

## Rating Action: **Moody's assigns A2 IFSR to Direct Line Group's UK Insurance Limited**

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Global Credit Research - 27 Feb 2012

London, 27 February 2012 -- Moody's Investors Service has assigned a first-time A2 insurance financial strength rating (IFSR) to UK Insurance Limited (UKI). The rating outlook is stable. UKI is the main (UK) operating subsidiary of Direct Line Insurance Group plc ("DLG"), underwriting around 90% of DLG's business.

### RATINGS RATIONALE

Moody's said that the rating reflects DLG's very strong position in the UK personal lines market, a relatively conservative investment portfolio, good capitalisation, and 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. DLG also has to execute a successful full divestment from its current owner, the Royal Bank of Scotland Group plc (RBSG, A3 senior debt, on review for possible downgrade), by the end of 2014.

Moody's elaborated that DLG has an excellent market position. At YE10, it was the largest personal Motor and Home lines writer in the UK, and its brands, especially Direct Line and Churchill, are very powerful. DLG's UK market share has been declining recently as a result of exiting unprofitable business, the cessation of the Tesco Personal Finance (TPF) joint venture, and the strong market growth in price comparison websites. However, going forward, we expect DLG's personal lines market position to remain very strong.

DLG also has a relatively conservative investment portfolio. Currently, it has no exposure to equities, and the credit quality of the fixed income portfolio is very good with no exposure to peripheral European sovereign debt. However, there is concentration risk in the government bond portfolio via its significant proportion of UK gilts, and within the corporate bond portfolio there is significant exposure to the banking sector. Going forward, there is some transition risk as DLG adopts an independent (of RBSG) investment management and treasury function, and looks to reposition its investment portfolio.

Other credit strengths include low product risk given the preponderance of personal lines risks, and low financial leverage, with financial debt currently confined to intra-group loans and overdrafts and other borrowings. We expect financial leverage to remain relatively low going forward, but financial flexibility is somewhat constrained by DLG's lack of track record in accessing capital markets as a result of its current ownership. Any hybrid capital issuance prior to divestment would be DLG's first test in this regard, and RBSG's targeted commencement of its IPO of DLG in H2 2012, subject to market conditions, will also be a major test of stand-alone financial flexibility.

Moody's views DLG's capital adequacy as good. Capitalisation improved in 2011 reflecting lower business volumes as a result of discontinuing certain lines, and an increase in shareholders' equity of around 11% following the 3% decrease in 2010. Moody's gross underwriting leverage metric has also improved and was relatively low at below 3x at YE11, and the estimated IGD coverage ratio at YE11 is a high 306% (H1 2011: 254%). However, capital adequacy could weaken somewhat during 2012, with potential dividend payments, subject to regulatory approval, negatively impacting equity.

In terms of credit challenges, Moody's said that it views DLG's business line diversification 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.

A further challenge is sustaining recent performance improvements and growing profitably. DLG's results were impacted in 2009, and especially 2010, by significant UK Motor bodily injury reserve strengthening, and in these years DLG reported very high combined ratios for its UK Motor business. However, performance has significantly improved during 2011, with DLG returning to profit and recording a Moody's return on capital metric of 7.5% (YE10: -6.3%), and reporting an improved overall core combined ratio of 100% (YE10: 121%). The reported core UK Motor loss ratio also improved to 82% (YE10: 120%). 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. Nevertheless, 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.

With regard to rating drivers going forward, Moody's said that the following DLG developments could put upward pressure on UKI's rating: 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, successful divestment from RBSG. Conversely, negative rating pressure could arise from: 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.

The principal methodology used in this rating was Moody's Global Rating Methodology for Property and Casualty Insurers published in May 2010. Please see the Credit Policy page on [www.moody.com](http://www.moody.com) for a copy of this methodology.

At YE11, DLG reported an operating profit of GBP 407 million (including non-core business), a core combined ratio of 100%, core gross written premium of GBP 4,098m million, and equity of GBP 3,912 million.

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