "more pension, less prescription". Sadly, it looks though more prescription will inevitably lead to less pension. We are in danger of providing more and more security for fewer and fewer people.

Is the *Pensions Bill* a simpler way to better pensions? Sadly, I think that the answer is "no" on both counts.

# Occupational Pensions: a divided nation

The ACA's May 2004 report *Occupational Pensions: a divided nation* examines trends in smaller firms with fewer than 250 employees. The report, based on 459 responses, supports much of what appears in the Pensions Commission Report with its main conclusions being:

- **The survey found a very high level of scheme reviews.** Within a period of 2 years, over 9 out of 10 firms will have reviewed their pension arrangements, the most marked trend being the closure of defined benefit schemes to new entrants, or one or more schemes being placed in wind up.
- **Where defined benefit schemes are offered in smaller firms (29 per cent), only 36 per cent are now open to new members. Combined employer and employee contributions into defined benefit schemes now average 21 per cent of earnings, up 2.1 per cent on a year ago.**
- **Three-quarters of defined benefit schemes have been recommended to increase their contributions by their actuary because the scheme is in deficit and over one-third have increased employee contributions, mostly by around 1 per cent of earnings.** Around 1 in 10 schemes have changed their accrual rate, with a move from 60ths to 80ths being the most common.
- **The 'contribution gap' – the difference between the combined employer and employee contribution into defined benefit and defined contribution schemes – has grown over the last 3 years since the last ACA survey of the sector in 2001.** Employer contributions into defined benefit schemes now average close to three times those made by firms into defined contribution and GPP schemes, and six times those into Stakeholder schemes.
- **Group Personal Pensions (GPPs) – attracting average combined employer and employee pension contributions of 8.6 per cent – are now the prevalent type of pension arrangement in these smaller firms.** 44 per cent of firms offer such arrangements, with 25 per cent only offering a GPP.

- **There is considerable interest, particularly from firms not offering pension schemes (42 per cent), in multi-employer schemes.**
- **Many firms have also established stakeholder schemes (37 per cent) either alongside other arrangements or as stand alone schemes, 44 per cent of which are attracting no employer contribution.** Average combined employer and employee contributions are just 4.8 per cent of earnings into these schemes.

## Pensions Bill: little enthusiasm

- **Following the publication of the *Pensions Bill* a majority of firms (51 per cent) feel its measures will decrease occupational pension scheme coverage. Fewer than 1 in 10 firms feel the measures will improve coverage.**
- **Close to 9 out of 10 firms say the Bill's measures will either add to costs (49 per cent) or make no difference (38 per cent) as against the Government's claims that there will be £130 million savings.**
- **Support for the Pension Protection Fund has grown to 8 out of 10 firms. However, support will be judged by the per head levy that schemes are charged to fund the scheme.** 64 per cent of schemes say that a cost of £15 per defined benefit scheme member would be 'too much', with not far short of a half saying even £10 per head is too much.

Copies of the report are available FREE OF CHARGE from the ACA contact address (see panel below) or the report can be accessed at [www.aca.org.uk](http://www.aca.org.uk) (see 'What's New', 19 May 2004)

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