

## **Sanjay Malhotra: Regulation by Reserve Bank of India - some reflections**

Text of the Second V K R V Rao Memorial Lecture by Mr Sanjay Malhotra, Governor of the Reserve Bank of India, Delhi School of Economics, New Delhi, 20 November 2025.

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Prof. Ram Singh, Director, Delhi School of Economics, Prof. Pami Dua, distinguished faculty of the Delhi School of Economics, assembled dignitaries and dear students. Good afternoon.

I am pleased to be here at the Delhi School of Economics (DSE) to deliver the Second V.K.R.V. Rao Memorial lecture. The late Professor Rao was not only a distinguished scholar - being one of the first three Ph.Ds in Economics from Cambridge University and winning the prestigious Adam Smith Prize in 1935 - but also an eminent institution builder. He served as member of the Planning Commission and Union Education Minister. For his outstanding contribution to public policy and economic research, Professor Rao was awarded the Padma Vibhushan in 1974. It is an honour to deliver a lecture in the memory of such a distinguished personality.

DSE is an august institution that has made stellar contributions in the economic development of our country. The people who have studied, researched, or taught here have had profound influence in shaping economic policy in India over the years. We, at the Reserve Bank of India too have benefited immensely given that many students have joined the Bank. Many of them have risen to the upper echelons of the Bank's management over the years. I thank Prof. Ram Singh and DSE for giving me this opportunity to address you all at this prestigious institution.

You all have been in my thoughts for the last few days. You are all very bright and intelligent, having got admission to this prestigious institution, through a rigorous selection process. I have been thinking about you because you are the future leaders of our country. I have been pondering about what I should speak to you bright men and women. India looks up to you to shape and influence public policy and economic research in our country, as many of your predecessors have done.

Considering the erudite audience, I have chosen to speak on regulation making, because regulations are pervasive. They represent an invisible fabric that enables markets to function, protects consumers, and maintains the delicate balance between innovation and stability. I have structured my speech into five parts – (i) the role of regulation in public policy, (ii) how financial regulation is different and critical, (iii) RBI's objectives of regulation, (iv) RBI's key principles of regulation, and finally (v) some challenges in regulation making. I hope this will trigger some interest for research in this area among the students and faculty.

### **I. Role of Regulation in Public Policy**

You are all aware that while markets are powerful engines of growth and efficiency, they can fail and when they do, the consequences can be severe. Regulations attempt

to address market failures caused due to a variety of reasons: information asymmetry, externalities, natural monopolies, systemic risks, and consumer protection, to name a few. Regulation is a pragmatic response to the inherent limitations of unregulated markets in specific contexts.

## **II. Financial Regulation: A Different Paradigm**

Financial regulation operates in a fundamentally different framework compared to other sectoral regulations. This difference stems from three unique characteristics of financial markets.

First, financial institutions are interconnected in ways that non-financial entities rarely are. If a bank fails, it has a cascading effect - depositors lose savings, inter-bank markets freeze, credit supply contracts, and payment systems falter. This impacts the entire economy, which can feed into a systemic crisis. The 2008 global financial crisis in the Advanced Economies (AEs) demonstrated this with devastating clarity.

Second, financial institutions are inherently fragile due to maturity and liquidity transformation. Banks accept short-term deposits and make long-term loans. This transformation is economically valuable but creates vulnerability. A loss of confidence can trigger bank runs, converting liquidity problems into solvency crises within days. Unlike a manufacturing unit that can be shut down temporarily, a bank facing a run must be resolved immediately, or contagion spreads.

Third, financial markets are prone to procyclicality and herd behaviour. During booms, risk is under-priced, lending standards deteriorate, and asset bubbles form. During busts, credit vanishes precisely when it is most needed. This amplification of business cycles distinguishes financial markets from most other sectors. The procyclical behaviour and its amplification effects on economic volatility are well recognised.

These characteristics explain why financial regulation is more complex, and more consequential than regulation in other sectors. It is not merely about protecting individual consumers and promoting efficiency - though these are of paramount importance - but also about safeguarding systemic stability and, by extension, the entire economy.

## **III. RBI's Objectives of Regulation**

I will now spell out RBI's main objectives of regulations.

The foremost priority and key objective is to ensure financial stability in the system. Financial Stability is defined as a "condition in which the financial system – comprising of financial intermediaries, markets and market infrastructure – is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities"<sup>1</sup>.

For us in the Reserve Bank, financial stability remains the north star, because we realise that short term growth achieved at the cost of financial stability can have bigger consequences for long-term growth. Research shows that financial instability may not

only more than offset the gains of higher short-term growth, but also make recovery more distressful and longer.

Although financial stability remains the bedrock, there are other objectives, occasionally overlapping, yet distinct. These, inter alia, include:

- a. Prudential aspects, for example liquidity and capital requirements, to ensure safety and soundness of financial operations in the interest of all stakeholders, especially, depositors;
- b. Conduct related measures for consumer protection;
- c. Assistance in law enforcement, e.g., prevention of money laundering; and
- d. Broad socio-economic objectives, e.g., lending to priority sectors.

#### **IV. RBI's Key Principles of Financial Regulation**

As I mentioned in one of my past speeches<sup>2</sup>, there are five key principles of our regulation making: preference for principle-based formulation; proportionality; consultation; evidence and data-based; and lastly, regular review. Let me briefly touch upon these principles to elaborate their importance.

##### *Preference for Principle-based Regulation vis-a-vis Rule-based Regulation*

First is the idea of principle-based regulation. Principle-based regulation focuses on outcomes. It uses high-level general statements or principles. These principles are designed to be applicable across a wide range of circumstances. It often contains explanations of the intent behind the principle and qualitative rather than quantitative terms.

In contrast, rule-based regulation uses specific statements to define requirements that entities must meet. These necessarily focus on specific areas and tend to use quantitative terms. If one was to draw an analogy with parenting, the explicit to-do list made by parents in early formative age is akin to "rule-based regulation" and the broad guidance given as the child grows older is akin to "principle-based regulation".

The global discourse on regulatory simplification, argues for principle-based regulations over rule-based approaches, for simplicity over exhaustive specification. The logic is compelling: complex rules create compliance cultures rather than risk management cultures. They invite gaming and arbitrage. Moreover, they become outdated as markets evolve.

Principle-based regulation reduces the potential for 'creative compliance', avoids the 'tick-box approach', and obviates the need for frequent updations. However, principle-based regulation, while simple, is subject to interpretation risk. Principles without clear standards can lead to inconsistent application and regulatory capture. This may also significantly increase cost of compliance for regulated entities due to the requirement to form their own policies with detailed rationale.

We often face a question as to which approach is better. There is no straight-forward answer to this, even though we prefer principle-based regulation. And that's why you would observe that while we are moving towards a principle-based regulatory regime, most of our regulations are hybrid - a combination of rules and principles. The proposed expected credit loss (ECL) framework for provisioning norms, announced in October this year<sup>3</sup>, is a good example of this evolution. The framework combines principles for provisioning with rule-based prudential floors to avoid misuse and misinterpretation.

The challenge for us is to achieve "optimal simplicity" - regulation that is as simple as possible but no simpler, to paraphrase Einstein.

### *Proportionality*

Coming to the second principle, proportionality, it is an emerging feature of more rationalised regulatory frameworks across the world. Indian financial system comprises a diverse set of financial institutions and banks with varying scales of operation, levels of complexity and extent of risks. It is therefore natural that our regulations are proportionate in measure. The principle of proportionality is like a customised set of risk-sensitive regulations, balancing the costs and benefits based on the risk implication of the institutions concerned.

This fundamental principle reflects duly in our policy formulation across and within groups of entities. For example, the idea of proportionality has been embedded in the regulatory architecture for NBFCs in the form of scale-based regulations; tier-based structure for cooperative banks; and higher capital requirements for domestic systematically important banks (D-SIBs). Similarly, proportionality is also reflected in differential treatment of banks as compared to the NBFCs on several parameters including granularity of exposure, liquidity and capital requirements. Proportionality is kept in mind even for differential risks perceived by similar entities, for example, different capital requirements are prescribed for different types of loans and other exposures keeping in view their differential risks. All of these buttresses the point I mentioned earlier that proportionality is a "customised set of risk-sensitive regulation".

### *Consultation*

The third principle is consultation. We realise that triangulation is a must. We appreciate that we do not have the monopoly for knowledge. Consultation has been an integral part of our decision making. It explicitly embeds accountability and transparency, which are important to us as a public authority. It bridges information asymmetry. It enables us to look at things through the eyes of others and see many more dimensions. Consultation improves our regulation making. At the Reserve Bank, we have institutionalised this requirement in our framework<sup>4</sup>. Every major regulation is proposed in draft form for public consultation.

### *Evidence-based Approach*

The fourth element is to make regulations evidence-based, as far as possible. Evidence-based policymaking refers to the method of policy development that prefers facts and credible, relevant evidence, over opinion, intuition, anecdotes and common sense to take decisions.

While we may not have at our disposal the rigorous approach of randomised controlled trials, the principle is certainly inspired by it. We try to look for evidence on what works and what not. This may sometimes be difficult and challenging because of non-availability of local data. In such cases, we use international standards, which are customised to our context and conditions. Let me give a few examples of evidence-based regulation making.

One, the revised guidelines on project finance, emerged from a careful study of default rates, recovery rates, and the cash flow characteristics of such lending by banks. Two, the increase in the run-off factors for digital deposits under the refined liquidity coverage ratio (LCR) requirements for banks demonstrates another example of evidence-based regulation. Three, we increased the risk weights on bank credit to NBFCs in view of certain emerging risks in this segment post-covid; these were subsequently restored to original weights, once the evidence suggested so.

### *Regular Review*

The fifth element is regular review. Regulations need to change when the context changes. However, there is a stickiness to regulation because of regulators' proclivity to adhere to status quo. A variety of well-recognized behavioural phenomena aid in explaining such a bias: common cognitive biases and risk aversion tend to advantage the status quo. In laboratory experiments, for instance, psychologists find that framing specific options as the status quo result in those options being selected far more frequently than when there is a neutral framing of the options. Banking regulators' behaviour is no different. Claudio Borio, former senior official of Bank for International Settlements, observed that, "The fear of going against the manifest view of markets can have a powerful inhibiting effect." The International Monetary Fund in discussing regulators' implementation of macroprudential policy tools, also notes "biases in favour of inaction."

Roberta Romano of Yale Law School contends that there is an Iron Law of Financial Regulation: following financial crises, Congress enacts legislation that increases financial regulation. She terms them as a regulatory ratchet. You are all aware that the ratchet effect describes a process or an economic phenomenon that, once set in motion, is difficult to reverse, similar to how a mechanical ratchet moves in one direction only. Similarly, Romano contends that new statutes are layered atop existing laws and new regulations are grafted onto existing ones, creating an increasingly complex and opaque regime.

This calls for a periodic review of regulations. The FSDC under the chairpersonship of the Finance Minister has decided that all financial regulators conduct a review of all regulations every 5-7 years. We too have started the process.

A number of measures<sup>5</sup> that we announced in October, this year are a result of the review of the regulations. Some of these regulations were framed to meet the twin balance-sheet problem post the Global Financial Crisis, in the wake of aggressive fiscal and monetary stimulus. The regulatory and supervisory frameworks have been

strengthened since then. The performance and health of the banking sector is much improved. As a result, these regulations needed to be reviewed and accordingly they were reviewed and finetuned.

## **V. Challenges in Regulation Making and Enforcement**

Having covered the main principles of regulation making, I will now describe the challenges that we face in this regard. Creating effective regulation is an exercise in navigating multiple tensions. Let me highlight five of them.

### *Balancing Cost-benefit Trade-offs*

The first challenge is to balance the cost-benefit trade-off. While regulations do offer benefits in terms of stability, consumer interest, etc, they come with a cost. Economic interest warrants increasing efficiency, and promoting innovation. We recognise that just like there are no free lunches, regulation too is not devoid of costs. There are trade-offs between the benefits and efficiency.

We keep this trade-off in mind while formulating regulations. We attempt to strike the right balance, keeping in view the benefits and costs of each and every regulation. This has been embedded in our regulation making framework, which we formalised in May this year.

Before releasing draft or final guidelines, we thus try to estimate direct and indirect impact of our proposed regulations. Where exact calculations are difficult, we tend to rely on estimates. This helps us finetune the measures to ensure that cost of regulation is not weighing down the benefits disproportionately.

### *The Boundary Problem: What Should Be Regulated?*

A subset of the cost-benefit trade-off is whether to regulate or not. Financial innovation continuously creates entities and activities at the regulatory perimeter. Stablecoins, cryptos, buy-now-pay-later schemes, etc. challenge traditional regulatory categories. Should they be banned, tolerated, or brought within regulatory frameworks?

This is a deep question, which needs judgment about the balance between potential benefits and risks. The rapid pace of innovation means that this judgement needs to be made continuously so that regulatory approaches evolve and keep pace with the needs of the times. The RBI has not only kept pace with the development but has been proactive in this regard, adopting a balanced and prudent approach. It adopted a cautious approach to cryptocurrencies contrasts while taking an enabling stance towards regulated digital innovations like UPI or digital lending.

### *The Innovation-Stability Trade-Off*

A related dilemma is how much innovation to permit when its risks are not fully understood. Excessive caution stifles beneficial innovation and can drive activities underground. Excessive permissiveness can allow risks to accumulate and even threaten financial stability.

The RBI's regulatory sandbox approach represents an attempt to balance the trade-off - creating controlled environments where innovations can be tested under regulatory oversight before being scaled. However, questions remain about the optimal design of such sandboxes, the criteria for graduation, and the balance between experimentation and protection.

### *Procyclicality in Regulation*

Fourth, sometimes regulations themselves can amplify business cycles. Emerging markets face particularly acute procyclicality challenges because capital flows amplify domestic cycles. Mark-to-market accounting forces institutions to recognize losses during downturns, potentially triggering fire sales. Capital requirements, if not designed carefully, can force deleveraging precisely when credit is most needed. Provisioning norms that respond to current conditions rather than expected losses create procyclical dynamics.

The Basel III framework attempts to address this through countercyclical capital buffers - requiring banks to build capital during booms that can be released during stress. The RBI has implemented these provisions, but there are questions about their calibration from time to time.

### *Regulatory Forbearance vs. Strict Enforcement*

The fifth challenge every regulator faces is with regard to implementation when strict enforcement of standards seems to threaten broader stability. The temptation towards forbearance - temporarily relaxing requirements - is understandable but dangerous. It can allow problems to fester, create moral hazard, and undermine regulatory credibility.

India has grappled with this dilemma. Repeated restructuring schemes for stressed assets and loan waivers, while providing short-term relief, delayed recognition of fundamental problems. The RBI's shift towards tighter enforcement, including the Insolvency and Bankruptcy Code's prompt resolution provisions, reflects this approach. Yet, the COVID-19 pandemic prompted temporary regulatory relief measures, as is the case with trade-related regulatory measures taken recently. These illustrate that context matters.

Our approach towards forbearance is clear: forbearance should be exceptional, time-bound, and transparent. It should not become a substitute for addressing underlying problems.

## **VI. Conclusion: Regulation as an Evolving Discipline**

Let me now conclude. The intent of my detailed treatment of this topic today was to expose you to a relatively diverse set of issues, igniting your interest in the area of regulation making.

As you advance in your academic and professional journeys, I encourage you to view regulation not as a static set of rules but as an evolving discipline that responds to

changing markets, technologies, and risks. Effective regulation certainly requires technical expertise, but also judgment, humility about what regulators can and cannot achieve, and constant learning.

The Reserve Bank of India is trying to continuously adapt. We are vigilant and alert to emerging risks and evolving conditions. We are encouraging innovation while being mindful of our regulatory objective of safeguarding systemic stability. We are trying to simplify regulations where possible while maintaining necessary safeguards. We are strengthening coordination with other regulators while respecting jurisdictional boundaries. We are trying to enforce rules consistently while recognizing that circumstances sometimes warrant flexibility.

These tensions cannot be permanently resolved - they must be continuously managed. Managing this requires not just regulators but informed citizens, responsible financial institutions, engaged scholars, and yes, bright students like yourselves who will shape the future of Indian financial system. Achieving good regulatory outcomes is almost always a collaborative effort: by the government, amongst regulators, the regulated, and the broader community.

I wish all of you a great success in all your endeavours.

Thank you. Namaskar. Jai Hind.

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<sup>1</sup> [Financial Stability Review, ECB \(December 2006\)](#)

<sup>2</sup> [Inaugural Address by Shri Sanjay Malhotra, Governor, Reserve Bank of India at the FIBAC 2025 Conference, Mumbai, August 25, 2025](#)

<sup>3</sup> [Draft "Reserve Bank of India \(Scheduled Commercial Banks-Asset Classification, Provisioning and Income Recognition\) Directions \(Oct 2025\)](#)

<sup>4</sup> [Framework for Formulation of Regulations \(May 2025\)](#)

<sup>5</sup> [Statement on Developmental and Regulatory Policies, RBI \(Oct 2025\)](#)

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