CREDIT OPINION

17 December 2024

Update

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RATINGS

Direct Line Insurance Group plc

Domicile	London, United Kingdom
Long Term Rating	Baa2 , Possible Upgrade
Type	Subordinate - Dom Curr
Outlook	Rating(s) Under Review

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 to credit analysis

Summary

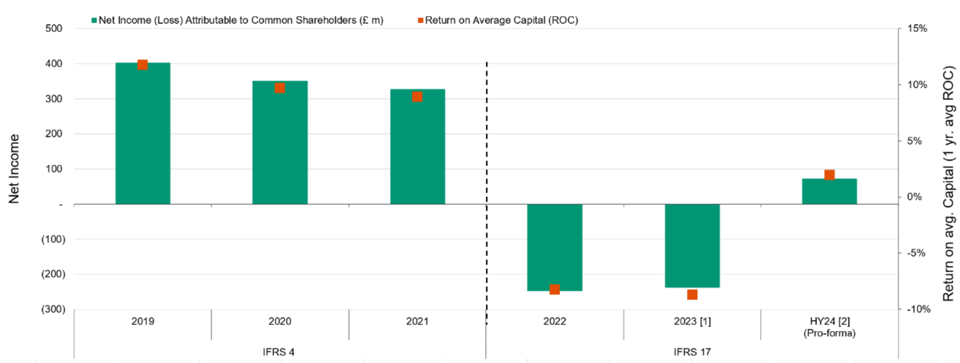
Direct Line Insurance Group plc (DLG's) ratings are on review for upgrade following a joint statement by DLG and Aviva Plc (Aviva) that they have reached preliminary agreement on the financial terms of a potential acquisition of the entire share capital of DLG by Aviva. Based on Aviva's last closing share price before the offer period, this proposal represents total consideration of at approximately £3.6 billion. Aviva has until 25 December 2024 to make a firm offer. The transaction will be also subject to regulatory and shareholder approvals. The review is contingent on the successful acquisition of DLG by Aviva. If the transaction does not proceed, DLG's ratings and outlook would revert back to its standalone level before the announcement.

DLG's existing ratings reflect (i) its position as a leading personal lines property and casualty (P&C) insurer in the UK, with powerful brands and good market share in motor and home insurance, and (ii) the group's strong solvency position, relatively conservative investment portfolio and low financial leverage. These strengths are offset by (i) underwriting performance which, while historically strong, is recovering following a significant deterioration due to claims inflation and difficult pricing conditions in 2022 and 2023, and (ii) concentration in the UK personal lines P&C market.

Exhibit 1

Historically strong profitability went negative in 2022. Returned to profit in the first half of 2024

Return on capital (%) and net income (£ millions)



[1]Net income in 2023 excludes a £443.9 million gain on the disposal of brokered commercial business. [2]The HY24 figures are annualised by multiplying the HY net income amounts by two

Source: Company filings and Moody's Ratings

Credit strengths

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

» Generally low product risk, although exposure to inflation and weather events through personal motor and home have weighed on recent results

» Relatively low financial leverage

» Relatively conservative investment portfolio

Credit challenges

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

» Heightened regulatory scrutiny by the Financial Conduct Authority

» Growing market share in highly competitive UK personal lines market in light of potential reputational damage

» Concentration in UK personal lines, especially motor

Rating outlook

We placed DLG's ratings on review for upgrade due to the anticipated benefits from its acquisition by Aviva (Aa3 IFSR for key operating entities, stable). This includes support from a larger, more diversified parent group with a higher credit rating. Additionally, cost synergies are expected to materialise over time, contingent on DLG's successful integration into the group. Previously, the outlooks were stable.

Factors that could lead to an upgrade

Before placing the ratings under review, factors were:

» Material strengthening of the group's franchise, evidenced by improved market share and greater diversification leading to materially lower concentration in UK personal lines

» Profitability sustainably restored to historical levels, evidenced by low-90% combined ratios and return on capital in excess of 10%

» Maintenance of the group's Solvency II ratio at or above 180%

» Adjusted financial leverage consistently below 20%

Factors that could lead to a downgrade

Before placing the ratings under review, factors were:

» Ongoing weak profitability of the business, evidenced by combined ratios nearing 100% and return on capital consistently below 5%

» Material weakening of the group's franchise

» Solvency II ratio remaining at 140% or below

» Adjusted financial leverage consistently above 35%

Key indicators

Exhibit 2
Direct Line Insurance Group plc

Direct Line Insurance Group plc [1][2]	2023	2022
As Reported (Pound Sterling Millions)		
Total Assets	8,417	7,424
Total Shareholders' Equity	2,405	2,192
Net Income (Loss) Attributable to Common Shareholders	206	(249)
Insurance revenues	3,602	3,229
Moody's Adjusted Ratios		
High Risk Assets % Shareholders' Equity	24.8%	28.3%
Reinsurance Recoverables (or Reinsurance Contract Assets) /Shareholders' Equity	56.0%	51.1%
Goodwill & Intangibles % Shareholders' Equity	34.0%	39.1%
Gross Underwriting Leverage	3.3x	3.3x
Return on Average Capital (ROC)	7.6%	NA
Sharpe Ratio of ROC (5 yr.)	NA	NA
Adv. (Fav.) Loss Dev. % Beg. Reserves	5.6%	-5.1%
Financial Leverage	15.7%	18.9%
Total Leverage	27.8%	29.0%
Earnings Coverage	9.4x	-7.6x

[1] Information based on IFRS17 financial statements as of the fiscal year ended 31 December; previous years' financial statements were prepared under legacy IFRS 4, which are not comparable to IFRS17 and are not included in the exhibit. [2] Certain items may have been relabeled and/or reclassified for global consistency.
Source: Company filings and Moody's Ratings

Profile

DLG is one of the UK's largest personal lines property and casualty (P&C) insurers, with leading positions in personal motor and home insurance. in 2024, DLG has established a new management team with significant experience in UK personal lines, which we consider credit positive. While initial steps have been taken to expand distribution, focus on DLG's key strengths and reduce costs will defend its market position and reduce costs over time, they would result in greater concentration in motor and home if its strategic review leads to the exit of its pet and travel businesses. The group is bolstering its pricing capabilities and digitalising and simplifying its business, however we view this as necessary to defend the group's top-tier market position rather than credit positive.

Detailed credit considerations

The A2 IFSR is in line with the adjusted scorecard indicated outcome as shown in the Moody's scorecard (Exhibit 6).

Insurance financial strength rating

Market position, brand and distribution: New management aim to overcome DLG's recent challenges

DLG is one of the leading personal lines insurers in the UK, with powerful brands, hence we consider its market position to be strong. However, recently DLG has been less successful in navigating difficult UK personal lines market conditions, especially motor, than a number of peers leading to weak underwriting results in 2022 and 2023. Additionally, the group overstated 2023 Solvency II ratio and has faced regulatory scrutiny over past pricing and claims payments which are negative to the franchise. The group has achieved substantial price increases in motor and home, aided by improved market conditions, however competition and regulatory scrutiny remain intense.

DLG's new management team, appointed in 2024, have significant experience in the UK personal lines market and are focussing on successful delivery of the group's core personal lines businesses including motor, home, commercial direct (SME) and rescue. This includes the launch of Direct Line on motor price comparison websites, targeted technology investment and the cessation of investment in non-core lines such as pet and travel. As the strategy was only disclosed in July 2024, we expect benefits to emerge gradually.

Despite DLG's scale, its expense ratio (including acquisition cost) is high compared to personal lines peers, driven by high marketing costs associated with the Group's direct brand propositions. The group has been focussed on reducing expenses in recent years, with a further target of reducing run-rate expenses by £100 million before the end of 2025.

Product risk and diversification: Concentration in UK personal lines but generally low product risk

DLG's business is concentrated in the highly competitive and highly regulated UK personal lines market. Product diversification is relatively low, especially since the group disposed of its brokered commercial lines business. Personal motor comprises around two-thirds of the group's continuing business (excluding lines in run-off). This level of concentration drove weak results in 2022 and 2023, although DLG is well placed to benefit from improved market conditions over the near term. We consider DLG's product risk to be low as a result of its focus on high frequency, low severity personal lines business and lower volatility SME commercial business. The Group is however exposed to large bodily injury claims volatility and weather related losses such as windstorm, flood and subsidence which DLG mitigates using reinsurance.

Asset quality: High quality portfolio, although high corporate credit exposure

DLG has a high quality investment portfolio, as evidenced by a low high-risk assets to shareholders' equity ratio, although relatively high exposure to corporate bonds (over 50% of cash and investments) exposes the group to spread risk. Around 90% of the fixed income portfolio, including private placements, is investment grade and around two-thirds A-rated or higher. The portfolio duration is 2-3 years, which is closely matched to claims liabilities. The group also has a low reinsurance recoverable to shareholders' equity ratio. The group's goodwill and intangibles to shareholders' equity ratio is relatively high, driven mainly by capitalised internally developed software.

Capital adequacy: Capital to be maintained at higher levels than recent years

DLG is currently targeting Solvency II coverage in excess of 180% following issues in 2022 that led to coverage falling to the low 140%s and suspension of the group's final dividend. Solvency was restored following the sale of the group's brokered commercial lines business in 2023, although DLG's reported year-end figure of 197% was overstated due to a miscalculation relating to the group's quote share reinsurance agreement. Adjusting for this, Solvency remained in excess of 180% and we expect it to be maintained at or above these levels over the medium term.

Profitability: Results will lag historical levels at least over the medium term

Following poor results in 2022 and 2023, driven mainly by pricing lagging claims inflation in motor, we expect DLG's results to improve gradually. The group's written margins have improved following double-digit price increases in motor, but reported results will still be dragged by older motor business and below average reserve releases over the next few months.

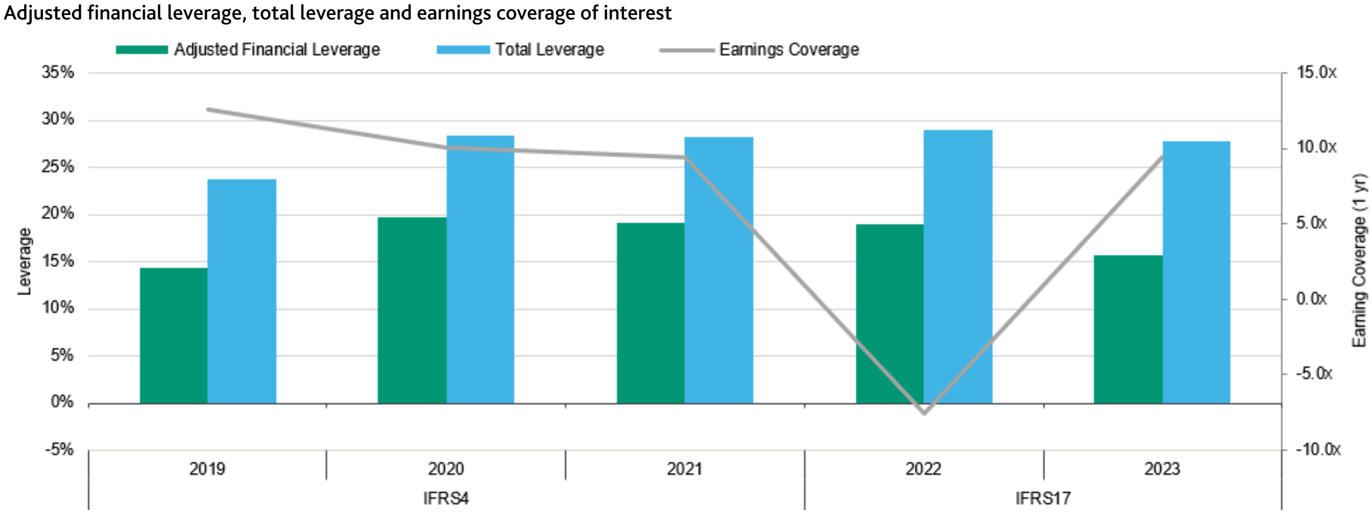
DLG's historical performance was very strong, measured by combined ratio and return on capital. We do not expect the group to achieve performance in line with pre-2022 levels over the medium term, however initiatives from the new management team to improve pricing capabilities and broaden distribution, direct investment towards to core lines of business and reduce expenses will be supportive of stronger performance.

Reserve adequacy: Reserve releases trending down; reserving risk is relatively low although long-tail motor bodily injury claims add risk
DLG's reserving risk is largely low, with the majority of its business being short tail personal lines. In recent years, however, the wider motor insurance market has faced claims inflation driven by high used car costs, high repair costs relating to advanced technology, longer repair times owing to supply chain disruption and higher credit hire costs. Long tail bodily injury claims, including PPOs that account for around 10% of net claims reserve, add to reserving risk and also expose the company to inflation and interest rate risk.

DLG's reserve strength weakened in 2022 due to overly optimistic inflation assumptions, leading to reserve strengthening in recent periods. We expect reserve releases to remain muted but gradually increase as the company restores its reserve margins on new business with stronger pricing. The group reserves at 75th percentile, including risk adjustment, under IFRS 17.

Financial flexibility: Leverage expected to remain relatively low but earnings coverage muted by underwriting performance
DLG's financial flexibility is good, with low total and financial leverage according to Moody's metrics (Exhibit 3). DLG is listed on the London Stock Exchange, but recent weak performance and suspension of the group's 2022 final and 2023 interim dividends may have reduced the group's access to equity capital.

Exhibit 3
Leverage and earnings coverage have been deteriorated
Adjusted financial leverage, total leverage and earnings coverage of interest

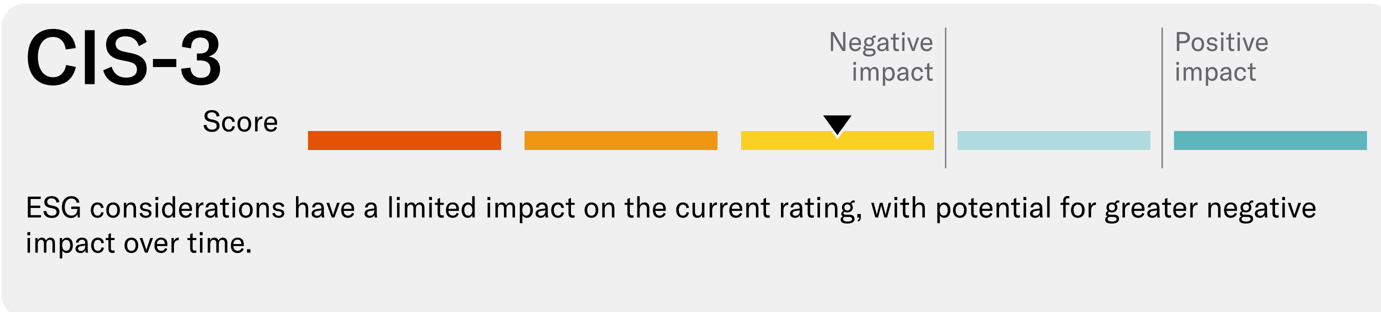


Source: Company filings and Moody's Ratings

ESG considerations

Direct Line Insurance Group plc's ESG credit impact score is CIS-3

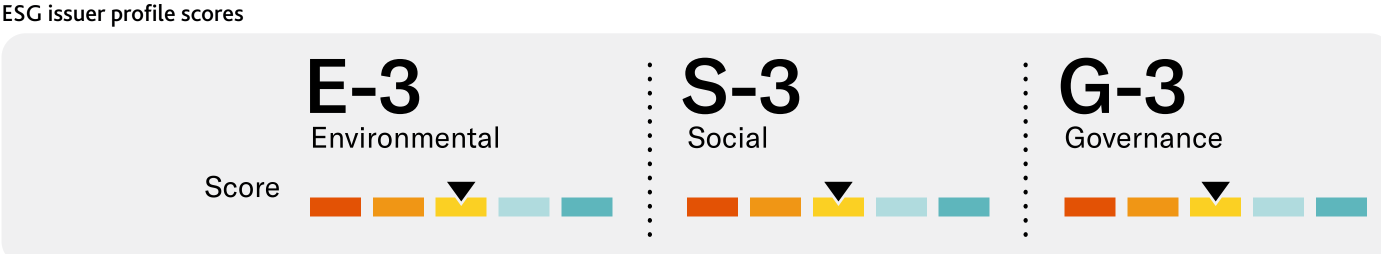
Exhibit 4
ESG credit impact score



Source: Moody's Ratings

Direct Line's **CIS-3** reflects the limited impact of ESG considerations on the current rating, with potential for greater impact over time, mainly due to moderate governance risks. These relate to recent poor financial performance and heightened regulatory scrutiny by the Financial Conduct Authority, including two past business reviews the group is carrying out in relation to pricing and claims payments. The group is also exposed to environmental and social risks, in particular customer relations risk and physical climate risk, which are mitigated by effective risk management and governance, along with good capitalization and use of reinsurance.

Exhibit 5
ESG issuer profile scores



Source: Moody's Ratings

Environmental

Direct Line Group is moderately exposed to 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 moderately exposed to 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 and heightened regulatory scrutiny by the Financial Conduct Authority, including two past business reviews the group is carrying out in relation to pricing and claims payments. 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 moderate governance risks, primarily related to its financial strategy and risk management along with management credibility and track record. These risks arise as a result of recent poor performance and heightened regulatory scrutiny by the Financial Conduct Authority, including two past business reviews the group is carrying out in relation to pricing and claims payments. This has raised concerns surrounding the level of oversight of frontline operations. Aside from the recent challenges, the group had demonstrated a long track record of consistently meeting objectives and financial targets, which are well articulated by the group, and regulatory compliance. The group's strong risk management, policies and procedures, along with good board oversight, position it to overcome these more recent challenges.

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, which are eligible as Tier 2 Solvency II capital, are rated Baa2(hyb). The rating is derived from the A2 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. The group's Restricted Tier 1 Notes (RT1) take into account the IFSR of UKI and the Solvency II ratio of DLG.

Rating methodology and scorecard factors

Exhibit 6

Rating Factors

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	A
-Relative Market Share Ratio			X						
-Net Underwriting Expense Ratio			26.5%						
Product Focus and Diversification (10%)								Baa	Baa
-Product Risk		X							
-P&C Insurance Product Diversification				X					
-Geographic Diversification						X			
Financial Profile								A	A
Asset Quality (10%)								Aa	A
-High Risk Assets % Shareholders' Equity	24.8%								
-Reinsurance Recoverables (or Reinsurance Contract Assets) / Shareholders' Equity		56.0%							
-Goodwill & Intangibles % Shareholders' Equity			34.0%						
Capital Adequacy (15%)								A	A
-Gross Underwriting Leverage			3.3x						
Profitability (15%)								A	A
-Return on Capital (5 yr. avg.)			7.6%						
-Sharpe Ratio of ROC (5 yr.)									
Reserve Adequacy (10%)								Baa	A
-Net Loss Reserves Development / Beginning Net Loss Reserves (5 yr. wtd. avg.)				2.1%					
Financial Flexibility (15%)								Baa	A
-Financial Leverage		15.7%							
-Total Leverage			27.8%						
-Earnings Coverage (5 yr. avg.)					0.9x				
-Cash Flow Coverage (5 yr. avg.)									
Operating Environment								Aaa - A	Aaa - A
Preliminary Standalone Outcome								A2	A2

[1] Information based on IFRS17 financial statements as of fiscal year ended December 31, 2023. 5-year ratios calculated using only those years for which IFRS17 data are available. [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 Ratings

Ratings

Exhibit 7

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	Rating(s) Under Review
Subordinate	Baa2 (hyb)
Pref. Stock Non-cumulative	Ba1 (hyb)
U K INSURANCE LIMITED	
Rating Outlook	Rating(s) Under Review
Insurance Financial Strength	A2

Source: Moody's Ratings

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