Capital requirements and constraints in Indian life insurance sector in the current environment

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A SLOWDOWN IN CAPITAL INJECTIONS

Since the global financial crisis in 2008, capital injections into Indian life insurance companies have fallen off significantly. The level of capital injections dipped from Rs.8,170 crores in FY2008-09, to Rs.4,152 crores in FY2009-10, and down to Rs.2,156 crores in the nine months of FY2010-11. The main reasons for this include a general paucity of capital following the global economic downturn along with a cautious approach taken by Indian insurers in light of a slowdown in new business volumes, high expense levels, and delayed break-even targets. Poor early-year policy persistency levels, resulting in high surrender profits, would have also helped companies relieve some strain on capital requirements.

The recent IRDA guidelines capping charges on unit-linked products that were introduced on 1 September 2010 may also have had a significant impact on promoters' desires to invest significant capital into the business in the near future. This is likely to impact the level of capital infusions in the near future, until promoters gain greater confidence around the regulatory environment and revise their strategies accordingly.

The graph in Figure 1 illustrates the build up of capital levels for selected Indian life insurance companies over the past few years.

Despite the recent slowdown in growth and capital infusions, we believe that the industry will still need to inject significant volumes of capital in order to achieve the full potential that the sector has to offer. When the largest companies are in 1,500 to 2,000 locations, companies with a current footprint of only 200 to 300 branches and a desire to be *national* players, are still looking at a lot of investment requirements.

The source of this capital and the constraints on promoters' abilities to support the capital requirements have been subjects of much debate recently.

Scarcity of capital in the market

There is a general scarcity of capital in the market. The domestic promoters of the Indian life insurance companies, which are predominant owners of the joint ventures with 74% of the holdings, have competing commitments for the deployment of such capital.

Almost all of the private sector companies are either approaching or have passed the duration by which their promoters had originally expected them to have reached a break-even stage and be self-financing.

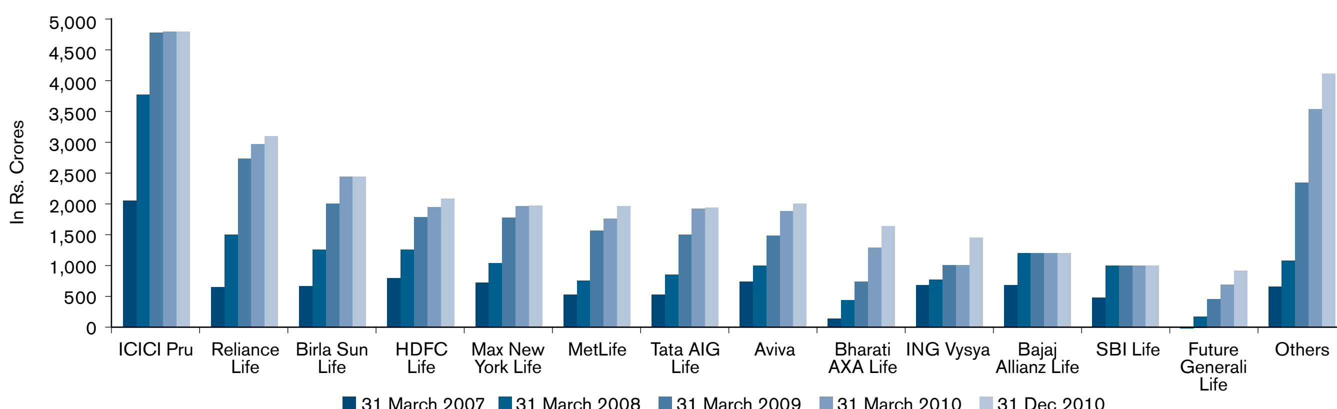
Naturally, therefore, promoters are questioning the merits of diverting available capital away from their core businesses to their life insurance businesses, where the break-even targets may now be further delayed following the recent regulatory developments.

Delay in raising the cap on FDI

The proposal to increase the foreign direct investment (FDI) cap in the insurance sector from the current level of 26% has been pending ever since the industry was opened for private sector participation in 2000. Most recently, in the Union Budget for 2011, the finance minister has again sought support from the political parties for carrying out further reforms in the industry.

Most joint venture agreements permit foreign promoters to raise their stakes as soon as the regulations allow. Some joint ventures

FIGURE 1: TOTAL CAPITAL OF LIFE INSURANCE COMPANIES IN INDIA



Source: IRDA Annual Reports, Individual company financial disclosures

may take the opportunity of raising additional capital at the same time as the sale of existing shares by domestic promoters.

Although relaxing the FDI cap may not automatically guarantee an immediate increase in equity stake by foreign promoters, it would certainly open up one avenue for insurance companies to raise additional capital.

Delay in IPO

Some life insurance companies have expressed a desire to raise capital by way of initial public offerings (IPOs).

Although there have been some positive developments on this front, with the Securities and Exchange Board of India (SEBI) reportedly agreeing to allow insurance companies to launch IPOs and waiving the requirements to demonstrate historical profitability, the detailed disclosure norms and listing requirements for life insurance companies are yet to be published by the SEBI and the IRDA.

It is worth noting, though, that following the eventual release of these disclosure norms, it may still take some time for companies to launch the IPO, given the following:

- Promoters of life insurance businesses may need to take a close look at their shareholding agreements and the opportunities posed by the prospects of an IPO. Would it be more beneficial for the domestic promoters to sell their stakes in an IPO as opposed to divesting in favour of their joint venture partners? These difficult questions need to be considered by the various promoters–who may have conflicting interests–in spite of the regulatory requirements and the specific terms of joint venture agreements.

- Life insurance companies may first need to carve out their strategies in the *new world* (following the recent regulatory changes) and demonstrate a track record of performance consistent with this before they approach the market.

- From an operational point of view, in order to execute a successful IPO it will take the companies several months to prepare the various disclosure documents and materials that can stand the test of scrutiny by the market and the investors.

In the interim, companies may continue to face capital constraints.

Difficulties in consolidation

If the current scenario of lower new business volumes and constraints on capital for further expansion persists, the Indian life insurance industry at some stage may start to see some consolidation, as we have seen in other markets. It is also possible that one or more promoters in a joint venture will choose to exit (possibly to be replaced by new shareholders or potential new entrants to the sector). We could even witness the closure of a company to new business, running off the existing business as *closed book*.

The industry faces some challenges and hurdles in the context of such scenarios:

- The joint venture structure of most insurance companies is likely to make any shareholder restructuring extremely difficult. All the promoters of the business would need to agree on any proposed plan for consolidation, and existing shareholders would typically have the right to decide the course of action should one shareholder want to exit and sell out its interest.

- Even though there will be and indeed are many other potential investors for the sector, there could well be major differences in terms of valuation expectations, particularly in the current highly uncertain environment. This may make any transaction a difficult and a lengthy process.

- The detailed rules and regulatory provisions covering all the possible options for consolidation are not spelt out clearly in the current legislation. This could lead to delays in seeking regulatory approvals for any such consolidation plans by companies.

Support by PE—but only a short-term solution?

In the context of consolidation, many private equity (PE) firms are keen to invest in the sector. Such transactions may not be straightforward because:

- PE firms may only be able to invest via an indirect route, by investing in the promoter or holding company of the insurance joint venture as opposed to investing directly in the joint ventures. This may make transactions more difficult and the number of opportunities for the PE firms may be limited.

- Given their very nature, PE investments are typically short-term in nature. Although they may support the immediate capital requirements of the business in the short term, they would typically need to be provided with an exit route over the next three to five years. Given this, the PE route may only be viewed as a short-term solution.

- As with other options for consolidation, there may also be a gap in the valuation of the insurance business by the existing promoters and by the PE firms.

Restrictions on other avenues of capital support

Besides the options discussed above, the current regulations do not permit other avenues through which insurance companies can access capital, including financial reinsurance, subordinated debt, etc.

Although there may be other indirect internal sources of capital that an insurance company may consider (such as a significant reduction in costs), the amount of such internally sourced capital may not be sufficient to meet all the future capital requirements of the industry to support sustained growth over the medium term. Besides, the efforts by the industry to raise such capital may take some time to be effective.

CONCLUSIONS

Given the legislative restrictions and the recent regulatory changes, the life insurance industry is currently facing significant challenges in accessing capital for growth.

We believe that there need to be some urgent steps required on the part of the policymakers and the IRDA in order to enable the industry access to much-needed capital. In addition to the much talked about alternatives of raising the FDI cap and enabling IPOs, other means of raising capital should also be considered, so that the industry can support a period of sustained growth in the future.

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