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CREDIT OPINION
23 June 2022

Update

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RATINGS

Direct Line Insurance Group plc

Domicile	BROMLEY, United Kingdom
Long Term Rating	Baa1
Type	Subordinate - Dom Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Direct Line Insurance Group plc

Update to credit analysis

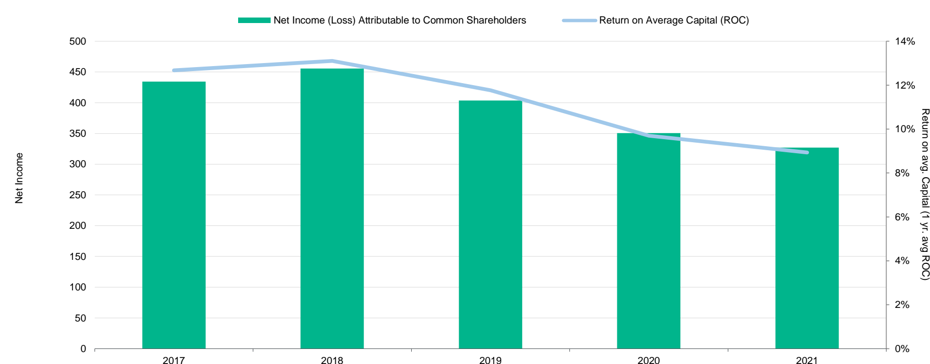
Summary

Direct Line Insurance Group plc's (DLG) main operating entity UK Insurance Limited (UKI) is rated A1 for insurance financial strength with a stable outlook. The rating, affirmed on 27 April 2022, reflects DLG's (i) consistently strong return on capital (ROC, Exhibit 1) and underwriting results, (ii) very strong position in the UK personal lines general insurance market, (iii) relatively conservative investment portfolio and relatively low financial leverage, and (iv) good capitalisation.

These strengths more than offset the Group's dependence on the very competitive and highly regulated UK personal motor insurance market. While we believe the Group's earnings are sustainable, there is some execution risk around the change in drivers of future profitability, and the Group's technology transformation although with the roll-out of the new motor technology platform the programme is now largely complete.

Exhibit 1

Net income and return on average capital (1 year average)



Source: Company reports and Moody's Investors Service

Credit strengths

- » Very strong position in the UK personal lines market, with powerful brands
- » Low exposure to product risk, with a personal lines orientation
- » Consistent track record of strong returns on capital and underwriting results
- » Relatively low financial leverage and strong earnings coverage of interest
- » Relatively conservative investment portfolio

Credit challenges

- » Enhancing contributions, both from a premium and profitability perspective, from non-personal lines motor businesses (e.g. commercial and rescue segments)
- » Successfully execute the roll out of the new technology systems and convert efficiency gains into a lower cost base
- » Sustaining recent underwriting performance in the very competitive UK personal lines market and as the contributions from prior year reserve releases reduces
- » Navigating and adapting to changes, including the FCA's pricing measures, in the highly regulated and dynamic UK personal lines market
- » Limited geographical and business line diversification in which motor business predominates

Rating outlook

The rating outlook is stable reflecting our expectation that DLG will sustain its strong profitability both from a return on capital and underwriting perspective, while maintaining its very strong position in the UK personal lines general insurance market. The stable outlook is also underpinned by our expectation that the Group will maintain its relatively conservative investment portfolio, good capitalisation and relatively low financial leverage.

Factors that could lead to an upgrade

- » Enhanced capital adequacy with gross underwriting leverage of below 2x and Solvency II coverage above 200%;
- » Average ROC (Moody's definition) through the cycle above 15% and a reported combined ratio consistently around 90%;
- » Adjusted financial leverage consistently below 10%;
- » Continued profitable development of non-motor business

Factors that could lead to a downgrade

- » A material reduction in premiums resulting in a material loss of market share; and/or
- » Average return on capital through the cycle below 8%; and/or
- » Adjusted financial leverage in excess of 25% with earnings coverage below 8x; and/or
- » Meaningful deterioration in capital adequacy as reflected in the Group's Solvency II ratio falling sustainably well below 160%

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on https://ratings.moodys.com for the most updated credit rating action information and rating history.

Key indicators

Key financial indicators

Direct Line Insurance Group plc [1][2]	2021	2020	2019	2018	2017
As Reported (Pound Sterling Millions)					
Total Assets	9,309	9,622	9,434	9,535	9,948
Total Shareholders' Equity	2,897	3,046	2,990	2,905	3,062
Net Income (Loss) Attributable to Common Shareholders	327	351	403	455	434
Gross Premiums Written	3,172	3,180	3,203	3,212	3,392
Net Premiums Written	2,985	2,949	2,987	2,988	3,184
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	24.1%	22.2%	23.0%	24.8%	23.1%
Reinsurance Recoverable % Shareholders' Equity	43.6%	39.0%	42.5%	42.4%	38.8%
Goodwill & Intangibles % Shareholders' Equity	35.1%	31.7%	29.6%	25.6%	21.6%
Gross Underwriting Leverage	2.4x	2.3x	2.4x	2.6x	2.6x
Return on Average Capital (ROC)	8.9%	9.7%	11.8%	13.1%	12.7%
Sharpe Ratio of ROC (5 yr.)	611.5%	549.5%	422.0%	393.0%	327.2%
Adv. (Fav.) Loss Dev. % Beg. Reserves	-10.0%	-6.5%	-10.2%	-12.9%	-12.9%
Adjusted Financial Leverage	19.1%	19.7%	14.4%	15.0%	14.6%
Total Leverage	28.2%	28.3%	23.7%	24.6%	23.8%
Earnings Coverage	9.4x	10.1x	12.6x	14.3x	13.3x

[1] Information based on IFRS financial statements as of the fiscal year ended 12/31/2020. [2] Certain items may have been relabeled for global consistency.
Source: Company filings and Moody's Investors Service

Profile

DLG, which was listed on the London Stock Exchange in 2012 after being divested from RBS in July 2012, is the UK's largest personal lines property and casualty (P&C) insurer, with leading positions in personal motor and home by inforce policies (IFP).

The Group underwrites around £3.2 billion of gross written premiums (GWP) through its highly recognised brands — Direct Line, Churchill, Privilege and Green Flag — and partners, including NatWest Group (Baa2 positive).

The Group has four core classes of business in the UK P&C insurance market: personal motor (representing 49.2% of premiums for the YE2021), commercial (20.6%), home (18.2%), and rescue & other personal lines (12%), which sells insurance solely to small and medium-sized enterprise (SME) businesses.

Detailed credit considerations

The A1 IFSR is in line with the adjusted scorecard-indicated outcome as shown in the Moody's scorecard (Exhibit 5).

Insurance financial strength rating

The key factors currently influencing the rating and outlook are:

Market position, brand and distribution: Aa - Very strong position in UK personal lines; market remains very competitive

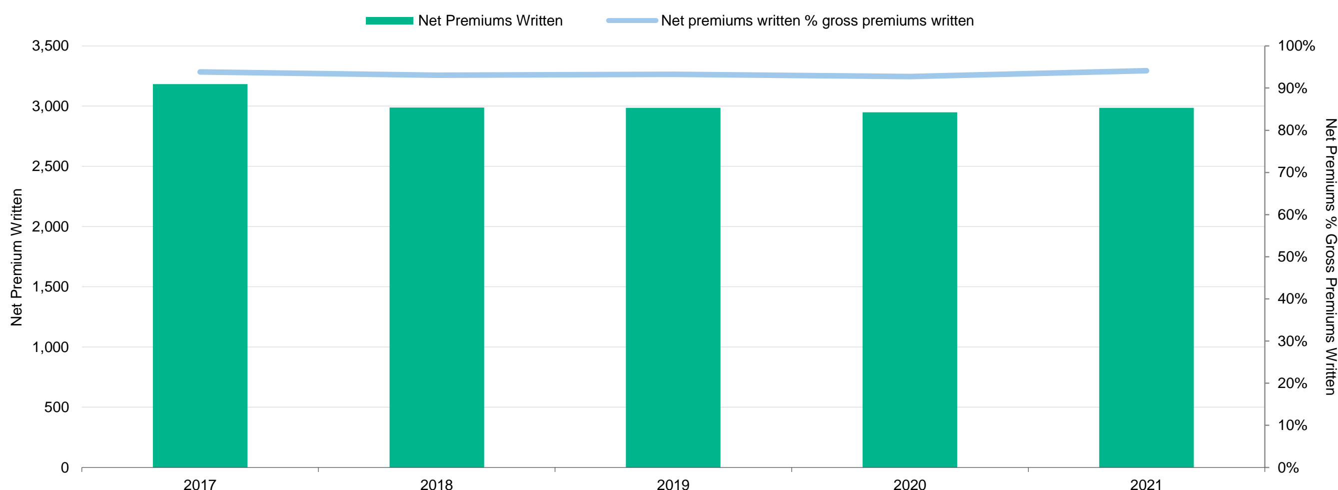
As one of the leading personal motor and home underwriters in the UK, we consider DLG's market position to be very strong. Its brands, in particular Direct Line and Churchill, are also very powerful. Notwithstanding the decline in total net written premiums (NWP) since 2017, we expect DLG's personal lines market position to remain very strong benefiting from planned growth via its direct brands, price comparison website (PCW) presence and its rescue (via Green Flag) business. DLG's SME commercial business continues to grow profitably, supported by the Group's investments into risk selection and pricing capabilities. DLG's estimated share of SME

commercial insurance market is now around 7%, although the Group has a relatively modest position in the overall UK commercial insurance sector.

The Group's NWP have declined by 7% to £3.2 billion between 2017 and 2021 (Exhibit 3), largely as a result of exiting of a number of Home distribution partnerships, as well as difficult pricing conditions and the negative impact of COVID-19 on sale volumes in 2020. While the impact of the Coronavirus-induced economic slowdown continued into the first half of 2021, there has been greater premium stability with gross written premiums down only 0.3% during 2021.

We expect the group's premiums to remain flat or reduce incrementally during 2022 as pricing on new business and renewals is optimised, Beyond this, we expect the group to report top line growth in both home and motor , as it benefits from recent significant investment into customer services, platforms and technology-enabled underwriting capabilities. DLG's partnership with Motability will also deliver premium growth, with an expected 15% uplift to motor premiums over the coming years. We expect DLG's commercial segment to continue growing, supported by both the Group's initiatives as well as the underlying expansion of the SME market.

Exhibit 3
Net written premium development



Source: Company reports and Moody's Investors Service

We view DLG's distribution as strong with leading direct to consumer propositions. Personal lines products are sold directly by phone, over the internet, through online aggregators, as well as via partnerships particularly in the home segment. The commercial division also benefits from some direct distribution (via Direct Line for Business, "DL4B") and some through the PCW channel (via Churchill for Business), although the majority of premiums are still accessed via brokers. DLG continues to improve its distribution capabilities by investing in new websites, digital propositions (e.g. Darwin, which targets PCWs customers using an alternative pricing system) and by targeting less traditional partnerships.

Despite the Group's inherent scale advantages, at around 28.5% DLG's underwriting expense ratio remains relatively high and above its personal-lines-orientated peers. However, this is driven by high marketing costs associated with the Group's direct brand propositions, which we view as favorable, as well as elevated amortisation and depreciation expenses following the rollout of the group's new technology platforms. Going forward, we expect the Group's expense ratio to reduce, via the implementation of ongoing efficiency programme initiatives and top-line growth. DLG is aiming to improve its operating expense ratio (excluding commissions) to 20% by YE23 (YE21: 23.9%).

In our view, DLG's multichannel distribution strategy, powerful brands, recent technology investments and strong financial resources will enable the Group to adapt to longer-term changes in the market place, particularly as increasing car safety features, electric cars and eventually autonomous vehicles, start to transform the traditional risk pool.

Product risk and diversification: A - Relatively low product risk, offset by limited business diversification and dependence on the UK

In our view, product line diversity is relatively limited in light of the Group's dependence on the UK P&C insurance market as well as the preponderance of personal motor, which accounted for 49% of GWP and 54% of operating profit in 2021. However, the Group's commercial business is growing, and accounted for 21% of GWP and 11% of operating profit for YE21, up from 15% of GWP for YE16, benefitting from its technology transformation.

More positively, DLG's product risk is considered low as a result of this preponderance of personal lines, which accounted for 79% of YE21 premiums as well as the focus on SME clients within the commercial business.

The Group is however exposed to large bodily injury claims volatility, windstorm and flood catastrophe risk, although DLG purchases significant reinsurance cover to mitigate these risks.

Asset quality: A - Relatively conservative investment portfolio, notwithstanding relatively high exposure to credit versus peers

We view DLG's asset quality as good, supported by the Group's relatively conservative investment portfolio, low reinsurance recoverables as a percentage of shareholders' equity and low levels of goodwill and other intangible assets relative to equity.

As at YE21, c.71% of the Group's assets were held in fixed income securities (including private placements) and c15% in cash. The Group's high risk assets as a percentage of shareholders' equity ratio stood at around 24% as of YE21, primarily comprising property investments (5% of invested assets) and high yield bonds. DLG also has an exposure to UK infrastructure (4%), which supports the asset strategy backing longer-dated periodical payment order liabilities (PPOs), as well as commercial real estate loans (3%).

The average duration of the group's debt securities was 2.5 years at YE21 comprised almost entirely of corporate bonds. This is significantly higher than a number of its UK/European P&C peers reflecting in part the consequences of not investing in equities. However, the credit quality of the fixed income portfolio is good, with c.91% investment grade (including investment grade private placements) and c.57% rated A or higher, with a well-diversified portfolio by sector.

Over the next 12-18 months, we expect only modest tweaks to the Group's investments as the Group continues to shift its portfolio towards its targets.

Capital adequacy: A - Good capitalisation notwithstanding dividend pay-outs and share buybacks

DLG's capital adequacy is good, supported by the Group's proven track record in strong internal capital generation. The YE21 regulatory solvency ratio, stood at 176% (YE20: 191%) after taking into account the final dividends and planned share buybacks. Following the redemption of the £250 million Tier 2 debt instrument (27 April), the Solvency II ratio reduces to 160% on a pro-forma basis.

We expect DLG's Solvency II ratio to remain robust and relatively stable at around 160% over the coming years. DLG has a general strategy of returning excess capital to shareholders via special dividends or share buybacks, which we expect the Group to use to maintain the coverage ratio around the middle of its target range of 140%-180%. As part of its YE21 results, the Group announced a £100 million share buyback program, which it intends to completed in two tranches during 2022.

The Group's quality of capital remains good, with eligible tier 1 capital (after foreseeable dividends and share buybacks) amounting to 71% of own funds and 126% of Solvency II capital requirements (down from 75% and 143% respectively as at YE20). Given the retail general insurance orientation of the group's business and limited exposure to equities, regulatory capital requirements (SCR, after diversification) are comprised primarily of underwriting risk (77%) with market risk accounting for a more moderate 16% of the SCR as at YE21.

With regard to capital sensitivities, the Group has disclosed that its greatest exposures are: (1) a 100bps increase in the inflation assumption for motor PPOs; (2) catastrophe losses from extensive flooding of the River Thames; and (3) catastrophe losses, equivalent to the 1990 storm "Daria", which would all individually reduce the Solvency II ratio by 9ppts as at YE21. A 100bps increase in credit spreads would also reduce the Group's coverage ratio by 8pts. Given the Group's relatively conservative investment portfolio and lack of equities exposure, DLG's Solvency II ratio is relatively insensitive to market movements aside from those related to credit spreads.

Profitability: A - Consistently strong profitability, but the highly competitive, regulated and dynamic UK personal insurance market is a challenge

DLG's YE21 five-year average ROC remains strong at 11% and the Sharpe ratio of ROC improved to 612% (YE20: 550%).

In 2021, the Group's operating profit increased by 11% to £582 million due to both a stronger investment return and a higher underwriting profit, with a combined ratio (COR) of 90.1% (YE20: 91%). Underwriting performance was supported by a non-repeat of COVID-19 travel claims incurred in 2020, more benign weather in 2021 and higher prior year reserve releases. Normalised for weather, the Group's COR was 91.1% vs the group's long-term target of 93%-95%, benefitting from lower motor claims frequencies due to lock-down restrictions in H1 2021.

However, the group's 2021 ROC fell to 8.9% (YE20: 9.7%) largely as a result of excess capital held after the group completed an early refinancing of its Tier 2 debt in 2020. Profit before tax for 2021 was also down 1.2% to £446 million, as DLG's higher operating profits was more than offset by a £62 million increase in restructuring and one-off costs primarily related to the restructuring of the group's property portfolio, including the purchase of the Bromley office in early 2021. Nevertheless, these results translated to a very strong return on tangible equity (RoTE) of 23.6% and combined ratio of for the year (YE20: 19.9%) vs the group's ongoing 15% RoTE target.

In 2022, we expect the group's operating profit to come under pressure as motor frequencies climb back up to pre-pandemic levels and underwriting profits are affected by a continuation of above trend inflation and the Financial Conduct Regulator's pricing practice reforms. However, we expect DLG to maintain its COR within its target range of 93%-95%, supported by its disciplined underwriting approach and ability to control motor repair costs, thanks to network of in-house garage network.

Over the medium term, we expect DLG to grow its operating profit base, benefitting from its strong brand differentiation, ongoing cost reduction initiatives and revenue growth, supported by the group's new partnership with Motability Operations and recent investment to strengthen the group's pricing capabilities. This is notwithstanding the extremely competitive nature of the UK personal lines market, which makes it more difficult for price increases to match claims inflation and elevated execution risk as the group enters the next phase of its transformation program.

Reserve adequacy: Aa - Reserve releases trending down but to remain a feature, notwithstanding the inherent challenge of motor bodily injury claims

DLG has reported significant prior-year reserve releases since 2011, as reflected in the five-year weighted-average favourable loss development as a percentage of opening reserves, of 9.7% (2021-2017). These reserve releases were driven mainly by the Group's motor division in relation to favourable developments in bodily injury claims.

Given the Group's prudent reserving approach of current accident years, we expect reserve releases to remain a material contributor to future operating profit. Overall reserving risk is considered moderate although some volatility will likely remain a feature particularly within the UK motor portfolio. Most notably, we will continue to monitor changes in PPO propensities and large bodily injury claims, particularly as DLG has changed it excess of loss reinsurance protection, increasing the retention rate to £5 million for 2022 from a £1 million (which has been in place since 2014).

Motor claims inflation, for which the Group has a 3%-5% long-term range, also remains an inherent reserving risk for the market. Motor claims inflation is driven by the rising cost of damages from repair costs because vehicles are fitted with more advanced technology, used car prices and credit hire costs. During 2017, there was also a rise in home claims inflation related to the escape of water, although DLG has taken a number of significant actions across pricing, underwriting and claims management to manage escape of water claims costs.

Financial flexibility: A - Leverage increased in 2020 but expected to remain relatively low, and strong earnings coverage

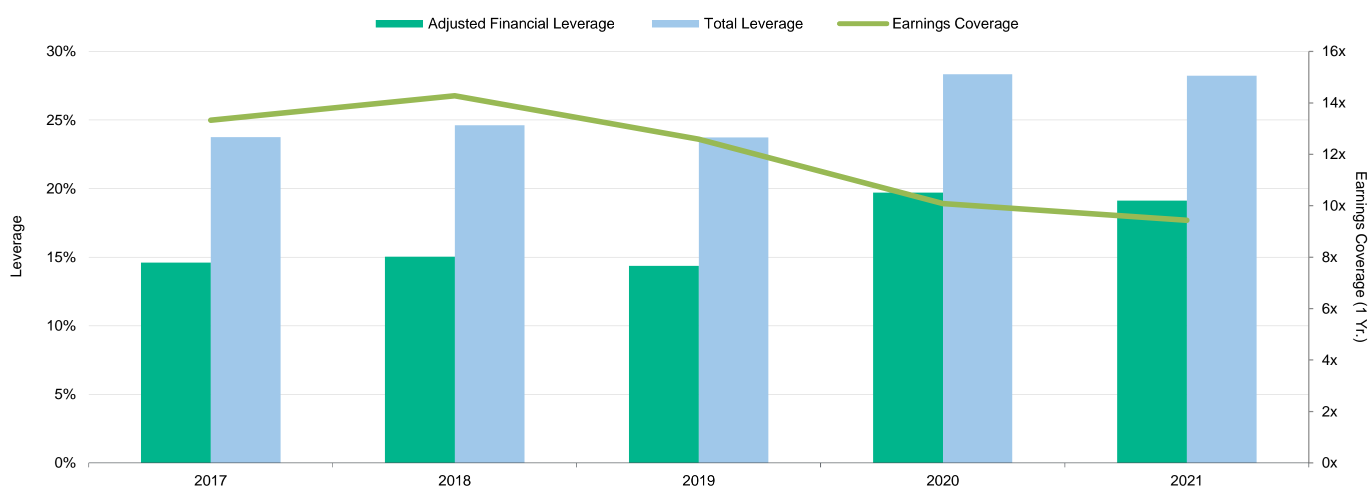
We view DLG's overall financial flexibility as very good with financial leverage sustainably below 20% and strong earnings coverage, averaging around 11x over the past five years at YE21 (Exhibit 4).

Adjusted financial leverage reduced slightly to c.19% as at YE21 (YE19: c.20%) but will fall to around 15% in 2022 following the £250 million Tier 2 (T2) subordinated debt repayment in April 2022. Going forward, absent further debt issuances, leverage should remain steady as the Group's dividend policy and future buyback schemes limit equity expansion.

Earnings coverage fell to 9.4x in 2021 due to the inflated finance costs associated with the early T2 debt refinancing. Earnings coverage will increase back towards historic levels in 2022 following the debt redemption, and continue to improve benefitting from lower finance costs and growth in operating profit.

Following the aforementioned debt redemption, the Group now has outstanding £260 million of T2 subordinated debt (4.0% due 2032) and £350 million of Restricted Tier 1 securities (4.75%, perpetual), which qualify for equity credit from us. The Group's borrowings also including bank overdrafts and an operating lease liability.

Exhibit 4
Leverage and earnings coverage



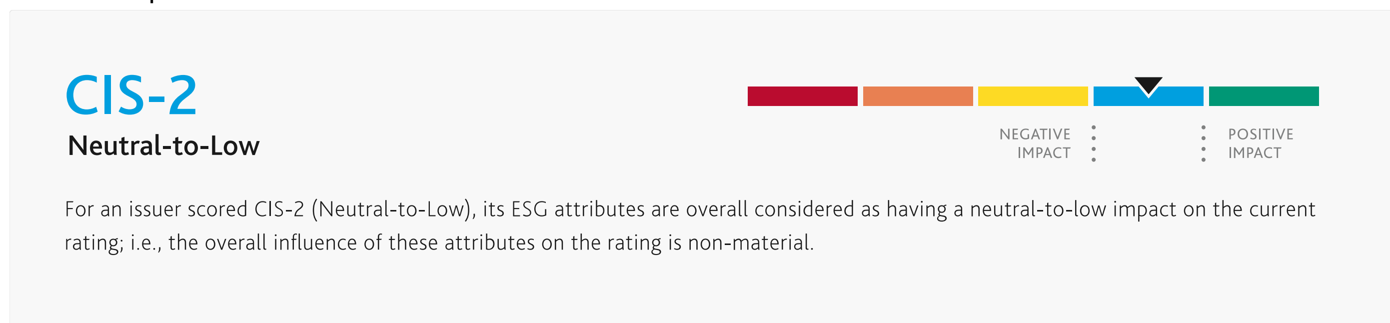
Source: Company reports and Moody's Investors Service

As a result of its historic ownership, DLG has a more limited record in accessing capital markets versus some of the largest UK/European insurers. However, we regard the restricted Tier 1 issuance in December 2017 and the IPO, following the lower Tier 2 debt issuance in April 2012, together with the most recent debt issuance in June 2020 as evidence that DLG can successfully access the capital markets.

ESG considerations

DIRECT LINE INSURANCE GROUP PLC's ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 5
ESG Credit Impact Score



Source: Moody's Investors Service

Direct Line's ESG Credit Impact Score is neutral-to-low (**CIS-2**). The score reflects a limited impact from environmental and social factors on the rating to date. The group's strong risk management and effective governance, along with good capitalization and use of reinsurance, mitigate its exposure to environmental and social risks, in particular customer relations risk and physical climate risk.

Exhibit 6
ESG Issuer Profile Scores

Source: Moody's Investors Service

Environmental

Direct Line Group has moderate environmental risks, in particular physical climate risk related to the effects of natural catastrophes on its P&C insurance operations. The company has a good track record of managing this risk through pricing and reinsurance. As the frequency and severity of natural catastrophes increase over time, Direct Line and its peers could find mitigating this risk more challenging.

Social

Direct Line is exposed to moderate social risk, most notably with respect to customer relations and changing societal and demographic trends in its personal P&C business. Customer relations risk are elevated in relation to the group's personal P&C insurance products and significant interactions with retail customers, particularly against a background of an increasing focus by the UK regulator on the fair treatment of customers. This is mitigated by well-developed policies and procedures. Changes in societal attitudes and the legal environment can impact P&C claims costs and reserve development, particularly in motor lines. Changing motor usage patterns and the rise of autonomous vehicles, which could reduce the demand for motor insurance. Rising digitization and interconnectedness of devices will increase customer privacy and data security risks, although these are mitigated by a strong technology risk framework, while also presenting business risks and opportunities for Direct Line.

Governance

Direct Line faces neutral-to-low governance risks, and its risk management, policies and procedures are in line with industry best practices. The management team has a strong track record in consistently meeting objectives and financial targets, which are well articulated within the group's multiyear strategy to improve efficiency and effectiveness supported by technology. The group also benefits from a strong board and a good track record of regulatory compliance and consistently low leverage levels.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Support and structural considerations

The subordinated notes issued by DLG in June 2020 are rated Baa1(hyb). The rating is derived from the A1 IFSR of UKI and the three notch differential reflects Moody's standard notching practices for an insurance holding company domiciled and operating in jurisdictions where group regulation is in effect, and also reflects the structural and contractual subordination of the notes.

The guaranteed subordinated notes issued by DLG in April 2012 are rated A3(hyb). The rating reflects the fact that the notes are unconditionally and irrevocably guaranteed by UKI on a subordinated basis and reflect standard notching (versus the senior rating) for subordinated debt that lacks a mandatory trigger we consider to be “meaningful.”

Rating methodology and scorecard factors

Exhibit 7

Direct Line Insurance Group plc

Financial Strength Rating Scorecard [1][2]	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adj Score
Business Profile								A	A
Market Position, Brand and Distribution (25%)								A	Aa
-Relative Market Share Ratio			X						
-Underwriting Expenses % Net Premiums Written				28.5%					
Product Focus and Diversification (10%)								A	Baa
-Product Risk		X							
-P&C Insurance Product Diversification			X						
-Geographic Diversification						X			
Financial Profile								Aa	A
Asset Quality (10%)								Aa	A
-High Risk Assets % Shareholders' Equity	24.1%								
-Reinsurance Recoverable % Shareholders' Equity		43.6%							
-Goodwill & Intangibles % Shareholders' Equity			35.1%						
Capital Adequacy (15%)								Aa	A
-Gross Underwriting Leverage		2.4x							
Profitability (15%)								Aa	A
-Return on Capital (5 yr. avg.)		11.2%							
-Sharpe Ratio of ROC (5 yr.)	613.3%								
Reserve Adequacy (10%)								Aaa	Aa
-Adv. (Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd. avg.)	-9.7%								
Financial Flexibility (15%)								Aa	A
-Adjusted Financial Leverage		19.1%							
-Total Leverage		28.2%							
-Earnings Coverage (5 yr. avg.)		11.9x							
-Cash Flow Coverage (5 yr. avg.)									
Operating Environment								Aaa - A	Aaa - A
Preliminary Standalone Outcome								Aa3	A1

[1] Information based on IFRS financial statements as of fiscal year ended December 31, 2021. [2] The Scorecard rating is an important component of the company's published rating, reflecting the standalone financial strength before other considerations (discussed above) are incorporated into the analysis.

Source: Moody's Investors Service

Ratings

Exhibit 8

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	STA
Subordinate	Baa1 (hyb)
BACKED Subordinate	A3 (hyb)
U K INSURANCE LIMITED	
Rating Outlook	STA
Insurance Financial Strength	A1

Source: Moody's Investors Service

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