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Responsible Ai in Indian Banking: A Critical Legal Assessment of the Rbi's Free-Ai Framework and the Future of Algorithmic Regulation

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ABSTRACT

Artificial Intelligence (AI) has been a game-changer in the banking and financial services industry, revolutionizing how financial institutions manage credit, fraud, risks, and customer service. AI-powered technologies present significant potential for enhancing operational efficiency, boosting financial inclusion, and accelerating banking service delivery. Their use is also fraught with legal and regulatory issues of algorithmic bias, transparency, data protection, accountability, and consumer rights. The challenge is especially significant in India due to the growing engagement between traditional banking institutions, non-banking financial companies and technology-enabled lending platforms.

The Committee on the Framework for Responsible and Ethical Enablement of Artificial Intelligence (FREE-AI) of the Reserve Bank of India (RBI) presented its report on 13 August 2025. The report outlines seven guiding principles and six strategic pillars with 26 recommendations for the responsible adoption of AI in the financial sector. The FREE-AI framework is reviewed in this paper in the context of the existing Indian legal and regulatory landscape with a critical objective. It examines the relationship between the framework and relevant legal instruments such as the Banking Regulation Act, 1949, the Reserve Bank of India Act, 1934, the Consumer Protection Act, 2019, the Digital Personal Data Protection Act, 2023, and the RBI (Digital Lending) Directions, 2025.

The paper calls for the translation of the recommendations made by FREE-AI into explicit regulatory expectations and feasible institutional protections, since the former is a substantial step in India's efforts at responsible governance of AI. It highlights the regulatory weaknesses relating to algorithmic fairness, explaining algorithms, independent evaluation of algorithms, third-party accountability, and providing consumers with a remedy. The paper calls for a proportionate, risk-based regulatory framework, complemented by algorithmic audits, effective human oversight, transparent customer communication, and greater accountability systems, all underpinned by strong board-level governance.

Keywords: Artificial Intelligence, Indian Banking, FREE-AI Framework, Algorithmic Accountability, Consumer Protection, Digital Lending, RBI, Data Protection.

1. INTRODUCTION

The use of digital technologies has revolutionized the work of the banking and financial services industry. Traditional banking activities, which were earlier dependent largely upon manual processes and human assessment, are increasingly supported by automated systems, data analytics and artificial intelligence. Financial institutions make use of these technological tools for processing customer information, for detecting suspicious transactions, determining creditworthiness, managing financial risks, and enhancing financial institutions' and customers' interactions.

One of the most powerful technologies in transforming this is Artificial Intelligence. AI-based systems can process vast amounts of data, detect patterns, and make predictions or recommendations, unlike traditional computer programs, which follow instructions. Machine learning, NLP, and predictive analytics are increasingly germane to financial institutions looking to boost the efficiency and effectiveness of their operations.

AI can apply to banking in a number of different ways, from automated credit assessment, fraud detection, customer profiling, transaction monitoring, risk management, through to the use of chatbots and digital loan processing. These applications can reduce operating costs, increase efficiency in financial services, and increase access to financial services. AI can also help financial institutions in countries like India, where income disparities and geographical factors make it difficult for some people and small businesses to access credit, by helping to identify them. But as the world advances, there is a lack of fairness and accountability. AI systems are built from the data they are trained on and assumptions that are included in their structure. The decisions made may perpetuate or exacerbate inequalities in the underlying data, if any, or fail to provide a complete dataset. An algorithm can also use variables that seem neutral, but are indirectly tied to socio-economic factors. As a result, automated systems can give results that are hard to comprehend, dispute, and/or rectify. Such concerns gain particular importance when it comes to decisions with regard to access to financial services. For example, an automated credit assessment system can say "no" to a loan application when considering a number of factors that are not fully communicated to the applicant. If the institution is not able to establish the key elements that affect the result, the customer might have trouble challenging the decision. Likewise, if a technology is created or run by an outside technology service provider, it can be difficult to establish liability for an inaccurate or unfair outcome.

On 26 December 2024, the Reserve Bank of India (RBI) set up a committee for the development of a Framework for Responsible and Ethical Enablement of Artificial Intelligence (AI) in the Financial Sector to address the opportunities and risks of AI. The committee tabled its report on 13 August 2025. The report (the FREE-AI framework) aims to support responsible use of AI, while maintaining institutional responsibility, accountability and financial sustainability. It enumerates seven principles of governance, six strategic pillars, and 26 recommendations. [1], [2]

The introduction of FREE-AI is a significant step in the financial regulatory system of India. It acknowledges the need for AI governance not just to be efficient and effective, but also fair, transparent, accountable, safe, and protective of consumers.

However, this does not mean an AI policy will solve all the legal questions that arise when using AI. There are questions about its legally binding nature, the duties of regulated entities, its protection of consumers, and the need for further protection of algorithmic decisions.

This paper thus seeks to critically analyse the FREE-AI framework and if current regulatory framework in India is sufficiently robust enough to meet the challenges created by the use of AI in banking.

1.1 Statement of the Research Problem

As AI becomes more prevalent in the banking sector, regulators are facing new challenges that go beyond cybersecurity and data protection concerns. Banking consumers' rights and interests can be impacted by algorithmic bias, lack of transparency in decision-making, third-party dependence, and uncertainty of responsibility.

The RBI has proposed the FREE-AI framework to promote responsible AI use; while the recommendations are welcome, they need to be explored in the context of enforcement and implementation and the interplay between these and existing banking regulations.

The main problem in the current legal and regulatory regime is whether it offers sufficient protection to maintain fair, transparent, accountable, and consumer-friendly banking operations through AI.

1.2 Research Questions

The following research questions are discussed in the paper:

Does the RBI's FREE-AI framework sufficiently cover the legal and regulatory challenge posed by the use of AI in the Indian banking sector?

Whether the framework offer adequate protection against algorithmic bias and algorithmic injustice?

Do the existing Indian banking laws and RBI guidelines cover the transparency and accountability of AI-enhanced banking decisions?

Will the current framework for safeguarding consumers in financial decisions that involve AI make for effective remedies for those impacted by such decisions?

Do we need more and stricter sector-specific regulations for responsible use of AI in the financial industry?

1.3 Objectives of the Study

The aim of the study is:

To explore the increasing application of AI in the Indian banking and financial services industry.

To understand the principles, pillars, and recommendations under RBI's FREE-AI framework.

To analyse the current Indian legal and regulatory landscape surrounding AI in banking.

To identify the legal aspects of algorithmic bias, transparency, accountability, and consumer protection.

To assess the current level of protection and suggest steps for improving the governance of responsible AI in banking.

1.4 Research Hypothesis

The paper follows the premise that:

The RBI's FREE-AI framework offers a significant groundwork for responsible use of AI in the banking sector in India, but enhanced regulatory clarity, robust institutional oversight, and heightened consumer protection measures are key to its success.

2. RESEARCH METHODOLOGY AND SCOPE

This research was conducted using a doctrinal and analytical approach of legal research. It mainly analyzes the existing laws, directions of regulation, policy documents, committee reports, and judicial decisions related to artificial intelligence and the banking sector in India.

The study is based on primary sources of law, namely regulatory instruments of the Reserve Bank of India and Parliamentary laws. Secondary sources such as academic literature, policy, and international regulatory documents are consulted to gain insight into the general evolution of legal and technical issues around responsible AI.

The study is qualitative. It does not attempt to evaluate the extent of algorithmic discrimination statistically nor to examine empirically any individual banking institution. Rather, it examines the effectiveness of the current legal regime and suggests possible aspects of reform.

The study is restricted to the geographical area of India. Special focus is on the use of AI in banking, automation, algorithm-driven lending, and other financial services.

A big challenge in the study is that the proprietary AI systems and internal institutional policies are not always available. The paper therefore does not aim to provide an actual picture of the prevalence of algorithmic bias in financial institutions, and it does not look to law or regulation, but it does consider the legal and regulatory framework.

3. ARTIFICIAL INTELLIGENCE IN BANKING: OPPORTUNITIES AND REGULATORY CHALLENGES

3.1 Meaning and Nature of Artificial Intelligence in Banking

Artificial Intelligence is a broad term for any computational system that can be used to do what a human being would do, but that involves learning, recognizing patterns, understanding language, and making predictions.

The banking industry is also seeing significant applications of AI in decision-making and automating repetitive tasks. Machine-learning systems can analyze past data on transactions, customer details, and financial trends to make predictions about risk, fraud, or creditworthiness.

Some machine-learning models can adapt their behaviour when more data is fed into them, unlike a rule-based system. This capability may be of value to enhance their prediction, but also may make it harder to understand how a specific outcome was achieved.

The legal relevance of AI is therefore not only the technology itself but rather the implications from its use in activities that impact individuals and financial institutions.

3.2 Applications of AI in the Banking Sector

There are multiple uses of AI in the banking industry today.

Credit assessment and lending: AI tools can be used by financial institutions to review loan applications, including loan history, income trends, transaction behavior, and other data, to make informed decisions.

Fraud detection: AI systems can spot unusual transaction patterns and help institutions to detect potentially fraudulent activities.

Risk management: Financial institutions can use predictive analytics to determine credit risk, operational risk, and potential financial exposure.

Customer service: Chatbots and virtual assistants can interact with customers for common enquiries and information about banking products and services.

Regulatory compliance: AI-driven systems can aid in transaction monitoring, detection of suspicious activity, and internal compliance processes.

Personalisation of financial services: Customer data could be used to provide financial products and services according to the identified needs and patterns.

While these applications can increase efficiency, they need to be within a legal and regulatory framework.

3.3 Algorithmic Bias and Discrimination

Algorithmic bias is a major concern when it comes to AI in banking.

Algorithmic bias is defined as systematic inaccuracies or inequities in the results produced by an algorithm. This can happen due to historical information, missing or incomplete data, or because some va-

riables in a model are inappropriate, or the model is poorly designed.

For instance, a credit assessment system developed with the data from past loans can replicate the historical patterns of exclusion. The formal credit market may have been biased against certain groups of individuals, so they may not be judged as creditworthy.

An additional problem is that of proxy variables. Wherever an algorithm does not employ a sensitive characteristic, it might depend on variables which are closely linked to socio-economic disadvantage.

However, it is important to differentiate between statistical disparity, algorithmic bias and legally established discrimination. An actual difference in outcomes does not necessarily constitute an illegal act. The facts, the law, and the evidence should be considered.

The regulatory problem is thus how to detect and correct unfair patterns while not mischaracterizing any algorithmic outcome difference as illegal discrimination.

3.4 Transparency and Explainability

Complex AI models could make it challenging for customers and regulators to understand the rationale behind a financial decision.

With conventional banking, a customer can speak with an officer and request an explanation about the decision. For automated systems, the decision can be based on many factors and statistical relationships that are not immediately obvious.

This generates a worry around explainability.

Explainability also involves institutions having the capacity to determine the key drivers behind an AI's decision and to provide the information in a comprehensible way.

It doesn't need to be the goal to reveal the full source code and/or proprietary structure of each algorithm. Instead, the consumers should be able to comprehend the main motivation behind the decision, which has a significant impact on their finances.

3.5 Accountability and reliance on third parties

Many financial institutions outsource their data analytics, AI systems, and digital lending.

Such arrangements may enhance technological capacity, but can also raise accountability issues. If a financial decision is made by another party using an algorithm, the customer may be uncertain about who is liable to respond to the complaint.

Technological functions should not be outsourced without losing legal responsibility.

A regulated financial institution should have suitable systems of oversight for the systems used in its operations, whether developed or maintained by the regulated financial institution or by external parties.

This shall include the proper contractual protections, audit privileges, documentation, security requirements and procedures in the event of error or system failure.

4. THE RBI'S FREE-AI FRAMEWORK: OBJECTIVES, PRINCIPLES AND RECOMMENDATIONS

4.1 Background and Development

On 26th December 2024, the Reserve Bank of India (RBI) constituted the FREE-AI Committee in the wake of its policy announcement related to developing a framework for responsible and ethical AI usage in the financial sector. [2]

The committee presented its report on 13 August 2025. This report aims to provide a framework for financial institutions to thrive with AI, acknowledging and managing its potential risks. [1]

The framework is especially important because it recognizes the need to not limit the regulation of AI to a technology perspective. It needs to take into account institutional governance, fairness, consumer protection and accountability.

4.2 The Seven Foundational Principles

The FREE-AI Committee found seven principles, known as the seven Sutras, which cover the fundamentals. [1]

1. Trust is the foundation

Trust is essential for the sustainable adoption of AI in financial services. Consumers need to trust that financial institutions are putting technology to good use and that they are safeguarding their best interests.

2. People First

AI systems must be deployed to serve human interests, and should not be used without regard to the implications for customers and society.

3. Innovation over Restraint

The framework will acknowledge the value of technological innovation and promote responsible experimentation instead of needless restrictions.

4. Fairness and Equity

Unfair outcomes and unequal access to financial services should be minimised when designing and deploying AI systems.

5. Accountability

When institutions implement AI, they need to have clear and stringent responsibilities and accountability for the systems they operate within their institutions.

6. Understandable by Design

Develop and implement AI systems that are transparent and explainable.

7. Safety, Resilience and Sustainability

AI systems should be: reliable, secure and not pose unacceptable risks to financial institutions or the wider financial system.

The FREE-AI principles provide the normative underpinning of the FREE-AI framework.

4.3 The Six Strategic Pillars

The recommendations in the report are grouped by six strategic pillars. [1]

The first three pillars are directed towards enabling innovation:

Infrastructure: Building infrastructure and resources that enable responsible adoption of AI.

Policy: Development of relevant policy recommendations on how to implement AI.

Capacity: Building of institutional and human capacity to comprehend and manage AI systems.

The other three pillars are about risk reduction:

Governance: Setup of proper institutional governance.

Protection: Security of customers, information, and the financial system.

Assurance: Methods to enhance trust in AI systems, such as ensuring their suitability and providing sufficient monitoring.

There are six pillars and 26 recommendations in the report. [1]

The reason why this structure is important is that it is trying to balance innovation with risk management. It acknowledges the need for both the technology and the institutional safeguards needed for responsible use of AI.

4.4 Board-Level Governance and Institutional Responsibility

The Board is responsible for ensuring that there is institutional responsibility and governance at the board level.

There is a crucial institutional governance component in the FREE-AI framework.

AI adoption must not be viewed as an operational or technical matter. It could have an impact on the institution's risk profile, regulatory compliance, customer relations, and reputation.

The board and senior management thus should have a suitable awareness and understanding of the institution's AI systems.

A board-adopted policy for AI can define:

Allowing and blocking the use of AI.

Internal approval procedures.

Responsibility of senior management.

Requirements for model validation and monitoring.

Data governance standards.

Processes to detect and mitigate algorithmic bias.

Vendor management requirements.

Reporting and escalation procedures.

The board does not have to make technical model assessments themselves. It, however, should ensure that there is competent personnel within the institution, and that the internal control and reporting mechanism is sound.

This strategy aligns responsible AI governance to the broader tenets of corporate governance and institutional accountability.

5. EXISTING INDIAN LEGAL AND REGULATORY FRAMEWORK

India's banking sector regulation of AI can't be analysed by just one law. It's based on several legal instruments, including Banking, Consumer Protection, Data Governance, Outsourcing, and Financial Services.

5.1 Banking Regulation Act, 1949

Banking Regulation Act, 1949 is one of the key legislative acts that regulates banking companies in India. [3]

The Act sets out the statutory guidelines for the regulation and supervision of banking companies and also vests the RBI with important regulatory powers.

The Act wasn't particularly created to control AI; however, the regulatory framework is applicable to banking operations that are driven by technology. [1]

A banking institution's existing statutory and regulatory requirements do not cease to apply with the implementation of AI. Financial institutions remain responsible for carrying out their operations in accordance with banking laws and RBI directions.

The Act, however, does not establish a comprehensive algorithmic bias or model explainability or a specific impact assessment framework for AI.

[1] The Banking Regulation Act, 1949

5.2 Reserve Bank of India Act, 1934

The RBI is established by the RBI Act, 1934, which gives the RBI its statutory powers. [4] [2]

The RBI is a critical institution in maintaining monetary and financial stability and also in regulating the relevant financial institutions.

With the growing importance of AI in financial operations, the RBI's supervisory and regulatory roles assume greater significance.

The regulatory authority shall ensure technological innovation does not compromise financial stability, institutional soundness or customer interests.

However, the regulatory expectations of AI need to be clearly expressed using the proper legal and regulatory tools.

5.3 RBI (Digital Lending) Directions, 2025

The RBI (Digital Lending) Directions, 2025 have been published on 8 May 2025. They bring together regulatory guidance on digital lending and tackle issues in relation to third-party engagement, borrower protection, disclosures and grievance redressal, and data practices. [5] [3]

The Directions apply to specific types of regulated entities such as commercial banks, relevant cooperative banks, NBFCs and All-India Financial Institutions.

They are very relevant in the context of AI-powered lending.

A. Creditworthiness Assessment

The Directions mandate regulated entities to evaluate borrowers' creditworthiness and gather pertinent information regarding borrowers' economic profile. [4]

It's crucial when data on borrowers is analysed by an AI-based system.

Automated assessment tools do not eliminate the obligation of a regulated entity to meet the requirements for credit decisions.

B. Borrower Disclosures

The Directions prescribe disclosure requirements which are expected to enhance transparency in digital lending. [5]

The requirements are necessary as the borrower should have an understanding of the terms and conditions of the credit facility.

But not all loan disclosures and explanations of algorithmic decision-making are the same. AI may affect an adverse credit decision and may require additional guidance.

C. Lending Service Providers

Lending Service Providers (LSPs) are often engaged in digital lending arrangements.

The Directions deal with the obligations of regulated entities in their relationships with LSPs. [6]

This is important since it is incorrect to suggest that an institution can hide behind a third party when delivering digital lending services to avoid regulatory obligations.

D. Grievance Redressal

Directions must include arrangements for grievance redressal.

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[2] Reserve Bank of India Act, 1934

[3] Reserve Bank of India, Reserve Bank of India (Digital Lending) Directions 2025, RBI/2025-26/36, DOR.STR.REC.19/21.07.001/2025-26 (8 May 2025), paras 2–6.

[4] Reserve Bank of India, Reserve Bank of India (Digital Lending) Directions 2025 (8 May 2025), para 7.

[5] Reserve Bank of India, Reserve Bank of India (Digital Lending) Directions 2025 (8 May 2025), paras 8–11.

[6] Reserve Bank of India, Reserve Bank of India (Digital Lending) Directions 2025 (8 May 2025), paras 5–6 and 12–15.

The regulated entity is still liable to handle grievances that stem from the digital lending activities, including those with LSPs.

E. Data Collection and Protection

The Directions also have provisions about the collection, use, and sharing of borrower information.

They address the need to have appropriate consent and restrictions in relation to mobile-phone resources.

The relevance of these provisions is tied to the fact that AI lending is often based on gathering and analyzing customer data.

Even with these protections, the Digital Lending Directions are not a complete set of rules for the use of AI in the financial industry. They do not provide specific standards or guidelines for algorithmic impact assessments, bias testing, and explainability in one all-encompassing framework for all AI uses. [7]

5.4 Digital Personal Data Protection Act, 2023

The Digital Personal Data Protection Act, 2023 is applicable in the context of AI-enabled banking due to the handling of personal data by financial institutions in the course of providing services, financial assessment, and monitoring of transactions. [6]

The Act sets out the statutory provisions related to the processing of the personal data of which a person is the holder in digital form. [8]

However, an important issue relates to its commencement. [9]

The notification of commencement (13 November 2025) covers staged implementation. A number of substantive obligations, such as the obligations in relation to the processing of personal data, will take effect 18 months after the publication on 13 May 2027. [7] [10]

At that time, therefore – 14 November 2026 – it would not be correct to say that all provisions of the DPDP Act are in force.

The Act has implications for financial institutions as they are preparing their data governance systems, however.

Financial services can be subject to a large amount of personal data in AI. Institutions should therefore review:

The reason given for the collection of personal data.

The relevance of the information used in AI systems.

How data is passed on to third parties.

Data security and data retention measures.

The roles of relevant organisations.

Conforming to pertinent consent and processing requirements as applicable requirements begin.

Also, it is important to note that data protection and algorithmic fairness are not the same thing and need to be addressed separately.

An unfair or poorly justified result may be produced by a system, even when processing personal data as required.

Combined, data protection law and algorithmic monitoring can therefore not fully solve the problems of algorithmic discrimination and explainability.

[7] Reserve Bank of India, Reserve Bank of India (Digital Lending) Directions 2025 (8 May 2025), paras 5–15.

[8] Digital Personal Data Protection Act 2023, ss 3–17 (subject to the commencement notification).

[9] Digital Personal Data Protection Act 2023, s 1(2).

[10] Ministry of Electronics and Information Technology, Notification GSR 843(E), Gazette of India, Extraordinary (13 November 2025).

5.5 Consumer Protection Act, 2019

The Consumer Protection Act, 2019 establishes a legal framework for consumers to present their complaints on defective goods, deficient services and unfair trade practices, with its scope and applicable legal requirements. [8] [11]

Neither consumers nor regulators may find it comfortable to deal with AI in financial services when automated systems lead to misleading representations, inadequate or unfair service.

For instance, if a customer is provided with incorrect data via an automated banking system or if a service is provided which fails as a consequence of an AI-driven process, questions might arise about the responsibility of the service provider in question.

The challenge is greater when the consumer does not know the basis of an algorithm-influenced decision. It is therefore important that the grievance-redressal mechanism can at least provide the consumer with an opportunity to ask questions, to dispute incorrect information and to receive suitable reconsideration.

5.6 Constitutional Right to Privacy

In Justice K.S. Puttaswamy (Retd.) v. Union of India, the Supreme Court recognised privacy as a constitutionally protected right under Article 21 and the broader guarantees of Part III of the Constitution. [9] [12]

The decision is important in the digital banking arena because AI systems could use a lot of personal data. [13]

The collection and treatment of monetary data should then be considered in terms of the relevant privacy and data protection obligations.

But the essence of fundamental rights in the constitution is subject to the context of the law and the type of entity concerned. The decision should not be used as precedent to establish a constitutional case against any private banking institutions automatically. [14]

6. CRITICAL ASSESSMENT OF THE FREE-AI FRAMEWORK

The FREE-AI framework is a positive step toward the governance of AI in the Indian financial industry. However, from the legal enforcement, institutional implementation, and consumer protection standpoint, its effectiveness must be reviewed.

6.1 Strengths of the Framework

A. Recognition of AI-Specific Risks

The framework acknowledges the risks AI adoption poses and that they must be mitigated with a different approach than traditional technology regulation.

It raises awareness of the concepts of fairness, accountability, explainability, and institutional governance.

B. Balance Between Innovation and Regulation

One of the greatest attributes of FREE-AI is that it strives to balance and manage risks with the advancement of technology.

If there is an overly restrictive regulatory approach, then it can stunt innovation that is useful. However, customers and institutions could be subject to unnecessary damage if the deployment is unrestricted.

[11] Consumer Protection Act 2019, ss 2(11), 2(47), 35 and 39.

[12] Justice K S Puttaswamy (Retd) v Union of India (2017) 10 SCC 1.

[13] Reserve Bank of India, FREE-AI Committee Report (13 August 2025), ch 2; Financial Stability Board, The Financial Stability Implications of Artificial Intelligence (14 November 2024).

[14] Justice K S Puttaswamy (Retd) v Union of India (2017) 10 SCC 1; Constitution of India, art 21.

The framework aims to achieve a balance between these objectives.

C. Institutional Governance

The framework is aware that it's essential for responsible AI adoption to be based on institutional responsibility. [15]

Focusing on governance and board-level policies can help drive the creation of structured, internal policies to oversee AI use in financial institutions. By emphasizing governance and board-level policies, the focus can encourage the development of structured internal policies to oversee the use of AI in financial institutions.

D. Consumer Protection

The principles of people first and fairness believe that financial technology should be used for customers. This is especially crucial in situations where automated systems are playing a role in access to credit and financial services.

6.2 Limitations of the Framework

A. Legal Enforceability

The primary one is the nature of the FREE-AI report.

The report has recommendations that will assist in responsible use of AI. Its guidelines, however, should not be accepted as binding statutory provisions or RBI directions. [16]

This is important to distinguish since there must be an appropriate legal or regulatory basis for obligations that can be enforced.

B. Absence of Uniform Algorithmic Assessment Requirements

Algorithmic fairness is more than a commitment to equality.

Financial institutions must have mechanisms for evaluating the quality of data, evaluating for potential bias and tracking the performance of AI systems.

Nonetheless, if the standards are not clearly defined, institutions can have different approaches to testing and monitoring.

C. Explainability and Customer Rights

The framework recognises the importance of understandable AI.

Where the AI has a significant impact on a decision of importance to the customer, however, there might need to be further regulatory guidance to define minimum expectations concerning customer-facing explanations.

D. Third-Party Accountability

Financial institutions could rely on third-party vendors to build and maintain AI systems. Financial institutions could rely on vendors outside of the company to build and maintain AI systems.

A vendor may argue that its algorithm is proprietary/commercially confidential.

The regulated entity should, however, keep adequate access to information to aid in the understanding of the system, its risk and its response to their regulatory or customer concerns.

E. Unequal Institutional Capacity

Banks or financial institutions with strong financial and technical resources might be able to set up dedicated governance structures for AI within their organisations. Banks or financial institutions with

[15] Reserve Bank of India, FREE-AI Committee Report (13 August 2025), ch 4, recommendations under the Protection and Assurance pillars.

[16] Reserve Bank of India, FREE-AI Committee Report (13 August 2025), ch 4.

robust financial and technical capabilities may be able to create dedicated governance structures within their organizations for AI.
Smaller institutions might have a problem setting up similar systems.
A proportional approach to regulation is needed to avoid stifling innovation through disproportionate measures in the governance of AI.

6.3 The Difference Between Principles and Enforceable Obligations

One of the core challenges in this paper is that there needs to be a clear mechanism for implementing responsible AI principles.
Fairness, accountability and transparency are principles that are important but only have meaning if a measurable institutional need exists.
For instance, the concept of fairness can be realized by means of:
Periodic review of training data.
Documentation of relevant variables of a model.
Evaluation of possible proxy discrimination.
Independent validation.
Performance monitoring of models.
Corrective actions taken when unfair outcomes are determined.
Likewise, transparency of accountability demands the identification of the institution and officers in charge of governing the AI.
Otherwise, responsible AI could be a mere declaration of intent, not a viable regulatory duty.

7. TOWARDS A MORE EFFECTIVE REGULATORY FRAMEWORK FOR RESPONSIBLE AI

FREE-AI's efforts and relevant RBI guidelines should serve as an important starting point for the development of responsible AI governance in India.
A comprehensive approach doesn't have to apply the same demands to all AI systems. Rather, the regulatory requirements should be based on the potential impact of the system and potential risks of its use. [17]

7.1 Adoption of a Risk-Based Regulatory Approach

AI applications must be categorized based on the purpose, level of autonomy, and impact.
An automated system that is used to answer simple customer questions, for instance, might not need the same level of regulatory review as one that has a material effect on eligibility for loans or on the pricing of credit.
More stringent documentation, validation, monitoring and human oversight requirements should apply to high-impact applications of artificial intelligence.

7.2 Board-Approved AI Governance Policies

All board-approved AI governance policies will be followed. All board-approved AI governance policies will be adhered to.
There should be a formal AI governance policy, approved at a senior level, within financial institutions.
These policies should seek to identify:
The allowed applications of AI.

[17] Reserve Bank of India, FREE-AI Committee Report (13 August 2025), ch 4; OECD, Recommendation of the Council on Artificial Intelligence, OECD/LEGAL/0449 (2019, amended 2024).

The responsibilities of relevant departments.
Risk-assessment procedures.
The approval and monitoring of models.
Internal audit arrangements.
Third-party technology requirements.
Incident reporting and escalation procedures.
The board needs to be kept regular updates on material AI systems and major risks related to the use of such systems.

7.3 Algorithmic Impact Assessments

Financial institutions should perform the proper assessments prior to the deployment of AI systems that could have a material impact on customers.
An algorithmic impact assessment should include consideration of:
The function of the system.
The accuracy and pertinence of the data.
Potential discriminatory effects.
Reliability and accuracy.
Security and privacy threats.
The potentiality of human intervention.
The repercussions of misguided results.
These evaluations should be made periodically and when there is any change in the system.

7.4 Independent Model Validation and Auditing

High-impact AI systems should be independently validated. [18]
The aim is to determine if the model works properly and if the results are consistent with the institution's declared purpose.
Data quality, model performance, possible bias, security, and system behaviour changes should be covered in an audit.
If significant deficiencies are noted, the institution is expected to take corrective action and/or to temporarily stop use of the system when necessary.

7.5 Meaningful Human Oversight

Human oversight must be a key factor in the governance of AI.
In the case of an automated system having a material impact on an important decision affecting a customer, there should be a suitable mechanism for human reconsideration.
The rethinking should be substantive and not just a formality.
The individual checking the decision should be able to access the information and have the authority to challenge or overrule the automated recommendation.

7.6 Strengthening Third-Party Accountability

Contractual agreements between financial institutions and AI tech companies should include the following points:
Data security.
Confidentiality.

[18] Reserve Bank of India, FREE-AI Committee Report (13 August 2025), recommendations under the Governance and Assurance pillars.

Audit rights.
Documentation requirements.
Model updates.
Incident reporting.
Subcontracting.
Business continuity.
Arrangements for termination and exit.
Financial institutions must take care that outsourcing does not hinder compliance with their regulatory obligations.

7.7 Transparent Customer Communication

Where AI is materially having a significant influence on a customer's financial decision, the customer must be provided with appropriate information. [19]
The institution can explain the main reasons for the adverse decision in a manner that is comprehensible.
This does not mean that source code or other commercially sensitive technical information needs to be disclosed.
To give customers enough information to make a decision and to ask for the appropriate review.

7.8 Effective Grievance Redressal

The grievance-redressal system should be improved in regard to complaints related to AI.
Financial Institutions should have policies that allow consumers to:
Question inaccurate information.
Ask for an explanation about an automated decision.
Ask for rethinking humans, when appropriate.
Report any unfairness or errors as they are suspected.
Get updates on the progress and result of their complaint.
Such options would boost consumer trust and reinforce institutional accountability.

7.9 Regulatory Reporting of Material AI Incidents

An appropriate reporting system could be put in place for material incidents related to AI. [20]
These can range from major failures in the model, security issues, systematic inaccuracies or even unauthorized data use or other events that could impact the customer or financial stability.
Reporting would enable regulators to gain a clearer picture of trends and take suitable supervisory action.

8. FINDINGS AND RECOMMENDATIONS

Based on the analysis of the FREE-AI framework and the current Indian legal regime, the following findings are obtained.
First, AI offers significant potential for enhancing banking efficiency, fraud detection, risk management and financial inclusion. These benefits are, however, dependent on the reliable and responsible governance of the systems used.
Second, there are legal issues of algorithmic bias, opacity, and accountability. They need care and attention that goes beyond traditional cybersecurity and data protection strategies.

[19] Reserve Bank of India, FREE-AI Committee Report (13 August 2025), recommendations under the Protection pillar; Reserve Bank of India (Digital Lending) Directions 2025, paras 8 and 11.
[20] Financial Stability Board, The Financial Stability Implications of Artificial Intelligence (14 November 2024); Reserve Bank of India, FREE-AI Committee Report (13 August 2025).

Thirdly, the FREE-AI framework is a big step towards responsible AI adoption in Indian Banking. It offers a useful framework of its seven principles and six strategic pillars for institutional and regulatory development.

Fourthly, the FREE-AI report should not be confused with binding legal documents. The recommendations it makes should not be presumed to be binding legal requirements.

Fifth, the RBI (Digital Lending) Directions, 2025 offer significant protections on various aspects of the regulated entities, LSP arrangements, creditworthiness assessment, disclosures, grievance redressal, and data practices. They are not a full code of good practice on AI governance, however.

Sixth, the DPDP Act 2023 applies to banking that is using AI, but it is not of immediate effect; it will commence in stages over time, so this needs to be taken into account as to which sections are operative at a specific time.

Based on the above, the following recommendations are made:

The RBI needs to spell out the implementation process for the FREE-AI recommendations.

Governance requirements for high-impact AI systems need to be proportionate and well-defined.

Financial institutions need to have inventories of material AI systems.

Appropriate high-risk uses should be encouraged and/or required to have independent model validation and algorithmic impact assessments.

Formal AI governance policies need to be further strengthened at the board level.

When AI plays a substantial role in a critical adverse action, customers should be provided with "meaningful explanations."

Financial institutions should maintain sufficient accountability and control of the AI systems acquired or used by third parties.

Current grievance-redressal processes must be enhanced to address grievances involving AI.

There should be suitable reporting procedures for material AI incidents.

The regulatory approach needs to be reviewed on a regular basis, taking into consideration technological development and the experience gained by regulated entities.

9. CONCLUSION

AI is playing an increasingly significant role in the banking sector today. It can be used to enhance operational efficiency, improve fraud detection, enable risk management, and create new avenues of financial services. Meanwhile, the application of AI introduces legal and regulatory issues, such as algorithmic fairness, transparency, accountability, data protection and consumer rights.

Overall, the RBI's FREE-AI framework is a significant step in India's efforts to adopt AI responsibly in the financial sector. The report outlines seven principles, six pillars and 26 recommendations that will help balance innovation and risk mitigation.

It also highlights the importance of trust, fairness, accountability, and understandability, underlining that the development of responsible AI cannot be limited to technology. It demands institutional control, regulation, and safeguards for the people involved in automated systems.

The effectiveness of the framework relies on its implementation, though. The suggestions made in the report must be reflected in suitable regulatory expectations and institutional practices. There are existing legal safeguards, especially the RBI Digital Lending Directions, 2025, which are important vis-à-vis technology-driven financial services. The DPDP Act, 2023, is also part of the evolving legal framework, but the staggered implementation of the Act needs to be considered.

An important hurdle is the difference between general principles and obligations that are to be enforced. Financial institutions should be able to show the proper evaluation, monitoring and governance of their AI systems. When there is a material effect on the financial interests of the customer, it should be provided with meaningful explanation and effective mechanisms for the customer to raise grievances and seek redress.

Therefore, India needs a proportional and risk-based approach to the regulation of AI. This should foster new technology and accountability for financial institutions in the systems they employ. This goal can be achieved through a number of ways, including board-level governance, independent model validation, algorithmic impact assessments, human oversight, and third-party accountability.

Finally, the role of responsible AI in banking shouldn't be judged on just algorithms' speed, accuracy or commercial efficiency. It should also be judged on the ability of financial institutions to ensure fairness, transparency, institutional responsibility and public trust. The future of AI regulation in India will hinge on creating a legal landscape where technological progress and financial consumers' rights intersect.

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