MOODY'S
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CREDIT OPINION
2 May 2017

Update

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RATINGS

Direct Line Insurance Group plc

Domicile	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

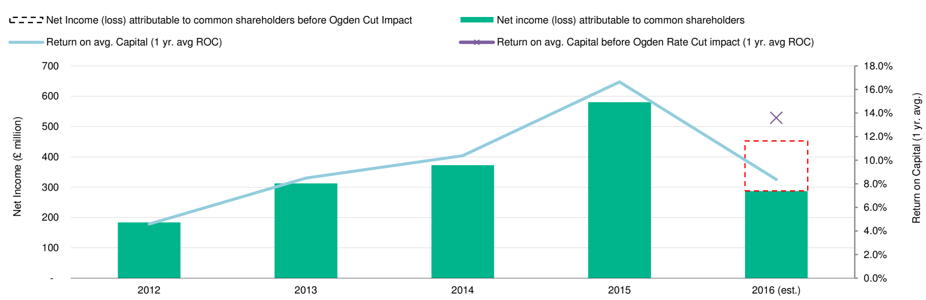
Semi-Annual Update

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 somewhat offset by the group's limited geographic and business line diversification, the challenge of sustaining recent performance (see exhibit 1) in the very competitive UK general insurance market and execution risk associated with the group's ongoing restructuring program.

Exhibit 1

Direct Line Group's Net Income and 1-year Average Return on Capital



In 1Q17, the UK Governments cut the Ogden Discount Rate, used to calculate large bodily injury awards, from 2.5% to -0.75% in March 2017. This reduced DLG's YE2016 profit after tax by £174m, including prior year reserve strengthening of £205m. See our report: Motor (Re)insurance – UK - Ratings Unaffected by Ogden Rate Cut Despite Material One-Off Reserving Hit
Source: Company reports and Moody's Investors Service

Previously part of the Royal Bank of Scotland Group plc (RBS), DLG launched its new corporate identity in July 2012 the point at which it became legally and operationally independent and underwent an IPO in October 2012. At 2016 gross written premiums (GWP) from DLG's ongoing operations were split: 47% UK personal lines motor, 26% UK personal lines home, 12% UK rescue and other personal lines and 15% UK commercial.

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 profitability, which has been improved year-on-year and has exceeded internal targets
- Good capitalisation as measured by Solvency II and relatively low financial leverage

Credit Challenges

- Sustaining the premium base following the loss of the Nationwide and Sainsbury's distribution agreements
- Limited geographic and business line diversification in which motor business predominates
- Sustaining recent underwriting performance in the very competitive UK personal lines market and as the contribution from prior year reserve releases reduces
- Enhancing contribution of the Commercial business to overall operating profit
- Execution risk associated with the group's on-going restructuring program and balancing investments into new technologies with expense reductions

Rating Outlook

The outlook is stable reflecting Moody's expectation that the group will sustain its recent financial performance and that its on-going investment and change initiatives will continue to 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.

What to Watch For:

- Pricing trends in the very competitive UK Motor and Home markets
- Impact of further regulatory developments in the UK personal lines insurance market, including whiplash reforms and the most recent Ogden discount rate consultation
- Growth in own brand in force policies vs reductions volume reductions from partnership, particularly in Home

Factors that Could Lead to an Upgrade

- Average return on capital through the cycle of at least 8% with modest premium growth
- Sustained gross underwriting leverage of 3x or below
- Profitable development of the Commercial and Personal Lines Rescue & Other businesses

Factors that Could Lead to a Downgrade

- Material reduction in premiums resulting in a material loss of market share
- Average return on capital through the cycle below 6%
- Adjusted financial leverage in excess of 30% with earnings coverage below 6x
- Meaningful deterioration in capital adequacy

Key Indicators

Exhibit 2

Direct Line Insurance Group plc[1][2]	2015	2014	2013	2012	2011
As Reported (British Pound Millions)					
Total Assets	9,957	11,226	11,788	12,698	13,770
Total Shareholders' Equity	2,630	2,811	2,790	2,832	3,871
Net income (loss) attributable to common shareholders'	580	373	313	184	249
Gross Premiums Written	3,153	3,099	3,230	4,001	4,168
Net Premiums Written	2,961	2,917	3,071	3,636	3,911
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	25.1%	20.4%	7.8%	4.7%	2.8%
Reinsurance Recoverable % Shareholders' Equity	36.6%	29.3%	35.4%	38.4%	21.8%
Goodwill & Intangibles % Shareholders' Equity	26.4%	24.7%	28.2%	25.3%	18.7%
Gross Underwriting Leverage	2.9x	2.7x	3.1x	3.5x	2.9x
Return on avg. Capital (1 yr. avg ROC)	16.6%	10.4%	8.5%	4.6%	6.2%
Sharpe Ratio of ROC (5 yr. avg)	197.5%	66.4%	NA	NA	NA
Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg)	-11.5%	-9.5%	-9.1%	-6.7%	-3.6%
Financial Leverage	18.3%	18.1%	18.7%	21.7%	14.4%
Total Leverage	22.2%	21.8%	22.1%	25.2%	14.4%
Earnings Coverage (1 yr.)	16.7x	11.8x	9.5x	8.9x	88.5x

[1] Information based on IFRS financial statements as of Fiscal YE December 31.

[2] Certain items may have been relabeled and/or reclassified for global consistency.

Source: Company reports and Moody's Investors Service

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

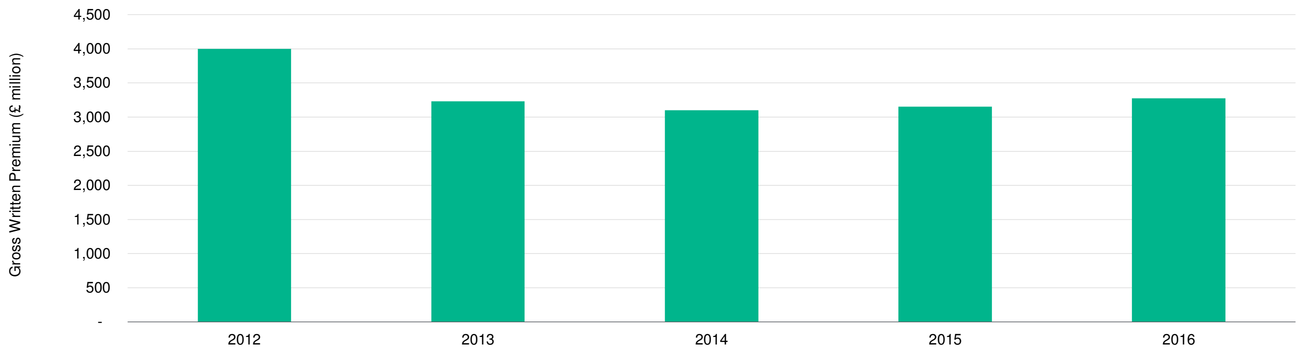
Moody's rates UKI A2 (stable outlook) for insurance financial strength, which is in line with the adjusted rating indicated by the Moody's insurance financial strength rating scorecard. The key factors currently influencing the rating and outlook are:

MARKET POSITION, BRAND AND DISTRIBUTION: Aa - VERY STRONG POSITION IN THE UK PERSONAL LINES MARKET MODEST GROWTH TO CONTINUE THROUGH OWN BRANDS

As the largest personal motor and home lines writer in the UK, we consider DLG's market position to be very strong and its brands, in particular Direct Line and Churchill, are very powerful. We expect DLG's personal lines market position to remain very strong going forward. DLG's SME commercial business is growing, but its overall market share remains relatively modest at this stage.

In 2016, GWP from ongoing operations grew once again, albeit by a modest 4% (2015: 2%) after several year of decline. Growth was helped by an increase in motor rates, but in line with the group's strategy, own brand in force policies (IFP) also increased across all segments. Group total IFP reduced by a total of 1.6% in 2016 (2015: reduction of 1.4%), driven by a reduction in partnership policy numbers in home (-1.2% in 2016 vs -3.1% in 2015) and rescue (-4.9% in 2016 vs -2.4% in 2015). These reductions are in line with our expectation, and will continue into 2017 affected by the termination of DLG's distribution agreement with Nationwide, which accounts for a material portion of the group's home premium base.

Exhibit 3
Direct Line Group's Gross Written Premiums



Source: Company reports and Moody's Investors Service

Overall we view DLG's personal lines distribution as strong, with products sold directly by phone, over the internet, through PCWs as well as via partnerships particularly in the home segment. To improve efficiency and effectiveness, DLG has been re-establishing its partnership capabilities, including exiting a number partnerships and renegotiated existing deals. For example in 2016 the group extended its travel agreement with Nationwide until 2018, signed a 3 years extension with RBS for Home and Private Insurance and extended its Prudential partnership in Home and Motor for a further 2 years. The Commercial division also benefits from some direct distribution, although the majority of premiums are still accessed via brokers. Overall, DLG continues to improve its distribution capabilities by investing in new websites, digital propositions and by targeting less traditional partnerships.

DLG's underwriting expense ratio remains relatively high and above personal-lines-orientated peers, despite the group's inherent scale advantages. However, the increase to 36.8% in 2016 (YE15: 34.5%), reflects the £39m intangible asset impairments and the £24m Flood Re levy, which together added 2.1ppt to the expense ratio. We expect the group's expense ratio to trend downwards via (i) the implementation of ongoing efficiency programs initiatives; (ii) the reduction of business distributed through partnerships, which typically include high commissions; and (iii) top line growth.

PRODUCT RISK & DIVERSIFICATION: Baa - RELATIVELY LOW PRODUCT RISK OFFSET BY LIMITED BUSINESS DIVERSIFICATION & DEPENDENCE ON THE UK

DLG writes UK non-life business only, split 85% personal lines and 15% commercial lines. DLG has four main business segments, including motor (47% of GWP and 51% of ongoing operating profit pre Ogden impact), home (26% and 29%), rescue & other (12% and 8%) and commercial (15% and 12%). In our view product line diversity is therefore relatively limited in light of the preponderance of personal motor and home lines.

More positively, DLG's product risk is considered low as a result of this preponderance of personal lines. Although the business is exposed to large bodily injury claims volatility, windstorm and flood catastrophe risk, DLG purchases significant reinsurance cover.

ASSET QUALITY: A - RELATIVELY CONSERVATIVE INVESTMENT PORTFOLIO NOTWITHSTANDING INCREASING HIGH RISK ASSETS

We view DLG's asset quality as good. The group has a relatively conservative investment portfolio, with 89% held in fixed income securities and cash, but continues to undertake some re-risking actions. This is reflected in the ongoing steady increase in DLG's high risk assets (HRA) as a % of shareholders' equity ratio to an estimated 29.1% at YE16 from 7.8% at YE13. DLG continues to have no exposure to, or appetite for equities and, as such, HRA are primarily comprised of property investments and high yield bonds. DLG did however start investing into UK infrastructure during 2014 to support the asset strategy backing periodical payment order (PPO) liabilities.

As at YE16, DLG's invested assets comprised of 71.8% fixed income securities, 16.9% cash and cash equivalents, 5.0% property investments, and 5.1% infrastructure debt, with an overall duration of 1.6 years (excluding property). In addition, a modest 1.2% of the portfolio is invested in the group's new asset class - commercial real estate loans. DLG also continued to reposition the credit part of its portfolio. Corporate bonds represented 66.6% of invested assets at YE16 (YE15: 60.5% (vs the group's target of 68.0%), which is significantly higher than a number of UK/European P&C peers. However, the credit quality of the fixed income portfolio is very good, with around 70% of the fixed income portfolio rated A or higher as at YE16 with a well-diversified portfolio by sector. However, DLG is increasing its exposure, to high yield credit, which at YE16 amounted to 6.2% of invested assets, slightly above the group's target of 6.0%.

DLG's overall asset quality also benefits from low level of reported goodwill & intangible assets (including DAC) at 26.8% at YE16 (YE15: 26.4%). Reinsurance recoverables have historically been low 30-40% over the last 5 years, but rose to 52% as at YE16, largely driven by outstanding recoverables related to the Ogden rate impact. We expect recoverables to fall to normalised levels during 2017.

CAPITAL ADEQUACY: A - GOOD CAPITALISATION NOTWITHSTANDING REDUCED SHAREHOLDERS' EQUITY; SOLVENCY II RATIO RELATIVELY INSENSITIVE TO MARKET MOVEMENTS

We view DLG's overall capital adequacy and quality of capital as good. Given the reduction in shareholders' equity since 2011, total equity as a % of net written premiums has been declining, particularly over the last two years, although gross underwriting leverage (GUL) has remained around 3x, which is in line with our expectation for a personal lines player at the current rating level.

DLG's internal model was approved by the PRA in June 2016 and the group estimated YE2016 Solvency II ratio was 165% post dividends (174% pre-dividends), down from the 184% as at 30 June 2016 (199% pre-dividend) including a 24ppts impact from the Ogden rate. Nevertheless, the YE16 coverage ratio is above the mid-point of the group's 140-180% target range. Given the group's progressive dividend strategy, with DLG announcing a 5.8% increase in the regular dividend to 14.6pence per share in 2016, we expect the group's Solvency II ratio to remain within its target range going forward.

With regard to sensitivities, the group has disclosed that its greatest exposures is a 10% motor premium rate reduction, which would reduce the Solvency II ratio by 14ppt at YE16). A large cat loss equivalent to the 1990 storm and extensive flooding of the river Thames would also have a meaningful 9ppt impact. Given the group's relatively conservative investment portfolio and lack of equities exposure, DLG's Solvency II ratio is relatively insensitive to market movements including changes in credit spreads and interest rates.

In terms of quality of capital, 72% of the group's own available funds comprised of Tier 1 capital in the form of shareholders' equity (after foreseeable dividends). Tier 2 capital relates solely to the group's £0.6bn subordinated debt and accounts for 26% of the group's own fund, with the remaining 9% in the form of Tier 3 capital.

PROFITABILITY: A - PROFITABILITY TARGETS HAVE BEEN EXCEEDED ONCE AGAIN, BUT THE HIGHLY COMPETITIVE UK PERSONAL MARKET REMAINS A HEADWIND

For 2016, DLG reported another strong set of results, and excluding the impact of the Ogden rate cut has once again exceeded its internal targets with return on tangible equity (RoTE) at 20.2% (14.2% post Ogden), supported by a very good combined ratio (COR) at 91.8% (97.7%) and a 2.5% investment income yield. For 2017, the group has not changes its guidance: RoTE at 15%, COR in the range of 93%-95%, 2.4% investment yield and a further reduction in the expense ratio in 2017 and thereafter.

With regard to Moody's scorecard metrics, despite the Ogden rate impact, DLG's 5 year average return on capital (ROC) improved to 9.7% (YE15: 9.3%) and the Sharpe ratio of ROC improved to 219.4%, reflecting the year-on-year improvement in performance since 2011, aided by benefits from the group's claims transformation programme, cost savings and disciplined approach to underwriting.

DLG's ongoing operating profit increased by 11% to £579m in 2016 driven by strong performance in Home and Commercial, with the latter reporting an underwriting profit for the first time, partially offset by reductions in Motor and Rescue & Other Personal Lines. We believe DLG's operating profit improvements are sustainable despite recent results benefitting from benign weather and our expectations of ongoing motor claims inflation, pricing pressure in home and SME commercial lines and reducing reserve releases. DLG's focus on own brands growth, a more effective marketing strategy, and investments into technological to improve the customer experience, DLG's pricing capabilities and enhance the value of its propositions, should continue to stimulate overall top line growth and expense reductions.

RESERVE ADEQUACY: A - RESERVE RELEASES EXPECTED TO REDUCE BUT REMAIN A FEATURE, NOTWITHSTANDING INHERENT CHALLENGE OF MOTOR BODILY INJURY CLAIMS

DLG has reported significant prior year reserve releases since 2011, as reflected in the 5 year weighted average favourable loss development as % of opening reserves, of 9.3% (2016-2012). These reserve releases were driven mainly by the group's motor division in relation to favourable development on bodily injury claims.

Notwithstanding the market impact of the Ogden rate cut, for 2016, the group still recognised an strong overall reserve releases of £290.1m (2015: £449.3m). Excluding the impact of the Ogden rate cut, prior year reserve releases would have been £205.1m higher than reported.

Given the groups prudent reserving approach of current accident years, we expect reserve releases to remain a material contributor to future operating profit. However, following the change in the group's reserving approach together with motor claims inflation at the top of the group's 3-5% long-term range, we expect releases to trend downward. Motor claims inflation is driven by the rising cost of damages from repair costs as vehicles are fitted with more advance technology, used car prices and credit hire costs.

Furthermore, volatility will likely remain a feature particularly within the UK motor portfolio. We will continue to monitor the impact of any future outcome of the latest Ogden rate consultation, as well as changes in PPO awards propensities and large bodily injury claims.

FINANCIAL FLEXIBILITY: A - RELATIVELY LOW LEVERAGE AND EXCELLENT EARNINGS COVERAGE

We view DLG's overall financial flexibility as very good. Adjusted financial leverage at YE16 remained relatively low at 19.3% (YE15: 18.3%), including £500m of dated subordinated notes, which qualify for some equity credit from Moody's, together with bank debt and an operating lease expense adjustment. Following the ordinary and special dividend payments in 2016, leverage has increased, but we expect it to remain below 20% going forward, i.e. relatively low in relation to the A2 IFSR. Similarly, earnings coverage has been excellent and remained stable in 2016 at 16.2x (YE15: 16.7x).

As a result of its historic ownership, DLG has a somewhat limited record in accessing capital markets. However, we regard the IPO, following the lower Tier 2 debt issuance in April 2012, as evidence that DLG can successfully access capital markets.

Rating Methodology and Scorecard Factors

Exhibit 4

Financial Strength Rating Scorecard [1][2] YE15	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				32.4%					
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		25.1%							
- Reinsurance Recoverable % Shareholders' Equity		36.6%							
- Goodwill & Intangibles % Shareholders' Equity		26.4%							
Capital Adequacy (15%)								Aa	A
- Gross Underwriting Leverage		2.9x							
Profitability (15%)								A	A
- Return on Capital (5 yr. avg)		9.3%							
- Sharpe Ratio of ROC (5 yr. avg)				197.5%					
Reserve Adequacy (10%)								Aaa	A
- Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd avg)	-9.3%								
Financial Flexibility (15%)								Aa	A
- Financial Leverage		18.3%							
- Total Leverage		22.2%							
- Earnings Coverage (5 yr. avg)	27.1x								
- Cash Flow Coverage (5 yr. avg)									
Operating Environment								Aaa - A	Aaa - A
Aggregate Profile								Aa3	A2

[1] Information based on IFRS financial statements as of YE15 December 31. [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: Company reports and Moody's Investors Service

Ratings

Exhibit 5

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	STA
U K INSURANCE LIMITED	
Rating Outlook	STA
Insurance Financial Strength	A2

Source: Moody's Investors Service

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MOODY'S INVESTORS SERVICE