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MERGER ACTIVITY

Mergers & Acquisitions in the Indian Insurance Sector – Time for a New Era of Consolidation?

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India's insurance sector offers tremendous opportunities with its life insurance and general insurance markets growing at compounded annual growth rates of approximately 13% and 9%, respectively, in the last decade, according to India Brand Equity Foundation. Despite sustained growth, India's insurance penetration remains relatively low and stood at only about 3% in the 2015 financial year compared to other Asian economies such as Taiwan (18%), Hong Kong (12%) and South Korea (11%). Growth so far has largely been attributable to tax incentives and mandatory requirements under law for customers to purchase insurance, such as third-party auto insurance, but future growth is expected from increasing financial awareness of insurance policies being suitable savings and tax-planning products, higher disposable incomes and favorable government policies. By an estimate published in *Forbes*, the country's insurance market is expected to quadruple over the next ten years from its current size of $60 billion.

The insurance sector in India currently comprises 53 companies, of which 24 provide life insurance and 29 provide other types of insurance, such as auto insurance, marine insurance and home insurance. There has been significant interest in the Indian market since limited foreign investment was permitted in 2000, when foreign investors were allowed to own up to 26% equity in companies operating in the sector. Currently, 39 Indian insurance companies have foreign joint venture partners. In 2015, the Insurance Laws (Amendment) Act was passed, which raised the foreign investment limit in Indian insurance companies and insurance intermediaries from 26% to 49%, subject to ''control'' remaining with the Indian partner. This has led to several foreign investors raising their stakes in their Indian insurance joint ventures, demonstrating continued optimism on the sector's prospects.

Of the 24 life insurance companies that operate in India, the public sector insurer, Life Insurance Corporation of India, represents approximately 50% of the life insurance market and the top four private-sector life insurers have approximately 30% of the market. Similarly, in the non-life general insurance business, the top six private-sector general insurance companies represent approximately 36% out of the 56% market share enjoyed by all private-sector general insurance companies. As a result, there is likely to be consolidation among the remaining market participants, as they seek to gain market share, lower costs and improve distribution channels. For example, in August 2016, HDFC Life, one of the largest life insurers in India, and Max Life an-

nounced a merger of their life insurance businesses – a deal that is expected to create the largest listed life insurance company in India.

This article briefly discusses the legal regime applicable to mergers and acquisitions transactions in the Indian insurance industry and includes practical tips for deal makers to keep in mind for such transactions.

Legal Regime

M&A in the insurance sector is primarily governed by the following laws and regulations:

1. *Insurance Act*: The Insurance Act, 1938 (''Insurance Act'') governs all aspects of the conduct of business by private insurance companies and also established the Insurance Regulatory and Development Authority of India (''IRDA''), which regulates such companies. The following provisions are important to note from an M&A perspective:

   (i) ''Indian insurance company'' is defined as a company in which total foreign investment does not exceed 49% of its paid-up capital and which is ''Indian owned and controlled''; and

   (ii) prior IRDA approval is required for a transfer of shares (a) where the transferee's shareholding in the company exceeds 5% and/or (b) where the cumulative shares transferred by any individual, group or bodies corporate under common management exceeds 1%.

Note that ''total foreign investment'' is defined to include direct and indirect foreign investment, including foreign portfolio investment (i.e., investments by foreign portfolio investors and non-resident Indians permitted under the portfolio investment scheme of the Reserve Bank of India (''RBI'')).

2. *Foreign Exchange Regulations*: The Foreign Exchange Management Act, 1999 (''FEMA''), the notifications issued by the RBI and the ''Consolidated FDI Policy'' issued by the government under FEMA (''FDI Policy'') (collectively, the ''Foreign Exchange Regulations'') specify the conditions governing all foreign investments in Indian companies. Such investments must comply with certain pricing guidelines that require foreign investors purchasing shares of an unlisted Indian company to pay at least the fair value of such shares as determined by a registered merchant banker or chartered accountant in accordance with any internationally accepted pricing methodology on an arm's-length basis.

The FDI Policy was recently amended to allow up to 49% foreign investment in insurance companies under the automatic route, i.e., without prior approval from the Foreign Investment Promotion Board (FIPB).

3. *Control Guidelines*: As discussed above, Indian insurance companies are required to be ''Indian owned and controlled''. In October 2015, the IRDA issued guidelines (''Control Guidelines'') to clarify what would constitute control. The Control Guidelines require that:

   (i) a majority of the non-independent directors on the board of the insurance company be nominated by Indian parties;

   (ii) key management personnel (such as the CEO and MD) be appointed by the board or the Indian parties. However, a foreign investor may nominate other key management personnel subject to confirmation by the board; and

   (iii) the board exercise control over significant policies of the company.

The term ''Indian owned and controlled'' has led to significant uncertainty among foreign investors, following the introduction of this term in the 2015 amendment to the Insurance Act. For example, the extent to which minority protection rights, such as consent rights, typically sought by foreign investors might be construed as giving ''control'' has been unclear. Customarily, foreign investors seek consent rights with respect to a broad spectrum of matters to protect their minority interest. However, after the issuance of the Control Guidelines, consent rights with respect to operational matters, such as annual budgets and annual business plans, may be considered by the IRDA as amounting to ''control'' despite being acceptable previously. With the dust having settled on many foreign joint ventures stake raises, experienced practitioners should be able to advise on what sort of rights the IRDA may be willing to let foreign partners have.

4. Other Forms of Capital: The Insurance Act requires that the share capital of an insurance company only consist of equity shares or such other forms of capital as may be specified by regulations. The IRDA recently issued regulations (''Capital Regulations'') that allow insurance companies to issue preference shares and subordinated debt provided that:

   (i) these forms of capital are subordinate to the claims of policyholders and other creditors and, therefore, cannot be secured or guaranteed;

   (ii) IRDA approval is obtained prior to issuing such instruments; and

   (iii) no put options with respect to such instruments are granted. Call options are permitted subject to compliance with certain conditions including, obtaining IRDA approval prior to exercise.

The issuance of the Capital Regulations indicates IRDA's recognition of the growing need for capital in the sector. Indian insurers now have additional avenues for raising capital that is expected to encourage investment (both domestic and foreign) as demonstrated by the recent private placement of subordinated debentures by ICICI Lombard General Insurance.

Regulatory Consents

In addition to the legal regime, deal makers should be aware of the regulatory approvals that may be required for undertaking an M&A transaction in the insurance sector:

- As mentioned, prior IRDA approval is required in case of a transfer of more than 1% of an Indian insurance company's shares and any transfer that causes the shareholding of the transferee to exceed 5% of the paid-up capital of an insurance company.

- In addition, depending on whether the M&A transaction exceeds the thresholds set under the Competition Act, 2002 and the notifications under it, an investor may require merger control approval from the Competition Commission of India which can take up to 210 days but typically takes 60 – 80 days.

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Deal Tips

High growth potential and low overall penetration have made the Indian insurance sector attractive for investment. Below are a few tips for dealmakers to keep in mind:

- In view of the IRDA approval requirement for share transfers of insurance companies, foreign investors may consider investing indirectly in the holding company of the insurance company. Investing through this structure may offer the foreign investor additional exit options (for instance, buybacks of shares are discouraged by the IRDA but would be permitted at the holding company level) and also allow for a faster exit without the need for prior IRDA approval. However, the foreign investor will need to ensure that the aggregate foreign ownership in such holding company does not exceed 49% and foreign investors do not ''control'' the holding company, thereby controlling the insurance company subsidiary.
- Foreign investors should also consider investing through an entity situated in a jurisdiction that has a favorable bilateral investment treaty (''BIT'') with India. BITs are designed to help protect investments against political risks such as unfair and inequitable treatment, expropriation or nationalization. In some cases, a BIT jurisdiction may also be the most tax-efficient jurisdiction resulting in dual benefits for the investor. According to the United Nations Conference on Trade and Development, India has BITs with 72 countries (not including the US) that are currently in force.
- Setting up a greenfield insurance company in India requires registration with the IRDA and the process can take 8 – 10 months from submission of an application or longer if the IRDA requests additional information. Investors may find it easier to invest in an existing Indian insurance company to gain immediate access to the market.
- In view of some ambiguity regarding the treatment of minority protection rights (such as consent rights) under the Control Guidelines, foreign investors should seek the advice of experienced legal advisors who have previously dealt with the regulator on these issues and are familiar with the IRDA's concerns and thought process regarding such issues.

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