M&A Hotline

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PE INVESTMENT IN INSURANCE COMPANIES: RELAXATION OR RESTRICTION?

- Private equity investments in insurance companies expressly permitted;
- Investments can be made by private equity funds as an 'investor' or as a 'promoter';
- Conditions imposed in both cases

INTRODUCTION

The Insurance Regulatory and Development Authority of India ("**IRDAI**") has recently notified the IRDAI (Investment by Private Equity Funds in Indian Insurance Companies) Guidelines, 2017 ("**PE Guidelines**") on December 5, 2017, which regulates investments by private equity funds into insurance companies.

BACKGROUND

Prior to the PE Guidelines, there were no regulations specifically catering to private equity investors, and they were considered at par with any other investor for the purpose of investment.

In 2015, the IRDAI notified the IRDAI (Transfer of Equity Shares of Insurance Companies) Regulations, 2015 ("**2015 Regulations**"), which restricted the quantum of investment by 'Indian investors' to 10% individually, and to 25% cumulatively. The individual or overall ceiling did not apply to the promoters or foreign investors.

Private equity investors historically have invested in insurance companies in their capacity as investors, taking minority positions, which would be within 10% (in case of domestic investors, in line with the 2015 Regulations). However, in the recent past, the appetite for private equity funds to take over controlling stake in insurance companies has been on the rise, and this prompted the IRDAI to notify the PE Guidelines and regulate any such investment by private equity funds.

CHANGES AND ANALYSIS

1. Applicability – 'PE Funds': The PE Guidelines are applicable for investment by 'Private Equity Funds' into insurance companies. 'Private Equity Funds' ("**PE Funds**") is defined in an inclusive manner and includes an alternative investment fund formed under the SEBI (Alternative Investment Fund) Regulations, 2012,. The investment by PE Funds may be structured either as an investor (if the investment is 10% or lower), or as a promoter (if the investment is in excess of 10%).

Analysis

The PE Guidelines are an extension of the 2015 Regulations, permitting PE Funds to acquire stake of more than 10% if they agree to become a 'promoter' of the insurance company. Prior to the enactment of the PE Guidelines, while there were restrictions on domestic private equity funds to acquire not more than 10% individually and 25% in the aggregate in an Indian insurance company, there were no restrictions on foreign private equity funds.

It appears that it is IRDAI's intention for these requirements to be met by all kinds of PE Funds, both resident and non-resident. The implications of this is significant since the same results in a restriction on foreign funds, which were not hitherto under any such restrictions.

- While the restriction appears to be prospective, structures where insurance companies currently have more than 25% investment by domestic and foreign funds may face severe challenges in raising any funds going forward.
- If any insurance company has any foreign private equity investment, the limits available for domestic private equity funds to invest in the capacity as investors are reduced to such extent.

2. Applicability – 'Unlisted Indian insurance company': The PE Guidelines are applicable to all Indian insurance companies which are unlisted.

Analysis

While PE Guidelines are applicable to unlisted Indian insurance companies, it is silent on their applicability post listing of insurance companies. Most of the insurance companies where PE Funds would acquire substantial stake would be unlisted companies, which may be listed over the course of the next few years.

As noted below, the PE Guidelines provide for certain conditions on investment, including lock-in of the shareholding of the PE Funds in insurance companies. If the applicability of the PE Guidelines, and consequently, the lock-in continue to apply post listing, it may result in an anomaly, where there are lock-in restrictions under the IRDAI

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regulations, as well as under the SEBI regulations.[1]

The only logical interpretation of the PE Guidelines to ensure a harmonious construction would be to exempt Indian insurance companies that are going for listing from the applicability of the PE Guidelines.

3. PE Fund as an "investor": The PE Guidelines permit PE Funds to invest into insurance companies as 'investors', subject to compliance with the following conditions:

- The PE Fund shall not hold more than 10% of the paid up equity share capital of the Indian insurance company.
- All Indian investors, including the PE Funds jointly shall not own more than 25% of the paid up equity share capital of the Indian insurance company.
- Minimum shareholding of the promoter / promoter group in the insurance company should be 50% or more, unless the current shareholding of the promoter/ promoter group is less than 50% (in which case such lower number shall be the minimum shareholding of the promoter).
- The PE Fund shall not be entitled to create any encumbrance or leverage the investment in the Indian insurance company.

Analysis

- Limit on investment: A PE Fund is not permitted to acquire more than 10% of the paid up capital of the insurer as an investor. This is in line with the earlier practice, where IRDAI required such shareholder (holding more than 10%) to be classified as a promoter. Such investment can be made by the PE Fund directly.
- Cumulative cap of 25%: The clause reads that all 'Indian investors', including PE Funds should not hold more than 25% of the paid up capital of the insurer. While this should be technically interpreted to mean that the PE Funds referred to here only refer to domestic investor, as mentioned above, we understand that IRDAI's intent is to cover foreign private equity funds as well.
- Minimum promoter shareholding: The intent of the provisions seems to be to ensure that the promoter continues to remain in control of the insurance company.

With respect to the carve out provided, the language of the clause seems to suggest that if the current promoter shareholding is more than 50%, such shareholding of the promoter shall be the minimum prescribed shareholding for the promoter / promoter group. However, it is to be seen whether the promoter shareholding is looked at post investment by the PE Fund or prior to such investment.

For example, if the promoter / promoter group owns 52% prior to the PE Funds' investment, and the PE Funds invests 9% shareholding, pursuant to which the promoter's shareholding falls below 50%, the prescribed minimum limit for the promoter/ promoter group should be the post issuance shareholding of the promoter. However, the language of the PE Guidelines does not clarify this. It is most likely that the IRDAI shall provide the promoter/ promoter group's minimum shareholding when the insurance company approaches the IRDAI for approval for the PE Fund's investment.[2]

4. PE Fund as a "promoter": The PE Guidelines permit PE Funds to invest into insurance companies as 'promoter', subject to compliance with the following conditions:

- The investment into the Indian insurance company shall be made only through a special purpose vehicle ("**SPV**").
- The PE Fund shall not be entitled to create any encumbrance or leverage the investment in the Indian insurance company.
- The investment by the SPV into the insurance company, and the investment by the shareholders into the SPV shall both be subject to a 5 year lock-in. The lock-in is however, not applicable in case the shareholder of the SPV holds less than 10% of the paid up capital of the SPV.
- Induction of any new shareholder in the SPV by issue of fresh shares beyond 25% shall require the prior approval of the IRDAI.
- Minimum shareholding of the promoter / promoter group in the insurance company should be 50% or more, unless the current shareholding of the promoter/ promoter group is less than 50% (in which case such lower number shall be the minimum shareholding of the promoter).
- The insurance company must be owned and controlled by resident Indians.
- Governance:

  i. At least 1/3rd of the directors of the insurance company must be independent directors;
  ii. Chairman of the insurance company shall be an independent director, and if the chairman is not an independent director, the chief executive officer / the managing director / the whole time directors must be professionals, and not nominees of the promoter.

- The PE Fund shall need to undertake to subscribe to rights issue of the insurance company to ensure that the company is not short of funds.

Analysis

- Requirement to invest through SPV:

  The requirement to invest through an SPV seems to be two-fold:

  - IRDAI contemplates multiple shareholders at the SPV level to pool funds for investment into the Indian insurance company. This is clear due to the fact that the IRDAI requires the SPV to seek its approval if a new shareholder is inducted into the SPV by way of issuance of shares.
  - If the PE Funds are non-residents, the extant exchange control regulations would not permit investment above 49% in the insurance company. If the SPV is a resident entity (per the provisions of the IRDA regulations and the

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exchange control laws), the investment by the SPV would be considered as domestic investment.

The SPV would be a pure investment company, i.e. the only object of the SPV would be to invest in the share capital of the insurance company. Under the existing exchange control norms, any investment into a purely investment / holding company (i.e. a company without any operations) would be under the government approval route. Accordingly, while investment into the insurance sector would be under the automatic route, this would require government approval. This seems to be an unwanted situation, and it is expected that appropriate amendments to permit investment into the SPV under the automatic route should be introduced by the government.

- Lock-in: The PE Guidelines imposes a lock-in on the SPV for its investment into the insurance company, as well as on the shareholders of the SPV for their investment into the SPV. It was noted that even prior to this written restriction, the IRDAI would impose such restrictions on large shareholders in any case. This brings more certainty and clarity on the extent of lock-in expected by shareholders. However, while the lock-in restrictions also apply to the shareholders of the SPV, they do not apply to any shareholder holding less than 10% of the SPV's shares.
- Commitment to participate in rights issue: This is an important consideration for PE Funds, since it would entail commitment to invest in case the insurance company undertakes a fresh capital raise. As is the case with most PE Funds, the commitment period (i.e. the period during which a private equity fund may invest in companies) are limited to a few years. Post such period, investment by private equity funds may require special consents/ approvals from their investment boards/ investors. This may pose a challenge for a large number of private equity funds, and may need to be harmonized with market practice.
- 'Resident owned and controlled': The insurance company, in line with the provisions of the Insurance Act, 1938 and the exchange control norms, would need to be resident owned and controlled.

CONCLUSION

Considering that a 'promoter' under IRDAI regulations and the PE Guidelines is required to undertake a number of obligations, such as participating in all future fund raises, confirming to IRDAI that the insurance company is 'resident owned and controlled', the PE Funds may be vary of becoming 'promoters'.

While the PE Guidelines seek to regulate investments by financial pooling vehicles into Indian insurance companies, the implications are substantial. The PE Guidelines, on a technical reading, appear to relax the conditions prescribed in the 2015 Circular. However, how the IRDAI finally interprets its applicability and conditions may result in it being a further restriction, rather than a relaxation.

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You can direct your queries or comments to the authors

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[1] SEBI requires promoter securities of a company going for an initial public offering to be locked in for a period of 3 years (up to 20%) and 1 year (for the balance shareholding of the promoter above 20%).

[2] Under the Insurance Act, 1938, any change in the shareholding of an insurance company which results in 1% of the share capital of the insurance company to change requires the prior approval of the IRDAI.
