M&A Hotline

December 24, 2015

IRDAI: WALKING THE TALK?

- IRDAI provides clarity on the 'Indian ownership and control' test required to be met by all Indian insurance companies and insurance intermediaries.
- Defines 'Control' to mean the right to appoint a majority of the directors or control the management or policy decisions.
- Provides a compliance window till February13, 2016 to comply with the guidelines which may be extended for another period of 3 months upon request being made to the IRDAI.
- IRDAI allows Indian insurance companies to issue preference shares and debentures, subject to prior approval from the IRDAI and certain restrictions on the terms of such instruments.

In a move to liberalize the insurance sector, the Insurance Laws (Amendment) Act, 2015 ("**2015 Act**") was notified in March, 2015. The 2015 Act, amongst other things, increased the foreign investment limit in Indian insurance companies and allowed Indian insurance companies to issue 'other forms of capital' as may be prescribed by the Insurance Regulatory and Development Authority of India ("**IRDAI**").[1] In exercise of the powers provided to IRDAI by virtue of the 2015 Act, IRDAI has now clarified 'Indian ownership and control' and has also permitted fund raising avenues, in addition to equity shares, for insurance companies in India.

BACKGROUND

The 2015 Act, while increasing the foreign investment limit in insurance companies provided that the insurance company would, at all times, necessarily be required to be owned and controlled by Indian residents.[2] The IRDAI, by a notification dated October 19, 2015 ("**Guidelines**") has issued guidelines clarifying the aspects of Indian residents maintaining 'ownership' and 'control' for insurance companies. By a circular dated November 20, 2015, the principles mentioned in the Guidelines have now been extended to all insurance intermediaries as well.

Insurance companies were hitherto prohibited from issuing any form of capital, other than equity shares. The 2015 Act has now amended Section 6A of the Insurance Act to allow insurance companies to issue 'other form of capital', as may be prescribed by IRDAI. Pursuant to such change, the IRDAI has now permitted other forms of capital to be issued by insurance companies by way of the IRDAI (Other Forms of Capital) Regulations 2015 notified on November 13, 2015 (the "**Regulations**"). The Regulations lay down the framework for the instruments eligible as 'other forms of capital' and the conditions for such issuance.

'CONTROL'

In the Guidelines, while acknowledging that 'control' may be exercised by virtue of (i) shareholding; (ii) management rights; (iii) shareholders' agreement; (iv) voting agreements; or (v) any other means as per applicable laws, the IRDAI has sought to provide some clarity on its interpretation of 'control'.

- **Applicability:** The Guidelines have clarified that the Indian owned and controlled test would be required to be met by all insurance companies, whether seeking to increase their foreign investment or not. The Guidelines are also applicable to all 'insurance intermediaries' as defined in the Insurance Regulatory and Development Authority of India Act, 1999, such as brokers, third party administrators, surveyors and loss assessors.
- **Board and key management personnel:**
  - Composition of the board: The Guidelines clarify that the majority of the directors, excluding the independent directors should be nominated by Indian promoters/ Indian investors. The chairman of the board can have a casting vote, provided such chairman is appointed by the Indian promoter/ Indian investor. Accordingly, it seems that the foreign investor may also be entitled to appoint the chairman of the board, provided such chairman does not have a casting vote.
  - Key management personnel: The key management personnel, including the chief executive officer, the managing director, the principal officer, etc. shall generally be appointed through the board of directors or by the Indian promoter/ Indian investor. However, the key management persons may also be nominated by the foreign investor provided the board of directors approves such nomination in accordance with the conditions mentioned above.
  - Quorum: The Guidelines clarify that the quorum for meetings shall be constituted by a majority of Indian directors, provided however, that a foreign investor's right to have its nominee director present for constituting a valid quorum shall not be considered 'control'.

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- Significant policies: The Guidelines clarify that the board of the insurance company shall control all 'significant policies' of the insurance company. While the intent seems to be to ensure that the foreign investors do not control such policies, the Guidelines fall short of explaining what 'significant policies' are.
- Lack of clarity on negative control: Most foreign investors in existing insurance companies had extensive rights, including veto rights, since there was no requirement of control of an insurance company to be with Indian residents. The Guidelines are silent on the ability of the foreign investor to have veto or affirmative voting rights. It is to be seen if IRDAI considers any veto right to tantamount to control. Considering that the foreign investor is entitled to have a nominee present for the purposes of formation of a quorum (for minority protection purposes), it may be assumed that veto rights which are merely minority protection would be permissible.

- **Compliance mechanism and the timelines:** Under the Guidelines, every Indian insurance company needs to file an undertaking signed by its chief executive officer and the compliance officer confirming that the company is 'Indian owned and controlled'. Along with such undertaking, the insurance company also needs to file a resolution of the board of directors confirming that the company is 'Indian owned and controlled'. All insurance companies existing at the time of the issuance of the Guidelines need to comply with the Guidelines within 3 months from the date of the issuance of the Guidelines, which may be extended for another period of 3 months, on an application by such insurance company to the IRDAI. Insurance companies coming into existence post the notification of the Guidelines would need to comply with the Guidelines prior to the grant of registration of certificate.

CONCLUSION

While the Guidelines have provided clarity on what would be objectively prohibited to ensure that the control resides with Indian residents, most of the rights which a foreign investor may exercise have been left subjective, which has resulted in lack of certainty. This assumes further significance for existing joint ventures, which have to amend their existing agreements to ensure that the principles under the Guidelines with respect to Indian ownership and control are adhered to.

'OTHER FORMS OF CAPITAL'

Insurance companies were hitherto permitted to issue only one class of equity shares. The Regulations now permits insurance companies to issue 'preference shares' and 'debentures' as defined under the Companies Act 2013 ("**CA 2013**"), subject to prior approval from the IRDAI. Accordingly, insurance companies can now issue preference shares and/ or debentures, provided they fulfil the conditions discussed below.

- **Terms:** The preference shares or debentures to be issued by the insurance company must necessarily meet, among others, the following conditions:
  - It must be unsecured and should not be covered by any guarantee of the insurer or any other arrangement that enhances the seniority of the instrument holder above that of the claims of the insurer's policyholders or creditors;
  - It must have a maturity or redemption period of not less than 10 (ten) years (reduced to 7 (seven) years in the case of health insurance companies);
  - The floating rate of interest (if applicable) for a debenture shall be with reference to a market determined rupee interest benchmark rate;
  - Rate of interest or dividend payable on such instruments shall, at all times, be subject to compliance with the solvency margin as prescribed by the IRDAI;
  - the dividend or interest payable on such instruments shall not be cumulative. Consequently, unpaid dividend or interest in a given year cannot be paid in the subsequent years;
  - If such instruments are being issued to foreign investors, the provisions of Foreign Exchange Management Act, 1999 ("**FEMA**") and the terms and conditions, if any, stipulated by Securities Exchange Board of India / other regulatory authorities in relation to issue of such instruments, are to be complied with. This would necessarily imply that if the preference shares and/ or debentures are being issued to non-residents, the instruments would need to be compulsorily convertible into equity shares.
- **Limits:** The Regulations provides that the total quantum of the instruments issued under the Regulations (i.e. the debentures and preference shares) shall not, at any time, exceed (i) 25% of the equity share capital and securities premium of the insurer; and (ii) 50% of the net worth of the company. It would be interesting to note how this would be dealt with by IRDAI. In case the net worth of the insurance company falls below 50%, the insurance company would be compelled to increase its equity share capital, which could be a challenge at such time.
- **Prior approval of IRDAI for issuance:** A company proposing to issue instruments under the Regulations shall have to make an application for obtaining the prior approval of IRDAI for issuance of the instruments. The application for approval shall include the prescribed details, including projected business plan, terms of the instruments to be issued, rational for issuance of such instruments over equity shares.

  While most of the disclosures seem to be standard, it is to be seen how IRDAI deals with the rationale for the issuance of 'other capital' as against issuance of equity shares. Preference shares, especially convertible preference shares, are generally issued to provide anti-dilution protection to investors whilst debentures, whilst they are principal protected instruments, are also issued for tax optimization. It is unclear to what extent the IRDA will seek to inquire into the rationale of why these instruments are being issued.
- **Call option/ put option:** While the instruments cannot be issued with a 'put option', it is unclear as to whether the restriction on issuing these instruments with a put option is vis-a-vis the issuing company, and whether a put option against the promoters of the issuing company would be permitted. However, instruments with call options are permitted vis-a-vis, provided that the call option can be exercised only (i) post 5 (five) years of its issuance, and (ii) the prior approval of the IRDAI has been obtained for such exercise. The Regulations also provide the IRDAI with the authority to allow a company proposing to exercise call option to replace the called instrument with an equal or

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996
September 22, 2024

better quality instrument.

- **Transfer of shares:** While the Regulations do not prohibit transfer of the instruments issued under the Regulations, Section 6A of the Insurance Act, 1938 requires the approval of the IRDAI for any transfer of shares if the transferee holds 5% or more shares of the insurance company. Since preference shares forms part of the share capital of a company, approval of the IRDAI should be required in case of a transfer of preference shares issued under the Regulations. However, debentures issued under the Regulations do not squarely fall under the same restriction.
- **Conversion:** While the Regulations are silent as to whether the convertible instruments issued under the Regulations can be converted into equity shares, it seems to suggest that the same may be permitted after the expiry of the minimum maturity period prescribed under the Regulations. It is also to be seen as to whether an approval from the IRDAI would be required for conversion of such convertible instruments, if such conversion attracts Section 6A of the Insurance Act, 1938.
- **Available solvency margin:** The total quantum of the instruments issued under the Regulations will be eligible to be included as part of the capital for the purposes of calculation of 'available solvency margin'[3] for the first year from the date of issuance of these instruments. However, there will be a progressive hair-cut in the proportion in which the instruments are to be included for the purposes of calculation of the 'available solvency margins' for the final five years prior to maturity of such instruments.

This will be a huge reprieve for insurance companies as they will have more flexibility in terms of permitted capital raising avenues to comply with the solvency margin prescribed by the IRDAI. While the Regulations are a step in the right direction, it creates a number of ambiguities, which require clarification. Further, investments into Non-Convertible Debentures ("**NCDs**") issued by Indian companies have become an attractive proposition for foreign portfolio investors due to the non-applicability of pricing restrictions and tax optimization purposes. NCDs allow foreign investors with a lot of flexibility in terms of interest rates and the redemption premium on the NCDs can also be structured to provide market linked returns obtained through exposures on exchange traded derivatives, in addition to the returns assured on the coupon on the NCD. However, the excessive restrictions placed on the issuance of instruments under the Regulations, including NCDs will be a kill joy as it takes away the flexibility from the foreign investors to structure their investments and returns. Therefore, in order for these instruments to be a success, the instruments may need to be more commercially viable, so as to attract the investors.

– Rishabh Sharma, Abhinav Harlalka & Simone Reis
You can direct your queries or comments to the authors

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[1] For a detailed analysis on changes in the foreign investment introduced by the 2015 Act, please refer to our earlier hotline here

[2] Control is defined under Section 2 (7A) of the Insurance Act to include '*the right to appoint a majority of the directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements'*.

[3] Clause 1(a) of Schedule III-A of the Insurance Regulatory and Development Authority (Assets, Liabilities, and Solvency Margin of Insurers) Regulations, 2000 defines 'Available Solvency Margin' to mean, "*the excess of value of assets (furnished in IRDA- Form- AA) over the value of life insurance liabilities (furnished in Form H as specified in Regulation 4 of Insurance Regulatory and Development Authority (Actuarial Report and Abstract) Regulations, 2000) and other liabilities of policyholders' fund and shareholders' funds*".
