Insurance | Spring 2021 | Legal Briefing

M&A and investment in the Indian insurance market – key drivers

India is the under-insured relative to other more developed economies and the Indian insurance market offers considerable growth opportunities. This has led to significant strategic and private equity investment in this sector in the past. Going forward, the growth story remains, but investment and M&A transactions will also be driven by certain critical regulatory issues summarised below.

Distribution-driven factors

The market for life insurance products is heavily reliant on bancassurance as its key distribution channel. However, some Insurance and Regulatory Development Authority of India (IRDAI) requirements, in particular, the requirements of the IRDAI (Registration of Corporate Agents) Regulations 2015 (the Agency Regulations) do create some issues. The Agency Regulations state that an insurer cannot require an agent to insure every client with it. Also, agents are required to have a policy on open architecture. These fall short of restricting exclusivity, but the IRDAI does interpret these requirements restrictively in practice. There are also caps on commission payments to insurers. These restrictions have created incentives for incentive alignment and the creation of synergies through investments by banks in insurers. Therefore, historically, a number of leading insurers in India have a significant shareholding by banks and this has driven some recent transactions, although the Reserve Bank of India's (RBI) requirements will mean that these deals are limited to smaller minority stakes. For instance, Axis Bank's investment in Max Life was only approved after the direct investment percentage was reduced to below 10%. These issues are discussed below.

Banking restrictions

Investments by banks in insurers have always been regulated. The Banking Regulation Act 1949 limits investments by banks in the shares of other companies (a cap of the lesser of 30% of the paid-up share capital and reserves of the target company or 30% of the paid-up capital and reserves of the bank applies). That aside, there is an additional overlay of restrictions in RBI's master directions on financial services. However, the drafting of these regulations causes some ambiguity as to the cap in the insurance context.

Notwithstanding all of this, the leading banks are the controlling shareholders in a number of life and general insurers. As a reaction to the general levels of financial stress in the Indian economy and the high levels of non-performing loans, the RBI has become increasingly focused on the capital adequa n encouraging banks to limit their holdings in insurers. In November 2019, press reports suggested that the RBI informally requested banks to limit their shareholding in insurers to 30% and, more recently, in 2021, press reports suggest that the RBI is considering a lower limit of 20%.

The outcome of the RBI's determination on this issue is keenly awaited by the market and this will be a key factor that shapes M&A in this sector in India.

Digital focus

Although bancassurance remains the dominant distribution channel for life insurance products, online insurers are emerging as fast-growing investment prospects in India. Particularly in the general insurance category, companies in this sector have seen significant interest from venture investors.

Apart from these online insurers, mobile connectivity has created a large online customer base and the advent of Covid has underscored the importance of digital platforms. Consequently, digital distribution of all financial products (including insurance products) is becoming a key strategic focus for a number of financial services conglomerates. Also, a number of technology investors and the family offices of the founders of technology companies have started expanding their investment footprint to cover insurance. This may contribute to dealflow as digital footprint becomes increasingly important.

Finally, the IRDAI is also open to innovative insurance-tech products and has a 'regulatory sandbox' scheme. Interested parties are able to put forward proposals to the IRDAI in relation to innovative products. The IRDAI may approve these, for an initial period of six months, extendable by a further six months. If an approval is considered successful by the IRDAI, it can then be formalised in longer term regulations. This presents an opportunity for investment in innovations in this sector in India.

Increase in the FDI cap

In February 2021, the finance minister of India announced an increase in the foreign direct investment (FDI) cap from its current limit of 49% to 74%. The changes are being implemented quickly. As of 21 April 2021, the Insurance Act 1938 has been amended to remove requirements of Indian control and the government has published draft amendments to the Indian Insurance Companies (Foreign Investment) Rules 2015. Once these come into force, the only remaining steps are the repeal of the IRDAI's previous Indian ownership and control guidelines and the inclusion of the 74% cap in the Foreign Exchange Management (Non-Debt Instruments) Rules 2019 and the consolidated FDI policy, either directly or through a 'press note'. Both of these steps are expected to take place shortly and will likely be implemented by the time this article is published.

The IRDAI has imposed certain requirements that accompany the higher FDI cap, including residency requirements for directors and key managerial personnel, the requirement for a higher retention of net profits for insurers with low solvency margins (where foreign investment exceeds 49%) and enhanced corporate governance requirements in relation to independent directors.

There are, of course, larger questions around why foreign investment should condition the ability to pay dividends, but these requirements were foreshadowed in the finance minister's budget speech and so were anticipated by the market, so the market has reacted positively to this. Therefore, once fully implemented, the increase in the FDI cap is likely to spur further investment and M&A activity.

Takeaway

The combination of any stake sales driven by RBI policy and an increase in the FDI cap is likely to result in a significant overhaul of the insurance market in India. This, together with the growth of digital opportunities, will drive transactions in the year ahead.

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