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74% FOREIGN INVESTMENT IN INDIAN INSURANCE COMPANIES | IMPLEMENTATION PROCESS MOVING QUICKLY

21 April 2021

The Indian government is moving quickly with the changes needed to implement the increase to the foreign investment cap in Indian insurance companies from 49% to 74%, which was announced in this year's budget speech (2021 Budget Speech).

As discussed in our previous Ergo of 4 February 2021, a number of separate pieces of legislation and regulations needed to be amended for this increase in the foreign investment cap to take effect.

The two key questions that international investors had at that stage were how quickly these changes would be implemented and what the various conditions referred to in the 2021 Budget Speech were likely to mean in practice. Both of these questions have now been answered.

In relation to the first question, the Insurance Act, 1938 (Insurance Act) was amended with effect from 1 April 2021, to, amongst others, remove the statutory requirement that Indian insurance companies must always be "*owned and controlled*" by Indian residents and to empower the Indian government to impose foreign investment-linked conditions through delegated legislation. This has been followed on 15 April 2021 by the publication of draft proposed amendments to the Indian Insurance Companies (Foreign Investment) Rules, 2015 (Foreign Investment Rules, and such proposals, the Draft Amendment). As far as the second question is concerned, the conditions imposed appear to be in line with market expectations and do not, so far, go beyond the matters referred to in the 2021 Budget Speech.

Summary of the proposed changes

The Draft Amendment proposes three key changes that are consistent with the approach indicated in the 2021 Budget Speech. Of these, the first will affect all Indian insurance companies that have foreign investment (i.e. regardless of the level of foreign investment) and the remaining two will affect only those Indian insurance companies that have foreign investment above 49%.

(1) *Residency requirement for directors and KMPs*. Indian insurance companies with foreign investment will now need to ensure that: (i) a majority of their directors; (ii) a majority of their key management persons (KMPs); and (iii) at least one of the board chairperson, the managing director and the CEO, are "*resident Indian citizens*".

(2) *Higher retention of net profits for insurers with low solvency margins (applicable only if foreign investment is more than 49%)*. Indian insurance companies with more than 49% foreign investment will now need to retain at least 50% of their net profits as part of their general reserves if, in the relevant financial year, they have paid a dividend on their equity shares and their solvency margin was lower than 1.2 times of the control level of solvency.

(3) *Increased number of independent directors (applicable only if foreign investment is more than 49%)*. Indian insurance companies with more than 49% foreign investment will now need to satisfy the following governance requirements: (a) at least half of the board will need to comprise independent directors (if the board chairperson is not independent); or (b) at least one-third of the board will need to comprise independent directors (if the board chairperson is independent).

Indian insurance companies will have up to one year to comply with the new residency requirement for directors and KMPs. However, surprisingly, the Draft Amendment does not contemplate a similar dispensation in respect of the new independent director requirement for insurers with more than 49% foreign investment.

Implications

The practical implications of the Draft Amendment for international insurers are summarised below.

Foreign ownership and control permitted, but with majority local director and KMP requirements

The key question that international insurers had in February was the extent to which the Indian government would dismantle the requirement that the "*ownership and control*" of an Indian insurance company must remain in the hands of Indian residents at all times. The concern, in particular, had been around the reference to "*safeguards*" in the 2021 Budget Speech and what that might mean in this regard. However, subject to certain further implementation steps that are needed (see "*Fate of the IOC Guidelines*" below), the amendments to the Insurance Act and the Draft Amendment appear to put that concern to rest. There are no ownership or control restrictions, instead, only certain citizenship and residency requirements for the board and KMPs, which are unlikely to cause a significant concern and certain governance requirements, which again, are unlikely to be problematic in practice.

This is the most significant regulatory development and, following enabling changes to Indian exchange control rules (see "*Next steps*" below), ought to result in increased foreign investment inflows and also further consolidation of existing holdings of international insurers.

While the Draft Amendment itself does not exclude independent directors while calculating whether a majority of directors of an insurer are resident Indian citizens, the Guidelines on Indian owned and controlled dated 19 October 2015 (IOC Guidelines) provide that a majority of directors of an insurer must be nominees of the Indian promoter, after excluding independent directors (on this, see "*Fate of the IOC Guidelines*" below). Greater clarity on this front is expected after the consultation process described below is completed.

Additional layer of solvency control for insurers with more than 49% foreign investment

The proposed new requirement of retaining at least 50% of net profits under general reserve is linked to: (a) the solvency margin being lower than 1.2 times of the control level of solvency; and (b) the payment of dividend on equity shares.

The "*control level of solvency*" for both life and general insurers is currently specified as a minimum solvency ratio of 150%. Whether 1.2 times of that ratio is an appropriate threshold will need to be assessed.

In concept, this was foreshadowed in the 2021 Budget Speech, so this is not unexpected. That said, in concept, if the regulatory concern is to bolster solvency requirements, it seems unclear why purely domestic insurers should be treated differently and, ultimately, any controlling shareholder will want the ability to pay itself dividends. Therefore, new market entrants may factor this into valuations going forward.

Note that in relation to foreign investment in insurance intermediaries (where 100% foreign investment is permitted), the Insurance and Regulatory Authority of India's (**IRDAI**) prior permission is required for repatriating dividends. This requirement has not been imposed under the Draft Amendment for insurance companies, but international investors may wish to consider suggesting some ability to declare dividends with IRDAI approval above these thresholds, as part of the consultation process with the Indian government (for which, see "*Next Steps*" below).

Next steps

Consultation Process

The Draft Amendment is currently the subject of a consultation process as the Indian government has invited comments or suggestions until 30 April 2021. It is likely to be notified (subject to any changes made by the government as a result of this consultation process) after 30 April. Therefore, if any market participants have any views on the Draft Amendment, they ought to take advantage of this process now. In particular, the withdrawal/ recission of the IOC Guidelines (see "*Fate of the IOC Guidelines*" below) is something that ought to be flagged to the government in this consultation process.

Fate of the IOC Guidelines

The Insurance Act and the Foreign Investment Rules merely specified the requirement that Indian insurance companies must be "*owned and controlled*" by residents. The detailed governance requirements in this regard, however, are set out under the IOC Guidelines. For example, the IOC Guidelines impose specific requirements that the majority of non-independent directors must be nominated by the Indian promoter and that control over significant policies must be exercised through the Indian promoter-controlled board. These are clearly inconsistent with the amended Insurance Act and the Draft Amendment, but nevertheless, still remain in force. Therefore, the IRDAI will need to formally withdraw or rescind the IOC Guidelines together with the notification of the final amendment to the Foreign Investment Rules.

Exchange control regulations

The Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 (NDI Rules) and the consolidated FDI policy published by the Department of Industrial Policy and Promotion (FDI Policy) will also need to be amended, or a clarificatory notification in the form of a press note with similar effect will need to be published, as a final step. However, no legislative changes are needed to achieve this and given the pace of developments so far, this may well be implemented very shortly.

Comment

These measures and the pace of changes are encouraging. While there may be more general questions around why the citizenship and residency requirements are needed and how these benefit Indian policyholders, the changes represent a big step forward from the earlier regime, are unlikely to cause practical difficulties for international insurers and do not exceed the measures foreshadowed in the 2021 Budget Speech. Similarly, although there are questions around the dividend related provisions, international investors could look to deal with these restrictions by factoring them into valuation. Therefore, on the whole, the changes are seen as being positive.

The critical next steps will comprise the formal notification of the Draft Amendment, the withdrawal/ recission of the IOC Guidelines and the introduction of enabling provisions and changes to the NDI Rules and the FDI Policy. That will complete the measures needed to implement the increase in the foreign investment cap, although as a longer term project, the IRDAI may also wish to re-visit the IRDAI (Investment by Private Equity Fund or Alternate Investment Fund in Indian Insurance Companies) Guidelines, 2017 to liberalise certain aspects of those guidelines in light of the greater scope for foreign investment.

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