PRIVATE EQUITY INVESTMENTS IN INDIAN INSURANCE COMPANIES NOW PERMITTED

Introduction

On December 5, 2017, the Insurance Regulatory and Development Authority of India (the "**IRDAI**") issued the IRDAI (Investment by Private Equity Fund or Alternate Investment Fund in Indian Insurance Companies) Guidelines, 2017 (the "**PE Investment Guidelines**").

The PE Investment Guidelines provide the framework for investments by private equity funds either as an investor or promoter in unlisted Indian insurance companies. A "private equity fund" (a "**PE Fund**") has been defined to include an alternate investment fund registered with the Securities Exchange Board of India (the "**SEBI**") under the SEBI (Alternative Investment Fund) Regulations, 2012 or a fund specifically formed for the purpose of investment in one or more entities by one or more persons, provided that the foreign investment in the fund is determined as per the guidelines of the Department of Industrial Policy and Promotion, Government of India (the "**FDI Policy**").

Investment Routes

The PE Investment Guidelines provide for two (2) different routes of investment by PE Funds: (i) a direct investment in an insurance company as an investor (and not as a promoter) (the "**Direct Route**"); and (ii) an indirect investment in an insurance company through a special purpose vehicle, either as a promoter or investor (the "**SPV Route**"). The PE Investment Guidelines have defined a "special purpose vehicle" ("**SPV**") to mean a company registered under the Companies Act, 2013 or a limited liability partnership under the Limited Liability Partnership Act, 2008 set up by the PE Fund.

Conditions

- Under both, the Direct Route and the SPV Route, a PE Fund cannot hold shares in an insurance company exceeding 10% of the paid-up equity share capital of the insurance company, and all Indian investors of an insurance company (including the PE Fund(s) jointly) cannot hold more than 25% of the paid-up equity share capital of the insurance company. Further, a PE Fund cannot create any encumbrance on or otherwise leverage the investment in the insurance company.

- A PE Fund set up through an SPV can be a promoter of an Indian insurance company, but it can only invest in one health, life and general insurance company, respectively, and in one reinsurer. Moreover, as it cannot hold shares exceeding 10% of the paid-up equity share capital, it will have to tie up with other funds. Additionally, as all PE Funds will not be able to hold more than 25% of the paid-up equity share capital, they will have to tie up with other strategic partners or banks. Therefore, deal structuring can get complicated.

- Lock-in requirement: Under the SPV Route, a lock-in period of five (5) years (the "**Lock-in Period**") is applicable to SPVs. The Lock-in Period is also applicable to the shareholders of the SPV holding at least 10% capital of the SPV. This effectively means that during the Lock-in Period, neither the SPV will be able to exit the insurance company nor will the SPV's shareholders be able to exit the SPV. This is in line with the five (5) year lock-in period applicable to promoters and strategic

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investors of Indian insurance companies. As such, private equity funds that do not have a long term approach will, effectively, be precluded from investing. However, shareholders of SPVs holding a smaller stake (less than 10%) are allowed to exit, which is positive.

- Undertaking regarding a rights issue: Under the SPV Route, a SPV has to undertake to subscribe to a rights issue of shares of the insurance company so as to ensure that the insurance company is not cash strapped. This means that the SPV has to be appropriately capitalized from time-to-time to meet the funding obligations of the insurance company. Considering the high capital requirements of this industry, a private equity fund without deep pockets should not venture in this space.

- IRDAI approval for inducting new shareholders in SPVs: Under the SPV Route, prior IRDAI approval is required for inducting new shareholders in the SPV through "issue of fresh shares beyond 25%." It is not clear from the language of the PE Investment Guidelines whether (i) IRDAI approval will be required when the SPV proposes to issues fresh shares more than 25% of its paid-up capital; or (ii) IRDAI approval will be required when a shareholder of the SPV will hold more than 25% of the total paid-up capital of the SPV after the fresh issuance of shares. This needs to be clarified by the IRDAI.

- Post Lock-in Period divestment: Under the SPV Route, an undertaking has to be submitted by the SPV in respect of the post Lock-in divestment plan, preferably through an initial public offering, in accordance with the applicable regulations. This is not practical, as it may not be easy to contemplate a divestment plan at the time of investing in an insurance company considering the long-term nature of this business.

- "Fit and proper" criteria: Any investment by a PE Fund, under both the Direct Route and the SPV Route, will be subject to compliance of the "fit and proper" criteria, an illustrative list whereof has been provided in the PE Investment Guidelines. The criteria include track record, proof of source of funds, regulatory compliance, etc.

- Board structure of insurance companies: If a PE Fund invests in an insurance company under the SPV Route, the chairman (the "**Chairman**") of the board of directors (the "**Board**") of the insurance company has to be an independent director. Further, at least one-third of the Board is required to comprise of independent directors. These conditions are contradictory to the Guidelines for Corporate Governance for Insurers in India issued by the IRDAI on May 18, 2016 (the "**CG Guidelines**"). The CG Guidelines provide that: (i) the Chairman can either be an executive director or a non-executive (or independent) director; and (ii) the Board is required to have a minimum of three (3) independent directors (or two (2) independent directors for the first five (5) years following incorporation of the insurance company). It is not clear whether the PE Investment Guidelines are intended to supersede the criteria under the CG Guidelines, if PE Funds are investing in an Indian insurance company. This needs to be clarified by the IRDAI.

- Minimum shareholding by the promoters: Under both, the Direct Route and the SPV Route, the minimum promoter shareholding is required to be maintained at 50% of the paid-up equity share capital of the insurance company. However, the PE Investment Guidelines have created a carve out under which insurance companies whose current promoter shareholding is below 50% can continue

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with this lower promoter shareholding as the minimum shareholding. The rationale behind this requirement is unclear.

- Pre-IPO Placements: A number of domestic and foreign institutional investors invested in the pre-IPO placements of insurance companies that went public in 2017, prior to the issuance of the PE Investment Guidelines. Although there is no specific clarity on whether these investors will be covered by the PE Investment Guidelines, it seems that these guidelines will apply. Therefore, pre-IPO investors should assess the impact of these guidelines on their investments.

General Comments

The PE Investment Guidelines are a step in the right direction as they pave the way for PE Funds to invest in Indian insurance companies in a structured manner and make available to the Indian insurance sector, an additional capital source. However, PE Funds looking for short term returns and an easy exit may not find it lucrative to invest. Moreover, some of the concerns highlighted above will have to be clarified by the IRDAI.

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