National Audit Office

REPORT

Financial services regulation: Adapting to change

Financial Conduct Authority

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Financial services regulation: Adapting to change

Financial Conduct Authority

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

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Key facts

50,000	June 2023	16%
approximate number of firms regulated by the Financial Conduct Authority (FCA)	the Financial Services and Markets Bill receives Royal Assent	increase in overall staff numbers between August 2020 and August 2023

The financial services sector is essential to the UK's economic growth:

£173.6 billion estimated gross value added by the financial services industry to the UK economy in 2021

July 2021 the date government announced its vision for an open, green and technologically advanced financial services sector that acts in the interest of consumers

There are big changes happening within the sector:

10 files of retained EU law that the FCA has set out it is currently working to replace as at October 2023

1,400 cases related to unregulated crypto-asset activity that the FCA has dealt with between January 2020 and June 2023

The FCA has started to take action in response:

£317 million spent on the FCA's change programme from 2020-21 to 2022-23

March 2025 the date by which the FCA plans to have reduced key data risks from red to amber rating

104 metrics used by the FCA within its public performance reporting

Summary

Introduction

1 The financial services industry was worth an estimated £173.6 billion to the UK economy in 2021.[1] Financial services include banking, insurance and investment fund management, and the sector has an impact on other businesses and individuals who use the services it offers. The Financial Conduct Authority (the FCA) regulates financial services firms and financial markets in the UK. The FCA regulates nearly 50,000 firms, from large banking corporations down to individual financial advisers. It does not regulate all financial activity – for example, buy-now pay-later lending arrangements or many transactions involving crypto-assets.[2] It also does not regulate all aspects of the financial services industry – for example, stability of the financial system as a whole.

2 Following the UK's exit from the EU, HM Treasury (HMT) and the FCA have more freedom in the design and operation of the financial services regulatory framework, in terms of tailoring it to the UK market. The Financial Services and Markets Act 2023 (FSMA 2023) gave the FCA more responsibility to develop regulation and also a new secondary objective to facilitate the international competitiveness and growth of the UK economy. The financial services sector is also undergoing significant changes: whole new sets of products, such as crypto-assets, and rapid advances in technology, such as AI, provide opportunities for innovation but also risks to businesses and consumers which the FCA must plan for.

Scope of the report

3 This study examines how well placed the FCA is to respond to the changes that the financial services sector is undergoing, and to support government's ambitions for the sector. Our evaluation is based on our published good-practice principles of effective regulation and criteria for performance measurement by regulators. We have identified and focused on the key processes and enablers for managing change and this approach is supported by insight from previous work on regulators facing change.

1 In terms of Gross Value Added (GVA). GVA is similar to GDP but used to measure the contribution of part of the economy, such as an industry. It is the contribution of part of the economy, minus any costs incurred in production.

2 Crypto-assets are a digital representation of value or rights that can be transferred, stored or traded via a secure electronic system.

4 This report examines how the FCA is responding to changes in its regulatory powers and remit, and wider developments in the financial services sector. It sets out:

- the changes to the financial services landscape, what this means for the FCA's accountability and strategy, and how it is changing in response (Part One);
- whether the FCA has the tools and resources it needs to identify and respond to change, and to influence future innovation and change (Part Two); and
- how the FCA measures, reports and learns from its performance (Part Three).

5 As this report is focused on how the FCA is responding to changes in the market and to its remit, it does not seek to establish the overall effectiveness of the FCA's business-as-usual work, nor does it review how the FCA has managed individual regulatory decisions or cases.

Key findings

Changes to the financial services regulatory framework

6 The FCA recognised that it needed to change its approach, both because of changes in its remit as a result of the UK's departure from the EU and following a number of high-profile regulatory failures. In 2019, HMT started the Future Regulatory Framework review, working with the FCA and others to develop and take forward a new financial services framework, after EU Exit. The Treasury Select Committee and others have examined the FCA's regulation in the case of specific high-profile failures in the financial services sector. The FCA has acted on recommendations calling for operational changes but in recent years has still fallen below its service targets, including statutory targets for processing authorisations in a timely manner. In December 2022 HMT wrote to the FCA stating that the FCA's operational effectiveness was "a key priority" for HMT as well as the FCA (paragraphs 1.7 to 1.11).

7 In 2020-21 the FCA launched a transformation programme to bring about the operational changes it needed to make to improve its performance. In 2020, the FCA announced its transformation programme would make broad changes including structural changes, new senior management roles for key areas of responsibility, and actions aimed at delivering behavioural and cultural change. It has increased overall staffing by 16% from August 2020 to August 2023. The FCA is funded by a levy on financial services firms, and it has levied an additional £35 million from businesses over the period 2020-21 to 2023-24 specifically for its transformation programme. The FCA has extended its transformation work outside the original core plan, with work on areas including enforcement and improving operational data continuing into 2023-24 and beyond (paragraphs 1.12 to 1.16).

8 **New arrangements under FSMA 2023 give the FCA more direct power to regulate the financial services sector and make it more directly accountable to Parliament.** The FCA has responsibility for making new regulations to replace retained EU law revoked under FSMA 2023. The FCA's rule-making power comes under more direct parliamentary scrutiny, as it is required to notify Parliament when consulting on changes and respond to its feedback. HMT has oversight via powers to direct the FCA to make rules and being able to call for an independent review of existing individual rules. Under FSMA 2023 the FCA is required to set up additional mechanisms for independent accountability, such as a framework for monitoring and reviewing rules (see paragraph 18 below) and an independent statutory Cost-Benefit Analysis panel to scrutinise analysis underpinning regulatory decision making, which it told us it expects to have in place in 2024 (paragraphs 1.17 to 1.23).

9 **The FCA expects that its work to support the statutory changes will take years to complete.** The FCA published a multi-year strategy for the first time in April 2022, covering 2022–2025 and setting out its ambition to focus on outcomes rather than processes. The FCA is working to embed its new secondary objective within its existing work, and has delivered internal training, guidance and support to staff. It expects to have updated more than 40 key documents to reflect the new objective alongside development of its next strategy by April 2025, and is prioritising public-facing documents. The FCA has worked with HMT to develop a plan to make significant progress on repealing and replacing retained EU law in priority areas by the end of 2023. It is currently planning how it will manage the remaining retained EU law; however, this requires ongoing coordination with HMT, which is yet to formally set a timeline for completion (paragraphs 1.24 to 1.28).

How the FCA identifies and responds to change

10 **Since 2019, the FCA has become more transparent about what it does and does not regulate.** The FCA does not automatically regulate all financial services activities, and what it does regulate is defined in legislation. This means that government decides what new activities should be brought into the scope of regulation with input and advice from the FCA. Making changes to what the FCA regulates therefore takes time and requires action from HMT as well as the FCA. The FCA describes the limit of its remit as a "regulatory perimeter". New activities can sit outside the FCA's regulatory perimeter, which limits its ability to take action where it identifies an issue. In 2019 the FCA began publishing a report that describes what it does and does not regulate. It also sets out the FCA's work with HMT and other key stakeholders to address the issues it has identified (paragraphs 2.4 to 2.10).

11 **There can be a significant delay between the FCA identifying an issue to tackle, and it taking regulatory action.** In some cases, the FCA requires additional powers to act – for example, legislation must be approved by Parliament before the FCA can impose conduct standards on buy-now pay-later credit providers. Even where the FCA does have power to act, moving to enforcement can take time. While the FCA has required crypto-asset firms to comply with anti-money laundering regulations since January 2020, and began supervision work including engaging with unregistered firms, it did not begin taking enforcement action against illegal operators of crypto ATMs until February 2023 (paragraph 2.11).

12 **The FCA is making substantial changes to how it manages data to identify risk, but it expects that work to address this will take years to complete.** The FCA published a five-year data strategy in 2020 to support its ambition to be smarter in the way it uses data and analytics in its regulation. It has set up new processes for storing data and has piloted tools that combine different data sources to identify risks early. However, the FCA has identified significant risks regarding the management of its data, which will not be mitigated before 2025. It is still working on collating identified data risks across the organisation to be able to manage them consistently (paragraphs 2.12 to 2.14).

13 **The FCA has experienced high staff turnover, including at senior levels, in recent years. While turnover for the FCA as a whole has now fallen, delivery risks remain high in some specialist areas.** The FCA has recruited to meet overall turnover rates of more than 17% in each of the past two years, alongside its overall increase in staffing, requiring it to recruit and train more than 2,000 new members of staff. Seven out of 11 senior officials have joined the FCA since September 2020, and the executive team includes three new roles. In May 2023 the FCA cited staff resourcing as a risk in achieving priority commitments such as reducing and preventing financial crime and preparing financial services for the future. While voluntary turnover for the FCA as a whole has come back down to pre-COVID-19 pandemic levels, it remains high in some specific areas, and the FCA is aware it needs to maintain specialist skills to avoid causing delays in its work – for example, a shortage of crypto skills meant the FCA took longer than planned to register crypto-asset firms under money laundering regulations (paragraphs 2.15 to 2.20).

14 **The FCA recognises the importance of its international engagement work and is developing structures to strategically manage this.** Being able to influence international developments will be of increasing importance to the FCA in delivering its new secondary growth and competitiveness objective. The FCA has established a new international steering committee to provide cross-organisational oversight and support, which it recognised was lacking for the FCA's international engagement. The FCA works with other organisations to collaborate on common issues – both across the whole economy (for example, taking part in the Digital Regulation Cooperation Forum to consider, among other things, cross-sector support for firms with AI business models) and in the financial services sector (paragraphs 2.21 to 2.25).

15 **The FCA has well-developed tools to enable it to regulate innovations in financial services markets.** The FCA has set up processes to support firms who are developing innovative business models. In 2016 it set up a 'regulatory sandbox' to allow firms to test innovative products, services, business models and delivery mechanisms. It has also expanded its support into digital tools and more general support. At the end of 2022, the FCA reported that it has supported 867 firms via the regulatory sandbox, including firms from across the UK and internationally. In 2019, the FCA found that applications from firms which had used the sandbox were processed in around 60% of the time for standard applicants. The FCA continues to develop its innovation tools and review the effectiveness of specific programmes (paragraphs 2.26 to 2.29).

How the FCA measures, reports and learns from its performance

16 **The FCA's current public reporting is complex and makes it difficult for stakeholders, including HMT, to judge its performance.** In 2022, the FCA developed multiple sets of outcomes it wants to achieve and began reporting on its performance against them. We found that, beyond setting out the direction it expects metrics to move, the FCA has not set out what levels of performance it expects to achieve either overall or for individual metrics. This means that HMT and other stakeholders do not have the clarity necessary to judge whether the FCA is on track or not. The FCA is planning further metrics and reporting in the future, for example on progress against its new secondary objective (paragraphs 3.3 to 3.8).

17 **The FCA currently reports many different indicators to its senior management team but it is working to simplify this and make the reporting more useable.** In 2020, the FCA set up new processes for operational performance reporting designed to improve the consistency of internal reporting and reduce the time taken to produce them. In August 2022, the FCA also began reporting 49 indicators to its senior management showing progress on its strategy. The information on operational performance and strategy progress is provided together to senior management, but as a result they are monitoring a large volume of information. The FCA is considering how to simplify or reduce the volume of information provided to ensure it is useable (paragraphs 3.9 to 3.12).

18 **The FCA is developing a new evaluation strategy which sets out how it will review the effectiveness and proportionality of its regulatory interventions. The volume of work will vary year to year and the FCA has not set expectations on the amount of evaluation it expects to complete.** FSMA 2023 requires the FCA to have a framework for monitoring and evaluating rules. The FCA published a draft framework in July 2023, which sets out how it will monitor new rules and decide what to review and evaluate, building on its existing approach to evaluation. What reviews the FCA undertakes will be determined by a range of factors, which means the number will vary year to year as will the level of resources needed to carry them out. The FCA plans to use its business planning process to prioritise evaluations, at which point it will consider the resources required. It has not set expectations for the amount of evaluation work it expects to complete. For evaluations that are required urgently, the FCA may re-prioritise its resources (paragraphs 3.13 to 3.18).

Conclusion

19 The government has made major changes to the financial services regulatory framework to achieve its ambition that the sector is technologically advanced, globally competitive and acts in the interest of consumers. The FCA has responded by initiating a series of changes designed to help it meet those ambitions and improve on past regulatory failures. It is carrying out significant work to re-shape the organisation, and has put in place a multi-year strategy with a clear focus on outcomes, as well as developing the work needed to support its new responsibilities.

20 The FCA is attempting a significant amount of change, on a number of fronts, all at the same time. This brings risks. It has recently experienced high staff turnover, which is disruptive; it is still working on the transformation programme it started in 2020; and it must now respond to its new role under FSMA 2023. As it works towards its new objective, the FCA must complete its work on optimising its use of data, assessing whether it is achieving the outcomes sought and being able to direct resources to where they can have most impact. It must also be clear on which of the long list of activities it is monitoring internally are its priorities. If the FCA can do this, it will be well placed to demonstrate that it can act when it needs to, in an agile and targeted way.

Recommendations

21 As the FCA responds to major changes within the financial services market and its regulatory framework, it must make sure it knows if its response is having the desired effect, as well as ensuring that it has the tools and staff it needs to continue to respond. We therefore recommend that the FCA should do the following:

a **When appropriate, work with HMT and other stakeholders to review the effectiveness of new accountability arrangements.** It will be important for both the FCA and HMT for there to be timely review of the new arrangements for scrutiny required under FSMA 2023. HMT and the FCA should therefore support any such review where it touches on their areas of responsibility. The review should consider both of their perspectives as well as those of firms and consumers. The review should consider whether the accountability arrangements are achieving intended outcomes and their impact on the FCA's ability to regulate effectively. The review could cover areas including:

- the FCA's processes for engagement with stakeholders, industry and consumers as it makes or amends rules;
- the quality and proportionality of cost-benefit analysis;
- the operation of the FCA's rule review framework in practice; and
- practical considerations of the new accountability arrangements. For example, if HMT uses its powers to call for new rules or rule reviews or for FCA to publish information, the review could consider the impact of this on the FCA's forward plans and resourcing requirements.

b **By autumn 2024, consider and plan how to make changes to provide clarity and coherence within its external reporting on performance.** As the FCA develops its new mechanisms for accountability, it needs to ensure it can explain its performance clearly to stakeholders. This might involve developing a core set of performance metrics, and testing their presentation and reporting with stakeholders to ensure the FCA articulates performance in a transparent and understandable way. This is likely to be an incremental process that takes place over a number of business reporting cycles.

c **By December 2024, ensure it has the operational processes it needs to manage the scale of change it has in motion.** The FCA's operational changes are far-reaching and will continue to take time to move into operation. The FCA needs to make sure that as its projects get closer to their planned end dates, it has considered and put in place the mechanisms needed to prioritise or take action if they take longer than expected, need additional staff or other resources, or fail to have the impact needed.

d **By September 2024, building on the FCA's current work to develop its strategic workforce planning, develop and maintain a long-term plan for workforce needs.** The nature of the FCA's work means that the areas of its operations which are under most demand change as it responds to changes in the market. The FCA does not expect to make further significant changes to staffing in the medium term, and must therefore ensure that it can use its staff flexibly to meet future strategic needs. The FCA should therefore build on its current strategic workforce planning development to ensure it has a continuing long-term plan for workforce needs including maintaining expertise in specific key areas and training staff to be able to move as needed.

Part One

Changes to the financial services regulatory framework

Introduction

1.1 The financial services industry was worth an estimated £173.6 billion to the UK economy in 2021.[3] Financial services include banking, insurance, and investment fund management, and the sector provides essential services to businesses and individuals.

1.2 This part of the report looks at:

- the Financial Conduct Authority's (FCA's) role within the financial services' regulatory regime;
- structural changes within the regime and the FCA's operational performance; and
- how the FCA is changing including operational changes and new accountability to Parliament and HM Treasury (HMT).

The FCA's role

1.3 The FCA regulates financial services firms and financial markets in the UK. It is responsible for conduct regulation, which aims to protect consumers from unfair practices, for nearly 50,000 firms. It is also responsible for prudential regulation, which aims to protect consumers from risk to the stability of the financial system, for 46,000 firms. The FCA regulates firms from large banking corporations down to individual financial advisers. The types of firms and specific activities that the FCA regulates is set out in legislation.

3 In terms of Gross Value Added (GVA). GVA is similar to GDP but used to measure the contribution of part of the economy, such as an industry. It is the contribution of part of the economy, minus any costs incurred in production.

1.4 The FCA sits within a wider financial services regulatory regime made up of a range of public bodies, whose work often overlaps and requires effective coordination (see **Figure 1** on pages 14 and 15). Key stakeholders include the following.

- HMT – responsible for setting financial services policy and delivering legislation. The FCA is an operationally independent regulator but is accountable to HMT as well as to Parliament.
- The Prudential Regulation Authority (PRA) – undertakes prudential regulation of all banks, building societies, insurers and credit unions, and major investment firms. It has the power of veto over the FCA in certain circumstances.
- The Financial Policy Committee (FPC) – a statutory committee of the Bank of England. It issues recommendations and directions to the regulators to ensure the stability of the financial system as a whole.

1.5 The FCA's strategic objective is "ensuring that relevant markets function well". It is supported by operational objectives to:

- secure an appropriate degree of protection for consumers;
- protect and enhance the integrity of the UK financial system; and
- promote effective competition in the interests of consumers.

The FCA has a broad set of powers to allow it to advance these objectives, from making rules and giving guidance to firms, to authorising firms and approving individuals, and issuing fines or taking legal action when they do not follow the FCA's rules and guidance. It also has a set of general principles to be applied, including using resources in the most efficient and economic way and the need to contribute towards environmental targets such as net zero.

1.6 There have been significant changes within the financial services sector, from new products and services, to the way in which the FCA regulates. This study examines how well placed the FCA is to manage these changes and support government's ambitions for the sector. We have identified and focussed on the key processes and enablers for managing change and this approach is supported by insight from previous work on regulators facing change. Our evaluation is based on our published good-practice principles of effective regulation and criteria for performance measurement by regulators. We have examined four case study areas in detail (**Figure 2** on pages 16 and 17) and use our findings throughout this report. As this report is focused on how the FCA is responding to changes in the market and to its remit, it does not seek to establish the overall effectiveness of the FCA's business-as-usual work, nor does it review how the FCA has managed individual regulatory decisions or cases.

Figure 1

Key regulators and other bodies involved in regulating the financial services sector

The Financial Conduct Authority (FCA) regulates financial services firms and financial markets in the UK, alongside other regulators and bodies with whom it must work closely

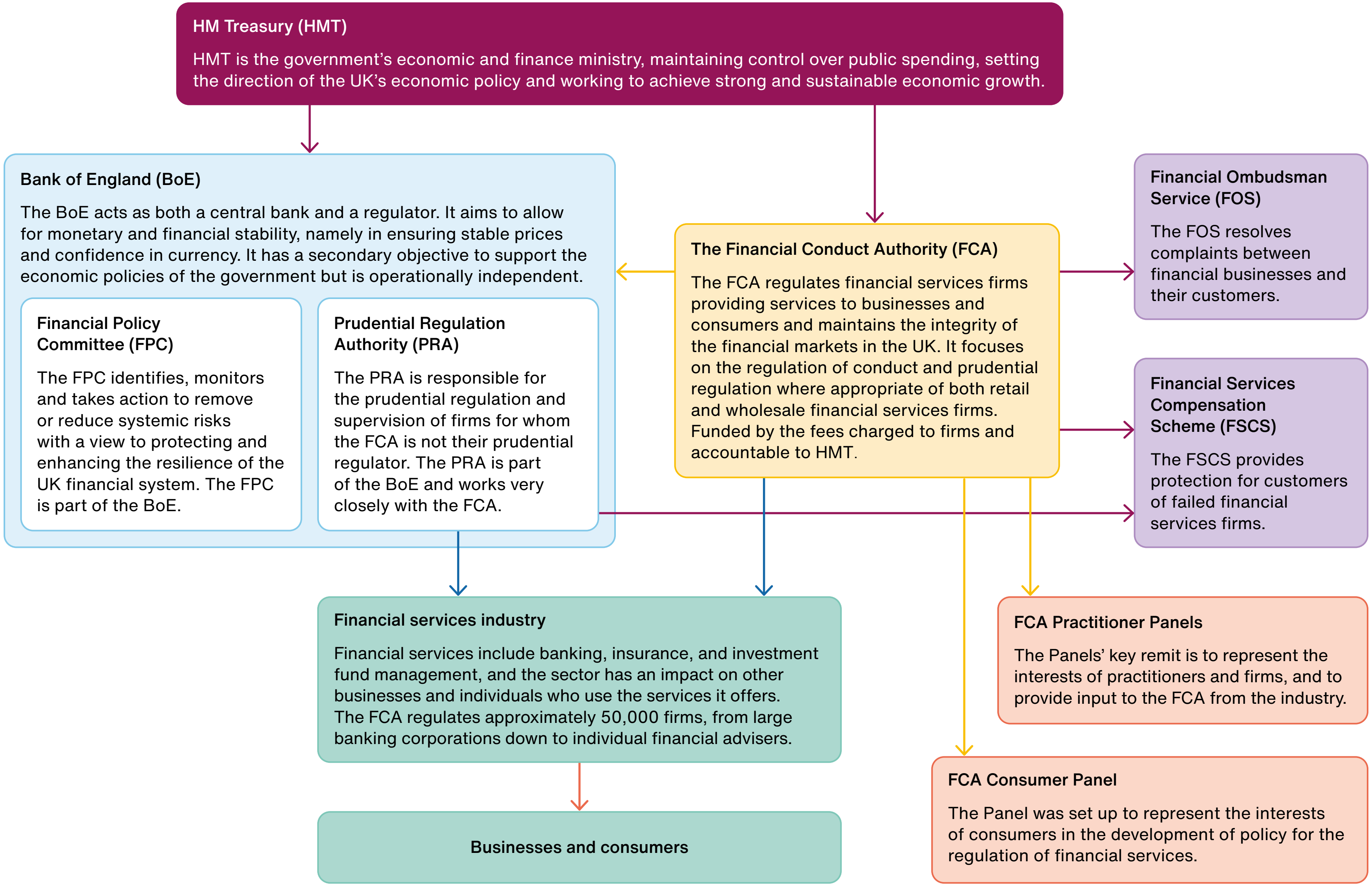


Figure 1 *continued*

Key regulators and other bodies involved in regulating the financial services sector

- HM Treasury
- Bank of England
- Financial Conduct Authority
- Financial services industry
- Redress bodies
- Statutory stakeholder panels
- → Supervision
- → Regulation
- → Coordination
- → Service provision

Note

1 Parts of the financial services industry, such as payment systems, auditors or pension schemes, may be subject to additional specific regulation.

Source: National Audit Office analysis of published documents

The need for change

1.7 The FCA recognised that it needed to adapt its approach, as a result of changes to the regulatory landscape following the UK's departure from the EU and to respond to criticisms of its operational performance.

Changes to the regulatory landscape following EU Exit

1.8 Following the UK's exit from the EU, HMT and the FCA have more freedom to tailor the design and operation of the financial services regulatory framework to the UK market. When the UK was part of the EU, HMT would negotiate the UK's position on policy proposals and, together with the FCA, amend UK legislation and regulator rules to ensure they complied with EU laws once they were in place. This would then be enforced by the FCA. When the UK left the EU, EU law was transferred onto the UK statute book. HMT regarded this as a temporary decision, taken because of the volume and complexity of EU legislation.

1.9 In July 2021, the government stated its ambition for "an open, green, and technologically advanced financial services sector ... that is globally competitive and acts in the interests of communities and citizens". In 2019 HMT, working with the FCA and others, started the Future Regulatory Framework review to consider how to tailor the regulatory regime to the UK's financial markets and enable them to adapt, innovate and grow. It conducted multiple consultations, from wide consultations on the model for future regulation and how it should be delivered, down to a narrow consultation on the changes needed to the regulators' objectives, accountability and scrutiny, and how retained EU law (REUL) would be managed.

Figure 2

Case studies of the Financial Conduct Authority's (FCA's) work

The FCA, working with others, has to adapt to new and emerging areas of regulation within the financial services sector. Our case study examples demonstrate that the FCA is at different stages of progress in developing and implementing these

Area the FCA is working on	What the FCA has done	How the FCA knows if it is working
The FCA's authorisation of European Economic Area (EEA) firms		
In December 2020, firms in the EEA who provided financial services in the UK were allowed to continue doing business via a Temporary Permission Regime (TPR), while they sought authorisation from the FCA to carry out regulated activites in the long term. The TPR was intended to avoid customer and market disruption. By December 2023 when the TPR ends, the FCA expects firms to have applied for full authorisation to continue doing business, or indicated that they expect to enter the Financial Services Contracts Regime (FSCR) under which the business must be wound down. The FCA aims for all firms who apply to receive a final authorisation decision before the end of December 2023.	The FCA wrote to all TPR firms, issued newsletters and provided information on its website to make firms aware of the requirements for authorisation, and firms were given specific 'landing slots' for applications to manage the workload on authorisations staff. 1,475 firms had entered the TPR and 511 applications for authorisation were submitted. The authorisation process requires firms to submit an application that includes financial information and demonstrates how it complies with the FCA's conditions for authorisation. The FCA may have to request further information and clarification, and the process can take between three and 12 months.	The FCA monitors application progress monthly. As at mid-July 2023, the FCA had processed 384 applications, with 127 remaining to be determined. While the FCA was behind its planned progress in processing applications, it is still confident that all applications will be processed by the December deadline.
The FCA's regulation of climate-related and sustainability disclosures		
In 2020, the government committed to making climate-related disclosures mandatory by 2025. The FCA already requires financial disclosures from regulated firms including data on their exposure to climate related risks. It has begun aligning requests to international standards and extending disclosures to other business models and sectors.	In November 2021 the FCA published an environmental, social and governance (ESG) strategy setting out its priorities. Through the Financial Services and Markets Act 2023 (FSMA 2023) the FCA must have regard for government's net zero goals. The FCA currently requires climate-related financial disclosures from regulated pension providers, asset managers and most listed companies. In 2022 the FCA consulted on measures to ensure consumers have good information on the sustainability of investment products. It is due to publish finalised rules by the end of 2023.	The FCA monitors compliance through its supervision and enforcement teams. It also monitors emerging risks through an ESG horizon scanning team. In June 2023 the FCA published a letter to firms providing loans to businesses which incentivise borrowers to meet sustainability objectives. The letter warned firms that poor practices were creating market integrity concerns. No enforcement action has yet been taken.

Figure 2 *continued*

Case studies of the Financial Conduct Authority's (FCA's) work

Area the FCA is working on	What the FCA has done	How the FCA knows if it is working
The FCA's work on artificial intelligence		
The FCA has an interest in how regulated firms use artificial intelligence (AI) to provide financial services but does not currently regulate the area.	The FCA introduced an AI strategy team within its Data Technology and Innovation division. It is working closely with UK and international bodies such as the Digital Regulation Cooperation Forum to understand best practice and challenges in the use of AI. In October 2020 the FCA launched the AI Public Private Forum with the Bank of England to understand how regulated firms use AI and key risks and mitigation strategies. In October 2022 the FCA published a discussion paper which looked at the benefits and risks of AI in the context of the FCA's regulatory objectives and how existing regulation supports innovation and mitigates risk. A separate team is working to deliver the FCA's own internal use of AI. Their work includes developing a set of principles and identifying potential uses across the FCA's work.	The FCA is in the early stages of understanding potential risks and opportunities. Consumer stakeholders have called for greater clarity on how the FCA will manage risks that some consumers experience bias and detriment, relating to protected characteristics and income levels, due to the way in which firms are using personal data and algorithms.
The FCA's regulation of crypto-assets		
The FCA began supervising crypto-asset firms in January 2020 through money laundering regulations (MLR). Firms wishing to exchange currency for crypto-assets (or vice versa), or exchange or safeguard crypto-assets in the UK must be registered and supervised by the FCA. Existing firms must have applied for registration by January 2021, and new firms must apply and be registered before they start operating.	The FCA assessed 158 applications between 2020 and 2021. Only 29 firms were registered, and the others were withdrawn, refused or rejected. The FCA created a temporary registration regime for firms to continue to operate after the deadline while it completed their assessments, and all cases were resolved by March 2022. In July 2020 HM Treasury (HMT) consulted on bringing financial promotions of crypto-assets within the scope of financial promotion regulations. In January 2022 the FCA consulted on strengthening its financial promotion rules for high-risk investments including crypto-assets to protect consumers. The regulation includes rules to restrict the type of firms that can legally promote to consumers, the content of promotions and the 'back-end' services provided to consumers wanting to invest, such as a personalised risk warning. HMT amended the legislation in June 2023 and decided that the regulations would come into force in October 2023. But the FCA identified significant risks in implementing the 'back-end' rules and has therefore agreed a modification to the rules which delays the date certain firms need to comply with these rules until January 2024, to allow them to put in place the systems required.	The FCA's supervision teams monitor non-compliance. The FCA told us that it has dealt with more than 1,400 cases relating to unauthorised crypto-asset activity. The FCA published a public list of unauthorised firms and since this list has been published more than 300 firms have been flagged by the FCA. The FCA has a dedicated team to tackle high risk and illegal financial promotions. In 2020, more than 3,150 crypto-asset scams were reported, rising to more than 6,300 in 2021 and more than 3,900 in the first half of 2022. The FCA will monitor reports to see how well the financial promotions regulations work.

Note

1 Crypto-assets are a digital representation of value or rights, that can be transferred, stored or traded via a secure electronic system.

Source: National Audit Office review of Financial Conduct Authority documents

The FCA's operational performance

1.10 In recent years, high-profile issues in the financial services sector have led to criticism of the FCA for regulatory failures. Independent reviews of the FCA were carried out after the collapse of London Capital and Finance in 2019, and the liquidation of the Connaught Income fund, as well as a specific review by the Treasury Select Committee into London Capital and Finance.[4,5] Both independent reviews were published in 2020 and made similar recommendations on the operation of the FCA. These included the need for more coordination and information-sharing between different teams within the FCA. The FCA took action in response to both reports, including joining policy, supervision and competition functions to "have a better approach to translating insights into risks and warnings before taking action to tackle them", and a stronger focus on data, including establishing a change programme for information and intelligence.

1.11 In recent years, the FCA has also identified and responded to issues with its operational performance in some key areas. The FCA has 54 standards that it uses to measure performance. In 2022-23, the FCA reported it achieved or exceeded the targets set for 68.5% of these standards, compared with 51% of the targets in 2021-22. Times taken for authorisations in particular are subject to high levels of public interest. The FCA has failed to meet a statutory target to process applications for authorised persons within three months every year since 2020-21. While performance has slightly improved from 85.7% within target in 2020-21 to 87.5% within target in 2022-23, the FCA has acknowledged this is an area where further improvement is needed. In December 2022 HMT wrote to the FCA stating that the FCA's operational effectiveness was "a key priority" for HMT as well as the FCA. The FCA responded with improved transparency on operational metrics.

Responding to the need for change

1.12 Government, HMT and the FCA made a number of changes in response to changes in the regulatory landscape and the FCA's operational performance. These included a transformation programme at the FCA, and the introduction of a three-yearly strategic planning cycle; legislative changes via the Financial Services and Markets Act 2023 (FSMA 2023) and accompanying changes to the FCA's accountability framework.

4 The Financial Services Authority initially handled the liquidation of the Connaught Income Fund Series 1 and connected companies before it was formally divided in 2013 into the Financial Conduct Authority and the Prudential Regulation Authority, at which point the FCA handled the case.

5 The Rt. Hon. Dame Elizabeth Gloster DBE, *Report of the Independent Investigation into the Financial Conduct Authority's Regulation of London & Capital Finance plc*, November 2020. Raj Parker, *Independent Review into the FSA and FCA's handling of the Connaught Income Fund Series 1 and connected companies*, December 2020. Treasury Select Committee, *The Financial Conduct Authority's Regulation of London Capital & Finance plc*, Fourth Report of Session 2021-22, HC 149, June 2021.

The FCA's internal transformation programme

1.13 The FCA launched a three-year transformation programme in 2020-21, and applied this programme to respond to external concerns regarding its operational efficiency and effectiveness. Its 2022–2025 strategy outlined how it will achieve some of the aims within the programme. The FCA extended the formal transformation programme into 2023-24. Many of the changes are still being embedded, and the FCA plans to make further improvements as it adapts to the changing regulatory landscape.

1.14 The FCA's transformation programme spans areas of the FCA including data, supervision and enforcement, and performance reporting. To strengthen the FCA's operating structure it has appointed a new chief operating officer, created new roles for executive directors to jointly oversee the FCA's supervision, policy and competition functions, and appointed a chief data, information and intelligence officer. It has also made changes to its supervision and enforcement functions and developed new data tools, processes and training to support day-to-day decision-making.

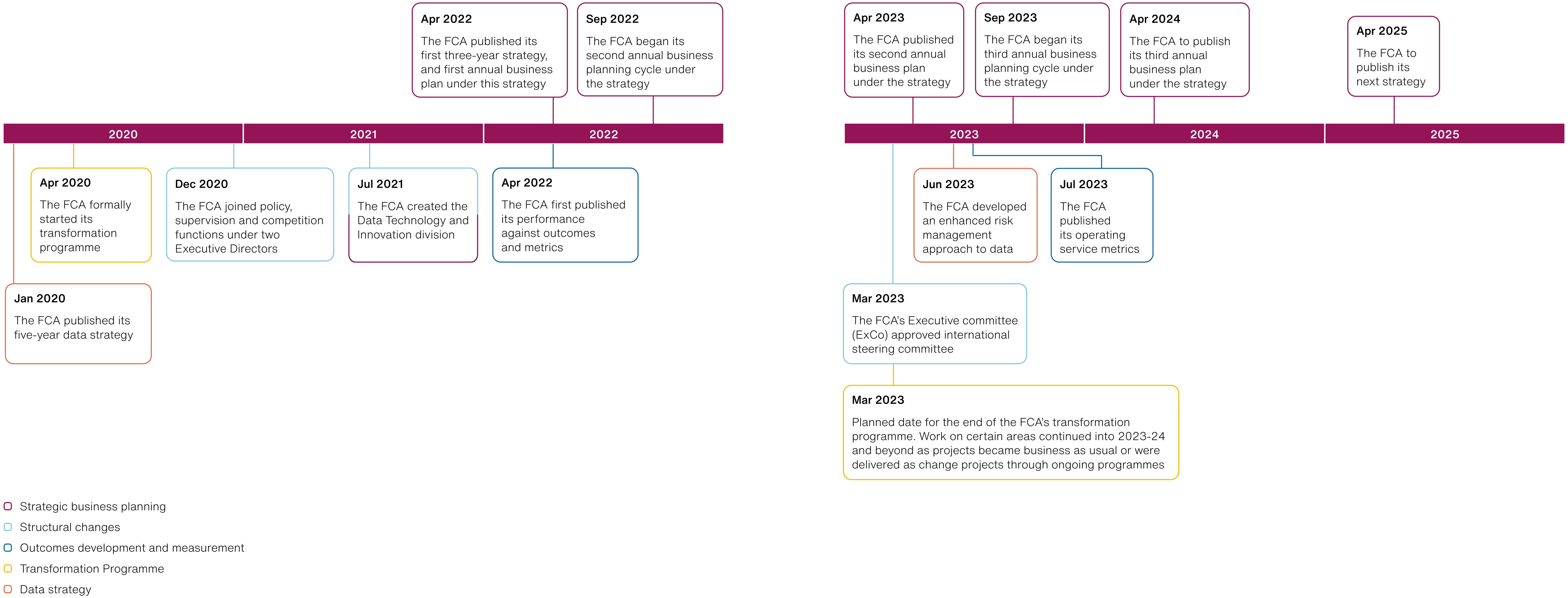
1.15 From 2020-21 to 2022-23 the FCA estimates it has spent £317 million on its change programme. Its overall staffing has increased by 16% between August 2020 and August 2023. The FCA is funded by an industry levy, which means regulated firms pay fees based on the activity they carry out and the scale of their business. The FCA levied an additional £35 million from businesses over the period 2020-21 to 2023-24 specifically for its transformation programme.

1.16 The FCA has extended its transformation work outside of the original core programme, and much of this work will continue beyond the original end of the programme into 2023-24 and beyond (see **Figure 3** on pages 20 and 21). Change programmes for key areas including enforcement will continue as separate projects, while others are expected to be picked up as part of normal business processes. From 2023-24, the FCA has change projects which will focus on improving coordination and efficiency. This includes plans to build a clear, common understanding of how the FCA operates by mapping costs, risks and resilience issues across the whole of the FCA and improving its operational data-reporting to inform strategic decision-making.

Figure 3

Timeline of key internal changes within the Financial Conduct Authority (FCA) 2020–2025

The FCA began transformation work in 2020 and expects change projects to run to at least 2024



Source: National Audit Office review of Financial Conduct Authority documents

The Financial Services and Markets Act 2023

1.17 In summer 2022, HMT put new primary legislation before Parliament to introduce a new secondary objective for the regulators, increase accountability arrangements, revoke retained EU law (REUL) on financial services, and create a new mechanism for regulating specific activities which relate to financial services but are not carried out by firms or individuals the FCA otherwise regulates (for example, offering stocks or bonds). The Financial Services and Markets Bill was laid before Parliament in July 2022 and was granted Royal Assent in June 2023, becoming the Financial Services and Markets Act 2023 (FSMA 2023).

1.18 FSMA 2023 makes several key changes to the FCA's roles and responsibilities, and these come into operation at varying times:

- introduces a new secondary objective to facilitate the international competitiveness of the UK economy (including, in particular, the financial services sector), and its medium-to long-term growth, subject to aligning with relevant international standards;
- revokes REUL relating to financial services and markets, enabling the FCA to replace them in many cases with its own rules; and
- requires the FCA to establish a new statutory panel to provide advice on cost-benefit analyses (CBA).

Accountability to Parliament and HM Treasury

1.19 HMT, the FCA and others are taking forward new accountability arrangements required under FSMA 2023 through a programme of work which picks up from the Future Regulatory Framework (see **Figure 4**).

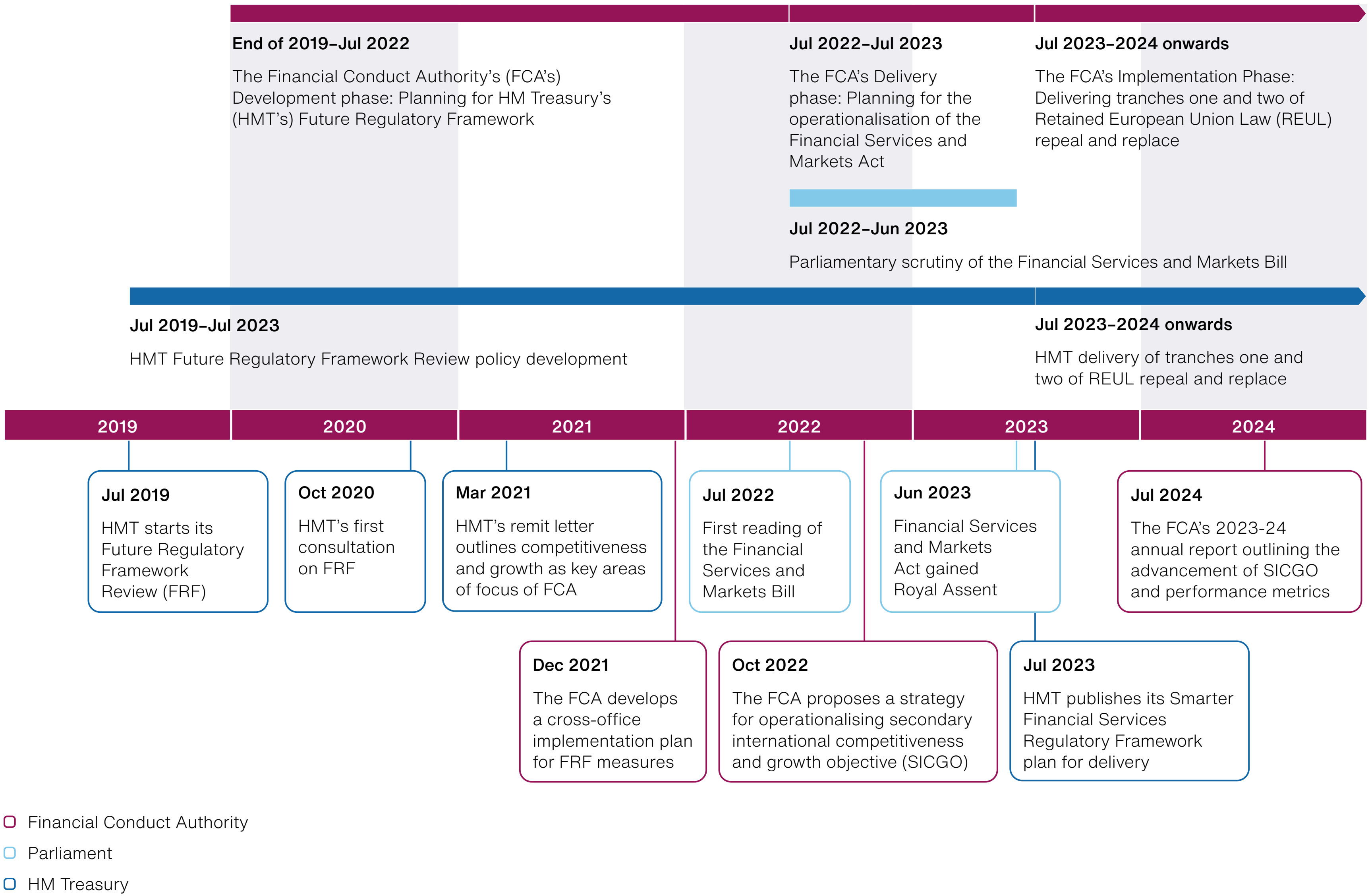
1.20 Under FSMA 2023, the FCA is required to notify parliamentary committees when it carries out consultations and to respond to consultation feedback from the committees. In response to EU Exit, the Treasury Select Committee decided to set up a specific sub-committee to scrutinise regulatory proposals. The level of scrutiny will depend on how much the FCA plans to change regulation from what was adopted as REUL.

1.21 While FSMA 2023 gives the FCA more direct power to set regulation via making rules, it also provides specific powers to HMT with regard to the regulatory policy development process. HMT has the power to require the FCA to make rules in specific areas, but it cannot specify the form or content of the rule. It has the power to require the FCA to review specific rules, or to ask for an independent review. FSMA 2023 also requires the FCA to respond in writing to recommendations made by HMT. HMT can also designate specific activities as requiring regulation, but the FCA has the power to decide how they will be regulated.

Figure 4

Timeline of key changes within financial services regulation 2019–2024

The Financial Conduct Authority (FCA) has been working with HM Treasury since 2019 to design, deliver and implement the Financial Services and Markets Act 2023



Source: National Audit Office review of Financial Conduct Authority and HM Treasury documents

1.22 HMT's role in the regulatory framework can affect the FCA's ability to strategically plan its work in some specific areas. For example, delays in HMT amending legislation meant the FCA had to change its sequencing of financial promotion regulations and limited its capacity to take on wider proactive work. Similarly, ad-hoc requests from HMT require the FCA to build additional work into its plans. For example, HMT asked the FCA to undertake a review of payment account access and closures, which required the FCA to analyse data from 34 firms to understand the volume of account terminations and complaints and their outcomes.

1.23 FSMA 2023 also sets out additional arrangements for the FCA to be transparent about its activities and performance. This includes:

- public reporting on the new secondary objective to facilitate the international competitiveness and growth of the UK economy 12 and 24 months after the Act comes into force and in the FCA's annual report;
- keeping under review all the rules it makes, and setting out how stakeholders can get involved; and
- publishing a statement on how it will conduct CBA and setting up a Cost-Benefit Analysis panel to scrutinise analysis underpinning regulatory decision making, with members independent to the FCA. The FCA told us it plans to have the panel in place in 2024.

Operational changes within the FCA

Introducing a three-yearly strategy

1.24 In addition to completing the work it set out to achieve in its 2020 transformation programme, the FCA is also carrying out work as a priority to support its delivery of its new secondary objective and its new responsibilities under FSMA 2023.

1.25 In 2022 the FCA published its first multi-year strategy, covering the period up to 2025. Prior to this it had only ever had a single-year business plan. The FCA's rationale for the strategy is to enable it to focus better on the outcomes it is trying to achieve, and on the operational model it needs to deliver them. The strategy sets out three areas of focus for the FCA: reducing and preventing serious harm; setting and testing higher standards; and promoting competition and positive change. The strategy is supported by annual business plans which set out the actions the FCA is taking to support these areas of focus and what outcomes it is prioritising. As it is only halfway through the period covered by the strategy, the FCA is yet to review whether the process is helping support outcomes or what changes it may make in future.

Delivering the new secondary objective of growth and international competitiveness

1.26 The FCA has work under way to embed the new secondary objective of growth and international competitiveness into its processes, and in July 2023 it published a statement explaining how it intends to advance the new objective alongside its existing objectives. Stakeholders we interviewed raised concerns over how the FCA will balance these. In January 2023 it started developing guidance for policy leads on how to deliver the new objective, produced e-learning training and provided practical examples where the objective has been delivered. It also established a central Regulatory Reform Unit to provide further support to staff. In March 2023 it identified more than 40 priority documents to update, including those which are: public-facing; play an important role in governance and decision-making; or are most often used by FCA teams in carrying out their duties. The FCA told us it plans to complete this work by April 2025, as it wants to revise many of the documents alongside developing its next strategy.

Reviewing retained EU law

1.27 The FCA must work with HMT to replace REUL, in many cases with rules within the FCA's regulatory handbook. The FCA has worked with HMT to develop a two-year plan to repeal and replace REUL files which they have identified as a priority to update, such as around offering shares or securities. In October 2023, the FCA set out 10 REUL files that it was currently working to replace. HMT has stated that it aims to achieve significant progress on repealing EU law in these areas by the end of 2023. HMT and the FCA are also considering whether some REUL files can be 'lifted and shifted' into the FCA's handbook where policy change is not required immediately. This will provide clarity to industry around what financial services regulation is likely to remain unchanged in the short term.

1.28 The FCA is considering how it will manage the remaining REUL files. It has developed a set of principles which set out how it will approach making changes – for example, consolidating requirements as far as possible and relying on outcomes rather than prescriptive requirements, where appropriate. It has also considered the level of resources required and the potential sequencing of files. However, it must coordinate with HMT, who will decide on the timeline for repealing REUL files as it must amend legislation, and to date no timeline has been formally set.

Part Two

How the Financial Conduct Authority responds to innovation and change

2.1 Identifying new issues or changes in the external environment promptly helps the Financial Conduct Authority (FCA) to ensure swift and effective regulatory responses to manage risk. The FCA needs appropriate business processes and capacity to enable timely operational decisions. It also needs to work collaboratively with stakeholders and other regulators, including internationally, to understand and influence the direction of regulation and ensure effective delivery of objectives.

2.2 This part of the report looks at:

- how the FCA identifies and responds to uncertainty and risk, and how it manages key data sources to provide insight and intelligence;
- whether the FCA has the capacity and skills it needs to be able to respond effectively; and
- how the FCA manages wider influencing work, including internationally.

Identifying and responding to uncertainty and risk

2.3 There are three key areas of uncertainty that may have an impact on the FCA's ability to regulate, and which it is actively monitoring:

- market developments that arise outside the market the FCA already regulates – for example, the creation of crypto-assets or the rise in buy-now pay-later schemes;
- market developments that affect the markets the FCA already regulates – for example, the standards expected for financial promotions or for sustainability disclosures; and
- uncertainty around the FCA's operations and whether it is achieving what it plans to – for example, whether the FCA has the resources needed to deliver its workload.

We examined the processes by which the FCA gathers insight on all three areas of uncertainty.

Horizon-scanning and risk identification

2.4 The National Audit Office (NAO) has previously set out our principles of effective regulation.[6] The principles emphasise the value of a proactive, forward-looking approach to identifying potential issues and responding proportionately. **Figure 5** overleaf sets out the steps the FCA generally follows from identifying an issue to implementing and reviewing its response.

2.5 Since publishing its 2022 strategy, the FCA has further developed its horizon-scanning process, which collates insights from across policy teams and intelligence sources including regulatory reports, thematic market analysis and macro-economic forecasting. This informs the FCA's decision-making on whether it needs to change existing projects or add new activities. This annual process happened for the first time in 2022 and the FCA does not yet have evidence to assess if it has strengthened its ability to respond to market developments.

2.6 When the FCA considers that it needs to do something to mitigate a risk, FCA teams can submit change projects. The Executive Finance and Delivery Committee meets regularly to consider whether to approve new projects. It will prioritise projects as part of the FCA's overall business planning process. The Committee will consider the importance and urgency of the issue and whether the FCA can make a difference in deciding whether a project will be approved. Funding is then allocated to projects via regular gateways which provide oversight on progress and spending.

2.7 The FCA uses regular data returns from regulated firms to monitor compliance and inform its decisions. It also issues ad-hoc data requests to inform the design of further interventions, such as the Future Regulatory Framework reforms. It collected 720,000 data items in the 12 months to July 2023 through 208 regulatory reports, and also planned a further 66 ad-hoc data requests. Industry stakeholders highlighted the impact these requests have on firms, and questioned the volume, relevancy and use of the data collected.

6 National Audit Office, *Principles of effective regulation*, May 2021.

Figure 5

The Financial Conduct Authority's (FCA's) regulatory decision-making framework under the Financial Services and Markets Act 2023 (FSMA 2023)

As a result of the FSMA 2023, the FCA must take additional action in key stages of its process to make decisions and respond to changes within regulated markets

Stage 1 – Identifying potential harm or markets not working as well as they could

The FCA conducts monitoring of issues through market data returns, surveys and other intelligence gathering tools such as engagement with statutory panels.

Stage 2 – Understanding cause, extent and potential development of the harm

The FCA develops the rationale for an intervention and may issue a call for evidence to canvas views from stakeholders.

Potential engagement with other bodies such as other regulators.

Stage 3 – Designing possible interventions

The FCA develops a causal analysis to understand how different interventions would work and to identify a preferred option.

The FCA develops its approach, including an impact assessment, options appraisal and plans for estimating costs and benefits.

To comply with requirements in FSMA 2023, the FCA needs to consider the impact of proposed rules on international trade agreements.

Stage 4 – Cost and benefit analysis (CBA)

The FCA drafts the intervention. If it will take the form of a new rule, it is usually presented in a consultation document alongside a CBA.

Under FSMA 2023, a new statutory panel will provide CBA advice. The FCA must have regard for specific policy priorities which HM Treasury (HMT) has set out and the FCA must notify parliamentary committees of consultations.

Stage 5 – Determining and presenting the final policy

The FCA publishes a policy statement presenting the final planned intervention and the date on which it will come into force. The statement includes an account of the feedback the FCA received to proposals and its response.

Under FSMA 2023, the FCA must respond to parliamentary committees if they formally respond to consultations.

Stage 6 – Implementing new rules

The FCA uses a range of intelligence sources to supervise firms and identify non-compliance.

Where non-compliance is identified, the FCA has a range of powers it can use, such as issuing guidance or warnings, or amending or revoking permissions.

These will be chosen based on a range of factors including the severity of misconduct and harm posed.

Stage 7 – Evaluating rules

The FCA has committed to assessing the impact of at least one intervention through one ex-post impact evaluation a year.

The FCA produces Post-Implementation Reviews for certain rules to examine if they met intended objectives and are still needed.

Under FSMA 2023, the FCA must generally monitor and assess the effects of its rules, which will help it identify where markets are not working. HMT may request a specific rule review under some circumstances and must lay any reviews before Parliament.

Note

1 The FCA may undertake other activities to those set out here to respond to changes in the markets, for example when making changes to existing rules, or when developing new rules where it feels it has sufficient understanding of the harm posed.

Source: National Audit Office analysis of Financial Conduct Authority documents

The FCA's regulatory perimeter

2.8 Through its horizon-scanning work, the FCA and others often identify areas where activity may cause harm to consumers or markets, but the activity is not regulated by the FCA and therefore sits outside its 'regulatory perimeter'. The type of activities regulated by the FCA are defined in legislation. Making changes to what the FCA regulates takes time, and requires HM Treasury (HMT) and the FCA to identify the issues and what changes are needed, HMT to prepare legislation where it determines there is a case for expanding the FCA's remit and Parliament to give its approval. The FCA announced in July 2021 that it and the government had agreed to jointly assess the state of the perimeter and that the FCA would continue to highlight gaps in legislation and the potential for harm.

2.9 Where an issue falls outside of the perimeter, the FCA will share information with others, such as other regulators, HMT and law enforcement bodies, who may have power to intervene or, in the case of HMT, will consider whether the regulatory perimeter should be expanded. The FCA can also use some of its softer regulatory powers, such as issuing warnings and alerts. It can generally only take harder action, such as issuing financial penalties or cancelling a firm's authorisation, on activities inside its perimeter or where the activity is carried out by firms or persons authorised by the FCA.

2.10 In 2019 the FCA began publishing a Perimeter Report to inform stakeholders, including Parliament, and support discussions with government. The report sets out which activities fall within the perimeter and which activities do not, focusing on areas where the FCA has identified issues such as potential consumer harm. It summarises the work the FCA has undertaken to review the perimeter, and work with HMT and other stakeholders to address the issues. The report forms the basis for an annual meeting between the FCA and relevant Treasury minister where the FCA can raise changes to the perimeter it feels are needed and why. In 2019, the Treasury Select Committee recommended that the FCA be given formal powers to recommend changes to the perimeter to HMT. The FCA agrees with this recommendation, noting that other comparable bodies, such as the Bank of England's Financial Policy Committee (FPC), already have this power. The government has disagreed with this recommendation, citing examples of where its current engagement with the FCA has led to the perimeter being changed as evidence that a formal power is not needed. Government has also set out that it does not feel that the FPC's powers are a good comparator to the FCA's due to differences in their remits.

The speed at which the FCA can respond to change

2.11 Whether an issue occurs inside or outside the FCA's regulatory perimeter, there are still processes it must follow to be able to take regulatory action (see Figure 5). This means that action may follow some time after the FCA has identified an issue.

- In February 2021, the FCA published an independent report into unsecured borrowing, which recommended that buy-now pay-later (BNPL) credit providers be brought into the regulatory perimeter. Also in February 2021, the government announced plans to bring the BNPL sector into the regulatory perimeter for the FCA. The government is currently still working on the legislation required to give FCA the necessary powers for this to happen. The FCA has taken some action under existing regulations – for example, in February 2022 it used powers under the Consumer Rights Act 2015 to ensure four firms made their BNPL consumer contracts fairer and easier to understand.
- When a change is made to regulation, the FCA needs to allow firms time to comply with new regulations. Our case studies on crypto-assets and European Economic Area firm authorisations both provide examples of the FCA implementing temporary regimes while firms prepare to comply with new regulations. While firms were in these temporary regimes, the FCA could take some action but had less information about the firms on which to base decisions (see Figure 2).
- Even when an issue falls inside the FCA's perimeter, or it has the power to act, it can take years for the FCA to implement any enforcement action. In January 2020 the FCA became responsible for regulating crypto under anti-money laundering regulations and began the process of registering firms.[7] Through this process the FCA's supervision team engaged with unregistered firms and identified specific areas it considered as high-risk. In March 2022 it published a warning to operators of crypto ATMs, which allow people to buy or convert money into crypto-assets, outlining that they must be authorised by the FCA and comply with money laundering regulations. The FCA reported publicly that it saw a significant drop of 68% in reported crypto ATM activities in 2022, although not all of this could be attributed to FCA activity. In February 2023 the FCA announced that, alongside specialist police teams, it had gathered evidence from sites suspected of hosting illegal crypto ATMs.

7 Crypto refers to an electronic currency that uses a secure peer to peer technology system to record who owns what and to make payments between users.

Data management

2.12 In January 2020 the FCA produced a new five-year data strategy which outlined its ambition to become a more efficient and effective data-led regulator. Key actions from the strategy were included in the FCA's response to the independent reviews published in 2020 which highlighted weaknesses, particularly in sharing data across the organisation and having a "single view" of the performance of firms across its various interactions with the FCA. In 2021 an external report commissioned by the FCA outlined significant concerns with the FCA's data architecture and management of data and suggested changes to the FCA's culture, organisation, skills and data processes.

2.13 The FCA's internal risk management system recorded around 70 risks relating to data as at the end of 2022. In July 2023, it recognised that its approach to identifying, assessing and mitigating data risks had not been fully integrated across the Data Technology and Innovation division or the business as a whole. It has sought to categorise the risks into four main themes: utilisation, acquisition, quality and storage. In July 2023, all four themes were rated as red and required strategic intervention. It is still working on collating identified data risks across the organisation to be able to manage them consistently.

2.14 The FCA has outlined key activities it is taking or is planning to take to mitigate data risks and create efficiencies. These include the following.

- Upgrading the FCA's 'data lake', which stores all FCA data and enables the FCA to share data across the organisation. In July 2023, the FCA described an upgrade to the data lake as "overdue", and necessary to ensure all FCA data was accessible, joined-up and interpretable.
- Creating a 'single view' platform for all front-line staff to access key information on firm performance. The platform links data from a range of sources and allows staff to quickly triage supervision cases, identify risks early and take enforcement action where required.
- Creating data analytics tools to produce automated alerts for supervisory staff where firms pose a particular risk or where less supervision is needed. This work relies on understanding business rules and specific risk appetites. The FCA told us that it is being rolled out to use within firm authorisations in December 2023.

The FCA estimates that this work will be completed by March 2025, at which point the risks will be substantially reduced from red to amber rating. However, some of the mitigations, such as additional staff training to improve digital data skills, are currently in the process of seeking funding through the next business planning round. In other areas the FCA still has much to do, for example, developing guidance for exactly how teams should interact with automated tools.

Staffing capacity and capability

Growth in staffing

2.15 In order to be able to regulate effectively, the FCA needs sufficient capacity and skills to discharge its duties now and in the near future. The FCA has grown significantly over the past few years. Between 2020 and 2023 it has increased overall staffing by 16%. As of August 2023, it employed a total of 4,584 staff (on a full-time equivalent basis). The FCA tracks its voluntary turnover rate over the longer term, and in the three years up to March 2020, it was between 9.4% and 12.0%, while it fell to between 6.5% and 8.7% in 2020-21 during the COVID-19 pandemic. In the past two years the FCA has published that its overall turnover rate has been more than 17% each year. This means that the FCA has had to recruit and train more than 2,000 staff in total over the two years, rather than just the increased headcount of around 600.

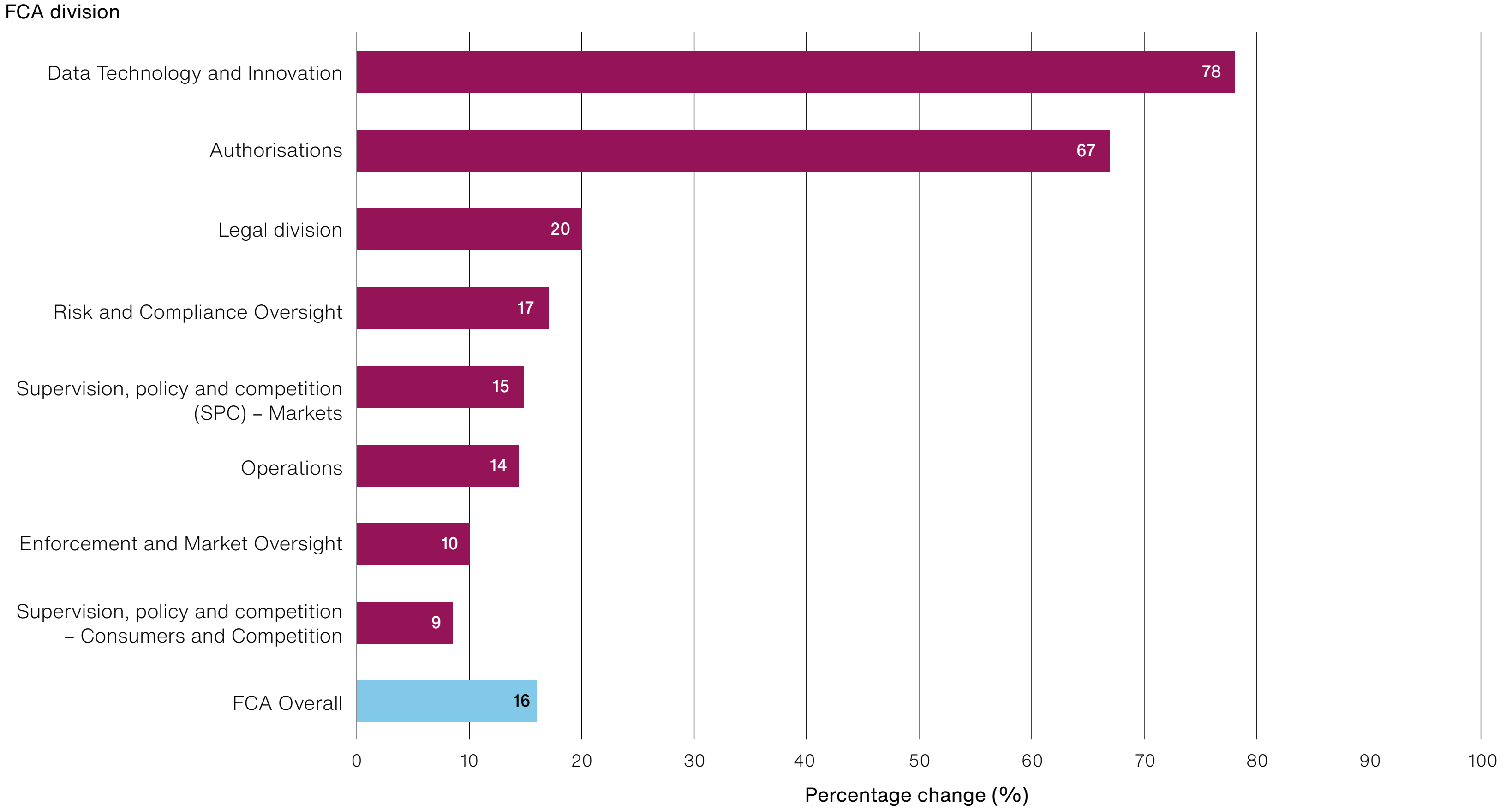
2.16 Over this time, the FCA's overall approach to staffing was focused on its location strategy (including opening an office in Leeds and employing more people in Edinburgh), and it took steps to ensure it had sufficient capacity to manage the level of recruitment. Individual areas were expected to manage and monitor their own risks. The FCA is working on strengthening its strategic workforce planning, and one of the key findings from an external report was that it is currently focused on immediate and short-term planning at divisional levels, although some areas were conducting more advanced analysis. The FCA does not intend to continue to grow substantially in the future, and some key areas have used temporary staffing to build short-term capacity. The numbers of temporary staff almost doubled from 2020 to 2023, increasing related costs from £20 million to more than £41 million.

2.17 Staffing increases have been concentrated in specific areas in the FCA, including senior management. The Authorisations division has grown by 67% and the Data Technology and Innovation" (DTI) division has grown by 78% from 2020 to 2023 (see **Figure 6**). Within DTI the FCA has recruited for skilled roles across artificial intelligence (AI), cloud engineering, digital technology, analytics, and data science. Much of the senior management at the FCA has also changed over the past three years as new staff have been appointed and new roles created. Of the 11 most senior officials at the FCA, 10 have been appointed to the role in the last three years, with seven of these officials each having joined the FCA since September 2020. This includes the chief executive officer, and the chief operating officer and the chief data, information and intelligence officer, both of whom have had key roles in implementing the FCA's transformation programme. The 11 senior roles also include three posts which have been created in the last three years.

Figure 6

Staffing increases in the Financial Conduct Authority (FCA) by division, August 2020–August 2023

While the FCA has increased staff numbers overall, much of the increase has been focused in specific areas



Notes

1 Percentage change is the change in full-time equivalent (FTE) staff.

2 During this period the FCA reallocated around 280 uncategorised staff to its divisions. It is not possible to track which divisions these staff moved to.

3 Actual numbers of staff increases between August 2020 and August 2023 are: Data Technology and Innovation – 234, Authorisations – 309, Legal division – 35, Risk and Compliance Oversight – 15, SPC Markets – 98, Operations – 77, Enforcement and Market Oversight – 62, SPC – Consumers and Competition – 59, FCA overall – 633.

4 Changes to staffing numbers in two FCA divisions – direct reports to the FCA chair and direct reports to the FCA chief executive officer – have not been presented in the graph but have been included within FCA overall staffing figures.

Source: National Audit Office analysis of Financial Conduct Authority information

2.18 The level of resources available has increased the risk to key projects. In May 2023 the FCA cited resourcing as a risk to achieving all four of its priority strategic commitments, including areas such as reducing and preventing financial crime and preparing financial services for the future. Within the FCA's work moving retained EU law (REUL) into the FCA's handbook, it has identified that a lack of internal expertise and senior capacity means that individuals need to work across multiple projects at the same time which risks delaying project delivery. The FCA estimates that this work will also mean it needs to increase resource in its Policy and Legal divisions due to the volume of legislation which the FCA will be responsible for replacing.

2.19 While the FCA has calculated that its voluntary turnover rate has come down to 9.6%-11.2% between August and October 2023, the rate remains high in some specific areas. For example, the FCA told us that the annual turnover rate for its international team was more than 20% as at October 2023, and there were five other operational teams where the annual turnover rate was more than 15% as at October 2023. The FCA monitors the length of service of staff and has found that it has not experienced a significant change in the proportion of staff who have been with the FCA for more than eight years. This has gone from 34% of the workforce (1,262 staff) in August 2022 to 31% (1,368 staff) in July 2023. The proportion of staff with less than two years' experience has gone from 22% to 37% over the same period.

2.20 The FCA is aware it needs to maintain specialist skills to avoid causing delays in its work, as happened when the FCA was assessing crypto-asset firms for authorisation under money laundering regulations. UK-domiciled firms that were trading before 10 January 2020 were required to apply for authorisation with the FCA by 10 January 2021 or cease their activities. The FCA received more applications than expected and did not have enough skilled staff to process all of these applications within the allocated time. It redeployed staff internally but they required additional training and support. The staffing shortages compared to applications meant that the FCA had to extend the initial deadline and operate a temporary regime. The regime was initially created to last until 9 July 2021, but was later extended to 31 March 2022. The FCA has found recruitment and retention of staff with crypto compliance skills is difficult due to competition between employers for people with these skills.

Influence and innovation

2.21 Given the global nature of the financial services sector, and the FCA's new secondary growth and competitiveness objective, it needs to work with international partners to collaborate, share learning, or influence international standards. It also needs to work with other regulators in the UK, particularly those that regulate other parts of the financial sector or those that may regulate the same firms in different ways.

International influence

2.22 The FCA already works with international groups and forums to establish international standards in a large number of areas. It has been working since 2019 to develop how it approaches this engagement, particularly after EU Exit. In March 2023, the FCA set out detailed plans for its international function, recognising that it lacked a structured process and approach to maximise the effectiveness of international engagement, and did not systematically prioritise objectives, plan for delivery over time, or manage key relationships.

2.23 The FCA plans to develop a long-term approach to international engagement and annual delivery plans. It has set up a new International Steering Committee to oversee this work, which met for the first time in June 2023. The committee is intended to also have responsibility for managing the FCA's requirement to notify or consult with HMT when there is a material risk that a regulatory intervention may be incompatible with areas which fall to HMT, such as mutual recognition arrangements and free trade agreements. The FCA has identified a set of thematic objectives to govern international engagement until the end of 2023. It has also undertaken international engagement within areas such as crypto and sustainability, and in September 2023 began joint work between the international and operational teams to develop delivery plans for international engagement in these areas.

2.24 Some financial services firms, as well as being regulated by the FCA, may also be regulated by other organisations such as the Prudential Regulation Authority. The FCA must work closely with these other organisations to ensure a coordinated approach (see Figure 1). Following HMT's 2019 call for evidence on regulatory coordination within financial services, the Financial Services Regulatory Initiatives Forum was jointly established by the Bank of England (including the Prudential Regulation Authority), the FCA, HMT and others in April 2020. The forum is intended to allow members to share information on regulatory initiatives, including on timing and operational impact on firms. For example, members publish a Regulatory Initiatives Grid twice a year, which outlines upcoming interventions. This allows firms and wider stakeholders to plan for upcoming changes.

2.25 The FCA also works with other UK regulators on cross-cutting issues such as AI, on which the FCA considers regulators must coordinate their work. It has produced joint papers with the Bank of England and the Prudential Regulation Authority specifically on AI in the financial services sector. In April 2021 the FCA moved from an observer member to a full member of the UK Digital Regulation Cooperation Forum.[8] The forum conducts research into key topics around the digital economy. On the use of AI, these include transparency, fairness and healthy competition. The FCA has a small dedicated AI Strategy team leading this work, supported by staff in the wider FCA who contribute to the work alongside other responsibilities. Although the FCA has not developed any specific policy regarding the use of AI, stakeholders we consulted had a comparatively favourable view of the FCA's level of understanding of new developments in the field. Other stakeholders raised concerns similar to those we have set out elsewhere regarding the FCA's capacity and time taken to regulate emerging technologies.

Supporting innovation

2.26 The government has set out that it wants the UK to "champion a pro-innovation approach", particularly on the use of digital technologies. The FCA supports innovation within regulated firms and new firms seeking to enter the market, through its regulatory sandbox. This was launched in 2016 to provide a 'safe space' for firms to test innovative products, services, business models and delivery mechanisms. The regulatory sandbox is offered to firms who have a minimum viable product and want to test their proposition live in the market with real customers. A case manager will work with the firm to develop a testing plan, outlining the test's objectives, success measures and risk mitigation plans. As well as supporting firms to get innovative products to market, the regulatory sandbox is meant to help the FCA ensure that new products have appropriate safeguards from the start.

2.27 At the end of 2022, the FCA reported it had supported 867 firms across six financial sectors via the regulatory sandbox, including firms from across the UK and internationally. The FCA has extended its work to support innovation to include with the following.

- Tech sprints – short events where firms collaborate with each other to propose solutions to regulatory issues. The first tech sprint was also held in 2016.
- The digital sandbox – similar to the regulatory sandbox, but providing firms with General Data Protection Regulation-compliant data sets, to support work on data-intensive projects. The digital sandbox started in 2020 and was made permanent in 2023.
- Innovation pathways – support for firms not yet ready to test their products, but who need help understanding the FCA's regulatory regime. Innovation pathways were launched in 2022.

8 Other members include the Competition and Markets Authority, Information Commissioner's Office and Ofcom.

2.28 The FCA has carried out specific reviews of its services to support innovation. It published a review of the regulatory sandbox in 2017 and a wider review of its innovation work in 2019. Both reports focused on the impact of the sandbox and what challenges there were for firms to take part, rather than examining the operation of the sandbox and whether the FCA could make any improvements. The 2019 evaluation also found that products which have been through innovation processes may be easier for the FCA to authorise when introduced at scale. It found the average authorisation application for insurance or payments firms which had used the sandbox were processed in around 60% of the time of a standard application. The FCA has responded to external suggestions for improvement – for example, in response to the 2021 Kalifa review the FCA made the regulatory sandbox available for use all year round, whereas it had only previously been available during specific application windows.[9] The FCA told us that it surveys firms on what it is doing well and what it could do better. As an example of how it is taking action, it told us that it was considering an 'alumni group' in response to feedback that firms would find it helpful to have access to firms that had already used the services. The FCA has published additional reports on specific tools such as tech sprints and the digital sandbox pilot which evaluate the effectiveness of these programmes. It does not have any current plans for more detailed evaluation of its innovation work.

2.29 The FCA is continuing to develop its tools. For example, it is currently working on a project where the digital sandbox platform will host AI-enabled synthetic data sets – statistically realistic data which are not about real people or companies and can therefore mitigate some concerns around privacy, commercial sensitivity or data-quality issues. These data will be used to support the development of anti-money laundering solutions. The Vallance report recommended in March 2023 that government should work with regulators to develop a multi-regulator sandbox for AI to be in operation within the next six months.[10] The government has since announced a 12-month pilot for this programme, with the service due to launch in the first half of 2024.

9 HM Treasury, *Kalifa Review of UK Fintech*, February 2021.
10 Sir Patrick Vallance, *Pro-innovation Regulation of Technologies Review: Digital Technologies Report*, March 2023.

Part Three

How the Financial Conduct Authority measures, reports and learns from its performance

3.1 Performance measurement is important for trust in regulators and regulation, and in providing accountability to stakeholders. It is also important in helping regulatory organisations to make sure that they are achieving their objectives and making the best possible use of their resources.

3.2 This part of the report sets out:

- how the Financial Conduct Authority (FCA) reports publicly on its performance;
- how the FCA reports internally on performance; and
- the FCA's work to improve and amend learning and evaluation.

Public performance reporting

3.3 To maintain transparency and trust, regulators must present performance against key criteria, measures and indicators in an accessible way. Up until 2022, the FCA only reported publicly on its performance against service standards such as time taken in enforcement cases and responses to complaints. As part of its 2022 strategy, the FCA developed a new system for performance reporting, which linked the outcomes it seeks to achieve with the tools and interventions it deploys. However, it still has more to do to develop the metrics and make the information accessible.

3.4 The National Audit Office's (the NAO's) 2016 report *Performance measurement by regulators* outlines that good performance measurement frameworks should be appropriate to and useful for decision-making within the organisation and meeting the needs of stakeholders outside the organisation.[11] In 2022 the FCA published 104 metrics to show performance against a range of outcomes, but it has not set out a short list of key performance indicators to provide an overall picture of performance. The FCA reported metrics against four 'consistent topline themes', which cut across all the markets and sectors the FCA regulates, 10 'topline outcomes', 13 'commitment outcomes', which are outlined in the FCA's business plan and are reviewed annually, and seven 'strategic transformation-linked outcomes', which relate more closely to the FCA's operational work (see **Figure 7** on pages 40 and 41). The FCA does not yet have the data needed to report on performance for 26 of the 104 metrics it has set out, and it does not have a clear plan for when data will be in place.

3.5 The FCA also provides some performance reporting in its annual report. The 2022-23 annual report focused on the business plan 'commitment outcomes' and not the other outcomes. It sets out the actions the FCA has taken in key areas, alongside reporting on the performance of the metrics. The FCA has set out the direction it expects metrics to move, but has not set out what levels of performance it expects to achieve, or an overall summary of performance, in either the annual report or the performance reporting on its website. This means that HMT and other stakeholders do not have the clarity necessary to judge whether the FCA is on track or not. The NAO performed its own analysis of reported performance using the information on the FCA website and found that 37 of 104 metrics were improving over time and 28 of 104 metrics were getting worse.

3.6 The FCA reports on operating service metrics separately, covering areas such as speed of processing regulatory applications or time to answer telephone calls. In its public reporting on these metrics it does set out overall performance. In 2022-23 the FCA reported that it met or exceeded the targets set for 68.5% of its metrics, compared with 51% of the metrics in 2021-22.

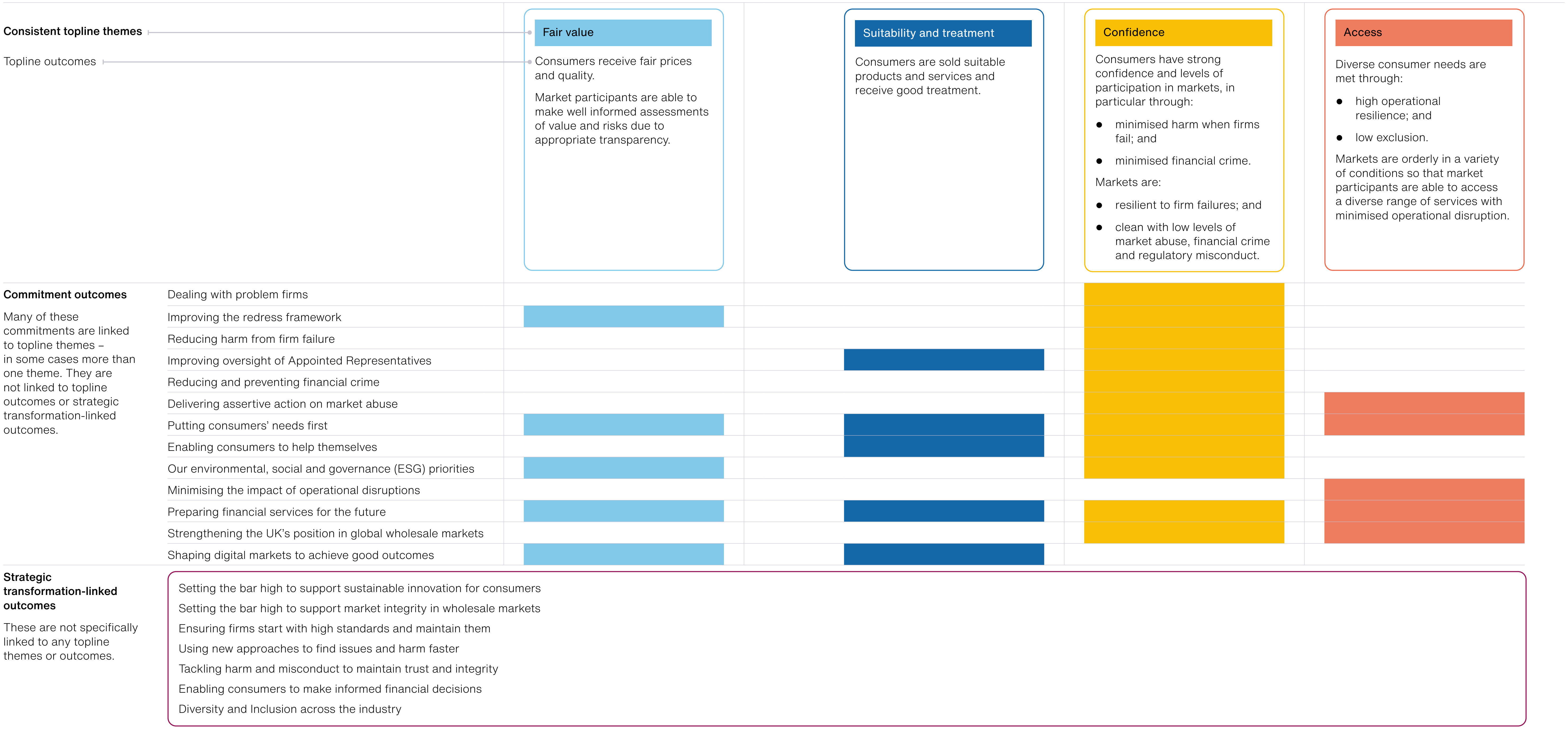
3.7 The FCA is planning further metrics and reporting in the future. In 2023 the FCA identified seven drivers of productivity that would facilitate progress against its new secondary objective, and are tied to its 'consistent topline themes'. These include the FCA's operational efficiency, innovation and proportionate regulation. The FCA plans to develop new metrics to use alongside existing metrics to provide additional reporting against these drivers, which will be included in the FCA's annual report. Additionally, in May 2023 HM Treasury (HMT) published a call for proposals on how regulators including the FCA should report on its new secondary objective. HMT told us that it is currently considering the responses to this call for proposals, and this may result in additional reporting metrics for the FCA.

11 National Audit Office, *Performance measurment by regulators*, November 2016.

Figure 7

The Financial Conduct Authority's (FCA's) reported outcomes against which it will measure performance, 2022–2025

The FCA has developed sets of outcomes related to its topline themes, strategic commitments and transformation work, but these are not clearly linked



Source: National Audit Office analysis of Financial Conduct Authority documents

3.8 The FCA also uses public reporting mechanisms, such as its annual reports and reporting on operating metrics, to support its engagement with HMT. For example, its 2023 response to HMT's formal recommendations was timed to coincide with publication of the FCA's 2022-23 annual report, and used the same information as a basis for reporting. The FCA also uses its annual report as a mechanism to provide updates for stakeholders to hold the FCA to account for its performance, and this will include its new secondary objective in future.

Internal performance reporting

3.9 Performance measurement is important in helping regulatory organisations achieve their objectives and make the best use of resources. Good performance information is essential for managing internal change and must be integrated with business planning, budgetary and operational processes, supported by clear understanding of the resourcing needs, and with clear links between inputs, outputs and outcomes.

3.10 Since 2020-21 the FCA has undergone significant structural changes in response to external recommendations, including bringing its policy, supervision and competition functions closer together and improving its approach to gathering and using data. In August 2022, the FCA began reporting on progress against its 2022–2025 strategy. It now produces a quarterly report for its Executive Committee (ExCo) on the delivery progress for its 13 business plan commitments, with status updates for the budget, resources, timeline and 49 leading indicators for 168 related activities. It also reports monthly on the four business plan commitments it is prioritising (these are: preparing financial services for the future; putting consumers' needs first; reducing and preventing financial crime; and strengthening the UK's position in global wholesale markets), and any other areas which rated as amber for overall delivery.

3.11 The FCA has also been working on a project to improve its operational performance reporting since 2020. The project aims to improve the consistency of operational performance reports and reduce the time it takes to produce them. The work is conducted along business lines, and covers discrete areas. The project aims to bring together information on spend, staffing, progress and quality, to allow senior management to identify areas of risk and take action. The FCA could not tell us when it plans to complete this work. As the work has extended to more areas, the team is considering how it can simplify or reduce the amount of information provided to ensure it remains manageable for consideration by ExCo.

3.12 Strategic and operational performance reporting are presented together to ExCo via the chief operating officer's report, which also highlights issues with each. However, the cross-organisational format of the business plan commitments can make it hard to link the two, and to identify the resourcing going into achieving each business plan commitment.

Evaluation

3.13 Robust evaluation can help evidence value for money, provide insight into unintended outcomes and refine regulatory interventions to improve outcomes. The FCA can learn from evaluations to help decide whether specific rules are delivering the intended outcomes and whether they should be improved or stopped altogether. Using evaluation evidence in policy design can enable the FCA to better target its interventions and maximise the chances of achieving desired objectives.

3.14 The FCA is making changes to how it carries out evaluation work, and how much it evaluates, in response to the requirements of the Financial Services and Markets Act 2023 (FSMA 2023). Before FSMA 2023, the FCA's evaluation work has been focused on assessing the impact of discrete interventions through Post-Implementation Reviews (PIRs), a formal requirement for reviewing regulation, and ex-post impact evaluations (EPIEs). Currently the FCA aims to complete one EPIE per year; however, it did not publish any during 2021 and 2022, which the FCA tells us is due to resources being reprioritised as a result of the COVID-19 pandemic. During this time, the FCA reported on the benefits of its regulatory activities, quantifying the impact where possible, and developed its outcome metrics. As required under FSMA 2023, the FCA published a draft Rule Review Framework (also referred to as 'the Framework') in July 2023 to explain how it plans to monitor and review how its rules are working in practice.

3.15 As set out in the Framework, when designing new rules, the FCA will identify and monitor lead indicators to understand if they are working as intended. This new monitoring data, general intelligence insights and stakeholder feedback will be used to determine if further evaluations are required for new or existing rules, balanced against wider demands for the FCA's resources. Within the Framework, the FCA set out three different types of review that it can undertake.

- Evidence assessment – to analyse data which indicates whether the key intended outcomes of the policy are being, or are on course to be, met.
- PIR – to assess whether the policy has met the intended outcomes, seeking to identify implementation issues and unintended consequences by assessing the wider state of the market after the intervention.
- EPIE – to quantify the impact of the FCA's interventions. These types of reviews are the most rigorous tool that the FCA utilises, with significant planning and resources required.

In the five years from 2018 to 2022 the FCA has published 135 policy statements, five EPIEs and three PIRs. So far in 2023 the FCA has published one EPIE and two PIRs. It will continue to publish these but does not plan to routinely publish evidence assessments. It will publish formal updates where required, for example where substantial reviews have taken place or rules are not working as intended.

3.16 The FCA views the framework as a cultural shift, moving away from ad-hoc evaluations, creating clear accountability for new rules and giving teams responsibility for continually monitoring their impact. In the Framework, the FCA sets out that it will review the effectiveness of retained EU law (REUL) as it works to repeal and replace the law. It has stated that this will use a significant proportion of the FCA's resources in the short term, but commits to continuing to carry out at least one impact evaluation per year. The FCA has not set expectations for the amount of evaluation work it expects to complete. It plans to use its business planning process to prioritise evaluations alongside its strategic priorities, at which point it will consider the resources required. For evaluations that are required urgently, the FCA may re-prioritise resources.

3.17 In the Framework the FCA sets out its intention to monitor all new rules unless it decides either that the impact is likely to be minimal (for example, administrative changes) or that monitoring the impact would not be an effective use of resources. When planning the Framework, teams highlighted resourcing as a major barrier to integrating monitoring and review into business as usual. The FCA has since considered resource requirements for the monitoring of new rules. The FCA is also planning on introducing new ways for stakeholders to flag rules that they believe are not working effectively. In addition, FSMA 2023 sets out the powers for HMT to direct the FCA to review a rule, provided that rule has been in place for at least 12 months and if, in the opinion of HMT, it is in the public interest for this rule to be reviewed. If HMT exercises this power, the FCA expects it may have to reprioritise other planned work to meet the demand for resources.

3.18 Using evaluation evidence in policy design can enable the FCA to better target its interventions and maximise the chances of achieving desired objectives. In May 2023 the FCA standardised its approach to applying lessons learnt through its change process, as set out in Part Two. It now requires teams to set out how they have drawn from previous lessons learnt when designing projects, and record their own lessons learnt and recommendations before closing down projects. For example, staff working on the authorisation of European Economic Area firms drew from lessons learnt on previous projects such as the authorisation of consumer credit firms to ensure the regime met its objectives. The FCA told us it has also begun its own lessons learnt report, which considers its approach to monitoring the time and resources required for different types of cases. The FCA told us that it expects evaluation work will be proposed and prioritised via the same change process.

Appendix One

Our audit approach

Our scope

1 This report presents our independent conclusions on how well placed the Financial Conduct Authority (FCA) is to respond to the changes that the financial services sector is undergoing, and to support government's ambitions for the sector. Our conclusions were reached following an analysis of evidence collected primarily between July 2023 and October 2023.

2 The evaluative criteria that we used to assess value for money was based on our 2021 *Principles of effective regulation* and criteria for performance measurement by regulators.[12] We have identified and focused on the key processes and enablers for managing change including strategy, accountability, capability and capacity, data and tools, stakeholder engagement and international influence, and evaluation and performance measurement. This approach was supported by insight from previous work on regulators facing change.

3 In forming our conclusions, we drew on a range of study methods and a variety of evidence sources, as described in the paragraphs below. We collated and analysed the evidence we obtained, using our evaluative criteria as a framework. We looked across different sources of evidence to support each of our findings. We triangulated any issues brought to our attention through our interactions with government bodies or other stakeholders against other sources. Where necessary, we asked questions of the relevant parties and/or asked for more information to ensure that we focused on the highest-priority areas.

12 National Audit Office, *Principles of effective regulation*, May 2021.

Our evidence base

Interviews

4 We conducted 32 virtual interviews with representatives from the FCA (26) and HM Treasury (HMT) (six). These took place from 3 August to 29 September.

5 We interviewed officials from the FCA and HMT selected to participate because of their job roles and their relevance to the audit. Meetings covered the following topics:

- the strategic direction of financial services regulation and the government's ambitions for the sector;
- the FCA's horizon-scanning work and business planning processes including its strategic prioritisation of resources;
- the FCA's supervision and enforcement work within our case study areas;
- the FCA's international engagement;
- the FCA's performance monitoring and evaluation;
- the FCA's work with HMT on developing new regulations and bringing activities within its regulatory perimeter; and
- the FCA's work with HMT on operationalising the requirements of the Financial Services and Markets Act 2023 (FSMA 2023).

Stakeholder interviews

6 Semi-structured interviews with stakeholders and experts. We met with other stakeholders to discuss: the impact of various changes within the financial services sector; how the FCA has responded to those changes; and their interactions with the FCA. We spoke to individuals and representatives from the following organisations:

- TheCityUK
- FCA's independent Practitioner Panels
- Citizens Advice
- The Personal Investment Management & Financial Advice Association (PIMFA)
- CryptoUK
- ClientEarth
- Fair By Design
- FCA's Financial Services Consumer Panel
- Ada Lovelace Institute
- Association of British Insurers (ABI).

7 Stakeholders were selected through independent research, and some contacted us directly via media coverage of our work-in-progress note.

8 We analysed the data, reviewing it against the themes identified in our evaluative framework, as well as taking into consideration themes emerging from the data. We used the analysis to:

- inform further lines of enquiry that were followed up with the FCA; and
- triangulate evidence from other sources (including our document review and evidence from wider stakeholders).

Document and literature review

9 We reviewed a range of published and unpublished documents to develop our understanding of changes affecting the financial services' regulatory regime and the FCA's work to respond to these. We also reviewed documentation related to key internal enablers such as the FCA's strategic planning, accountability, capability and capacity, data and tools, stakeholder engagement and international influence, and evaluation and performance monitoring.

- We reviewed documents in the public domain including the FCA's strategy, business plans and annual reports, and discussion papers, consultations and policy statements from both FCA and HMT including on the delivery of the Smarter Regulatory Framework and new areas of regulations.
- We reviewed documentation provided by the FCA that is not available in the public domain. This included strategic and risk documentation, board minutes and evidence and findings from internal reviews.

10 We reviewed each document against our overarching audit questions.

Case studies

11 We carried out four case studies of areas of regulatory change to illustrate how the FCA has responded to recent or emerging developments within the financial services sector, and one case study looking at how the FCA manages change. The aim of the case studies was to:

- explore how the FCA has evaluated key practices and plans to develop them in the future;
- understand how the FCA is engaging with and aligning to international bodies and standards;
- explore how the FCA manages capacity and capability requirements; and
- understand how the FCA is working with other regulators, both within the financial sector and more widely.

12 The case studies covered:

- authorising European Economic Area firms;
- crypto-assets – regulation in place and the likely development of future regulation;
- artificial intelligence (AI) – understanding risk; and
- sustainability disclosure requirements and the link to international standards.

13 We selected case studies to capture high-interest changes occurring within the financial services sector. It is not a representative sample, the case studies are not generalisable, and we have not drawn wider conclusions about the effectiveness of the FCA's work.

14 The primary sampling criteria were:

- regulatory change – areas must represent a recent change to the FCA's approach linked either to new legislation or to wider contextual changes such as technological innovations; and
- the extent to which managing the work has an impact on key enablers, that is, accountability, capacity and capability and so on.

15 Overall, we achieved good diversity across the primary sampling criteria. The achieved sample is set out in Figure 2.

16 Each case study consisted of interviews with the relevant teams within the FCA and HMT, as well as analysis of publicly available and internal documents.

Quantitative analysis

17 We conducted quantitative analysis of the FCA's published performance metrics as well as its staffing data.

18 The analysis of performance data examined whether the FCA are effectively achieving what it set out to do. We looked at baseline values alongside latest values to assess whether an improvement was shown or otherwise. This allowed us to identify how many of the metrics that the FCA set out for itself were being achieved. It also allowed us to make evaluative statements on the clarity of its performance data. For some of the FCA's performance metrics no data was available, and for others it was not possible to tell if performance had improved or not (for example, if the number and value of incidents had moved in opposite directions). We have therefore not included these within our reporting.

19 The analysis of its staffing data examined which areas are changing as well as general staff trends over time. This allowed us to look at which directorates are growing the most and consider how manageable this growth is. We did not audit the accuracy of staffing data provided by the FCA. The FCA defines voluntary turnover data as the number of individuals who actively choose to leave the organisation, and its overall turnover data as the number of individuals who actively choose to leave the organisation and individuals who do not actively choose to leave the organisation and rather exit due to planned or unplanned circumstances.

20 Our analysis was completed using Microsoft Excel and using data provided by the FCA.

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