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CREDIT OPINION
19 January 2023

Update

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RATINGS

Direct Line Insurance Group plc

Domicile	BROMLEY, United Kingdom
Long Term Rating	Baa1
Type	Subordinate - Dom Curr
Outlook	Negative

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

Update following affirmation with a negative outlook

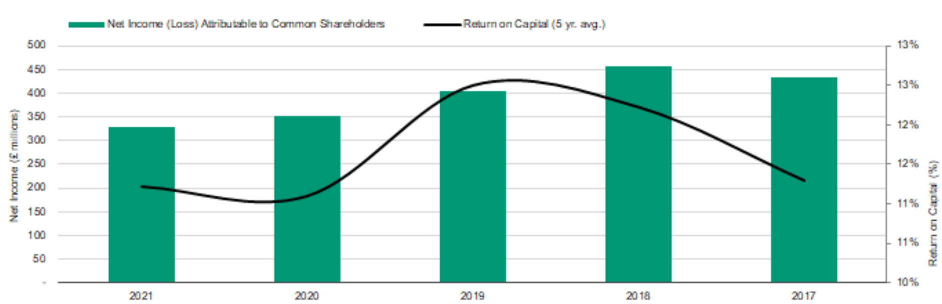
Summary

Direct Line Insurance Group plc's (DLG) has powerful brands and a top tier position in the UK retail P&C market, together with a growing share of the UK SME commercial market. This, together with the group's relatively conservative investment portfolio, low financial leverage and historical track record of underwriting discipline, which has consistently translated to strong returns on capital (Exhibit 1) support the A1 insurance financial strength rating on the group's lead operating entity U K Insurance Ltd.

On 16 January 2023, the ratings outlook was changed to negative from stable. This reflects the deterioration in DLG's profitability during YE2022, combined with Moody's expectation of further earnings headwinds, which could arise from high claims inflation and difficult pricing conditions in the UK retail property and casualty (P&C) market.

The negative outlook also reflects the risks that it could take the group longer than anticipated to rebuild its capital resilience, with the YE2022 Solvency II ratio expected to be towards the bottom end of DLG's target range of 140% to 180%. We view positively the actions taken by the Group to restore its balance sheet strength, but the suspension of the final YE2022 dividend, coupled with a challenging earnings outlook, could, at least temporarily, adversely impact the group's access to external market funding.

Exhibit 1
Return on capital has been consistently strong between 2017 and 2021
Return on capital (%) and net income (£ millions)



Source: Company filings and Moody's Investors Service

Credit strengths

» Strong position in the UK personal lines market, with powerful brands

» Low exposure to product risk, with a personal lines orientation

» Relatively low financial leverage and good average earnings coverage of interest

» Relatively conservative investment portfolio

» Consistent track record of strong returns on capital and underwriting results between 2017-2021

Credit challenges

» Restoring underwriting performance in a very challenging operating environment without a material loss of market share

» Rebuilding the Solvency II ratios towards 160% and the resilience of internal capital generation to fund business growth and dividends

» Limited geographical and business line diversification in which motor business predominates

Rating outlook

The outlook is negative, reflecting the deterioration in DLG's profitability during YE2022 combined with our expectation of further earnings headwinds, which could arise from high claims inflation and difficult pricing conditions in the UK retail property and casualty (P&C) market.

The negative outlook also reflects the risks that it could take the group longer than anticipated to rebuild its capital resilience, with the YE2022 Solvency II ratio now expected to be at the bottom end of DLG's target range of 140% to 180%. We view positively the actions taken by the Group to restore its balance sheet strength, but the suspension of the final YE2022 dividend, coupled with a challenging earnings outlook, could, at least temporarily, adversely impact the group's access to external market funding.

Factors that could lead to an upgrade

Given the negative outlook, there is limited upward pressure on the ratings, but the outlook could revert to stable over the outlook horizon in case of:

» DLG's underwriting earnings improving in line with management plans, without a meaningful loss of market share;

» The restoration of the group's Solvency II ratio to around 160%; and

» The group maintains its financial leverage below 25% (calculated based on IFRS4 equity)

Factors that could lead to a downgrade

» DLG is not able to restore its internal capital generation capabilities and underwriting profitability to towards the group's medium-term combined ratio target (under IFRS4)

» It becoming apparent that DLG's franchise is weakening; and/or

» The group's Solvency II ratio remaining consistently below 160%, the middle of the group's risk appetite range

Key indicators

Exhibit 2
Key financial indicators

	2021	2020	2019	2018	2017
As Reported (Pound Stering Millions)					
Total Assets	9,309	9,622	9,434	9,535	9,948
Total Shareholders' Equity	2,897	3,046	2,990	2,905	3,062
Net Income (Loss) Attributable to Common Shareholders	327	351	403	455	434
Gross Premiums Written	3,172	3,180	3,203	3,212	3,392
Net Premiums Written	2,985	2,949	2,987	2,988	3,184
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	24.1%	22.2%	23.0%	24.8%	23.1%
Reinsurance Recoverable % Shareholders' Equity	43.6%	39.0%	42.5%	42.4%	38.8%
Goodwill & Intangibles % Shareholders' Equity	35.1%	31.7%	29.6%	25.6%	21.6%
Gross Underwriting Leverage	2.4x	2.3x	2.4x	2.6x	2.6x
Return on Average Capital (ROC)	8.9%	9.7%	11.8%	13.1%	12.7%
Sharpe Ratio of ROC (5 yr.)	611.5%	549.5%	422.0%	393.0%	327.2%
Adv. (Fav.) Loss Dev. % Beg. Reserves	(10.0%)	(6.5%)	(10.2%)	(12.9%)	(12.9%)
Adjusted Financial Leverage	19.1%	19.7%	14.4%	15.0%	14.6%
Total Leverage	28.2%	28.3%	23.7%	24.6%	23.8%
Earnings Coverage	9.4x	10.1x	12.6x	14.3x	13.3x

[1] Information based on IFRS financial statements as of the fiscal year ended 31 December. [2] Certain items may have been relabeled for global consistency.
Source: Company filings and Moody's Investors Service

Profile

DLG, which was listed on the London Stock Exchange in 2012 after being divested from RBS in July 2012, is one of the UK's largest personal lines property and casualty (P&C) insurers, with top tier positions in personal motor and home by in-force policies (IFP).

The Group underwrites around £3.2 billion of gross written premiums (GWP) through its highly recognised brands — Direct Line, Churchill, Privilege and Green Flag — and partners.

The Group has four core classes of business in the UK P&C insurance market: personal motor (representing 49.2% of premiums for the YE2021), commercial (20.6%), home (18.2%), and rescue & other personal lines (12.0%), which sells insurance solely to small and medium-sized enterprise (SME) businesses.

Detailed credit considerations

The A1 IFSR is in line with the adjusted scorecard indicated outcome as shown in the Moody's scorecard (Exhibit 5).

Insurance financial strength rating

The key factors currently influencing the rating and outlook are:

Market position, brand and distribution: Strong position in UK personal lines could come under pressure

As one of the leading personal motor and home underwriters in the UK, we consider DLG's market position to be strong. Notwithstanding the decline in premiums since 2017, on the back of distribution partnership exits and difficult pricing conditions, the group's brands, in particular Direct Line and Churchill, remain very powerful. DLG's SME commercial business continues to grow profitably, supported by the Group's investments into risk selection and pricing capabilities. DLG's estimated share of SME commercial insurance market is now around 7%, although the Group has a relatively modest position in the overall UK commercial insurance sector.

The Group's total gross written premiums (GWP) reduced by around 3% in the first nine months of 2022 (9M22). This was driven predominantly by pricing actions taken in response to the FCA's pricing reforms in Home and Motor together with pricing actions taken in Motor to address claims inflation, which led to a reduction in the Group's competitiveness. The fall in retail home and motor GWP of 10% and 9%, respectively, was largely offset by continued strong growth in commercial lines, with GWP up 13% and a 1% uptick in Rescue and Other personal lines.

While the reduction in motor premiums slowed in Q4 2022, trading conditions remain challenging. We expect the group will prioritise its underwriting value, which could lead to a further reduction in volumes during 2023. Medium-term, we expect premiums to stabilise and begin to grow, supported by the group's new technology-enabled underwriting capabilities and by launching new propositions. DLG's partnership with Motability will also deliver growth, with an expected 15% uplift to motor premiums from YE24 onwards. DLG's commercial segment should continue growing, supported by both the Group's initiatives and good pricing momentum.

We view DLG's distribution as strong with leading direct to consumer propositions. Personal lines products are sold directly by phone, over the internet, through online aggregators, as well as via partnerships particularly in the home segment. DLG continues to improve its distribution capabilities by investing in new websites, digital propositions (e.g. Darwin, which targets PCWs customers using an alternative pricing system) and by targeting less traditional partnerships.

The commercial division also benefits from some direct distribution (via Direct Line for Business, “DL4B”) and some through the PCW channel (via Churchill for Business), although the majority of premiums are still written via brokers.

Despite the Group’s inherent scale advantages, its historic expense ratio has been relatively high and above its personal-lines orientated peers, driven by high marketing costs associated with the Group's direct brand propositions. However, notwithstanding the inflationary backdrop the Group’s will benefit from lower operating expenses, which reduce to around £700 million in 2022 with further targeted reductions in 2023.

In our view, DLG's multichannel distribution strategy, powerful brands, recent technology investments and strong financial resources will enable the Group to adapt to cyclical and longer-term changes in the market place, particularly as increasing car safety features, electric cars and eventually autonomous vehicles, start to transform the traditional risk pool.

Product risk and diversification: Relatively low product risk, offset by limited business diversification and dependence on the UK

In our view, product line diversification is relatively limited in light of the Group's dependence on the UK P&C insurance market as well as the preponderance of personal motor, which accounted for 49% of GWP and 54% of operating profit in 2021. However, the Group's commercial business is growing, and accounted for 21% of GWP and 10% of operating profit for YE21, up from 15% of GWP for YE16, benefitting from its technology transformation. The growth in the commercial segment has helped absorb some of the deterioration in underwriting results in retail segments during 2022.

More positively, DLG's product risk is considered low as a result of this preponderance of personal lines, which accounted for 80% of YE21 premiums as well as the focus on SME clients within the commercial business.The Group is however exposed to large bodily injury claims volatility, windstorm and flood catastrophe risk, although DLG purchases significant reinsurance cover to mitigate these risks.

Asset quality: Relatively conservative investment portfolio, notwithstanding relatively high exposure to credit versus peers

We view DLG's asset quality as good, supported by the Group's relatively conservative investment portfolio, which the group has further de-risked during 2022, low reinsurance recoverables as a percentage of shareholders' equity and low levels of goodwill and other intangible assets relative to equity.

As at YE21, c.74% of the Group's assets were held in fixed income securities (including private placements) and c11% in cash. The Group's high risk assets as a percentage of shareholders' equity ratio stood at around 24% as of YE21, primarily comprising property investments and high yield bonds. DLG also has some an exposure to UK infrastructure, which supports the asset strategy backing longer-dated periodical payment order liabilities (PPOs), as well as commercial real estate loans. During 2022, the group took some actions on its investment portfolio, most notably the sale of some longer duration credit, and recently announced a 15% value reduction in its property investment portfolio.

The credit quality of the fixed income portfolio remains good, with c.92% investment grade (including investment grade private placements) and c.57% rated A or higher, with a well-diversified portfolio by sector. The average interest rate duration of the group's debt securities was 2.5 years at YE21, comprised almost entirely of corporate bonds. This is significantly higher than a number of its UK/European P&C peers. We expect this has reduced slightly following with the aforementioned sales.

Capital adequacy: Solvency II ratio fell during 2022 but management will prioritise capital rebuild

Financial market volatility together with weak performance during 2022 has lead to an erosion of the group's capitalisation and resulted in DLG's decision to suspend its final dividend payment. The group's regulatory solvency ratio, which stood at 160% at YE21 (on a pro-forma basis after taking into account the final YE21 dividends, £100 million of share buybacks and the redemption of the £250 million Tier 2 debt instrument in April 2022), fell towards the bottom end of the group's target operating range of 140%-180% during 2022.

DLG's available capital was eroded by underwriting losses, widening credit spreads, losses on the sale of long duration credit and a £45 million reduction in the value group's property investment portfolios. This more than offset the decline in capital requirements relating to the sale of longer duration credit and other capital management actions taken during the period.

In addition to the suspension of its final YE22 dividend, we expect DLG to continue to rebuild its Solvency II ratio back up towards 160% with a focus on restoring the resilience of its internal capital generation capabilities. Nevertheless, the decline in the Group's solvency ratio and management actions taken to date have reduced the buffer and options available to DLG in the event of a short-term stress.

The Group's quality of capital remains good. As at YE21 eligible tier 1 capital (after foreseeable dividends and share buybacks) amounted to 71% of own funds and 126% of Solvency II capital requirements (down from 75% and 143% respectively as at YE20).

Profitability: Historically strong profitability, but market conditions will remain challenging into 2023

DLG's five-year average ROC (calculated on a Moody's basis) for the period 2017-2021 was strong at 11%. This, together with a sharpe ratio of ROC of 613% showcased the group's consistently strong performance, supported by conservative underwriting and low investment risk. During this period, the group also consistently met or exceeded its internal target of 93%-95% combined ratio and return on tangible equity (RoTE) of at least 15%.

However, in 2022 the group's operating performance came under greater pressure than anticipated. Operating earnings were down 47% to £196 million in H1 2022 and the combined ratio (COR) deteriorated to 96.5%. This was driven, in part by the normalization of motor claims frequency from lower levels during the pandemic related lockdowns, but also by significant levels of motor claims severity inflation.

The group is expected to generated an overall underwriting loss for YE2022, with a COR of around 102-103%, (normalised for weather). Elevated weather related losses, which are estimated to amount to around £140 million for the full year, are well above the group's £73 million budget and will contribute to the overall loss. Operating income will also be adversely affected by losses on the sale of long duration credit and the £45 million reduction in the group's investment property values.

We expect DLG to strengthen its profitability in 2023, with earnings supported by pricing increases, lower technology investment spend, lower operating expense and higher investment returns on the back of rising interest rates. Nevertheless, owing to challenging conditions, the group has lowered its underwriting profit forecast for the year ahead, expecting the combined ratio to be around 97%-98% (normalised for weather) versus the group's 93%-95% medium term combined ratio target).

YE2024 onwards, the group should start to benefit from its new tech-enabled pricing capabilities and its partnership with Motability Operations Ltd, which will expand the group's motor customer base by around 15%, whilst adding further scale to DLG's claims management service.

However, the negative outlook reflects the risk that it could take materially longer for the group to rebuild its earnings power owing to the difficult trading conditions in the UK retail P&C market, to which the group is highly exposed. Heightened competition in the home market together with high inflation and the cost-of-living crisis may result in the group sacrificing volume and market position to protect its combined ratio.

Reserve adequacy: Reserve releases trending down but to remain a feature; reserving risk is relatively low notwithstanding the inherent challenge of motor bodily injury claims

DLG has reported significant prior-year reserve releases since 2011, as reflected in the five-year weighted-average favourable loss development as a percentage of opening reserves, of 9.7% (2021-2017). These reserve releases were driven mainly by the Group's motor division in relation to favourable developments in bodily injury claims.

Given the Group's prudent reserving approach of current accident years, we expect reserve releases to remain a material contributor to future operating profit. Overall reserving risk is considered moderate although some volatility will likely remain a feature stemming from large bodily injury claims, which take longer to settle and typically involve court proceedings.

Claims inflation is an inherent reserving risk for DLG and the wider P&C market, heightened in the current environment. Motor claims inflation is being driven by higher used car costs, rising repair costs, as vehicles are fitted with more advanced technology, as well as elevated repair times owing to supply chain disruption leading to longer credit hire costs.

Motor repair cost inflation is due to more sophisticated car tech but repair times have increased due to supply chain disruption leading to longer credit hire durations

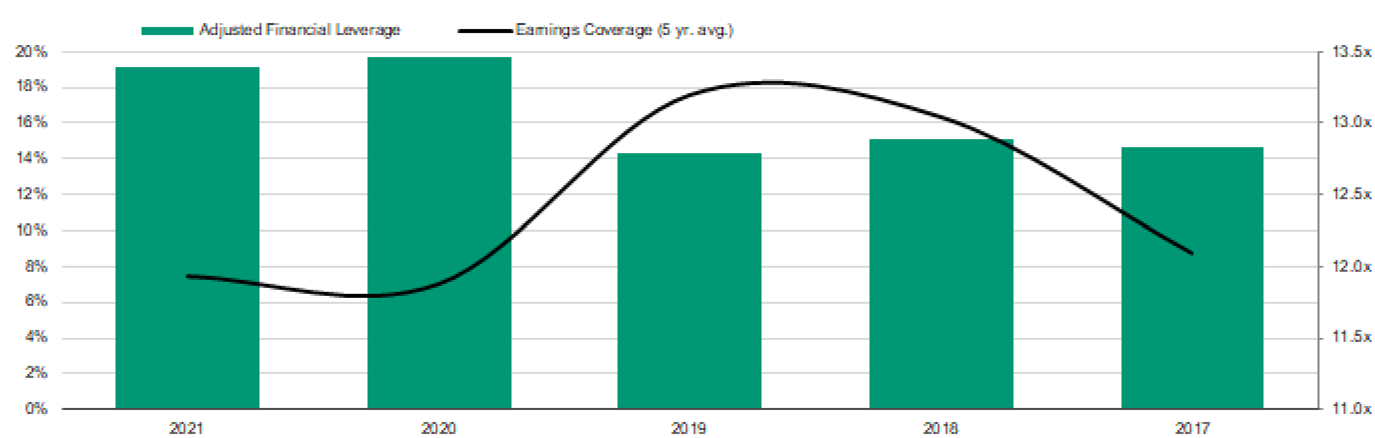
Financial flexibility: Leverage expected to remain relatively low but earnings coverage will weaken

We view DLG's overall financial flexibility as good, supported by relatively low financial leverage, which has been sustainably below 20%, and good earnings coverage, which averaged around 11x between 2017 and 2021 (Exhibit 3). However, the group's earnings coverage metrics will deteriorate for YE2022 owing to poor performance. Equity has also fallen in the period, driven predominantly by unrealised investment losses, but leverage should improve overall following the repayment of the remaining £250 million subordinated bond in 2022.

Exhibit 3

Leverage and earnings coverage have been strong but will deteriorate

Adjusted financial leverage and earnings coverage of interest



Source: Company filings and Moody's Investors Service

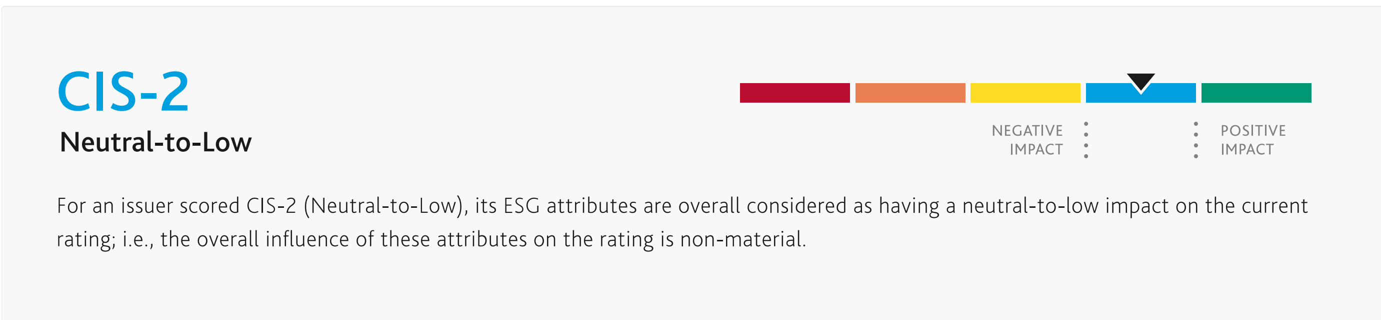
The prospect of weaker and more volatile performance over the outlook, together with the suspension of the group's final dividend, may, at least temporarily, reduce the group's access to external capital markets.

As at YE2022, the group had outstanding £260 million of T2 subordinated debt (4.0% due 2032) and £350 million of Restricted Tier 1 securities 4.75%, perpetual), which qualify for equity credit from us.

ESG considerations

Direct Line Insurance Group plc's ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 4
ESG Credit Impact Score



Source: Moody's Investors Service

Direct Line's ESG Credit Impact Score is neutral-to-low (**CIS-2**). The score reflects a limited impact from environmental and social factors on the rating to date. The group's strong risk management and effective governance, along with good capitalization and use of reinsurance, mitigate its exposure to environmental and social risks, in particular customer relations risk and physical climate risk.

Exhibit 5
ESG Issuer Profile Scores

Source: Moody's Investors Service

Environmental

Direct Line Group has moderate environmental risks, in particular physical climate risk related to the effects of natural catastrophes on its P&C insurance operations. The company has a good track record of managing this risk through pricing and reinsurance. As the frequency and severity of natural catastrophes increase over time, Direct Line and its peers could find mitigating this risk more challenging.

Social

Direct Line is exposed to moderate social risk, most notably with respect to customer relations and changing societal and demographic trends in its personal P&C business. Customer relations risk are elevated in relation to the group's personal P&C insurance products and significant interactions with retail customers, particularly against a background of an increasing focus by the UK regulator on the fair treatment of customers. This is mitigated by well-developed policies and procedures. Changes in societal attitudes and the legal environment can impact P&C claims costs and reserve development, particularly in motor lines. Changing motor usage patterns and the rise of autonomous vehicles, which could reduce the demand for motor insurance. Rising digitization and interconnectedness of devices will increase customer privacy and data security risks, although these are mitigated by a strong technology risk framework, while also presenting business risks and opportunities for Direct Line.

Governance

Direct Line faces neutral-to-low governance risks, and its risk management, policies and procedures are in line with industry best practices. The management team has a strong track record in consistently meeting objectives and financial targets, which are well articulated within the group's multiyear strategy to improve efficiency and effectiveness supported by technology. The group also benefits from a strong board and a good track record of regulatory compliance and consistently low leverage levels.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Support and structural considerations

The subordinated notes issued by DLG in June 2020 are rated Baa1(hyb). The rating is derived from the A1 IFSR of UKI and the three notch differential reflects Moody's standard notching practices for an insurance holding company domiciled and operating in jurisdictions where group regulation is in effect, and also reflects the structural and contractual subordination of the notes.

Rating methodology and scorecard factors

Exhibit 6

Direct Line Insurance Group plc

Financial Strength Rating Scorecard [1][2]	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adj Score
Business Profile								A	A
Market Position, Brand and Distribution (25%)								A	Aa
-Relative Market Share Ratio			X						
-Underwriting Expenses % Net Premiums Written				28.5%					
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	24.1%								
-Reinsurance Recoverable % Shareholders' Equity		43.6%							
-Goodwill & Intangibles % Shareholders' Equity			35.1%						
Capital Adequacy (15%)								Aa	A
-Gross Underwriting Leverage		2.4x							
Profitability (15%)								Aa	A
-Return on Capital (5 yr. avg.)		11.2%							
-Sharpe Ratio of ROC (5 yr.)	613.3%								
Reserve Adequacy (10%)								Aaa	Aa
-Adv. (Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd. avg.)	-9.7%								
Financial Flexibility (15%)								Aa	A
-Adjusted Financial Leverage		19.1%							
-Total Leverage		28.2%							
-Earnings Coverage (5 yr. avg.)		11.9x							
-Cash Flow Coverage (5 yr. avg.)									
Operating Environment								Aaa - A	Aaa - A
Preliminary Standalone Outcome								Aa3	A1

[1] Information based on IFRS financial statements as of fiscal year ended December 31, 2021. [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: Moody's Investors Service

Ratings

Exhibit 7

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	NEG
Subordinate	Baa1 (hyb)
Pref. Stock Non-cumulative	Baa3 (hyb)
U K INSURANCE LIMITED	
Rating Outlook	NEG
Insurance Financial Strength	A1

Source: Moody's Investors Service

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Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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