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Direct Line Insurance Group plc: Robust performance notwithstanding significant exposure to UK motor market

RATINGS

Direct Line Insurance Group plc

Guaranteed Subordinated Debt Rating	Baa1 Stable

U K Insurance Limited

Insurance Financial Strength Rating	A2 Stable

KEY INDICATORS

	31/12/13	31/12/12	31/12/11
GWP (£mil)	3,835	4,001	4,168
NWP (£mil)	3,467	3,636	4,168
Net Income (£mil)	313	184	248
ROC (1 yr.)	8.3%	4.5%	6.1%

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Summary

» Direct Line Insurance Group (DLG), rated A2 for insurance financial strength, is significantly exposed to the very competitive UK personal motor market which has consistently made underwriting losses for many years. And yet as competition in this market intensified during 2013, Direct Line's performance was robust with improved profits. The answer to what may appear to be a somewhat counter-intuitive development lies in: 1) the continuation of a transformation journey for the Group which began in 2010 and which has informed some favourable trends in its personal motor book; 2) the benefit of parts of their business yielding income but with no underwriting risk; 3) the fact that the majority of its premium income is not UK personal motor; 4) a multi brand and multi distribution approach.

» We expect these positive factors to continue, although to a lesser extent, to help off-set the challenge of sustaining performance improvements as a result of headwinds from : 1) our expectation that the UK personal motor market will remain inherently very competitive; 2) uncertainty as a result of regulatory probes; and 3) pricing pressure in other lines of business.

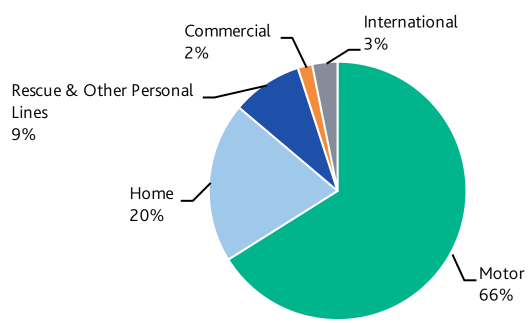
Performance Improvement Despite Significant Exposure to Very Competitive UK Personal Motor Market

DLG is the UK's largest personal lines motor insurer and is heavily reliant on this line of business for its profits

DLG has significant exposure to UK personal motor, a consistently competitive market which at YE12, according to the ABI[1], had not made an underwriting profit since 1994 . DLG is the largest UK private motor insurer with a 14% market share, writing £1.4 billion of gross premium written (GPW) in 2013[2] which represented 37% of its total GPW. Furthermore, DLG is heavily reliant for its profits on this line of business. As illustrated by exhibit 1 below, personal motor represented 66% of DLG's total operating profit at YE13, with an average contribution over the last three years of around 60%.

EXHIBIT 1

YE13 DLG's operating income split



Source: Direct Line

UK personal motor is highly competitive

During 2013, the UK personal lines motor market saw meaningful rate reductions - according to the AA's British Insurance Premium Index, comprehensive car insurance prices fell by 14%.[3] This was driven in part by a continuation of price competition, with increasing amounts of business written via Price Comparison Websites (PCWs), but also by insurers anticipating reduced claims costs following the implementation in 2013 of legal reforms.[4]

The inherently competitive nature of UK personal motor, as well as its vulnerability to bodily injury claims inflation, is illustrated by DLG's combined ratio averaging 114% over the last 5 years.

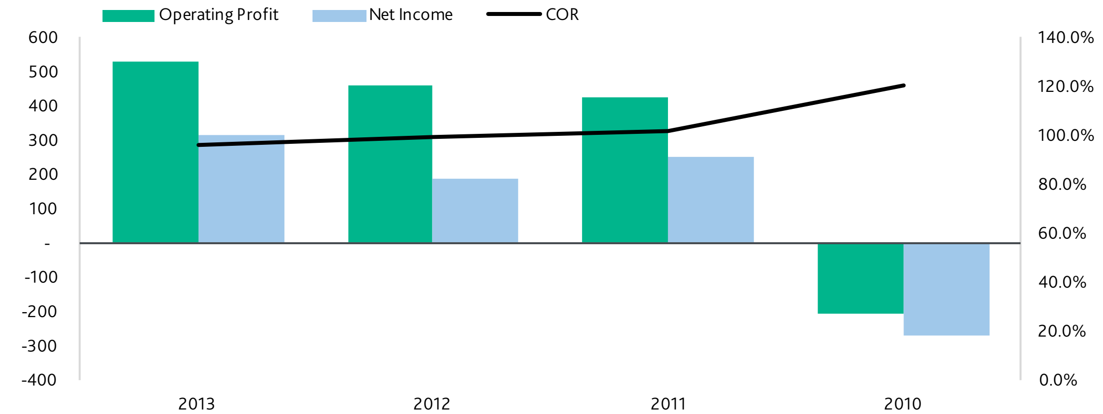
1 Please refer to ABI's "UK Insurance, KEY FACTS 2013" publication

2 YE13 financial information for DLG is derived from DLG's YE13 annual report

3 Please refer to the AA 's press release of 23/1/14.

4 Please refer to Moody's special comment "UK General Insurance: Motor Reforms Might Prompt Reduction in Claims Costs but Elevate Shot-Term Uncertainty," March 2013

EXHIBIT 2
2013-2010 DLG's profit development



Source: Direct Line

Despite difficult motor market, DLG's performance has improved

Notwithstanding the difficult trading conditions in UK personal motor, DLG's overall performance in 2013 was robust. Its net income and operating profit improved by 70% and 14% respectively. Furthermore, DLG reported a lower overall combined ratio 96.1% (YE12: 99.2%), its lowest level for 5 years, and thereby continuing its journey of consistent improvement.

For a company meaningfully exposed to such a competitive line of business as personal lines motor, this may appear somewhat counter-intuitive. This report outlines the contributing factors to these improvements and explains how we see their future development.

Key Factors Contributing to Robust Performance

DLG's positive personal motor trends have more than off-set rate reductions

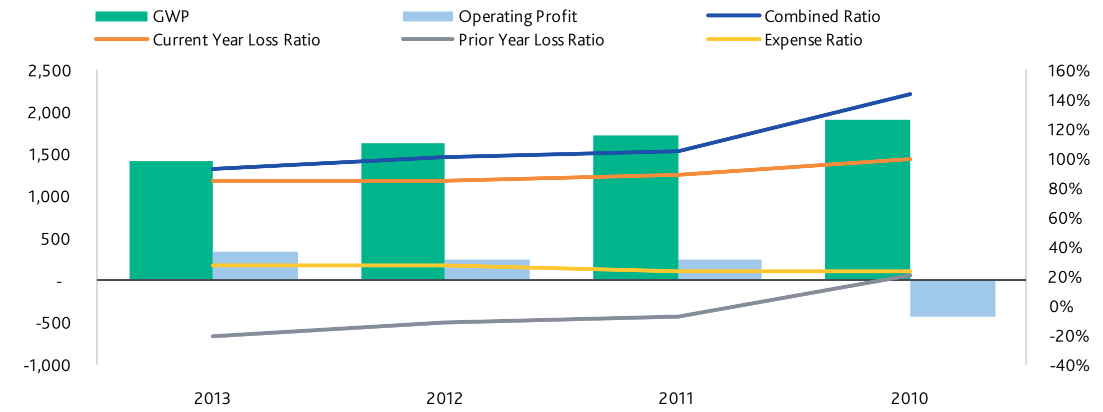
Notwithstanding the very competitive nature of the market during 2013, DLG recorded for personal lines motor: 1) a 33% increase in operating profit; 2) an 8.4% point improvement in the combined ratio to 93.2%; and 3) a stable current year loss ratio. Driving these improvements were:

Recent positive trends in bodily injury claims;

Although DLG reduced its motor prices on average by 3% during 2013, its current year motor loss ratio improved very slightly - benefiting from positive trends in small and large bodily injury claims. This reflects its claims transformation programme, including shorter settlement times and improved legal case management, as well as benefits from recent legal reforms.

Going forward, we expect DLG's personal motor loss ratio to benefit from it maintaining momentum on claims transformation. Also, both the frequency and severity of market-wide motor personal injury claims could reduce going forward as a result of legal reforms, although it will take time for the reform benefits to be fully realised which increases short-term pricing risks.

EXHIBIT 3
2013-2010 DLG's UK personal motor performance



Source: Direct Line

Stronger reserve releases

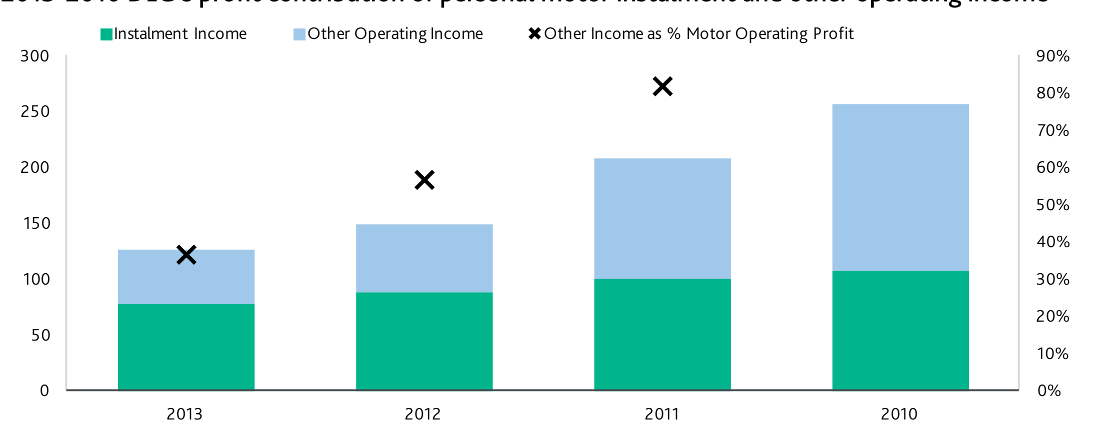
DLG's personal motor operating profit benefited from a substantial £292m (YE12: £174m) of reserve releases, equivalent to 20% (11%) points on the combined ratio. These releases were driven primarily by favourable bodily injury experience for recent accident years, partly attributable to better risk selection and benefits arising from claims transformation .

We expect DLG to remain prudent in its reserving of current accident years and therefore expect reserve releases to remain a meaningful contributor to operating profit, but not to the same extent as the exceptional level in 2013.

DLG materially benefits from additional non-underwriting income generated from its personal lines policies

DLG, like other UK personal motor insurers, is somewhat insulated from the effects of the pricing cycle due to the income it derives from non-underwriting risk activities. Although the amount of this income has consistently reduced since 2010, it was still meaningful in 2013, representing 36% (YE12: 57%) of DLG's personal lines motor 2013 operating profit. If other business lines such as home are included, instalment and other operating income represented 34% (43%) of DLG's 2013 total operating profit.

EXHIBIT 4
2013-2010 DLG's profit contribution of personal motor instalment and other operating income



Source: Direct Line

Instalment income (i.e. interest charged on insurance premiums paid by instalments), the majority of which is derived from personal motor, is the largest component of DLG's other operating income category at over 60%.

DLG's instalment income has been reducing in line with premium trends but still represented 22% of operating profit. Assuming that DLG's personal motor premium at least stabilises from 2015 as the market bottoms out/begins to improve, and subject to any regulatory intervention, instalment income in the future should remain a relatively stable and low-risk source of revenue.

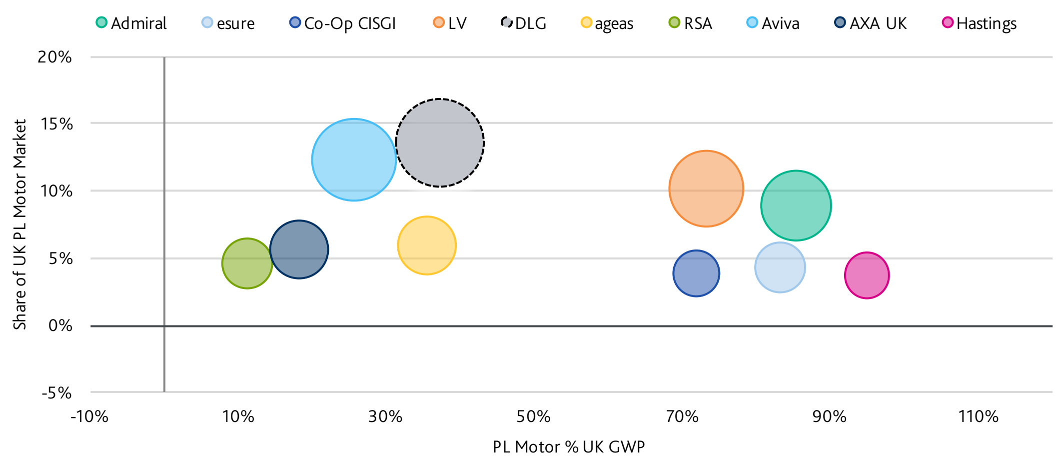
The remaining other operating income components, though less significant, still produced £62m of income in 2013.

DLG is more than just a personal motor insurer

Although DLG is the largest UK personal motor writer, the majority (63% at YE13) of its premium, unlike a number of its peers as illustrated by Exhibit 4 below, is derived away from this business line. DLG is also the UK's largest writer of home business, which represents 25% and 20% of its overall premium and operating profit. Whilst vulnerable to weather event losses (e.g. 2012 and 2014 floods), this home business has been inherently profitable and also benefits from instalment income.

EXHIBIT 5

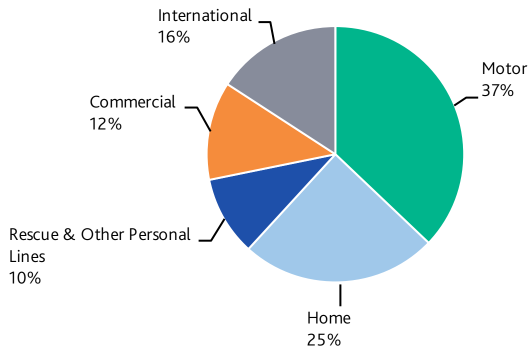
Personal lines motor as a % of total UK GPW



Source: 2012/2013 company reports and regulatory returns, 2012 Association of British Insurers data, and Moody's

DLG also benefits from writing a consistently profitable, albeit small, book of UK motor rescue business, via Green Flag. The Group's remaining Commercial (motor and property packages) and International (personal motor business in Germany and Italy) business lines continued to produce underwriting losses in 2013. However underlying performance has been improving, and both segments are now contributing positively to the Group's operating profit.

EXHIBIT 6
2013 DLG's split of business by gross premium



Source: Direct Line

Going forward, we expect personal motor's contribution to the Group's operating profit to be significant but to reduce as reserve releases reduce, and contributions from other segments improve. For example, DLG is particularly focused on improving the underwriting profitability of its Commercial segment where, assuming a normal level of claims from weather-related events and large losses, it is aiming to deliver a combined ratio of less than 100% in 2014. However, the Group's business line diversification will remain relatively limited in light of the preponderance of personal lines Motor and Home business, and we expect the proportion of UK business to operating profit to remain very significant for the foreseeable future.

Multi-brand and multi-distribution approach

DLG has a multi-brand and multi-distribution approach to selling personal line products. Its personal lines distribution is strong with products sold directly by phone, over the internet, through PCWs, and via partnerships including RBS/NatWest, Nationwide and Sainsburys. Furthermore, its Direct Line and Churchill brands are especially powerful in personal motor.

Direct Line branded business is deliberately not quoted on PCWs, and DLG's market share, especially in motor, has been negatively impacted by the strong market growth in PCWs. However, the fact that the Group sells a significantly higher percentage of its personal lines insurance through phone and internet channels compared with the UK market generally, is beneficial for customer retention and profitability compared to business sold via PCWs. Furthermore, direct customer relationships also allow the Group to better leverage cross-selling opportunities re products such as rescue, pet and travel.

Nevertheless, DLG is also an increasing player through its other brands on PCWs which will help its market share going forward.

But Headwinds To Sustaining Performance Improvement

Going forward, we expect the aforementioned positive factors to continue, although to a lesser extent, to help off-set the challenge of sustaining performance improvements as a result of headwinds from:

UK personal motor market expected to remain inherently very competitive

Competition in UK personal motor remains intense. DLG has reported that its personal motor GPW reduced by 10% in Q1 14 as a result of such competition, and more recently, according to the ABI's average motor insurance premium tracker, the average comprehensive private motor insurance premium was 6% lower than in Q1 13[5]. DLG reported average price reductions of 4% during Q1 14 compared to Q1 13 supported by positive claims trends and technical pricing initiatives.

It now could be that motor pricing does not improve until much later on in the year. This will further challenge profitability in 2014 for DLG which has also incurred an estimated £80m of claims from the UK storm/floods YTD as at Q1 2014.

Our expectation is that UK personal motor will remain as inherently competitive as it has been for many years, characterised by significant distribution via PCWs, and a meaningful number of players. Furthermore, volatility still remains within the external Motor market with large bodily injury claims continuing to be an industry-wide issue, and the number of Periodical Payment Order (PPO) awards continues to increase.[6]

As mitigants, DLG's loss ratio should continue to benefit from its updated technical pricing and improved rating models. Furthermore, the Group's results have and are expected to continue to benefit from expense reductions, and reduced restructuring costs which are forecast to fall from £190m in 2012 to £80m in 2014. The long-term extent of any competitive advantage may however be limited, given that many peers are also cutting costs and investing in pricing tools /claims efficiency.

Regulatory probes create uncertainty

Whilst we view the FCA's recent investigation into add-ons as only a modest credit negative development in itself,[7] it nevertheless represents a continuation of regulatory probes into the practices of UK personal lines insurance. This creates uncertainty and potential profitability headwinds for the industry.

Going forward, we will monitor in particular developments with regard to: 1) the FCA's thematic review into insurance price comparison websites; 2) The PRA's investigation into premium finance – instalment income as discussed elsewhere in this report is a valuable source of income for DLG and other personal lines players although we view instalment income as less pressured in this regard than some other ancillary income; and 3) The Competition Commission's (CC) investigation into the private motor insurance market – it is required to publish its final report by 27/9/14.

We note that one aspect of the CC's investigation is its probe into Credit Hire and garage repair costs. In our view, this adds further pressure to DLG's other operating income which has already been impacted by: 1) the cessation of solicitors' referral income from 1/4/13; and 2) the sale in February 2014 of DLG's stolen vehicle recovery business which produced revenue of £18m in 2013. However, we also note that DLG would benefit from lower claims costs if credit hire fees were banned.

DLG's other lines of business could remain under pressure

Competition is not just restricted to UK personal motor. The UK home market was highly competitive during 2013 with significant premium deflation experienced across the industry. Notwithstanding significant storm/flood claims, we expect such competition to remain in this sector. New capacity, attracted by the historic profitability and less commoditised nature of home business when compared to motor, along with increased distribution via PCWs is exerting pressure on prices.

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5 Please refer to ABI's news release of 30/4/14.

6 Please refer to Moody's special comment "Increase in PPOs: Credit Negative for UK Motor Lines", April 2012

7 Please refer to Moody's Sector Comment: "UK P&C Insurance Add-on Study is Only Modestly Credit Negative, But Continued Regulatory Probes Create Uncertainty for the Industry", March 2014

Competition has also intensified in the Italian motor market following a period of falling claims frequency, and we expect the UK SME commercial market to remain competitive and increasingly price sensitive as e-trading continues to grow.

As with personal motor, in this trading environment, we will monitor the extent to which DLG continues to prioritise targeting appropriate margins at the expense of premium volumes.

Moody's Related Research

Credit Opinion:

» Direct Line Insurance Group plc

Industry Outlooks:

» UK General Insurance Outlook, May 2013 (153419)

» 2014 Outlook – Global P&C Insurance, December 2013 (161170)

Special Comments:

» UK Property & Casualty Insurance: Scorecard, April 2014 (169648)

» European Insurance: Reduced Reserves Releases will Add to Profitability Pressures, June 2013 (155127)

» UK General Insurance: Motor Reforms Might Prompt Reductions in Claims Costs but Elevate Short Term Uncertainty, March 2013(151665)

» Increase in PPOs: Credit Negative for UK Motor Lines, April 2012 (140902)

Sector Comments:

» UK P&C Insurance Add-on Study is Only Modestly Credit Negative, But Continued Regulatory Probes Create Uncertainty for the Industry, March 2014 (165993)

» UK Flood Losses are Credit Negative for Property and Casualty Insurers, February 2014 (163776)

» Record Decline in UK Motor Premium Rates is Credit Negative for General Insurers, January 2014 (163363)

Rating Methodology:

» Global property and Casualty Insurer, December 2013 (161516)

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