

Rating Action: Moody's affirms Direct Line Insurance Group's IFRS at A1 changes outlook to negative

16 January 2023

London, January 16, 2023 - Moody's Investors Service (Moody's) has today affirmed the A1 insurance financial strength rating (IFSR) on Direct Line Insurance Group's (DLG) key operating entity - U K Insurance Limited - and changed the outlook to negative from stable.

A full list of affected ratings can be found at the end of this press release.

RATINGS RATIONALE

NEGATIVE OUTLOOK REFLECTS DIFFICULT TRADING CONDITIONS

The change in outlook to negative 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 now towards the bottom end of DLG's target range of 140% to 180%. Moody's views 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.

Akin to its peers, DLG reported a significant reduction in its earnings in the first half of 2022 (H1 2022), with profit before tax down 32% to £178 million. 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. More recently, the group announced that a further uptick in motor severity inflation coupled with elevated weather losses (totaling around £140 million, well above the group's £73 million budget) will result in an overall underwriting loss for YE2022, with a combined ratio (normalized for weather) in the range of 102-103%.

In addition to underwriting losses the group has also realized some investment losses related to the sale of longer duration credit and has been hit by a £45 million revaluation of its commercial property portfolio. This loss, together with the impact of volatile financial markets, has further eroded DLG's Solvency II ratio from its 152% position at H1 2022, towards the bottom end of its 140%-180% target range.

Moody's believes that the group will continue to take necessary actions to (1) rebuild its regulatory solvency ratio back up towards its operating target of 160%; and (2) restore its underwriting margins and internal capital generating capabilities.

Moody's believes DLG will 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% (versus the group's 93%-95% medium term combined ratio target). YE2024 onwards, as market pricing reaches a new equilibrium, 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.

Moody's also expects DLG to sustainably rebuild its Solvency II ratio to around 160% over the coming 12-18 months, supported by the suspension of the final dividend and investment portfolio actions taken to reduce the group's sensitivities to financial market volatility, most notably widening credit spreads.

However, the negative outlook reflects the risk that it could take materially longer for the group to rebuild its earnings power and capital adequacy 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 and high claims inflation and the cost-of-living crisis may result in the group sacrificing volume and market position to protect its combined ratio. Moreover, owing to the capital management actions already taken, there may be less scope for further changes to support the group's solvency ratio in a near term stress scenario.

RATING AFFIRMATION

The affirmation of DLG's ratings reflects the group's: (1) powerful brands and top tier position in the UK retail P&C market, together with a growing share of the UK SME commercial P&C sector; (2) a relatively conservative investment portfolio, which has been further de-risked during 2022; and (3) low financial leverage with good average earnings coverage of interest. These strengths, however, are tempered by the group's dependence on the very competitive and highly regulated UK personal motor insurance market.

Notwithstanding the significant decline in earnings during 2022, the group has a long track record of underwriting discipline, which had consistently translated into strong returns on capital, averaging 11% over the period from 2017 to 2021.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Negative rating pressure could arise over the next 12-18 months in case: (1) DLG is not able to restore its internal capital generation capabilities and underwriting profitability to towards the group's medium-term target; (2) it becoming apparent that DLG's franchise is weakening; and/or (3) the group's Solvency II ratio remaining consistently below 160%.

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: (1) DLG's underwriting earnings improving in line with management plans, without a meaningful loss of market share; (2) the restoration of the group's Solvency II ratio to around 160%; and (3) the group maintain its financial leverage below 25% (calculated based on IFRS4 equity).

LIST OF AFFECTED RATINGS

U K Insurance Limited:

..Affirmation:

Insurance financial strength rating, affirmed at A1

..Outlook Action:

Outlook changed to Negative from Stable

Direct Line Insurance Group plc:

..Affirmation:

Subordinated debt rating, affirmed at Baa1 (hyb)

Preferred Stock Non-cumulative, affirmed at Baa3 (hyb)

..Outlook Action:

Outlook changed to Negative from Stable

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Property and Casualty Insurers Methodology published in August 2022 and available at <https://ratings.moody.com/api/rmc-documents/391814>. Alternatively, please see the Rating Methodologies page on <https://ratings.moody.com> for a copy of this methodology.

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For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moody.com/rating-definitions>.

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