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U K Insurance Ltd.

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Outlook: Stable

The stable outlook reflects S&P Global Ratings' view that UKI will continue to maintain capital adequacy at least comfortably at the 'A' level over the next 24 months, per our risk-based capital model. We also expect that UKI will maintain stable earnings during this period, a conservative investment profile, and a strong competitive position in the U.K. non-life market.

Downside scenario

Although we consider a downgrade unlikely in the next two years, we could lower the rating on UKI if:

- Capital adequacy were to fall below the 'A' category and the group was unable or not committed to rebuilding capital to meet our 'A' level requirement; or
- UKI's underwriting profitability and market share significantly deteriorated with combined ratios consistently above 100%.

Upside scenario

We consider an upgrade unlikely in the next two to three years. However, we would consider raising the rating if UKI's management committed to maintaining its capital consistently at the 'AAA' confidence level.

Base-Case Scenario**Macroeconomic Assumptions**

- We forecast U.K. real GDP to increase by an annual average of 1.3% over 2018-2020.
- Although in the longer run we would expect a correlation between GDP and non-life premium growth, over our two-year rating horizon, we anticipate that legal and regulatory changes will prove a stronger determinant of sector profitability and growth.
- Government yields to gradually increase over the next three years, but to remain below long-term historical norms.

Company-Specific Assumptions

- GPW to fall in 2018 due to a lost partnership, but to rise in 2019 and 2020 on the back of own-brand business.
- Financial leverage to remain in the 20%-25% range.
- Reserve releases to continue in the future, but at a lower level.

Key Metrics

	2019F	2018F	2017A	2016A	2015A	2014A
GPW	~3,450	~3,300	3,392	3,274	3,153	3,099
Net income	>390	>380	434	279	580	373
EBITDA fixed-charge coverage (x)	>15	>15	6.8	10.9	16.9	11.4
Financial leverage (%)	25.0	25.0	23.8	23.7	23.7	22.8
ROE (%)	>15	>15	15.6	10.8	21.3	13.3
S&P Global Ratings capital adequacy	Very strong	Extremely strong				
Net investment yield (%)	~2.5	~2.5	2.5	2.5	2.4	2.2
Net combined ratio (%)	88-92	88-92	89.5	94	89.9	92.7
Return on revenue (%)	>15	>15	17.1	11.9	22.5	14.7

A--Actual. F--Forecast. GPW--Gross premium written. ROE--Return on equity.

Business Risk Profile: Strong

The group has demonstrated strong operating performance since its listing in 2012, reflecting its strong position in the U.K. market. In 2017, the group recorded a £539 million profit before tax (2016: £353 million) and a combined ratio of 91.8% (2016: 97.7%). At the same time, the group grew its topline by 3.6%. We expect the group will continue to perform strongly in the future, with combined ratios in the low 90s (the group gives forward guidance of a range of 93%-95%) and profits before tax in excess of £500 million. However, we expect premium will fall slightly in 2018 as a result of the loss of a partnership agreement with Nationwide Building Society. New business sales in Direct Line's own brand business will likely see the group return to growth in 2019.

In February 2017, the U.K. government's decision to change the Ogden rate used to calculate bodily injury claims in England and Wales to a negative 0.75% from 2.5% resulted in a £217 million pre-tax hit to the group's 2016 earnings. The unexpected ruling confirmed our view that the U.K.'s motor insurance sector is exposed to highly volatile claims settlements from bodily injury claims. Although we expect that the Ogden rate is likely to change again in the short term, most likely to somewhere between 0% and 1%, we have not included any impact from the reversal of rates in our forecasts. We also anticipate that the U.K. government's proposed so-called "whiplash reforms," which aim to disincentivize the number of minor, exaggerated, and fraudulent soft-tissue injury claims will pass into law within the next two years. We expect that the reforms may reduce the number and severity of claims but are also likely to lead to a softening in pricing in the market, thus having a muted impact on earnings.

All of UKI's business stems from the U.K. non-life insurance market and, in particular, the personal motor and home markets (which make up close to three-quarters of the group's GPW), where it holds the leading market share. While these markets are large and mature they are characterized by the predominance of so-called price comparison websites (PCWs) in the distribution model--over two-thirds of new motor insurance policies in the U.K. are sourced

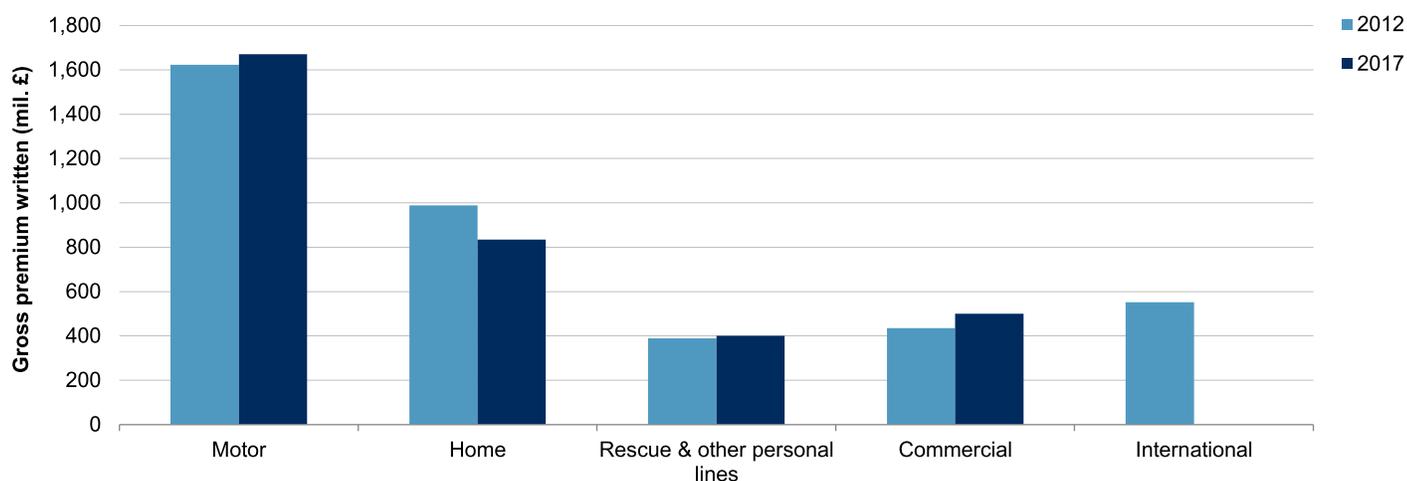
through PCWs. In our opinion, this model lowers entry barriers for new entrants because the need to invest heavily in advertising, a network of offices, salesmen, or broker agreements is limited. While UKI does compete on PCWs through its Churchill and Privilege brands, most of its motor income remains sourced directly (unlike peers such as Admiral and Hastings) through its Direct Line brand. In our opinion, this provides UKI with more control over its revenue streams and robust renewal rates, but comes at the expense of significant outlay in terms of advertising and marketing.

The preponderance of PCWs in U.K. personal line insurance has also led to increased price sensitivity in the market. PCWs' ranking of cover by price has led many customers to view price as the overriding factor when purchasing cover. In the past decade, U.K. motor insurers have found it increasingly difficult to differentiate through brand, service quality, or product features. Consequently, while we acknowledge the strength of UKI's brands (in our view, the most recognized in the U.K. motor and home markets), we believe the importance of brand and reputation in the U.K. motor market in particular is limited compared with other markets in Europe.

While the group has operated in Spain, Italy, and Germany in the past, the size of these operations was limited and over time the operations have been divested. UKI therefore remains comparatively undiversified geographically compared with some of its U.K.-domiciled peers such as Aviva and RSA. In terms of product diversity, UKI has grown its commercial non-life business in recent years. However, it operates mainly in the small and midsize enterprise segment and remains a small contributor to earnings, making up just 12% of operating profit in 2017. UKI's limited diversification in both geographical and product terms is a key constraint to a higher assessment of the group's business risk profile.

Chart 1

Direct Line Insurance Group PLC -- Premium Breakdown



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Financial Risk Profile: Very Strong

We assess UKI's capital and earnings as very strong. Its capital adequacy, per our risk-based capital model, was well above our 'A' confidence level. We expect this position will be maintained in the long term, with the group likely to return excess capital to shareholders through special dividends in the next two or three years. We expect management will at least maintain capital adequacy at our 'A' confidence level through 2018-2020.

The group's quality of capital is robust, and improved in 2017 when it issued £350 million of restricted tier one (RT1) debt and used the proceeds to repurchase £250 million of tier 2 debt in December. Financial leverage only slightly increased as a result, and remains below 24%. We do not forecast a deterioration in the fixed charge coverage ratio because the increase in the absolute amount of debt is offset by the lower coupon on the RT1 notes (4.75%) compared with the fixed coupon (9.25%) on the tier 2 notes.

UKI's financial position also benefits from the diversity of its investment portfolio and minimal exposure to employee postemployment-defined benefits obligations. The credit quality of the investment portfolio is gradually reducing in response to a low-interest-rate environment and a desire to better match asset-liability risk. Nonetheless, it remains strong. Nearly 90% of UKI's investment portfolio is concentrated in bonds and cash. We expect UKI's management will remain committed to its conservative investment strategy and strictly monitor its exposure and adhere to its credit benchmarks and limits allocated.

Other Assessments

The management team, led by Paul Geddes and the new CFO Penny James, continues to exhibit a focused strategy in maintaining its leadership position in the motor and home segments. In our view, management has a very clear strategy and focus on profitability, and is working hard to sustain strong performance in difficult market conditions. DLG's strategy appears to be well thought out and consistent with its organizational capabilities, taking into account market developments.

We hold positive views of the group's overall risk controls, risk model, and strategic enterprise risk management (ERM). However, in our opinion, the importance of ERM to the rating is low because UKI operates in a less complex risk environment than the companies to which we assign a high level of ERM importance. That said, we do not expect the group will experience losses outside its risk tolerance.

Related Criteria

- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- General: Insurer Hybrid Capital Instruments With Nonviability Contingent Capital (NVCC) Features, July 24, 2014
- Property/Casualty: Assessing Property/Casualty Insurers' Loss Reserves, Nov. 26, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013

- General: Enterprise Risk Management, May 7, 2013
- General: Insurers: Rating Methodology, May 7, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions, Oct. 22, 2012
- General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Banks: Assumptions: Clarification Of The Equity Content Categories Used For Bank And Insurance Hybrid Instruments With Restricted Ability To Defer Payments, Feb. 9, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

In addition to the ratings listed below, Direct Line Insurance Group PLC also has in issuance subordinated notes rated 'BBB+' that are guaranteed by the operating company, U K Insurance Ltd.

Ratings Detail (As Of May 3, 2018)

Holding Company: Direct Line Insurance Group PLC

Issuer Credit Rating

Local Currency

BBB+/Stable/--

Subordinated

BB

Operating Company Covered By This Report

U K Insurance Ltd.

Financial Strength Rating

Local Currency

A/Stable/--

Counterparty Credit Rating

Local Currency

A/Stable/--

Domicile

United Kingdom

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