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GUIDELINES ON PRIVATE EQUITY INVESTMENT IN INSURANCE COMPANIES

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On 5 December 2017, the Insurance Regulatory and Development Authority of India (IRDAI) published a set of guidelines to regulate private equity investment in insurance companies - the IRDAI (Investment by Private Equity Funds in Indian Insurance Companies) Guidelines 2017 (Guidelines). These Guidelines have come into effect from 5 December 2017, and apply to all unlisted Indian insurance companies and to Private Equity Funds (as defined in the Guidelines), which have invested in insurance companies.

Applicability

The Guidelines apply to investments by Private Equity Funds (PE Funds) in unlisted Indian insurance companies (and to the unlisted Indian insurance companies themselves), and not to investments in listed Indian insurance companies.

Comment*: It seems likely that the regulatory intent was to regulate all private equity investments in this sector in a uniform manner, so it would be safer to assume that a PE Fund will need to comply with the requirements in these Guidelines in respect of pre-existing insurance investments, unless the IRDAI indicates otherwise. PE Funds may also wish to discuss with the IRDAI as to whether, in relation to existing investments, they will be required to retrospectively provide the declarations, undertakings or certifications contemplated in the Guidelines.*

Definition of 'Private Equity Fund'

Under the Guidelines, a PE Fund is defined in an inclusive and not an exclusive manner. The definition includes: (i) an alternative investment fund registered with the Securities and Exchange Board of India (SEBI) under the SEBI (Alternative Investment Fund) Regulations 2012; and/or (ii) a fund specifically formed for investment in one or more entities by one or more persons.

Comment*: One immediate question that arises is whether funds that are incorporated outside India and not registered in India will qualify as PE Funds? Also, where does this leave other alternative asset managers, sovereign wealth funds and pension funds? As the definition is inclusive and because it is likely that the IRDAI intended to put in place a common set of guidelines, until there is further regulatory on this, , it would be advisable to treat such broader set of entities, regardless of whether the investment vehicle is incorporated or registered in India, as being covered.*

'Investor' v/s 'Promoter'

A PE Fund is permitted to invest in Indian insurance companies either as a "*promoter*", where its investment exceeds 10% of the equity capital of the insurer, or as an "*investor*", where its investment is less than or equal to 10%.[1] A summary of the main conditions that apply in each case are set out below.

INVESTOR INVESTMENT	PROMOTER INVESTMENT	COMMENT
A. Structuring entry		
1. Applicability		
Applies to investments not exceeding 10% of the paid-up share capital of an Indian insurer.	By implication, applies to investments exceeding 10% of the paid-up share capital of an Indian insurer.	This is consistent with the IRDAI's policy to date. The Guidelines do not refer to whether these thresholds are to be calculated on a "*fully diluted*" basis. Of course, given the other restrictions on capital instruments that insurers can issue, the dilution issue may be less problematic than in other sectors. However, there may still be employee stock options to consider. Until there is further clarity from the IRDAI, a PE Fund contemplating an investment should discuss this with the IRDAI.
2. Routing of investment		
A PE Fund can invest under this category either directly or through a "*Special Purpose Vehicle*" (SPV).	PE Funds are prohibited from investing directly in an Indian insurance company and the investment is required to be through an SPV, which the Guidelines require to either be a company registered under the Companies Act, 2013 or a limited liability partnership registered under the Limited Liability Partnership Act, 2008.	A PE Fund can invest under this category either directly or through an SPV. However, this is more restricted in scenarios where the PE Fund wishes to be a promoter (i.e. to invest in more than 10% of the shares of an Indian insurer). In such circumstances, it will need to invest only through an Indian vehicle (i.e. it must invest through an SPV and not directly from an offshore vehicle). This condition could expose a PE Fund to unintended consequences, such as dividend leakage in India as a result of dividend distribution tax.

[1] The IRDAI's "*promoter*" categorisation differs from broader definition of the term "*promoter*" in other company laws and securities regulations. The approach in these Guidelines is, in this respect, consistent with the IRDAI's previous informal policy on promoter categorisation in the insurance sector and also under the IRDAI (Transfer of Equity Shares of Insurance Companies) Regulations, 2015.

3. Multi-category investment		
Although not expressly addressed in the Guidelines, by implication, investments of below a "*promoter*" level threshold appear to be freely permitted (see above for the thresholds).	A PE Fund can be a promoter of only one life insurance, one general insurance, one health insurance and one reinsurance company.	This provides helpful clarity, particularly with regard to the treatment of health insurance as a separate category from general insurance.
4. Cap on investment		
All Indian investors (including the PE Fund) cannot hold more than 25% of the insurer.	N/A, but note the FDI cap of 49%.	The implication is that the shareholding of all shareholders holding no more than 10% each, is capped at 25% in aggregate. Therefore, the investment by a PE Fund might be affected by the levels of shareholding of other investors.
5. Minimum shareholding		
The minimum shareholding of promoters / promoter group is required to be maintained at 50% of the equity share capital of an insurer. The only exception to this is where such shareholding is already less than 50%, in which case such shareholding becomes the minimum promoter / promoter group shareholding.	Same as for investors as summarised in the column to the left.	This is a slightly confusing requirement (that also mirrors the requirement in the IRDAI's Guidelines for Listing Insurance Companies Regulations, 2016). In the private equity context, one concern here is that if a private equity investor elects to be a promoter by holding more than 10% of an insurer, it will not be able to exit (separately from the lock-in requirement) unless the holdings of the other promoters are such that the total promoter holding remains over this threshold. If this threshold covers new incoming 10%+ shareholders too, the issue might be less concerning (as a straight exit to a single shareholder would be a like-for-like swap). If the exit is to multiple investors such that there is no incoming promoter, then the exiting private equity investors will want to ensure that the other remaining promoters "*step up*" to ensure this requirement remains satisfied (and their investment documentation should provide for this).
B. Structuring exits		
1. Lock-up		
No lock-in requirement under the Guidelines.	There will be a 5-year lock-in of the investment, which shall apply to the SPV and to the shareholders of the	There are a number of points that are likely to be of interest to a PE Fund here. Firstly, it is unclear as to whether this requirement would fall away if the PE Fund is diluted to below 10% in the insurance company. Arguably, this

	SPV. However, the lock-in does not apply to shareholders holding less than 10% of the SPV.	should occur, but until the IRDAI's practice on this crystallises, it would be safer to seek the IRDAI's confirmation. Secondly, what is the continued applicability of this requirement upon the listing of an insurance company in circumstances where the original PE Fund's pre-IPO investment was less than 10% of the insurance company? Arguably, this should fall away upon listing because the Guidelines were drafted in the unlisted context. Also, there are separate SEBI "promoter" lock-in requirements that would apply (and so an overlap is duplicative and unnecessarily restrictive). However, until the IRDAI's view is clearer, PE Funds would be well advised to seek clarity on this with the IRDAI.
2. Divestment plan		
No specific restriction in the Guidelines.	The PE Fund will be required to provide an undertaking to the IRDAI on the post lock-in period divestment plan, and the planned divestment should preferably be by way of an IPO.	An undertaking on the post lock-in period divestment plan is required to be submitted to the IRDAI, and the planned divestment should preferably be by way of an IPO.
3. Change of shareholding in the SPV		
Not specifically restricted.	The entry of new shareholders in the SPV in circumstances where there is a primary issuance of > 25% requires the IRDAI's approval.	By implication, SPV-level shareholding in relation to "*investor*" category investments are not restricted. As far as SPVs facilitating promoter investments are concerned, there is useful clarity from the IRDAI. The IRDAI approval requirement appears to only apply where: (i) the change of shareholding is as a result of a primary issuance (not a secondary sale); and (ii) where it results in a new shareholder holding more than 25% of the SPV. By implication, any other shareholding change at the SPV level does not attract an IRDAI approval requirement under the Guidelines. Of course, transfers of direct shareholding in the insurer will, in any event, require the IRDAI's approval under the IRDAI (Transfer of Equity Shares of Insurance Companies) Regulations, 2015.

C.	**Funding and capitalisation**	
1.	Restrictions on leverage	
The PE Fund is required to provide an undertaking that no encumbrance or leverage on a PE Fund's investment is permitted. This will be of particular interest to private equity investors.	Same restriction as for investors, but note the incremental point in item C.2. Below.	In most cases, because of restrictions on acquisition finance in India, any leverage on investments is normally undertaken outside India. In this context, the broad reference to leverage is not expressly limited to onshore leverage (which, in any case, is limited because of the Reserve Bank of India's restrictions). Also, because the requirement is drafted as a positive obligation on the PE Fund to provide a negative confirmation, the legal and compliance teams of various PE Funds will need to consider this carefully. Any PE Funds with leverage on existing investments may need to discuss this further with the IRDAI.
2.	Source of funds	
No specific requirement other than item C.1 above. Note also the general disclosure requirement on fund strategy in item D.2. below.	The investment should be in accordance with the PE Fund's strategy, as reflected in its placement memorandum, and should be made through its own funds, rather than with borrowed funds. Further, the investment memorandum or charter documents of the SPV and the PE Fund should permit investment up to the proposed deal size as well as any future capital requirements of the investee insurance company.	The additional restriction on borrowed funds in the context of promoter investments, indicates that this is a point of emphasis for the IRDAI in relation to more substantial investments.
3.	Rescue funding / further capital commitments	
No requirement under the Guidelines.	The PE Fund and the SPV will need to provide an undertaking to subscribe to rights issues of the insurance company to ensure that the	The regulatory intent seems to impose a degree of long-term financial commitment in relation to a PE Fund's investments. In practice, rescue financings have not occurred to date in the insurance sector in India, but it is a factor that a PE Fund should consider when making its investment.

	insurer is not "*cash strapped*".	Beyond this, there are a few detailed points which are unclear. For instance, the term "cash strapped" is undefined, but our assumption is that this refers to situations where further funding is needed to maintain the solvency ratio. Also, as this only applies to rights issues, the other forms of emergency funding, for instance, in the form of a non-pre-emptive share issuances (such as a preferential allotment by way of a private placement) have not been addressed. One argument is that a PE Fund should not be required to provide further funding if all other shareholders have not been required to do so. However, the IRDAI's views on this need to evolve, and such issues ought to be discussed with the IRDAI.
D. Other		
1. "Fit and proper" status		
PE Fund will need to provide self-certification on its '*fit and proper*' status, which is to be based on criteria prescribed under the Guidelines.	Same as the requirements for an investor set out in the column to the left.	If the fit and proper criteria are intended to be exhaustive, then some of the criteria may require further clarifications from the IRDAI (eg corporate structure of the applicant (i.e. the PE Fund) to be in consonance with effective supervision and regulator of the insurer).
2. Fund strategy		
The investment in an insurer is required to be in accordance with the PE Fund's strategy as stated in its placement memorandum.	See item C.2. above on disclosure in the placement memorandum.	--
3. One-time investment		
In the event that the PE Fund only intends to undertake a one-time investment in the insurance company, a disclosure is required at the outset.	No corresponding provision.	By implication, it is unclear as to whether the IRDAI is seeking the self-certifications, undertakings and declarations required under the Guidelines every time a PE Fund makes an investment (in circumstances where it invests more than once). The IRDAI's practice will need to evolve in this regard.
4. SEBI approval		
Not applicable.	The Guidelines refer to a scheme to be filed with SEBI.	It is unclear why this would be needed in the unlisted context.

5. Indian ownership and control and foreign investment rules		
Not specifically referenced, but clearly these rules would bind the insurer in any event.	The promoter investment must be consistent with the Indian ownership and control guidelines issued by the Reserve Bank of India and also with the Indian Insurance Companies (Foreign Investment) Rules, 2015.	This would be required in any event, even if not referenced here. The main points of note are the 49% cap on foreign investment and also the governance restrictions on reserved matters / veto rights as a result of the Indian ownership and control regulations.
6. Other governance matters		
Not specifically referenced, but clearly these rules would bind the insurer in any event.	One-third of the board of the insurance company must be independent. The chairman of the board should be an independent director, failing which the CEO / Managing Director / Whole-Time Director should be a professional, and not a nominee of the promoter.	The IRDAI's corporate governance guidelines refer to an insurer's board having at least three independent directors, except for insurers whose registration is less than five years old – who will require only two independent directors. This implies that the presence of PE Fund investment slightly raises the bar on corporate governance. There is some inconsistency with the IRDAI's guidelines on 'Indian owned and controlled', which require that the CEO / Managing Director / Whole-Time Director should be appointed by the Indian promoter or Indian investor. The reference in the Guidelines is to these officers being professional and not nominees of the promoter. Although the Guidelines refer to PE Fund investment, is this intended to constitute a wider restriction upon Indian and non–PE Fund investors nominating these officers? This will also need to be clarified with the IRDAI.

Comment

The insurance market in India is growing and remains under-penetrated. That combined with the recent listings of a number of insurers has made the insurance sector an attractive one for private equity investors. The Guidelines provide clarity in that they set out an over-arching regulatory framework that will now apply. However, there remain a number of open ended questions on which further clarity is needed.

Although the Chairman of the IRDAI is permitted to clarify matters, it may be that further changes are made to these Guidelines as the IRDAI's practice evolves and as various market participants engage with the IRDAI on the issues highlighted in this alert memorandum, so private equity investors will need to "*watch this space*".

In the meanwhile, private equity investors should evaluate their current insurance holdings and also re-visit and future investment plans and consider how these may be affected by the Guidelines.

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