The Indian Insurance Industry : A Case Study

Introduction

ABC is foreign company having diverse business interests, including the marketing and selling of insurance products in the United States of America (USA). It has a strong infrastructure, good customer base and brand equity. ABC has heard that the Indian insurance market has opened up and seeks some information about opportunities there. ABC wants to tie-up with an Indian company ("XYZ") by forming a joint venture and wants to know the amount of equity it can hold in an Indian joint venture company and the insurance products it can sell in India. The company has distributable profits in three (3) preceding financial years, prior to the year in which shares with differential rights are to be issued;

Further, ABC has a subsidiary in India (the "ABC Sub"), which is engaged in manufacturing car tyres. ABC wants to know whether ABC Sub can enter into a joint venture with XYZ.

ABC also wants to know about the new regulatory regime, capitalization and related issues.

Observations and Comments

The Indian government has recently passed the Insurance Regulatory Development Authority Act, 1999 (the "IRDA") whereby amendments have been made to the existing insurance laws prevailing in the country, namely, the Insurance Act, 1938 (the "Ins Act"), the Life Insurance Corporation Act, 1956 (the "Life Act"), and the General Insurance Business (Nationalisation) Act, 1972 (the "GIB Act"). An authority called the Insurance Regulatory Development Authority (the "Authority") has been established to regulate the insurance sector. (Section 3 of the IRDA) The Authority, inter alia, will have the power to:

- issue to applicants a certificate of registration; renew, modify, withdraw, suspend or cancel such registration. (Section 14(2)(a) of the IRDA) A certificate of registration will have to be renewed annually. (Section 3A of the Ins Act r/w the First Schedule of the IRDA)

- prescribe prudential norms such as solvency margins and investment guidelines for insurance companies (Section 14(2)(k) and (l) of the IRDA)

- protect interests of policyholders in matters concerning assignments of policies, nominations by policyholders, insurable interest, settlement of insurance claims, surrender value of policies, and other terms and conditions of contracts of insurance. (Section 14(2)(b) of the IRDA)

However, the Indian Government has retained with itself the power to issue directions on questions of policy. (Section 14(2)(b) of the IRDA)

The definition of an "Indian insurance company" has been amended to include "any insurer being a company-

1. which is formed and registered under the Companies Act, 1956;

2. in which the aggregate holding of equity shares by a foreign company, either by itself or through its subsidiary companies or its nominees does not exceed twenty-six per cent (26%) of the paid-up capital; and

3. whose sole purpose is to carry on life insurance business or general insurance business or re-insurance business." (Section 2(7A) of the Ins Act r/w the First Schedule of the IRDA)

The explanation to this section provides that a "foreign company" is a company that is not a domestic company. (Section 2(23A) of the Income-tax Act, 1961 r/w section 2(7A) of the Ins Act r/w the First Schedule of the IRDA) The IRDA by amending the Ins Act clearly provides that the aggregate holding of equity shares by a foreign company, either by itself or through its subsidiary companies or nominees should not exceed

26% of the paid-up capital of the insurance company. It has been clarified that the twenty-six per cent (26%) cap applicable to foreign companies will also apply to foreign institutional investors, non-resident Indians and overseas corporate bodies. (Section 2(7A)(b) of the Ins Act r/w the First Schedule of the IRDA)

Thus, a foreign company is now permitted to own upto 26% of the equity in an Indian joint venture company. Therefore, if ABC proposes to form a joint venture with XYZ, ABC's shareholding will be restricted to a minority shareholding of 26% in the joint venture company. It must be noted that the Indian insurance company must be a public limited company. (Section 2C of the Ins Act)

Now, let us assume that ABC has a subsidiary company in India (the "ABC Sub") in which it owns a fifty-one per cent (51%) equity and decides that ABC Sub should enter into the insurance joint venture with XYZ. This will not be permissible. According to recent informal pronouncements of the Authority, Indian companies that are subsidiaries of overseas companies will not be allowed to tie-up with other Indian companies to do insurance business. The Authority perceives this as violation of the twenty-six per cent (26%) equity cap by foreing insurance companies.

ABC can, however, along with several other foreign companies have a stake in an insurance company operating in India as long as the combined equity stake of all foreign companies does not exceed twenty-six per cent (26%).

The Authority will not register any new insurance company carrying on the business of life or general insurance unless it has a minimum paid-up capital of Rs. 100 crores (approx. US$ 23,255,800). No composite license for life and non-life business will be granted. For companies in the reinsurance sector, a minimum paid-up capital of Rs. 200 crores (approx. US$ 46,510,000) is required. (Section 6 of the Ins Act) The foregoing paid-up share capital must be brought into the new company within six (6) months of issue of the license. (Section 6 of the Ins Act r/w the First Schedule of the IRDA) In addition, every insurer will be required to undertake such percentages of life insurance or general insurance business in the rural or social sector, as specified in the Official Gazette by the Authority in this behalf. (Section 27D of the Ins Act r/w the First Schedule of the IRDA) Furthermore, a new insurance company will be permitted to invest policyholders' funds only in India. (Section 27C of the Ins Act r/w the First Schedule of the IRDA) Every insurer shall, in respect of its life insurance business, be required to deposit with the Reserve Bank of India, either in cash or in approved securities, a sum equal to one per cent (1%) of its total gross premium written in India, not, however, exceeding Rs. 10 crores (approx. US$ 2,325,580). In respect of the general insurance business, this sum will equal three per cent (3%) of its total gross premium written in India, not, however, exceeding Rs. 10 crores (approx. US$ 2,325,580). In respect of re-insurance business, this sum will equal Rs. 20 crores (approx. US$ 4,651,160). (Section 7(i) of the Ins Act r/w the First Schedule of the IRDA)

There appears to be a grey area in the IRDA. It has been provided that an Indian promoter holding more than twenty-six per cent (26%) of the paid-up equity capital of an Indian insurance company will have to divest in a phased manner the share capital in excess of twenty-six per cent (26%), after a period of ten (10) years from the date of commencement of business by the Indian insurance company. (Proviso to section 6AA of the Ins Act r/w the First Schedule of the IRDA) On the one hand, the Indian government seeks to restrict foreign equity ownership in Indian insurance companies to twenty-six per cent (26%) whereas on the other hand, it wants Indian partners to divest their equity holdings to twenty-six per cent (26%) after ten (10) years. It is unclear whether the foreign partner will be permitted to purchase the equity to be divested. Additionally, what if there are no takers of the equity required to be divested! All these points will have to be adequately considered when formulating the regulations in respect of divestment.

The IRDA proposes to allow three kinds of insurance brokerage firms to operate in the country, namely, insurance, re-insurance, and composite brokerage firms. The twenty-six per cent (26%) equity cap will apply to such firms too, except that, composite brokers may enjoy a higher equity cap of forty-nine per cent (49%).

Company formation consideration

1. On complying with the registration formalities, ABC and XYZ will have to enter into a shareholders agreement. The main issue that arises here is exercise of control in the functioning of the joint venture company. Generally, exercise of control can be at two levels Board of Directors; and
2. Shareholders

Under the Companies Act, 1956 (the "Cos. Act") a company can carry on activities by passing either of two resolutions, special resolutions and ordinary resolutions. Ordinary resolutions can be passed by shareholders having 50% plus one shares with voting rights in the company, whereas special resolutions can be passed only by shareholders having 75% shares with voting rights in the company. A special resolution is, inter alia, required to amend the Memorandum and Articles of Association of a company, to issue further shares through a rights issue, to give loans or guarantees to other companies, etc. With a twenty-six per cent (26%) equity stake, ABC will only be in a position to block special resolutions. It will not be able to control the day-to-day functioning of the joint venture company.

Additionally, the Authority has prescribed that foreign insurance companies cannot retain Board control in Indian insurance joint venture companies. Therefore, ABC will not be able to appoint majority directors on the joint venture company's Board. Another pertinent point that arises is infusion of funds to the extent of seventy-four per cent (74%) of the equity of the joint venture company by the Indian partner, namely, XYZ. XYZ will have to bring in a minimum amount of US$ 17,209,292, if the joint venture company seeks to enter into the business of life or general insurance. Further, in the event of increase of share capital, XYZ will have to pump in an amount equal to its seventy-four per cent (74%) equity stake. This can cause some problems. It should be noted that preference shares cannot be issued by companies carrying on life insurance business (Section 6A(1)(i) of the Ins Act). As such, the joint venture company carrying on life insurance business cannot comply with the capitalization stipulations by issuing preference shares to ABC

In such circumstances, the parties can consider entering into a three-way joint venture either with another Indian company or with a bank. The Reserve Bank of India ("RBI") has permitted banks to enter into the insurance sector and to invest up to fifty per cent (50%) of their paid-up capital in insurance joint ventures.

Share transfer issues

Various issues arise if one of the shareholders in the joint venture company decides to transfer its shareholding. The transfer conditions depend upon the shareholders agreement. As per the guidelines stipulated under the IRDA, where the nominal value of the shares intended to be transferred by any individual, firm, group, constituents of a group, or body corporate under the same management, jointly or severally, exceeds one per cent (1%) of the paid-up capital of the insurer, previous approval of the Authority must be obtained to effect such a transfer. (Section 6A(4)(b)(iii) r/w the First Schedule of the IRDA) Further, where, after the transfer of shares, the total paid-up holding of the transferee in the shares of the company is likely to exceed five per cent (5%) of its paid-up capital, or where the transferee is a banking or an investment company, is likely to exceed two and a half per cent (2 ½ %) of such paid-up capital, prior approval of the Authority must be obtained in respect of the transfer. (Section 6A(4)(b)(ii) r/w the First Schedule of the IRDA) The aforesaid regulations will have to be complied with by ABC and XYZ in case of transfer of shares in the joint venture company

Conclusion

The liberalization of the Indian insurance sector has been the subject of much debate for some years now. Despite innumerable delays, the insurance sector is all set to open up to private competition. If ABC and XYZ can establish the right amount of trust and take a long-term perspective on the Indian market, their joint venture can be a major success.#