MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms A2 IFSR on Direct Line Group's UK Insurance Limited

Global Credit Research - 17 Apr 2015

London, 17 April 2015 -- Moody's Investors Service has today affirmed the A2 insurance financial strength rating (IFSR) on U K Insurance Limited (UKI) -- the main operating subsidiary of Direct Line Insurance Group plc (DLG) - and the Baa1(hyb) rating on the subordinate notes issued by DLG. The rating outlook remains stable.

RATINGS RATIONALE

The affirmation of the A2 IFSR reflects DLG's very strong position in the UK personal lines general insurance market, a relatively conservative investment portfolio, good capitalisation and low financial leverage. These strengths are somewhat off-set by the group's limited geographic and business line diversification, the challenge of sustaining recent financial performance trends in the very competitive UK general insurance market and execution risk associated with the group's on-going restructuring program.

DLG is the largest personal motor and home insurer in the UK, with powerful brands including Direct Line and Churchill. DLG's market share has been declining over the past 5 years reflecting increased competition in personal home and the continued market reduction in personal motor rates. Nevertheless, Moody's expect DLG's premiums to begin to stabilise and start to growth modestly as further reductions in home lines, driven by the group disciplined approach to underwriting in a competitive market place, are offset by growth in commercial, rescue and other personal lines.

DLG continues to have a relatively conservative investment portfolio, notwithstanding the on-going asset reallocations which are reflected in the increase in high risk assets as a percentage of equity to 20.4% as at YE2014 from 7.8% as at YE2013. The group continues to have no equities exposure but has increased its investments in real estate and short duration high yield bonds, and plans to allocate up to 6% of its invested assets to UK infrastructure and 4% to investment grade private placements debt.

Moody's views DLG's capital adequacy as good. Despite the 27% reduction in reported equity between YE2011 and YE2014, which was driven by significant dividend payments prior to the IPO, the group remains at the top end of its internal economic coverage target of 125%-150%, with a reported 148.2% ratio as at YE2014. With regard to Solvency II, Moody's believes the group is well on track to meet its requirements and notes that DLG plans to use the standard formula for at least six months before transitioning to an internal model.

DLG had successfully executed a full divestment from its previous owner, the Royal Bank of Scotland Group and achieved or surpassed all its financial targets for 2014. The group's total cost base has been reduced below GBP 1 billion, which alongside other transformation initiatives and DLG's disciplined approach to underwriting has driven the significant improvements in financial performance over the past three years. In 2014, DLG reported a 95% combined operating ratio (vs. a target of 95%-97%) and 16.8% return on tangible equity (vs. a 15% target), which equates to a very good 10.4% return on capital as calculated on a Moody's basis. However, Moody's notes that the 19% increase in net income to GBP 373 million in 2014 benefitted from higher than expected prior year reserve releases and no major weather events, partially offset by adverse experience in large bodily injury claims on the 2014 accident year.

Other credit strengths include low product risk given the personal lines orientation of the portfolio, a conservative reserving strategy and low financial leverage. The group's debt is confined to GBP 500 million of Tier 2 subordinated notes together with small amounts of bank debt and operating lease adjustments. Following the final and special dividend payments in April and post the international sale and special dividend expected later in Q2 2015, financial leverage will increase from the 17.6% level at YE2014, but Moody's expects it will remain below 20% going forward.

In terms of credit challenges, Moody's said that it views DLG's limited geographic and business line diversification as a rating constraint in light of the preponderance of personal motor and home lines, which accounted for 43% and 29% of 2014 premiums, respectively. Furthermore, following the sale of international, DLG is reliant on the UK insurance market where trading conditions remain difficult.

Consequently, a further challenge for DLG will be to sustain its recent financial performance trends whilst modestly growing the portfolio. Moody's expects the group to benefit from its on-going investments into pricing capabilities, digital propositions and other major change initiatives and notes that DLG has reduced its target COR to a range of 94%-96% for 2015. However, any substantial programme of investment will carry inherent execution risk and the timing and magnitude of benefits remains uncertain at this stage.

SUBORDINATED DEBT RATING

The Baa1(hyb) rating on DLG's guaranteed subordinated notes issued in April 2012 reflect the fact that the notes are unconditionally and irrevocably guaranteed by UKI on a subordinated basis and reflect standard notching (vs. the senior rating) for subordinated debt .

OUTLOOK

The outlook on DLG's ratings is stable. This reflects Moody's expectation that the group will sustain its recent financial performance and that its on-going investment and change initiatives will stimulate modest growth and further reduce expenses. However, tough trading conditions in the UK personal lines general insurance market are expected to remain a constraint in this regard.

RATING DRIVERS

With regard to rating drivers, Moody's said that the following developments could put upward pressure on the IFSR rating: (1) average ROC through the cycle of at least 8% with modest GWP growth; (2) sustained gross underwriting leverage of 3x or below; and (3) continued profitable development of the commercial and personal lines rescue & other businesses.

Conversely, negative rating pressure could arise from: (1) continued reduction in GWP resulting in a material loss of market share; (2) average ROC through the cycle below 6%; (3) adjusted financial leverage in excess of 30% with earnings coverage below 6x; or (4) a meaningful deterioration in capital adequacy.

The following ratings were affirmed with a stable outlook:

U K Insurance Limited: Insurance financial strength rating at A2

Direct Line Insurance Group plc: Backed subordinated debt rating at Baa1(hyb)

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Global Property and Casualty Insurers published in August 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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