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## Determining Accountability Criteria and Implications for Identifying Willful Defaulters: A Study

**Aditya Singh**

3<sup>rd</sup> Year Law Student at School of Law, CHRIST (Deemed to be University)

Email: adityaashish.singh@law.christuniversity.in

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### ABSTRACT

This paper discusses the criteria to determine who should be termed a willful defaulter coupled with general implications of identifying such a person within the banking and financial sectors. Basically, a willful defaulter is a person or organization that deliberately avoids loan repayment despite its capability to repay loans, using fund diversion, misrepresentation, or lacking cooperation on the part of the lenders. With non-performing assets threatening the financial stability of many countries, especially in the case of India, it has become more important than ever to identify a willful defaulter for regulators and policymakers. The very beginning involves outlining the prevailing legal frameworks and definitions on willful default across jurisdictions while examining the measurement of borrower intent and financial malpractice thereof. It further analyses issues concerning accountability criteria, subjectivity, and interpretation of borrower behaviour and problems in distinguishing actual financial distress from intentional default. The key accountability criteria-the cases of intentional default, fund misappropriation, and non-compliance on part of the borrowers are examined with great caution. To that extent, the research goes further into the implications of classifying individuals or companies as willful defaulters, such as legal consequences with lawsuits and asset

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seizures, financial repercussions such as restrictions on credit access and increases in systemic risk, and reputational damage that may affect business operations in the long term. Finally, the ethical perspectives concerning corporate governance and executive responsibility are investigated. Policy suggestions to make the identification of willful defaulters more accurate include an improvement in the regulatory framework and corporate governance practices as well as the effective exploitation of technology for better risk assessment.

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## **INTRODUCTION**

A willful defaulter means a person or legal entity who even after having the capacity to pay loan willfully defaults in paying of loan or debt. The former may not be in the class of some valid defaulters as he cannot pay due to sudden financial changes or adverse market conditions; instead, willful defaulters<sup>1</sup> refuse to pay back, where facts are manipulated, funds are diverted, and they do not co-operate with lending institutions. Willful defaults and their management have become a big issue for banking systems worldwide because their problems are not limited to hurting individual creditors but to the financial institutions also as a whole.

Willful defaults form a very significant share of the growing global problem of “non-performing assets (NPAs)” in the banking system. NPAs<sup>2</sup> are loans or advances that remain unpaid for a period, and when these assets start accumulating, they actually strain the balance sheets of banks and limit their lending capacities. Growth in NPAs has been quite alarming in countries like India, where willful defaults have reached an alarming level, accounting for a large proportion of the total NPA burden.

Broadly, around the world, an increase in NPAs arising from willful defaults threatens not only the banks but general economic stability also since it gives rise to problems of liquidity and trust within the financial markets<sup>3</sup>. Only through accountability of willful defaulters can any nation expect to maintain financial discipline in an economic system. Accountability prevents borrowers from taking any unnecessary risk or fraudulent behaviour that would foul up the sanctity of lending processes. It acts as a deterrent for potential defaulters since serious legal and financial consequences are imposed on anybody who deliberately avoids repaying. Another important principle of protection of other stakeholders' interests is accountability. Other stakeholders include depositors, shareholders, and the



general public. The financial loss due to willful defaults can lower the lending capacity of banks and push up interest rates and even lead to the failures of banks in extreme cases. It is, therefore, a real distinction that must be made between the “genuine defaulters” -those who cannot repay simply because of economic hardship-and the “willful defaulters” who have the wherewithal but will not repay. That is, once only those deliberately indulging in fraudulent or unethical activity are penalized, and not genuine cases, which are adequately restructured or relieved.

Nevertheless, this categorization has a problem in that determining intent is far from easy. That is because, while un-willing defaulters can make their financial position unclear or even make “end-running” through legal and regulatory loopholes to circumvent repayments, intent may not be easy to prove. Indeed, complexity in transactions, multi-layered influences of stakeholders, and different configurations of local regulations can make it hard for lenders and regulators to assess the intent of a borrower. Besides these, there may be instances where borrowing failures cite adverse market conditions, liquidity, or operational issues for defaulting, when in reality they have the wherewithal to service their dues. This complicates efforts at accountability toward such borrowers. The paper attempts a review of criteria for identifying willful defaulters and the legal, financial, and ethical implications arising from such identification.

It tries to analyse the existing regulations in place and keeps accountability criteria- intentional default, diversion of funds, and misrepresentation of facts- in the focus while driving the process of identification of willful defaulters. It will also consider the problems of using the criteria, such as demonstrating intent and how there are inconsistencies in their application by different jurisdictions and regulatory offices. Finally, the paper will discuss some of the higher consequences of declaring a person or an organization a willful defaulter. This encompasses not only high legal remedies and credit constraints but also reputational damage, access to credit, and even corporate restructuring. Furthermore, it will discuss the ethical perspectives of corporate governance and the role of management in its contributory step to avoid willful defaults.

## **DETERMINING CRITERIA FOR ACCOUNTABILITY**

The implication is that spotting willful defaulters requires some careful scrutiny of several important factors-all in an effort to ascertain whether indeed, the borrower has defaulted on loans willfully, despite having sufficient funds for repayment. In dealing with the core criteria to be used in the evaluation of willful defaulters, the **Reserve Bank of India (RBI) Master Circular**<sup>4</sup> on willful defaulters and the **Credit Information Bureau (India) Limited (CIBIL)**<sup>5</sup> plays important role in



determination of willful defaulter and proposing a framework to enhance the process of accountability, the paper intends to identify the criteria for deciding willful defaulters. Criteria to Decide Willful Defaulters<sup>6</sup>

1. Strategic Defaults- The bedrock of identifying a willful defaulter is establishing what is termed as intentional default—where a borrower decides with intent not to pay back his or her loan, although he or she has the capability of doing so. To establish intentional default, financial institutions and regulators shall have to gauge the financial health of a borrower and decide whether, out of inability or otherwise, he or she has failed to pay back the loan.

“Evidence of Willful Default” A number of modes can collect intent, including financial audits, cash flow analysis, and the overall asset base of the borrower. Borrowers maintaining healthy cash flows, profitable businesses, or whose assets are reasonably good but default on loans may be identified as willful defaulters. Further, those borrowers who delay repayments persistently or divert funds from their legitimate purposes with an intent of deflection from repayment may also be considered as willful defaulters.

For example, under the “Reserve Bank of India (RBI) willful defaulter”<sup>7</sup> definitions, some behaviours amount to willful default; they include intentional refraining from loan repayment, furnishing incorrect or concealed information regarding income or assets, and failing to expend loaned funds for their intended purpose. Such allegations become true only by forensic audits and financial reviews of banks and financial institutions. In practice, it is complicated and often a matter of the availability of direct financial evidence and circumstantial proof, such as a borrower's refusal to provide any relevant documentation or enter into restructuring discussions. Difficulties in Proving Intent is highly subjective, sometimes making it difficult to prove. Borrowers may then resort to economic downturns and declining revenues or adverse business conditions to default their obligations.

Regulators and financial systems, therefore have to find ways of distinguishing between the borrowers who are genuinely faced with unfavourable external circumstances and those who are being deliberately delinquent in the fulfilment of their obligations. Deepened research into the credit-worthiness of the borrower, conditions of the market and behaviour over the loan duration have to be utilized.

1. Tying up funds- The other glaring criterion of defining a willful defaulter is “diversion of loan funds”. Such borrowers who utilize loan proceeds for other purposes different from those as outlined in the loan agreement are categorized into willful defaulters. Diversion of funds implies that the loan is utilized for private benefits, business unrelated to their organizations, Or speculative investments



instead of the intended purpose of either business expansion or capital expenditures. Diversion of Funds:

Case Studies A good case in point about diversion of funds is that of the Indian business tycoon, “Vijay Mallya”<sup>8</sup>, who heads the airline company Kingfisher Airlines defaulted on loans amounting to over ₹9,000 crore, almost \$1.2 billion. Investigating teams found out that Mallya had diverted significant amounts of the loan proceeds into personal accounts and other unrelated businesses which he was supposed to use to run the airlines. Diversion of funds was one of the major reasons for the banks concerned characterizing Mallya as a willful defaulter. It affects the decision-making process. Fund diversion is mostly found during forensic audit where auditors trace the movement of loan proceedings to ascertain if indeed, they were used because of the loan accord<sup>9</sup>. When the auditors discover a difference between the declared purpose and usage of loan, then it has become a case of willful defaulter for the borrower. In addition to this, diversion of funds can harm banks more particularly since it damages the trust in the lending process and increases the risks of financial losses.

3. Manufacture of truth- Another very significant factor that indicates willful default is the misrepresentation of financial facts at the time of acquiring the loan or during the process of loan application. Such false statements involve forging statements of financial, over-invoicing income, hiding liabilities, and misrepresenting one's assets-all of which amount to fraudulent practices against the principles of lending and thus harming the sanctity of the system. Legal and Financial Consequences False representations of facts may lead to severe legal and financial repercussions for the borrowers. Several jurisdictions would resort to seizure of assets plus send some to prison for this offense of fraud by enforcing criminal charges against it. Inflated revenue companies can face losses financially through the regulators and lawsuits; executives will be held liable; hence, they will be more liable personally. Detection of Misrepresentation Noticeably, the regulators and auditors also identify a case of misrepresentation. Then, it will be left for banks and other financial institutions to rely on varied due diligence processes, third-party audits, and credit-rating agencies to ascertain that financial information submitted by a borrower is correct. In case of variations, the borrower may be marked for further investigation, which eventually makes him/her a willful defaulter.

2. Non-Cooperation with Lenders: A glaring problem of the financial sector is that of non-cooperation by borrowers with lenders. Most issues seem to have to do with the behavior of the borrower and what happens in the eventuality of a default. The borrowers cease all contact with lenders while perfectly capable of clearing their respective dues. Such an action not only makes the borrowers "willful



defaulters" but might also assume other forms such as ignoring requests from lenders for any financial updates, denial of access to collateral, and even obstructing recovery efforts. This would have severe consequences for a borrower labeled non-cooperative, ranging from restricted access to future credit to reputational damage that complicates their standing in the business community and increased scrutiny from lenders. Such monitoring usually translates to stricter lending conditions and higher costs for compliant borrowers. It also poses systemic risk in the financial system, as the rate of rated entities marks up as "Issuer Not Cooperating" (INC), complicates lending decisions by banks, and fosters risk aversion. Responsible borrowers may thus suffer at their hands due to increased costs in the form of risk premiums associated with lending to a potentially unreliable counterpart. Only collective efforts on the part of banks, regulators, and rating agencies can do justice to this challenge along with upholding the rule of law and an excellent marketplace. This will facilitate cultures fostering transparency and accountability toward a sounder environment for financial ventures, as such, to the benefit of stakeholders at large.

**Example of Non-Cooperation:** Examples of non-cooperation include a borrower's failure to present updated financial statements or inability to meet with the bank's representatives. One other form of non-cooperation in debt servicing is avoiding attempts at restructuring. Typically, borrowers delay or avoid contact with the bank in order to buy time with hopes that they might evade repayment or legally manipulate their way to a favourable position. "Role in Determining Willful Defaulters"<sup>10</sup>. Non-cooperation is taken too often as an intention to default. Normally lenders would want to co-operate with the distressed borrower through restructuring, refinancing, or long payment schedules. In the event of refusal by a borrower to participate in the processes, it immediately gives out a signal on lack of good faith and probable declaration as a willful defaulter.

### 2.1 Some Challenges in Accountability Criteria Application

**Subjective Meaning.** On subjective meaning, the only challenge here is the subjective interpretation of intent. There are infrequent differences between financial distress and Deliberate default as regulatory bodies and courts usually distinguish between them. This is quite challenging when the transaction is complex; situations are masked within economic downturns or industry-specific challenges that do not necessarily present non-willful circumstances. All the evidence that the financial statement, market conditions, and borrower behaviour offer to the courts and regulators need to be compensated with just judgment.

1. Unfriendly culture of enforcement- The third is in the inconsistent application of rules across different



jurisdictions, thereby making it challenging to identify willful defaulters. Regulations about loan defaults are fully different in every country and even financial institution in the same country. What would amount to willful default under Indian law would not be so under the jurisdictions of the United States or Europe. This makes enforcement of accountability very difficult, especially for multinational corporations operating across borders.

2. Corporate Shields Corporate governance failures contribute quite significantly to the causality of willful defaults. Often, top management and corporate executives' resort to fraudulent activity that causes default while leaving their personal liability behind. Known as "corporate shielding", it lets the key decision-makers go scot-free and bankrupt the shareholders and creditors financially. Proposed Framework on Accountability An integrated framework with legal, financial, and ethical accountability realms should be developed to address the challenges that are being experienced in identifying and holding willful defaulters accountable<sup>11</sup>. More than this, though, is needed: more structural and transparent frameworks are required.

2.1 Forensic Audits and Credit Rating-Mandatory forensic audits, especially when large loans are concerned, should be included in the loan monitoring process. Forensic audits can give a clear view of exactly how the loan money is being spent. They can also help find early warning signs of mismanagement. Adding this credit rating review together would bring much more accuracy into the assessment of the borrower's health and the probability of default.

2.2 Role of Technology- AI can now look into huge datasets to detect patterns related to willful defaults - unusual financial transactions, alterations in cash flow, or delayed repaying funds. Predictive analytics will help figure out the risk of default even before it occurs, thus allowing them to intervene in time.

2.3 Corporate Governance Strengthening Corporate governance reforms will prevent corporate shielding and hold the senior management accountable for financial impropriety. More stringent requirements to make financial reports transparent, so the board has oversight, and to offer protections to whistleblowers decrease the likelihood of willful defaults. Thus, detecting willful defaulters requires multifaceted approaches that need to study various financial, legal, as well as ethical considerations. Then only will regulators and banks take a more transparent framework with more structured approaches involving forensic audits, better governance and AI, where the regulators and the financial institutions can assess more accurately and bring in checks on the defaulters much faster.

## **SEQUELS AFTER DECIDING AS WILLFUL DEFAULTERS**





Determining a borrower as a “willful defaulter” leads to severe legal, financial, reputational, and ethical consequences. This chapter explores the after-effects on the individual/company and financially and socially for the system on a large scale once an individual or entity is determined to be a willful defaulter. Legal Implications Once a borrower is declared to be a “willful defaulter”, legal consequences can be severe and swift. Here, the financial institutions, regulators, as well as law enforcement agencies may take legal actions for which civil lawsuits, asset seizure, and criminal prosecution are results or probable outcome in relation to the consequences.

1. Civil Lawsuits and Legal Claims: The most immediate consequence of a declaration as a willful defaulter is the institution of “civil lawsuits” by lending institutions against the defaulter to recover the loan. Many banks and other institutions file suits for seizure of assets mortgaged as security, enforcement of personal guarantees, and initiating recovery proceedings in bankruptcy courts. For instance, in India, the “SARFAESI Act” regulates the recovery of the of the loans by allowing to selling the property of defaulters.

2. Fraud-Based Willful Default: In fraud-based willful default, criminal sanctions are imposed if financial data is misreported or funds diverted; borrowers would be held liable for criminal charges in such a case. Regulators like India's "Enforcement Directorate (ED)" or the "Securities and Exchange Commission (SEC)" in the U.S. could order investigations against allegations of money laundering, insider trading, or any suspected financial crime; people might get arrested and put into prison under such circumstances. For instance, the Nirav Modi case in India, where cases of loan frauds and willful defaults were connected to Punjab National

Bank, led to high-profile litigation among other extradition and indictment processes for laundering money and the cases of fraud.

3. Asset Seizure and Freezing of Accounts: Regulatory bodies and banks can attach and auction assets of the defaulter to recover their dues. This can include real estate, business assets, and bank accounts. Sometimes, personal properties of corporate executives can also be attached if they have given personal guarantees for corporate loans<sup>12</sup>.

4. Blacklisting and Regulatory Restrictions: In some jurisdictions, willful defaulters are “blacklisted”, that is they are debarred from fresh loans or access to capital markets. The “Reserve Bank of India (RBI)”<sup>13</sup> maintains a list of willful defaulters and ensures that such individuals and companies are not granted further credit by any financial institution which makes it almost impossible for them to raise any





funding for future projects. Regulatory bodies may also debar such entities from participating in government contracts, public tenders or in the course of any tendering process<sup>14</sup>. Conclusion being declared a willful defaulter not only invites instant legal proceedings but also long-term legal restraints and financial consequences that would make all future opportunities highly restricted for the people involved.

4.2 Financial and Economic Costs: Identification of willful defaulters has significant financial and economic implications not only to the defaulter but also to others in the financial ecosystem such as banks, investors, and the economy at large.

1. Loss of Creditworthiness- Declaration as a willful defaulter permanently destroys the creditworthiness of a person or firm. Furthermore, such financial institutions are legally restrained from granting any future loans or credit facilities to such companies, limiting the scope of issuing capital to finance business operations, expansion, or investment<sup>15</sup>. A company may suffer a total loss as it depletes its primary means of survival due to the inability to access capital, especially if it mainly relies on debt financing in its day-to-day activities or expansion. Liquidity problems, operation-based setbacks, or even insolvency may soon be their fate if they cannot access loans or capital markets.

2. Impact on Banks and Financial Institutions: Discovering willful defaulters is of extreme importance for any financial institution in the management of “non-performing assets” or even loans that are no longer generating income. These NPAs, particularly those collected from willful defaulters, directly impact the “credit risk” of the banking sector as a whole. This not only eats away at the bottom line but also impacts investor confidence and thereby increases the danger of financial instability<sup>16</sup>. Hence, a high level of NPAs reduces the capacity of a bank to lend as tied-up funds in unpaid loans are not available for further lending or investment.

In extreme cases, when huge conglomerates or groups are declared willful defaulters, the spillover defaults can cause “bank insolvency”<sup>17</sup> or even trigger a systemic crisis. Though not strictly a case of willful default, the collapse of “Lehman Brothers” in 2008 well depicts the impact of bad loans management and financial mismanagement that brings a cascade into an economic catastrophe.

3. Economic Consequences: Identification of gross willful defaulters is considered a source of financial instability in the macroeconomic world. High NPAs<sup>18</sup> would lower the attachment of credit to businesses and individuals; further growth will be hindered. Lastly, due to pressures experienced from willful defaults on government-backed financial institutions, bailouts in the form of governmental support are



required to restore liquidity before getting into further pressures on public resources and 'tax payers' funds.

4. Reputational Impact: Being branded as a willful defaulter brings about "unredeemable reputational damage", specially on high-profile business, corporation, or entrepreneurs' concerns. Reputation is the ultimate asset for any entity, and the erosion of trust among "stakeholders, investors, business partners", and society at large can be disastrous.

4.1. Investor Confidences Lost: It was, in fact, named a willful defaulter, and companies, in general, undergo a "sharp downward slide in investor confidence". Institutional as well as individual investors stopped relating to the enterprises whose record contained financial malpractices or unethical activities. This not only reduced the means to garner capital but leads to a fall in the company's share prices and market value, which further impairs the financial status of the company.

4.2. Business Relationships and Partnerships: Being viewed as a willing defaulter also affects "business relationships". Suppliers and contractors may shut their doors to firms that are perceived as unstable or unethical. Loss of these vital business connections means the resultant loss of operations, delayed projects, and even the failure of a venture.

4.3. Long-Term Effects: The reputational implication of being graded a willful defaulter might last long into the future, even for companies which recover eventually from financial exigencies. Years are required to regain trust and rebuild a good reputation in the perception of investors, lenders, and more broadly, society as a whole. Such damage impacts the company's ability to carry on business over the long term and might mean lost opportunities and an eroded market position.

4.4 Ethical Implications: Identification of willful defaulters in the cases of giant companies or business tycoons throws up several "ethics-related concerns". Questions of "liability of corporate management" and "equity of attributing default to the companies" arising out of defaults made by a few individuals are often raised.

1. Corporate Governance Failure: The largest ethical concern is about the "corporate governance mechanism" that has enabled willful defaults. For instance, it is an age-old adage that the senior officers or directors of a company can, in most cases, indulge in acts of siphoning away funds or presenting false and misleading information related to the financial conditions of the company leading to defaults<sup>19</sup>. Such persons are, however able to get themselves out of personal liability leaving the company and its shareholders and creditors to bear the brunt of the loss. This raises numerous pertinent questions in



terms of business leaders' responsibility towards ethics and the strength of governance structures in preventing willful defaults<sup>20</sup>.

Effect on Shareholders and Creditors: Impact of willful default on those shareholders and creditors who may neither be aware of these unscrupulous practices going on in a company nor do anything about them. Once a company is declared a willful defaulter, all shareholders face great loss as the stock prices crash and company's assets are confiscated<sup>21</sup>. Creditors, that is, small businesses or individual investors, also suffer significant financial loss at times, and the issue arises of the appropriateness of the method to exempt the corporate executives from personal liability for their conduct<sup>22</sup>.

2. Moral Hazard and Financial Integrity: The identification of willful defaulters falls within the larger scheme of moral hazard existing in the financial system. In this regard, if corporate executives or high-net-worth individuals can avoid accountability from themselves for financial mismanagement, it would further make the financial system less credible<sup>23</sup>. Therefore, regulatory bodies and corporate governance structures must be strengthened so that any action to the detriment of the financial system could be met with corresponding accountability from the people or entities involved, thus upholding the trust and confidence of all stakeholders in the financial system<sup>24</sup>.

## CONCLUSION

Willful default is an important issue that poses a significant threat to the stability and soundness of financial systems worldwide. As this paper has demonstrated, identifying the willful defaulters is not only an administrative task but also involves a very sensitive procedure that would call for understanding of intent behind the act of defaults, the type of financial behaviour of the borrowers involved, and the wider implications that such an approach may have on the economy. Unlike this, various intensive acts such as false representation of financial conditions and diversion of funds from financial institutions create instability in the economy rather than effecting only financial institutions. NPAs bring instability in the economy that usually drags the economy into instability. The connotations attached to branding a person as a willful defaulter are serious and imply not only the legal standings and the financial capabilities of individuals or corporations but also their reputation.

Such stringent methods of accountability and identification processes have to be developed for financial institutions to adequately manage the risk, which is becoming increasingly onerous for them. The suggestions spread out in this paper-from clear definitions and regulatory guidelines to enhanced corporate governance and information technology-would attempt to do justice to those complexities.



Reality is that the culture that would effectively mitigate the hazards of willful default would be of openness, accountability and ethical behaviour. However, if these recommendations come together, and stakeholders across the financial ecosystem align in that implementation, it will bring along better management of challenges, restored investor confidence, and a more stable and resilient financial environment. If we thus take proactive steps increasing identification as well as accountability of willful defaulters, we may strive for a financial system which is not only more secure but also fairer and more equitable to all concerned.

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