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CREDIT OPINION

17 May 2019

Update

Rate this Research

RATINGS

Direct Line Insurance Group plc

Domicile	United Kingdom
Long Term Rating	Ba1
Type	Pref. Stock Non-cumulative - Dom Curr
Outlook	Stable

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 rating action

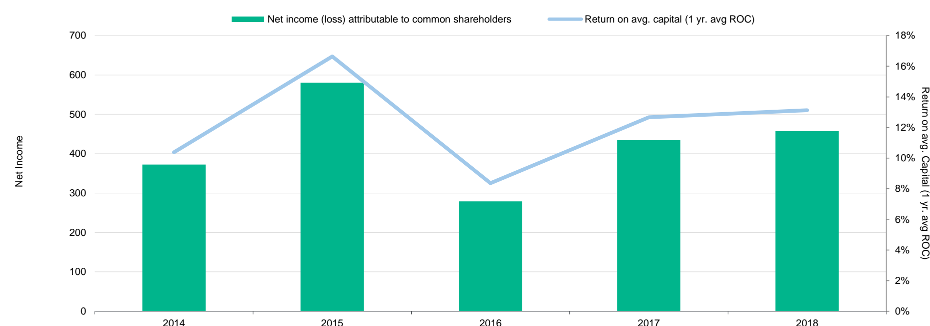
Summary

Direct Line Insurance Group plc's (DLG) main operating entity U K Insurance Limited (UKI) is rated A1 for insurance financial strength with a stable outlook. The rating, which was upgraded on 10 May 2019, reflects (i) DLG's track record of reporting consistently strong return on capital (ROC) and underwriting results, which we believe will be sustained, (ii) very strong position in the UK personal lines general insurance market, (iii) relatively conservative investment portfolio and low financial leverage, and (iv) good capitalisation.

These strengths more than offset the Group's dependence on the very competitive and highly regulated UK personal motor market and some execution risk around the Group's technology transformation and the change in drivers of future profitability.

Exhibit 1

Net Income and Return on Capital (1 yr. avg)



Source: Company reports, Moody's Investors Service

Credit strengths

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

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

» Consistent track record of strong returns on capital and underwriting results

» Relatively low financial leverage and strong earnings coverage of interest

» Relatively conservative investment portfolio

Credit challenges

» Enhancing contributions, both from a premium and profitability perspective, from non-personal lines motor businesses (e.g. commercial and rescue segments)

» Successfully execute the roll out of the new technology systems and convert efficiency gains into a lower cost base

» Sustaining recent underwriting performance in the very competitive UK personal lines market and as the contributions from prior year reserve releases reduce

» Navigating and adapting to changes in the highly regulated and dynamic UK personal motor market

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

Rating outlook

The rating outlook is stable reflecting primarily our expectation that the company will sustain its strong profitability both from a return on capital and underwriting perspective, while maintaining its very strong position in the UK personal lines general insurance market. The stable outlook is also underpinned by our expectation that the group will maintain its relatively conservative investment portfolio, good capitalisation and relatively low financial leverage.

Factors that could lead to an upgrade

Positive rating pressure is unlikely given the stable outlook but could arise from a combination of:

» Enhanced capital adequacy with gross underwriting leverage of below 2x and Solvency II coverage above 200%;

» Average ROC (Moody's definition) through the cycle above 15% and a reported combined ratio consistently around 90%;

» Adjusted financial leverage consistently below 10%;

» Continued profitable development of non-motor business.

Factors that could lead to a downgrade

Conversely, negative rating pressure could arise from:

» A material reduction in premiums resulting in a material loss of market share; and/or

» Average return on capital through the cycle below 8%; and/or

» Adjusted financial leverage in excess of 25% with earnings coverage below 8x; and/or

» Meaningful deterioration in capital adequacy as reflected in the Group's Solvency II ratio falling sustainably well below 160%.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 2

Direct Line Insurance Group plc

Direct Line Insurance Group plc [1][2]	2018	2017	2016	2015	2014
As Reported (Pound Sterling Millions)					
Total Assets	9,386	9,948	10,122	9,957	11,226
Total Shareholders' Equity	2,920	3,062	2,522	2,630	2,811
Net income (loss) attributable to common shareholders	457	434	279	580	373
Gross Premiums Written	3,212	3,392	3,274	3,153	3,099
Net Premiums Written	2,988	3,184	3,068	2,961	2,917
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	24.7%	23.1%	29.1%	25.1%	20.4%
Reinsurance Recoverable % Shareholders' Equity	41.7%	38.8%	51.6%	36.6%	29.3%
Goodwill & Intangibles % Shareholders' Equity	25.5%	21.6%	26.8%	26.4%	24.7%
Gross Underwriting Leverage	2.6x	2.6x	3.1x	2.9x	2.7x
Return on avg. capital (1 yr. avg ROC)	13.1%	12.7%	8.4%	16.6%	10.4%
Sharpe Ratio of ROC (5 yr. avg)	392.9%	327.2%	219.5%	197.6%	66.4%
Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg)	-12.9%	-12.9%	-8.1%	-11.5%	-9.5%
Financial Leverage	14.9%	14.6%	19.3%	18.4%	18.1%
Total Leverage	24.5%	23.8%	23.4%	22.3%	21.8%
Earnings Coverage (1 yr.)	14.3x	13.3x	9.2x	16.7x	11.8x

[1] information based on ifrs financial statements as of fiscal ye december 31. [2] certain items may have been relabeled and/or reclassified for global consistency.

Source: Moody's Investors Service, Company Filings

Profile

DLG is the UK's largest personal lines property and casualty (P&C) insurer, with leading 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, including Royal Bank of Scotland (RBS) (baa2 positve, baa3), NatWest and Prudential (A2 long term rating, stable).

The group has four core classes of business — personal motor (representing 52% of premiums in 2018), home (19%), rescue and other personal lines (13%), and commercial (16%). Following the disposal of its international operations in 2015, the group focuses exclusively on the UK P&C market.

The group was listed on the London Stock Exchange in 2012 after being divested by RBS in July 2012.

Detailed credit considerations

Insurance financial strength rating

Market position, brand and distribution: Very strong position in the UK personal lines market, own brand growth to continue

As the largest personal motor line writer in the UK as well as one of the leading home writers, we consider DLG's market position to be very strong and its brands, in particular Direct Line and Churchill, to be very powerful. We expect DLG's personal lines market position to remain very strong benefiting from planned growth via the price comparison website (PCW) channel and its rescue (via Green Flag) business. DLG's small and medium-sized enterprise commercial business is growing supported by the Group's investments into risk selection and pricing capabilities, but its overall commercial market share remains relatively modest at this stage.

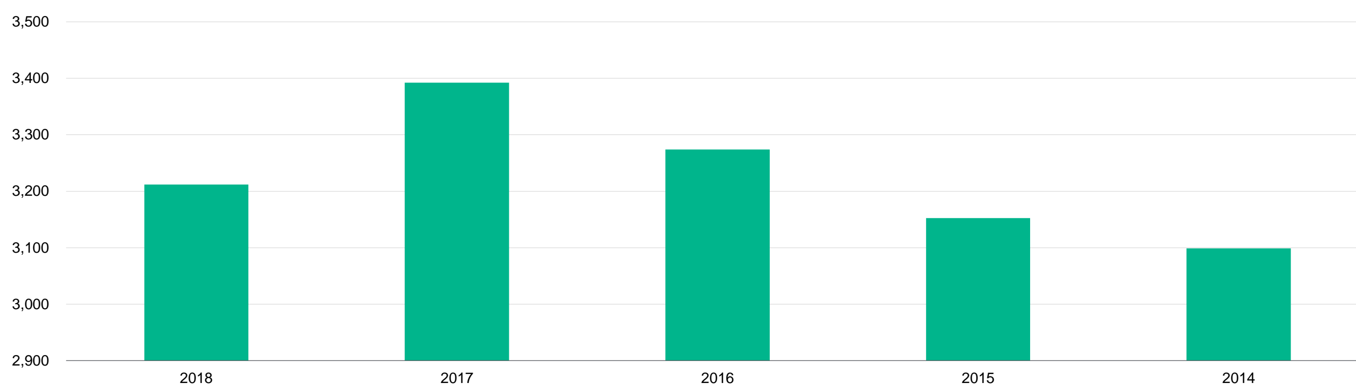
In the medium-to-long term, Moody's also believes that DLG's multi-channel distribution strategy, powerful brands and financial resources will enable the Group to adapt to changes in the market place, particularly as increasing car safety features, and eventually autonomous vehicles, start to transform the traditional risk pool.

In 2015, DLG started to modestly grow its premium base after several years of decline (see Exhibit 3), which reflected management's action to improve performance and difficult pricing conditions. GWP fell by c.5% during 2018 driven by the cessation of some distribution partnerships for Home insurance although the Group's own brands' premium grew by c.2%.

Exhibit 3

Gross Written Premiums evolution

£ million



Source: Company reports, Moody's Investors Service

Overall, we view DLG's personal lines distribution as strong, with products sold directly by phone, over the internet, through online aggregators, as well as via partnerships particularly in the home segment. To improve efficiency and effectiveness, DLG has been re-establishing its partnership capabilities, including exiting a number of partnerships and has renegotiated existing deals. For example, in 2018 the group signed a minimum 5 year partnership deal with Volkswagen Insurance Services (Great Britain), and again extended its travel agreement with Nationwide until 2023. In 2016, it signed a three-year extension with RBS for home and private insurance, and extended its Prudential partnership in home and motor for a further two years. The commercial division also benefits from some direct distribution (via DL4B), although the majority of premiums are still accessed via brokers. DLG also continues to improve its distribution capabilities by investing in new websites, digital propositions (e.g. Darwin) and by targeting less traditional partnerships.

The group's underwriting expense ratio remains relatively high and above its personal-lines-orientated peers, despite the group's inherent scale advantages. However, DLG's reported expense ratio reduced by 4.9% points to 29.9% in 2018 (2017: 34.8%), reflecting the combined effect of a reduction in the commission ratio of 2.6% points (as a result of business mix shift and exit from the distribution agreement in the Home business with Nationwide and Sainsbury's) and a reduction in the expense ratio of 2.3% points (as a result of a reduction of the operating expenses by £84 million).

Going forward, we expect the group's expense ratio to continue to reduce, via the implementation of ongoing efficiency programme initiatives (the group targets to reduce operating expenses below £700 million in 2019) and top-line growth.

Product risk and diversification: Relatively low product risk, offset by limited business diversification and dependence on the UK
DLG writes UK non-life business only, split 84% personal lines and 16% commercial lines. DLG has four main business segments, including motor (52% of GWP and 69% of operating profit in 2018), home (19% and 14%), rescue and other (13% and 7%), and commercial (16% and 10%). In our view, product line diversity is, therefore relatively limited in light of the preponderance of personal motor although the motor proportion of operating profit in 2018 is inflated by the positive profit impact of the Ogden discount rate change and by larger than average weather losses in Home.

More positively, DLG's product risk is considered low as a result of this preponderance of personal lines. Although the business is exposed to large bodily injury claims volatility, windstorm and flood catastrophe risk, DLG purchases significant reinsurance cover.

Asset quality: Relatively conservative investment portfolio, notwithstanding relatively high exposure to credit versus peers
We view DLG's asset quality as good. The Group has a relatively conservative investment portfolio, with 87% held in fixed income securities and cash. In recent years, the Group has undertaken some re-risking actions, reflected in the rise in DLG's HRA as a percentage of shareholders' equity ratio to around 25% as of YE18 from 8% as of year-end 2013. DLG continues to have no exposure to, or appetite for, equities, with HRA primarily comprising property investments and high yield bonds. Since 2014, DLG also has had an exposure to UK infrastructure, which supports the asset strategy backing periodical payment order liabilities.

As of YE18, DLG's invested assets comprised 69% fixed income securities, 18% cash and cash equivalents, 5% property investments, 5% infrastructure debt, and 3% commercial real estate loans with an overall duration of 2.5 years. [1]DLG has also repositioned its credit portfolio. Corporate bonds represented 67% of invested assets as of YE18, which is significantly higher than a number of its UK/ European P&C peers. However, the credit quality of the fixed income portfolio is very good, with around 64% of fixed income assets rated A or higher with a well-diversified portfolio by sector. However, DLG has increased its exposure to high-yield credit, which as of YE18, amounted to around 6.5% of invested assets, slightly above the Group's 6% target. Over the next 12-18 months, we expect only modest tweaks to the Group's investments as the Group continues to shift its portfolio towards its targets.

DLG's overall asset quality also benefits from a low level of reported goodwill and intangible assets (including Deferred Acquisition Costs) as % of equity although this metric increased to c.26% as of YE17 (YE17: 21.6%). Reinsurance recoverables have historically been low, although increased to c.42% at YE18 (YE17: 38.8%), slightly out of line with the typical 30%-40% over the last few years.

Capital adequacy: Good capitalisation notwithstanding dividend pay-outs; Solvency II ratio relatively insensitive to market movements
DLG's capital adequacy and quality of capital are good. The Prudential Regulation Authority (PRA) approved DLG's internal model in June 2016, and the Group's post-dividend Solvency II ratio was 170% as of YE18 (YE17: 165%). We expect the ratio to converge towards the middle of the Group's target range of 140%-180% although for the time being DLG, given current political and economic uncertainties, considers it appropriate to maintain the ratio towards the upper end of its target range. We also note the Group has a general strategy of returning excess capital to shareholders via special dividends which will negatively impact shareholders' equity, but we expect DLG's Solvency II ratio to remain robust.

With regard to capital sensitivities, the Group has disclosed that its greatest exposures are a change in reserving basis for motor Periodic Payment Orders (PPOs) to use a real discount rate of -1% and a 100bp increase in credit spreads, which would reduce the Solvency II ratio by 10 and 11 ppt respectively as of YE18. A large catastrophe loss, equivalent to the 1990 storm and extensive flooding of the river Thames, would also have a meaningful 8 ppt impact. Given the Group's relatively conservative investment portfolio and lack of equities exposure, DLG's Solvency II ratio is relatively insensitive to market movements.

The Group's quality of capital is very good. As of YE18, 84% (after foreseeable dividends) of the Group's own available funds comprised Tier 1 capital, split between £1.45 billion of unrestricted Tier 1 capital and £0.35 billion of restricted Tier 1 notes issued in December 2017. Tier 1 capital represents 143% of the Solvency Capital Requirement (SCR). In 2017 DLG used the proceeds of the restricted Tier 1 issuance to repay £250 million of subordinated Tier 2 debt. As a consequence, since YE2017 Tier 2 capital relates solely to the Group's £0.26 billion subordinated debt and accounts for 12% of the Group's own funds, with only 4% in the form of Tier 3 capital. DLG's Tier 2 and Tier 3 capital are, therefore, materially below the amounts permitted under Solvency II regulations.

Given the reduction in shareholders' equity since 2011, total equity as a percentage of net written premiums has declined. However, gross underwriting leverage, which historically has averaged around 3x, declined to 2.6x at YE17 and YE18 driven by lower reserves.

Profitability: Profitability targets met once again for year-end 2018, but the highly competitive and dynamic UK personal market remains a challenge

In 2018, the Group achieved a return on tangible equity (RoTE) of 21.5%, a combined ratio (COR) of 91.7% (below the Group's ongoing 93%-95% target range), a 2.5% investment yield and a further reduction in the expense ratio. This strong set of results benefited from a strong underwriting profit and significantly reduced finance costs notwithstanding reductions in prior year reserve releases and investment return. With regard to our scorecard metrics, DLG's five-year average ROC improved to 12.2% (YE17: 11.3%), and the Sharpe ratio of ROC improved to 393% (YE17: 327%).

Going forward, we expect DLG's performance to continue to benefit from its disciplined approach to underwriting and claims management, its pricing capabilities supported by its strong brand differentiation, ongoing cost reduction initiatives and revenue growth thereby enabling it to continue to meet its 15% return on tangible equity and underwriting targets. This is notwithstanding the UK motor market remains extremely competitive, which makes it difficult for price increases to match claims inflation and the uncertainty around the outcome of the FCA's review of general insurance pricing practices. More specifically to DLG, the Group plans to improve current year profitability to offset the expected decline in motor prior year reserve releases and faces some execution risk in the roll out of its new technology systems, on a large scale, in order to gain efficiency and capability improvements.

Reserve adequacy: Reserve releases expected to reduce but remain a feature, 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 11.5% (2018-2014). These reserve releases were driven mainly by the Group's motor division in relation to favourable developments in bodily injury claims.

Notwithstanding the market impact of the Ogden rate cut, for 2016, the Group still recognised strong overall reserve releases of £290 million (2015: £449 million). Excluding the impact of the Ogden rate cut, prior-year reserve releases would have been £205 million higher than reported. In 2017 and 2018, reserve releases were £435 million and £404 million respectively, with 2018 benefiting from a £51 million amount as a result of DLG assuming a higher Ogden discount rate of 0%. Prior year releases in Motor continued to reduce, consistent with the greater levels of reinsurance purchased in recent years.

Given the Group's prudent reserving approach of current accident years, we expect reserve releases to remain a material contributor to future operating profit. However, we expect releases to trend downward driven predominantly by increasing levels of reinsurance purchased by the Group, together with motor claims inflation for which the Group has a 3%-5% long-term range. Motor claims inflation is driven by the rising cost of damages from repair costs because vehicles are fitted with more advanced technology, used car prices and credit hire costs. During 2017, there was also a rise in home claims inflation related to the escape of water, although DLG has taken a number of significant actions across pricing, underwriting and claims management to mitigate escape of water inflation henceforth.

Furthermore, some volatility will likely remain a feature particularly within the UK motor portfolio. We will continue to monitor the impact of the future outcome of the latest Ogden rate consultation, as well as changes in periodical payment order award propensities and large bodily injury claims.

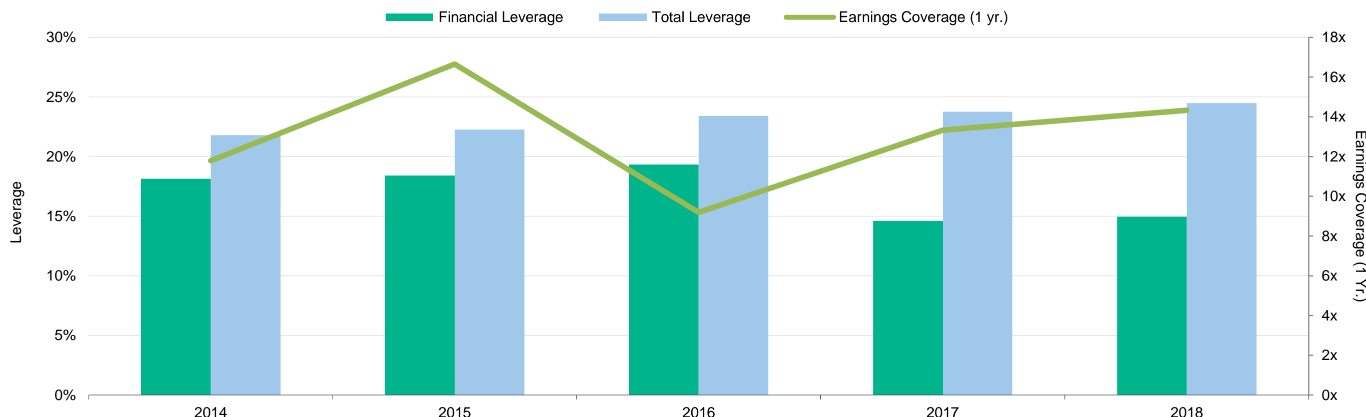
Financial flexibility: Relatively low leverage and strong earnings coverage

We view DLG's overall financial flexibility as very good. Adjusted financial leverage increased slightly at YE18 but remained low at 14.9% (YE17: 14.6%), including £260 million of dated subordinated notes and £347 million of restricted tier 1 securities, which qualify for equity credit from us, together with bank debt and an operating lease expense adjustment. Although leverage will likely be pressured by the Group's dividend policy, we expect it to remain relatively low in relation to the A1 IFSR.

Earnings coverage is strong, averaging around 13x over the past five years at YE18.

Exhibit 4

Financial Flexibility



Source: Moody's Investors Service, Company Filings

As a result of its historic ownership, DLG has a more limited record in accessing capital markets versus some of the largest European insurers. However, we regard the restricted Tier 1 issuance and the IPO, following the lower Tier 2 debt issuance in April 2012, as evidence that DLG can successfully access the capital markets.

Structural considerations

The guaranteed subordinated notes issued by DLG in April 2012 are rated A3(hyb). The rating reflects the fact that the notes are unconditionally and irrevocably guaranteed by UKI on a subordinated basis and reflect standard notching (versus the senior rating) for subordinated debt that lacks a mandatory trigger we consider to be "meaningful".

Rating methodology and scorecard factors

Exhibit 5

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 and Brand (25%)								A	Aa
- Relative Market Share Ratio			X						
- Underwriting Expense Ratio % Net Premiums Written				28.3%					
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	24.7%								
- Reinsurance Recoverable % Shareholders' Equity		41.7%							
- Goodwill & Intangibles % Shareholders' Equity		25.5%							
Capital Adequacy (15%)								Aa	A
- Gross Underwriting Leverage		2.6x							
Profitability (15%)								Aaa	A
- Return on Capital (5 yr. avg)	12.2%								
- Sharpe Ratio of ROC (5 yr. avg)		392.9%							
Reserve Adequacy (10%)								Aaa	Aa
- Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd avg)	-11.5%								
Financial Flexibility (15%)								Aa	A
- Financial Leverage	14.9%								
- Total Leverage		24.5%							
- Earnings Coverage (5 yr. avg)	13.1x								
- Cash Flow Coverage (5 yr. avg)									
Operating Environment								Aaa - A	Aaa - A
Aggregate Profile								Aa2	A1

[1] information based on ifrs financial statements as of fiscal ye december 31. [2] the scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis.

Source: Moody's Investors Service, Company Filings

Ratings

Exhibit 6

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	STA
U K INSURANCE LIMITED	
Rating Outlook	STA
Insurance Financial Strength	A1

Source: Moody's Investors Service

Moody's related research

» Moody's upgrades Direct Line's IFSR to A1; stable outlook (May 2019)

» UK P&C Insurance - 2019 Outlook remains stable as robust capital offsets profit pressure from claims inflation and possible regulatory costs (February 2019)

» Proposed personal injury and whiplash reforms are credit positive for UK insurers (March 2018)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 Excluding cash and cash equivalents, property, infrastructure loans and commercial real estate loans.

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