National Audit Office

REPORT

Financial services regulation: Adapting to change

Financial Conduct Authority

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Key facts

50,000
approximate number of firms regulated by the Financial Conduct Authority (FCA)

June 2023
the Financial Services and Markets Bill receives Royal Assent

16%
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.