MOODY'S
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Credit Opinion: Direct Line Insurance Group plc

Global Credit Research - 30 Jan 2014

United Kingdom

Ratings

Category	Moody's Rating
Rating Outlook	STA
BACKED Subordinate	Baa1 (hyb)
U K Insurance Limited	
Rating Outlook	STA
Insurance Financial Strength	A2

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Key Indicators

Direct Line Insurance Group plc[1]

	2012	2011	[2]2010	[2]2009	2008
As Reported (British Pound Millions)					
Total Assets	12,698	13,770	13,817	13,186	-
Shareholders' Equity	2,832	3,871	3,482	3,581	-
Net Income (Loss) Attributable to Common Shareholders	184	249	- 272	133	-
Gross Premiums Written	4,001	4,168	4,971	5,291	-
Net Premiums Written	3,636	3,911	4,788	5,092	-
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	5.0%	2.8%	3.0%	3.0%	-
Reinsurance Recoverable % Shareholders' Equity	38.4%	21.8%	22.0%	17.2%	-
Goodwill & Intangibles % Shareholders' Equity	25.3%	18.7%	18.2%	18.9%	-
Gross Underwriting Leverage	3.5x	2.9x	3.7x	3.4x	-
Return on Capital (1 yr)	4.5%	6.1%	-7.0%	NA	-
Sharpe Ratio of ROC (5 yr avg)	NA	NA	NA	NA	-
Adv (Fav) Loss Dev % Beginning Reserves (1 yr)	-6.7%	-3.6%	5.2%	-2.4%	-
Financial Leverage	25.3%	14.7%	16.4%	15.5%	-
Total Leverage	28.7%	14.7%	16.4%	15.5%	-
Earnings Coverage (1 yr)	9.0x	67.2x	-71.6x	17.4x	-
Cash Flow Coverage (1 yr)	NA	NA	NA	NA	-

[1] Information based on IFRS and financial statements as of Fiscal YE December 31. [2] Information for 2010 and 2009 is based on historical DLG Group financial statements as per Direct Line Insurance Group plc, Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012, and also, for reserve metrics, information derived from Price Range Prospectus dated 28 September 2012.

Opinion

SUMMARY RATING RATIONALE

Moody's A2, stable outlook, insurance financial strength rating (IFSR) on Direct Line Insurance Group plc's ("DLG") main operating entity, U K Insurance Limited ("UKI"), reflects DLG's very strong position in the UK personal lines market, a relatively conservative investment portfolio, good capitalisation, and relatively low financial leverage. These strengths are off-set by relatively weak geographic and business diversification, and the challenge of sustaining recent performance improvements within the very competitive UK Motor market, which remains vulnerable to bodily injury claims inflation. DLG also has to complete its divestment from the Royal Bank of Scotland Group plc ("RBSG", Baa1 Senior debt rating, negative outlook), by the end of 2014, although we note that RBSG's shareholding in DLG is now below 30%. Following the launch of a new corporate identity, DLG, from 1 July 2012, has been operating on a substantially stand-alone basis with corporate functions and governance independent of RBSG.

Further to an IPO by RBSG of 35% of DLG's shares in October 2012, RBSG's shareholding in DLG has since reduced to 28.5%, thereby complying with the EC State Aid requirement that it must cede control of DLG by 31 December 2013. This reduction in shareholding brings RBSG closer towards a further EC State Aid requirement that it divest its entire interest in DLG by 31 December 2014, and we will continue to monitor developments in this regard.

In light of this divestment requirement, which is encompassed within our rating on UKI, UKI's IFSR was not impacted by Moody's downgrade by one notch of RBSG's ratings on June 21, 2012. Since then, RBSG's ownership has significantly reduced, and DLG only has some IT migration to achieve in 2014 before becoming fully operationally independent. Therefore, we now see DLG as much less constrained by its current ownership, although there could be some credit negative implications if there was a delay to the divestment from RBSG.

UKI, which is DLG's main (UK) operating subsidiary, underwrites over 85% of DLG's gross written premium (GWP). Via a Part VII transfer effected in December 2011, UKI received almost all of the assets and liabilities of Direct Line Insurance Ltd (established by RBS in 1985), Churchill Insurance Company Ltd (established in 1989 and acquired by DLG in 2003), and the National Insurance and Guarantee Corporation Ltd (NIG, established in 1894 and acquired by Churchill in 2000). DLG also manages relatively small Italian and German insurance businesses. At YE12, DLG's business, which is UK Motor orientated, was split on a GWP basis: 40% UK personal Lines Motor, 25% UK personal lines Home, 10% UK personal lines rescue & other, 11% UK Commercial, 14% International and less than 1% other (predominantly personal lines brokers in run-off).

Credit Strengths

-Very strong position in the UK personal lines market, with powerful brands

-Low exposure to product risk with a personal lines orientation

-Relatively conservative investment portfolio

-Good capitalisation

-Relatively low financial leverage

Credit Challenges

-Relatively weak geographic and business diversification; UK and Motor business predominate

-Sustaining performance improvements and growing profitably in very competitive UK Motor market

-Bodily injury claims inflation in UK Motor market which led to significant reserve strengthening in 2010 and 2009

-Enhancing contribution of Commercial and International businesses to overall operating profit

-Complete divestment from RBS Group

Rating Outlook

The rating outlook is stable.

What to Watch For:

-Further reduction in RBSG's shareholding in DLG

-Pricing in very competitive UK Motor market

-Further legal developments in the UK Motor market and impact of various Motor reforms implemented in April 2013

-Reinsurance renewal rates for the UK personal motor market

What Could Change the Rating - Up

-Average return on capital through the cycle of at least 8% with combined ratio consistently below 100% and stable reserving

-Sustained gross underwriting leverage of 3x or below

-Profitable development of non-UK businesses

What Could Change the Rating - Down

-Average return on capital through the cycle below 6%

-Adjusted financial leverage in excess of 30%

-Earnings coverage below 6x

-Meaningful deterioration in capital adequacy either from an economic or an IGD perspective.

Notching Considerations

The guaranteed subordinated notes issued by Direct Line Insurance Group plc in April 2012 are rated Baa1 (hyb). The rating reflects 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 that lacks a mandatory trigger we consider to be "meaningful".

DETAILED RATING CONSIDERATIONS

Moody's rates UKI A2 (stable outlook) for insurance financial strength, which is in line with the adjusted rating indicated by the Moody's insurance financial strength rating scorecard. The key factors currently influencing the rating and outlook are:

MARKET POSITION, BRAND AND DISTRIBUTION: Aa PERSONAL LINES MARKET POSITION EXPECTED TO REMAIN VERY STRONG

We view DLG's market position as excellent. As at YE12, it was the largest (Source: Association of British Insurers) personal Motor and Home lines writer in the UK, and its brands, especially Direct Line and Churchill, are very powerful. DLG is also a meaningful player in the direct Motor markets in Germany and Italy, but its overall market position in these countries is very small.

DLG's UK market share has been declining recently as a result of exiting unprofitable business, de-risking the book, re-pricing, and the cessation of the Tesco Personal Finance (TPF) joint venture. Furthermore, in our opinion, its market share, especially in Motor, has been negatively impacted by the strong market growth in price comparison websites ("PCW") which encourage switching and in which, in our view, DLG has been relatively underweight, although Direct Line branded business is deliberately not quoted on PCWs. However, going forward, we expect DLG's personal lines market position to remain very strong.

DLG's personal lines distribution is strong with products sold directly by phone, over the internet, through PCWs and via partnerships including RBS/NatWest, Nationwide and Sainsburys. The much smaller Commercial insurance also benefits from some direct distribution, although the vast majority of business is accessed via brokers. However, given the direct/personal lines focus of the book, and DLG's inherent scale advantages, the underwriting expense ratio is viewed as relatively high, although we expect this ratio to improve via the implementation of efficiency programs.

PRODUCT RISK & DIVERSIFICATION: Baa - RELATIVELY WEAK GEOGRAPHIC AND BUSINESS DIVERSIFICATION WILL LIKELY CONTINUE

DLG writes non-life business, split approximately 90% personal lines, 10% commercial lines, with the main classes of business being Motor and Property. Management view the business on a divisional basis, which at YE12 and by GWP was split: UK Motor (40%), UK Home (25%), UK Rescue & Other (10%), UK Commercial (11%), International (14%) and other, predominantly the personal lines broker book in run off (less than 1%). DLG's product risk is considered low given the preponderance of personal lines risks, and although the business is exposed to windstorm and flood catastrophe risk, DLG purchases significant reinsurance cover.

However, business line diversification is viewed as relatively limited in light of the preponderance of personal lines Motor and Home business, and geographically the book is dominated by UK business. Going forward, geographic diversification could improve as DLG looks to grow organically its international business, but we expect the proportion of UK business to remain very significant for the foreseeable future.

ASSET QUALITY: A - RELATIVELY CONSERVATIVE INVESTMENT PORTFOLIO, ALTHOUGH HIGH WEIGHTING TO CORPORATE BONDS A FEATURE

We view overall asset quality as good. DLG has a relatively conservative investment portfolio, with 98% invested in bonds and cash as at 30 September 2013 (YE12: 99% & YE11: 93%), although the high weighting to corporate bonds has been a recent feature. The YE12 high risk assets as a % of equity (which for the purposes of our metrics includes equity credit from the Group's subordinated debt) ratio was very low at 5% (YE11: 2.8%) and DLG currently has no equities exposure.

The credit quality of the fixed income portfolio is very good, with around 87% of the fixed income portfolio rated A or higher at H1 13, although during 2013 DLG has increased the weighting to BBB credit within its corporate debt securities. DLG has no exposure to peripheral European sovereign debt and only £45m of corporate bond exposure to Italy, Ireland and Spain at H1 13. However, there is concentration risk in the government bond portfolio via its significant proportion of UK gilts, and within the corporate bond portfolio there remains significant exposure to the banking sector.

DLG, which has adopted an independent (of RBSG) investment management and treasury function, has been repositioning the credit part of its investment portfolio. At Q3 13, the credit allocation had increased to 65% (YE12: 57%) with corporate bonds representing 57% (YE12: 48%) of invested assets, which is significantly larger than a number of UK/European P&C peers. The Group is also planning an investment of around 5% of invested assets in structured credit.

DLG's asset quality benefits from its relatively low, albeit increased level of reinsurance recoverables, which at YE12 were 38% of equity (YE11: 22%), and still low level of reported goodwill & intangible assets (including DAC) which at YE12 were c.25% of equity (YE11: 19%).

CAPITAL ADEQUACY: A - GOOD CAPITALISATION NOTWITHSTANDING REDUCED EQUITY LEVEL

We view overall capital adequacy as good. Capitalisation improved in 2011 reflecting lower business volumes as a result of exiting certain lines, and an increase in reported total equity of around 11% following the 3% decrease in 2010. However, in line with our expectations, reported total equity reduced by 27% to £2,832m in 2012, following the £1bn dividend payment to RBSG and the reclassification (and subsequent repayment in January 2013) of the TPF non-controlling interest of £259m. As such, Moody's gross underwriting leverage metric, which was relatively low at 2.9x at YE11, increased to 3.5x at YE12. The IGD coverage ratio also reduced to 279% from 319%, and reduced again slightly at H1 13 to 272% but remains high and improved compared to the coverage level at YE10 (227%).

The Group's risk-based solvency coverage ratio also reduced during 2012 to 151% (YE11: 169.5%) or 145% post final dividend payment (55% of earnings from ongoing operations), but is at the upper end of DLG's target range of 125-150% and is still higher than the YE10 coverage ratio (122%).

We note that DLG's risk management and modelling capabilities continue to be developed. DLG is currently enhancing its economic capital model, which is used to calibrate ICA, to meet Solvency II requirements, and is aiming to fully embed ERM throughout the business in the near to medium term.

PROFITABILITY: A - UNDERWRITING PERFORMANCE CONTINUES TO IMPROVE, BUT THE HIGHLY COMPETITIVE UK MOTOR MARKET IS A CHALLENGE

We view overall profitability as good. Aided by further benefits from its claims transformation programme and cost savings, DLG is targeting a 15% RoTE from ongoing operations, and a 98% combined operating ratio for 2013 with a further improvement in the performance of its UK personal lines Motor book. In this regard, we note the improved underwriting performance during 2012 and 2013YTD. At YE12, DLG reported an annualised Return on Tangible Equity (RoTE) and pro-forma RoTE of 11.5% (YE11: 10%) and 13.4% respectively, net income of £184m (£249m) or £327m (£308m) for ongoing operations and an ongoing COR of 99.2% (101.8%). Reported net income in 2012 was impacted by around £190m of restructuring and other one-off costs, but benefited from reserve releases of £390m from prior years. The positive underwriting momentum continued during the first nine months of 2013, with, for ongoing operations, reported operating profit up 20% to £418m, a COR of 95.4%, and annualised RoTE at 16.8%, benefitting from fewer claims from major weather events.

Profitability from 2009-2012 has been mixed. DLG's results were impacted in 2009, and especially 2010, by significant UK Motor bodily injury reserve strengthening. But performance significantly improved during 2011, with DLG returning to profit and recording a Moody's return on capital metric of 6.1% (YE10: -7.0%), and reporting an improved overall combined ratio (COR) of 102% (YE10: 121%) for its ongoing business. The reported UK personal lines Motor COR also improved to 106% in 2011 (YE10: 144%). The UK Motor book benefited in 2011 from significant rate increases, new pricing models and engines, de-risking, exiting unprofitable lines, claims systems improvements, and the non-repeat of 2010 reserve strengthening.

However, a key challenge is that DLG is heavily reliant for its profits on UK Motor which remains a highly competitive market and vulnerable to bodily injury claims inflation, and which in recent years DLG has under-performed. Notwithstanding recent improvements, the Motor COR remained above 100% at YE12 at 101.6%, and the Motor attritional loss ratio, following consistent improvements from 2010-2012, deteriorated at H1 13, although the Motor COR improved to 95.8% (H1 12: 102.4%). However, we note that DLG materially benefits from additional income generated from its own brand Motor policies, and the performance of its UK Home and Rescue books has been generally good in recent years, with the Group's overall attritional loss ratio further improving at 9m 13.

RESERVE ADEQUACY: A - MEANINGFUL RESERVE RELEASES HAVE BEEN A RECENT FEATURE, BUT INHERENT CHALLENGE OF BODILY INJURY CLAIMS

DLG has reported a small, albeit increased, surplus position on average from 2012-2009 (see note 2 below). However, reserves for prior years were strengthened during 2009 and 2010, driven by respective £96m and £398m increases for UK Motor reserves, excluding TPF, with high inflation in bodily injury claims a feature of the UK Motor market. Aside from reserve strengthening with reserves including an additional margin beyond the actuarial best estimate, DLG's remedies, from 2009/2010, have also included de-risking, re-pricing, and new tools.

DLG returned to a prior year reserve release during 2011 for an amount of £227m (YE10: -£285m), and also released reserves of £390m in 2012 driven by portfolio de-risking and claims transformation. At 9m 13, DLG released reserves of £311m mainly in its Motor division where it has seen favourable development on Motor bodily injury claims which it currently expects to continue. Furthermore, we note that the Group's estimated reserve margin above Towers Watson's independent actuarial best estimate at 30 June 2012 was 7.1%. However, volatility still remains within the external Motor market with large bodily injury claims continuing to be an industry-wide issue, and the number of Periodical Payment Order (PPO) awards continues to increase.

FINANCIAL FLEXIBILITY: A - FINANCIAL LEVERAGE EXPECTED TO REMAIN RELATIVELY LOW, AND EARNINGS COVERAGE GOOD, ALTHOUGH FINANCIAL FLEXIBILITY SOMEWHAT CONSTRAINED

We view DLG's overall financial flexibility as good. Adjusted financial leverage at YE12 increased, but remained relatively low, at 25.3% (YE11: 14.7%). This was driven by the £500m issuance in April 2012 of lower Tier 2 capital in the form of dated subordinated notes, which qualify for 25% equity credit from Moody's, together with a significantly increased operating lease expense and reduced equity. During 2013 to-date, leverage has benefited from the repayment of the TPF subordinated loan. Going forward, we expect DLG's financial leverage to remain relatively low in relation to UKI's A2 IFSR.

Driven by the intra-group nature of financial debt, DLG's finance costs were around a mere £3m in 2010 and 2011. Following the lower Tier 2 issuance, finance costs have increased significantly - £29m for 2012 and £18.5m at H1 13- but we expect earnings coverage, which at YE12 was around 9x, to be good going forward.

Financial flexibility is somewhat constrained by DLG's limited record in accessing capital markets as a result of its ownership history. However, we regard the IPO, following the raising of lower Tier 2 capital in April 2012, as successfully demonstrating DLG's stand-alone financial flexibility, and we see the Group as now much less constrained by its current ownership.

Rating Factors

Direct Line Insurance Group plc[1][2]

Financial Strength Rating Scorecard	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adjusted Score
Business Profile								A	A
Market Position and Brand (25%)								A	Aa
- Relative Market Share Ratio		X							
- Underwriting Expense Ratio % Net Premiums Written					X				
Product Focus and Diversification (10%)								Baa	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	5.0%								
- Reinsurance Recoverable % Shareholders' Equity		38.4%							
- Goodwill & Intangibles % Shareholders' Equity		25.3%							
Capital Adequacy (15%)								A	A
- Gross Underwriting Leverage			3.5x						
Profitability (15%)									A
- Return on Capital (5 yr avg)									
- Sharpe Ratio of ROC (5 yr avg)									
Reserve Adequacy (10%)									A
- Adv (Fav) Loss Dev % Beginning Reserves (5 yr. wtd avg)									
Financial Flexibility (15%)								Aa	A
- Financial Leverage		25.3%							
- Total Leverage		28.7%							
- Earnings Coverage (5 yr avg)									
- Cash Flow Coverage (5 yr avg)									
Operating Environment								Aaa - A	Aaa - A
Aggregate Profile								A1	A2

[1] Information based on IFRS and financial statements as of Fiscal YE December 31 [2] The Scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis