Deal Destination

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STRUCTURING PE INVESTMENTS INTO INDIAN INSURANCE COMPANIES

Since the liberalization of Indian exchange control regulations in 2015 to increase the foreign investment limit from 26% to 49%, approximately INR 300 billion of foreign investment has been infused into Indian insurance companies. It is expected that further liberalization of the insurance sector from 49% to 74% would attract substantial foreign investment.

While Indian insurance sector had PE investments earlier as well, the IRDAI in December 2017, formalized norms for investment by private equity (PE) investors into the Indian insurance sector (IRDAI PE Guidelines). Investment by WestBridge Capital and Madison into Star Health, True North's investment in Max Bupa and Kedaara's investment in Religare Health Insurance denote the significance of investments into Indian insurance companies for PE funds.

Considering the increasing interest from PE funds into the Indian insurance sector, it may be pertinent to note some of the key issues that a PE fund should consider prior to investing in an Indian insurance company.

STRUCTURE RELATED ASPECTS

o *Foreign investment limits*

Indian insurance companies are permitted to receive foreign investment up to 49% only. The mechanism for determining foreign investment into Indian insurance companies requires indirect investment to be considered only in case an investor at the insurance company level has also invested in any Indian holding company (directly or through its holding company or subsidiaries) of such insurance company. Accordingly, foreign investment limits must be evaluated closely at all times. This may also impact exit of the PE investor post investment if the PE investor proposes to sell its stake to a foreign investor and the headroom for foreign investment limits is not available at that time.

o *Indian investment limits*

In case the investment is as an investor (i.e. lesser than 10% of the paid up capital of the insurance company), as opposed to as a promoter (i.e. more than 10% of the paid up capital of the insurance company), the Indian investment (considered as investment by all Indian investors, excluding promoter investment) should not exceed 25% of the paid up capital of the Indian insurance company.

o *Requirement of an SPV*

Under the IRDAI PE Guidelines, any investment by a PE investor (defined to mean any fund incorporated for investment into one or more entities by one or more persons, and specifically includes a SEBI registered alternative investment fund) in excess of 10% of the paid-up equity share capital of an Indian insurance company can be made only through a special purpose vehicle (SPV) formed in India (either as an LLP or a company). Accordingly, any such investment would necessarily require a SPV to be incorporated. Such SPV is not required if the investment is lesser than 10% of the paid-up equity share capital of the insurance company.

o *SPV: Company or LLP?*

There are various considerations that a PE investor would need to bear in mind when determining if the SPV should be formed as an LLP or as a company.

- Foreign investment: An LLP in a sector where 100% FDI is not permitted under the automatic route is not permitted to raise any foreign investment. Accordingly, if the SPV is formed as an LLP, such SPV cannot raise any foreign investment at any time (prior to or post the initial investment) since the SPV will qualify as an investment company and any foreign direct investment in an investment company not registered with the Reserve Bank of India as a NBFC requires prior approval of the Government and shall not be eligible to avail of the benefit of automatic route.
- NBFC: In case the SPV set up as a company receives any financial income from the investment into the insurance entity, it would satisfy the principal business test, and would need to be registered as a non-banking financial company / core investment company under the RBI regulations. While the RBI regulations do not cover an LLP, incorporating an LLP as an SPV may be a challenging from a procedural perspective.

Nonetheless the above, if the SPV is expected to have only Indian resident shareholders, LLP can be used as an SPV for the Indian PE promoter since LLP structure is more tax efficient than a company structure.

o *Instruments for investment*

Indian insurance regulations require that the capital of an Indian insurance company consists of only one class of equity shares as voting instruments. While certain forms of preference shares and debentures have been permitted

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by the IRDAI in 2016, these are mandatorily non-convertible and do not have voting rights. Accordingly, common investment instruments like CCPS and CCDs used by PE funds for investments in various sectors in India are not permitted in Indian insurance companies.

o *Approvals for subscription / transfer*

PE investment into Indian insurance companies require approval from the IRDAI, if the investment is in excess of 1% of the share capital of the insurance company. Additionally, the investment may require approvals from (i) the government for foreign investment (as explained above), (ii) the RBI for an NBFC registration (as explained above if SPV is set up as a company) and (iii) the anti-trust regulator, the Competition Commission of India (CCI). Unlike any other approvals, the IRDAI requires all other regulatory approvals to be obtained prior to its giving the consent for the investment. This may have a significant bearing on the timelines for all approvals to be obtained, and the same must be borne in mind by the PE investor.

o *Lock-in on shareholding*

The investment by the PE fund into the SPV as a promoter, and the SPV's investment into the insurance company is locked-in for a period of 5 years under the IRDAI PE Guidelines. However, there is no such lock-in under insurance laws applicable to PE funds investing as a non-promoter in the insurance company or its SPV. Any fresh issue of shares for more than 25% of share capital of SPV requires prior IRDAI approval. Such lock in does not apply if the investment is less than 10% of the paid up capital of the insurance company.

DILIGENCE RELATED ASPECTS

o *IRDAI inspections*

The IRDAI conducts onsite inspections of insurance companies periodically. The time taken from the onsite inspection till the final order of the IRDAI in relation to the findings of such inspections could take from 6 months to 18 months. The process is a detailed one and commences from preliminary findings being shared with the insurer, and based on the responses from the insurer, the final order being issued. PE investors should be wary of any ongoing inspection process, since any charges framed by IRDAI (even if prior to the period of investment) could result in losses to the PE investors, in addition to reputational concerns.

o *Non-insurance contracts*

PE investors should carefully analyse any contracts that the insurance company is a party which is not a distribution channel agreement with an IRDAI registered intermediary. The IRDAI has been particularly wary of these contracts in the past, including to ensure that core functions of insurance companies are not outsourced.

INVESTMENT AND GOVERNANCE RELATED ISSUES

o *Approval and information*

Considering the multiple regulatory approvals required, the PE investor would be required to provide details of the investors in the PE fund. Carefully evaluating the information provided to ensure that adequate information is provided is challenging at times, considering that PE investors are usually wary about disclosing details of the limited partners in the funds.

o *Undertaking to IRDAI to fund*

The IRDAI PE Guidelines require any PE fund which is becoming a promoter to provide an undertaking to IRDAI to ensure that it would invest in a rights issue to ensure that the insurance company is not cash trapped. This has particularly been a cause of concern for PE investors since this is commitment to keep the insurance company as and when required. However, practically, this is generally applicable only in cases where the insurance company is unable to meet the minimum solvency requirements under the IRDAI regulations, and if the insurance company is unable to take appropriate steps to improve on its solvency.

o *Seasonal nature of business*

Unlike some industries, which are seasonal in nature due to the products they offer, financial services in general, and insurance sector in general are not expected to be seasonal. While insurance sector is also not seasonal in the strict sense, the business of an insurance company generally sees a significant spike in the last quarter of the financial year, due to increased investments for availing of tax benefits. The same should be considered and factored in for valuation purposes.

o *Reserved matters*

As per the Indian exchange control and insurance laws, all Indian insurance companies must be Indian owned and controlled. While determining reserved matters, care must be taken that the rights do not tantamount to control in the hands of non-resident PE investors. The IRDAI has, in the past, raised concerns with certain operational reserved matters such as approval of business plan and settlement of claims. Accordingly, care should be taken to ensure that no reserved matters which may impede on the operational abilities of the insurance company to run its business are provided for. However, considering that any such matters would be evaluated by IRDAI upfront at the time of granting the approval, a PE investor may consider adding items critical to it, and remove them if the IRDAI raises concerns with any such rights prior to the investment. Further, it would be prudent to ensure that no party has a reserved matter on any further raising of funds where such funds are being raised to comply with regulatory requirements (i.e. solvency ratio).

While each investment into an insurance company may come up with its own challenges, the above issues are generally faced in any investment into an insurance company, and catering to the above may be important to any PE investor for investing in the ever-expanding, lucrative Indian private insurance sector.

– Abhinav Harlalka & Nishchal Joshipura
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