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U K Insurance Ltd.

Primary Credit Analyst:
Tatiana Grineva, London (44) 20-7176-7061; tatiana.grineva@standardandpoors.com

Secondary Contact:
Mark D Nicholson, London (44) 20-7176-7991; mark.nicholson@standardandpoors.com

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U K Insurance Ltd.

SACP* Assessments					SACP*		Support		Ratings
Anchor	a	+ Modifiers	0	=	a	+	0	=	Financial Strength Rating
Business Risk		ERM and Management	0		Liquidity	0	Group Support	0	A/Stable/--
Strong									
Financial Risk		Holistic Analysis	0		Sovereign Risk	0	Gov't Support	0	
Very Strong									

*Stand-alone credit profile.
See Ratings Detail for a complete list of rated entities and ratings covered by this report.

Rationale

Business Risk Profile: Strong

- No. 1 motor and household insurer in the U.K. with well-known brands in the U.K. market.

Financial Risk Profile: Very Strong

- Very strong capital and earnings supported by improving operating performance and capital adequacy that still exceeds our benchmark for 'AAA' confidence level, although which we expect to gradually reduce to the upper level of an 'A' in 2015-2016 due to lower level of retained earnings and increasing investment risk.
- Intermediate risk position, reflecting a well-diversified investment portfolio and minimal exposure to employees' postemployment obligations, which are offset by the cyclicality of the U.K. motor market and the increasing volatility of capital and earnings.

Outlook: Stable

The stable outlook reflects our view that U.K. Insurance Ltd. (UKI) will continue to maintain at least strong capital and earnings, with capital adequacy at least comfortably at the 'A' level over the next 12-24 months. We also expect that UKI will maintain stable earnings during this period, a conservative investment profile, and a strong competitive position in the U.K.

Downside scenario

We could lower the ratings if capital adequacy falls below the 'A' level, or earnings materially fail to meet our expectations. We could also lower the ratings if UKI's leading positions in motor and household insurance shrink unexpectedly in a competitive market environment.

Upside scenario

We consider an upgrade to be unlikely, but we may raise the ratings if UKI maintains its capital consistently at the 'AAA' confidence level, or if our assessment of the complexity and importance of enterprise risk management (ERM) to the rating increases.

Base-Case Scenario

Macroeconomic Assumptions

- We forecast real GDP to increase by an annual average of 1.9% over 2014-2016 and that inflation will be predictable and modest, falling to 2% by 2015.
- While in the longer run we would expect a correlation between GDP and non-life premium growth, over our rating horizon we anticipate that internal industry dynamics in the U.K. insurance market will prove a stronger determinant of sector profitability than these macroeconomic trends.
- For detailed macroeconomic assumptions, see "U.K. Property/Casualty Insurance Sector Carries An Intermediate Industry And Country Risk Assessment" published November 6, 2013).

Company-Specific Assumptions

- Gross premiums written to decline by 3% in 2014 with 0% growth in 2015.
- Capital adequacy will be managed at least comfortably at the 'A' level.
- Reserve releases to continue, but at a lower level in the future.
- Net income after tax to be at least £185 million in 2014, and £220 million in 2015.
- The combined ratio to remain strong between 97%-99% in 2014-2015.
- Return on revenue of less than 7% annually over the same period.
- Financial leverage to remain about 20% and coverage 6x-7x.
- A dividend payout ratio of about 90% of our forecasted net income after tax.

Key Metrics

(Mil. £)	2015f	2014f	2013	2012	2011	2010	2009
Gross premiums written	<3,700	<3,700	3,835	4,001	4,168	4,971	5,291
Change in gross premiums written (%)	0	(3)	(4.17)	(4)	(16.15)	(6.05)	N.M.
Net income (attributable to all shareholders)	>220	>185	313	184	249	(272)	133
Return on revenue (%)	>8	>7	11.11	4.95	6.53	(7.69)	N/A
Return on shareholders' equity (%)	>9	>7	11.13	5.5	6.77	(7.70)	N/A
Net combined ratio (%)	98-99	97-99	92.99	98.82	100.48	116.95	107.99

F--Forecast. N.M.--Not meaningful. N/A--Not applicable. Data in all tables is for the consolidated Direct Line Group.

Company Description: One Of The Largest Personal Lines Insurers In Personal Lines Market, With A Leading Position In U.K. Motor And Home

UKI is the main operating insurance subsidiary of Direct Line Group (DLG) and best known through its Direct Line brand. DLG wrote gross premiums in 2013 of £3.8 billion (2012: £4.0 billion) primarily directly. The U.K. personal lines business accounted for 72%, U.K. commercial for 12% and international business (Italy and Germany) for 16%, of DLG's gross premium income in 2013. DLG operates in the U.K. under well-known, market-leading brands like Direct Line, Direct Line for Business, Churchill, Privilege, NIG, and Green Flag.

Table 1

U.K. Insurance Ltd.-- Industry And Country Risk

Insurance sector	IICRA	Business mix (%)*
UK P/C	Intermediate risk	86
Italy P/C	Moderate risk	10
Germany P/C	Low risk	4

*Based on gross premiums written. P/C--Property and casualty.

Business Risk Profile: Strong

We assess UKI's business risk profile as strong, based on its strong competitive position in the mature and highly competitive U.K. non-life insurance market.

Insurance industry and country risk

Most of UKI's business stems from the large and mature U.K. insurance market, where we consider industry and country risks to be intermediate (see "U.K. Property/Casualty Insurance Sector Carries An Intermediate Industry And Country Risk Assessment" published November 6, 2013). We assess the industry risk for the U.K. P/C insurance sector as moderate. The assessment is dragged down by the relative ease of opening an insurance business in the U.K. and by the recent volatility of motor liability claims. Despite strong competition on price in personal lines, the sector's profitability overall is solid. DLG has international operations in Italy and Germany, but lacks scale in these markets. DLG's dependence primarily on the U.K. market somewhat constrains DLG's overall business risk profile. Entry to personal lines business has relatively few restrictions in the U.K. because of the sector's bias toward direct sales channels, especially Internet and aggregator sales channels, for major lines. Although an insurer still has to build its brand through marketing, a network of offices, salesmen, or broker contacts remains much more significant for commercial than for personal lines. Ease of entry to the U.K. market, compared with peer markets, leads to a corresponding oversupply of capacity at most stages of the pricing cycle. Thus, UKI is exposed to cyclicality, competitiveness, and possible legislative changes in its single market.

Competitive position

UKI has a strong competitive position. It is one of the leaders in the personal lines markets in the U.K. and has about a 10% overall market share (based on reported Association of British Insurers data). It also has strong positions in the motor and home segments. In our view, the group gains sustainable competitive advantage through economies of scale in pricing and wider costs. Historical claims data on such a large scale also enables UKI to price more accurately and has helped the group improve its operating performance since 2010. Market-leading brands and direct distribution channels create competitive advantages for UKI by enabling it to lower its acquisition costs below those of its peers.

Although the U.K. personal lines market is very competitive, we do not see any immediate threats to UKI's competitive position.

In our base-case scenario, we expect UKI to continue to exhibit a strong performance with a combined (loss and expense) ratio of 97%-99%, well above the U.K. overall insurance market with a five-year average combined ratio of about 102% (2008-2012).

Table 2

U.K. Insurance Ltd.-- Competitive Position					
	--Year-ended Dec. 31--				
(Mil. £)	**2013**	**2012**	**2011**	**2010**	**2009**
Gross premiums written	3,835	4,001	4,168	4,971	5,291
Change in Gross Premiums Written (%)	(4.17)	(4.00)	(16.15)	(6.05)	N.M.
Net premiums written	3,467	3,636	3,911	4,788	5,092
Change in Net Premiums Written (%)	(4.66)	(7.04)	(18.30)	(5.97)	N.M.
P/C: reinsurance utilization - premiums written (%)	9.60	9.13	6.17	3.69	3.77

N.M.--Not meaningful.

Financial Risk Profile: Very Strong

Our view of UKI's very strong financial risk profile is driven by our very strong capital adequacy assessment.

Capital and earnings: Capital adequacy to remain comfortably at least in the 'A' confidence level in 2014-2016

We assess UKI's capital and earnings as very strong. Its capital adequacy as of Dec. 31, 2013, is at the 'AAA' confidence level but under our base-case scenario, we expect it to gradually weaken to the 'AA' confidence level in 2014-2015 and to subsequently stabilize at the upper end of the 'A' confidence level in 2015-2016. We expect the reduction to be driven by a lower level of retained earnings and higher credit risk charges resulting from UKI's plans to diversify its investment portfolio into infrastructure, high yield debt, etc. resulting in a lower overall credit quality of the investment portfolio (see Company Specific Assumptions for our base-case scenario). In our view, low interest rates may also weaken UKI's investment income, which however may be compensated by the materialization of the plans to diversify the investment portfolio.

Table 3

U.K. Insurance Ltd.-- Capitalization Statistics					
	--Year-ended Dec. 31--				
(Mil. £)	**2013**	**2012**	**2011**	**2010**	**2009**
Common shareholders' equity	2,790	2,832	3,871	3,482	3,581
Change in common shareholders' equity (%)	(1.47)	(26.86)	11.18	(2.75)	N.M.

N.M.--Not meaningful.

Table 4

U.K. Insurance Ltd.-- Earnings Statistics					
	--Year-ended Dec. 31--				
(Mil. £)	**2013**	**2012**	**2011**	**2010**	**2009**
Total revenue	3,892	4,120	4,737	5,538	5,677
EBIT adjusted	490	258	360	(384)	N/A
Net income (attributable to all shareholders)	313	184	249	(272)	133
Return on revenue (%)	11.11	4.95	6.53	(7.69)	N/A
Return on shareholders' equity (reported) (%)	11.13	5.50	6.77	(7.70)	N/A
P/C: net expense ratio (%)	31.85	33.69	30.71	23.90	26.44
P/C: net loss ratio (%)	61.14	65.13	69.77	93.05	81.55
P/C: net combined ratio (%)	92.99	98.82	100.48	116.95	107.99

N/A--Not applicable.

Risk position: Intermediate due to a well diversified investment portfolio and minimal exposure to postemployment defined benefit obligations.

In our view, UKI's risk position is intermediate. While it benefits from the diversity of its investment portfolio and minimal exposure to employee postemployment defined benefits obligations, the credit quality of the investment portfolio is reducing in response to a low interest rate environment and in search of a better asset liability management ethos, but remains strong. More than 90% of UKI's investment portfolio is concentrated in bonds and cash. We expect UKI's management team to remain committed to its conservative investment strategy and strictly monitor its exposure and adhere to its credit benchmarks and limits allocated.

However, the cyclicality of the U.K. motor market may increase the volatility of capital and earnings in the future, if the level of volatility we observed in 2009-2010 when the group had to significantly strengthen reserves because of high industrywide increases in bodily injury costs and soft market conditions repeats.

Table 5

U.K. Insurance Ltd.-- Risk Position					
	--Year-ended Dec. 31--				
(Mil. £)	**2013**	**2012**	**2011**	**2010**	**2009**
Total invested assets	8,573	9,439	10,930	10,755	10,086

Table 5

U.K. Insurance Ltd.-- Risk Position (cont.)					
Net investment income	189	199	244	269	314
Net investment yield (%)	2.09	1.96	2.25	2.58	N/A
Portfolio composition (% of general account invested assets)					
Cash and short term investments (%)	10.60	15.98	26.25	26.08	26.39
Bonds (%)	79.06	75.34	67.01	65.08	62.39
Real estate (%)	2.61	1.37	0.64	0.78	0.77
Mortgages (%)	2.66	0.48	2.59	4.61	6.80
Loans (%)	5.08	6.83	N/A	N/A	N/A
Other investments (%)	0.00	0.00	3.50	3.45	3.64

N/A--Not applicable.

Financial flexibility: Adequate reflecting supportive leverage and coverage and potential ability to raise additional capital based on the recent experiences.

UKI has adequate financial flexibility, in our view, thanks to its good earnings stream, prospectively capital at least at the 'A' confidence level, a satisfactory level of financial leverage (at about 20%), a healthy level of fixed-charge coverage (6x-7x) in 2014-2015, and the successful flotation/sale of its shares in difficult market conditions in 2013 and 2014. It also successfully issued junior subordinated debt of £500 million.

In our view, however, UKI's capital market track record is not as long as that of its competitors, to which we assign the highest financial flexibility assessment.

Other Assessments

We consider that UKI's adequate with strong risk controls ERM, and satisfactory management and governance assessments are neutral for the rating. Liquidity is exceptional.

Enterprise risk management

UKI's ERM framework reflects our positive views of the overall risk controls, risk model and strategic risk management. In our opinion, the importance of ERM to the rating is low as it operates in a less complex risk environment compared to the companies to which we assign a high level of ERM importance. We, however, do not expect the group to experience losses outside its risk tolerance.

Management and governance

We consider that the executive team, headed by Paul Geddes, established a track record following a notable turnaround in DLG's operating performance, successful issuance of junior subordinated debt in April 2012, and oversubscribed flotation and subsequent follow-on sale of 99.7% of DLG's shares. In our view, the management team has a very clear strategy and focus on profitability, and is working hard to sustain a strong performance in challenging market conditions.

DLG's strategy appears to be well-thought-out and consistent with its organizational capabilities, taking into account market developments. However, the sustainability of the strategy has yet to be proven over the next two to three years, particularly with regard to growth targets and the sustainability of net combined ratios.

Liquidity

DLG's liquidity ratio is more than 200%, based on the strength of available sources, mainly the group's regular inflow of premium income and highly liquid asset portfolio.

Related Criteria And Research

Related Criteria

- Insurers: Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings Detail (As Of June 19, 2014)	
Operating Company Covered By This Report	
U K Insurance Ltd.	
Financial Strength Rating	
Local Currency	A/Stable/--
Counterparty Credit Rating	
Local Currency	A/Stable/--
Junior Subordinated	BBB+
Domicile	United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:
Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com