Draft regulations on issuance of other forms of capital by insurers

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Overview

The Insurance Regulatory and Development Authority (IRDAI) recently released a draft version of the IRDAI (Other Forms of Capital) Regulations 2015. These draft regulations follow the amendments to Section 6A of the Insurance Act 1938 which were made through the Insurance Laws (Amendment) Act 2015.

Previously, insurers could issue only equity shares of a single face value and equal voting rights. In accordance with the amendments, insurers' capital can now consist of equity shares of a single face value and "other forms of capital", as specified by the regulations.

The amendments to Section 6A of the Insurance Act 1938 and the draft regulations are of particular importance when read alongside the increase in the permissible foreign investment limit to 49% (with up to 26% foreign investment under the automatic route and up to the permissible limit of 49% under the approval route).

Due to the increase in foreign investment limits, existing and potential investors – in particular, foreign investors – are seeking to invest in Indian insurers and have eagerly awaited clarification from the IRDAI in relation to the permissible forms of capital. However, Section 6A provides that "the voting rights of shareholders are restricted to equity shares". As such, shareholders holding other forms of capital cannot receive voting rights by way of the IRDAI's regulations, as these regulations cannot override the Insurance Act 1938.

Draft regulations

The draft regulations have provided some much-anticipated clarification on the IRDAI's stance by specifying the instruments which will be considered other forms of capital and setting out the rules governing the issuance and rights associated with such instruments. 'Other forms of capital' has been defined in the draft regulations as preference share capital and subordinated debts issued by an insurer with the IRDAI's prior written approval in the manner specified in the draft regulations. The instruments issued by the insurer must be fully paid, be unsecured and have a redemption period of no less than 15 years to qualify as a form of capital.

To obtain the IRDAI's approval, insurers proposing to raise these other forms of capital must file certain documents with the IRDAI, including:

- the terms and conditions on which the preference shares or debentures are proposed to be issued; and
- the rationale for issuing other forms of capital in lieu of raising funds through the issuance of equity share capital.

In addition, foreign investors that invest in such instruments – including foreign institutional investors and foreign portfolio investors – must comply with the foreign exchange management regulations and other applicable regulations issued by the Securities and Exchange Board of India.

For entities operating outside the insurance sector, foreign investment has long been permitted by way of equity shares and other instruments, including fully and mandatorily convertible preference shares and debentures, subject to the terms and conditions applicable to the foreign investment in the relevant sector. This position is also captured in the latest Consolidated Foreign Direct Investment Policy, which was issued by the Department of Industrial Policy and Promotion on May 12 2015. The extension of this benefit to the insurance sector and the clarification provided by the draft regulations have been welcomed by the industry.

Foreign investors in other sectors have been highly innovative when determining the terms and conditions of the convertible instruments issued to them by Indian companies, while ensuring that they comply with the applicable foreign exchange management regulations and the regulations and directives of the Reserve Bank of India (RBI). One of the most significant rules prescribed by the RBI is that no assured or minimum return of investment (often called the 'internal rate of return') can be guaranteed to foreign investors in any manner, including by virtue of the terms of conversion of the convertible preference shares or debentures. This rule will also apply to the other forms of capital proposed by insurers. Further, it remains to be seen whether the IRDAI will be amenable to insurers' innovative structuring of the terms and conditions of proposed preference shares and debentures.

The draft regulations state that insurers cannot issue instruments with put options. Insurers can issue instruments with a call option; however, this may be exercised only after the instrument has run for at least five years. In order to exercise the call option, insurers must obtain the IRDAI's prior approval.

The need to obtain the IRDAI's prior approval at various stages is likely to increase the number of regulatory hurdles for insurers and may be a time-consuming process. An insurer proposing to issue other forms of capital to its shareholders must consider these factors.

Finally, the draft regulations provide that the total instruments taken cannot exceed 25% of the equity share capital of the insurer. Further, there is a progressive decrease in the proportion by which instruments are included as part of the capital (for the purposes of calculating available solvency margins) for the final five years before maturity of the instruments.

Comment

The draft regulations are seen as progressive, as they propose a framework for insurers to issue other forms of capital. However, they contain certain inherent restrictions and limitations. As such, if implemented in their present form, they may run contrary to the recent amendments to the Insurance Act, which aim to encourage and facilitate increased investment in the insurance sector.

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