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U K Insurance Ltd.

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U K Insurance Ltd.

Major Rating Factors

Operating Company Covered By This Report
Financial Strength Rating
Local Currency
A/Stable/--

Strengths:

- Extremely strong capital adequacy, as measured by our model.
- Strong competitive position.
- Conservative investment strategy and strong liquidity.

Weaknesses:

- Operating performance is viewed as a weaker component of the rating, despite a notable improvement.
- Although diminishing, execution risk of full divestment from RBS Group (RBSG) which could weaken financial flexibility and capitalization.

Rationale

The ratings reflect our view of U K Insurance Ltd.'s (UKI's) extremely strong capital adequacy, strong competitive position, and strong liquidity. The very strong quality of its investment portfolio is underpinned by conservative investment strategy, but marginally offset by unfavorable investment market conditions. These factors are offset by operating performance which is despite being viewed by us as good, remains a weakness to the ratings, and the remaining execution risk inherent in the divestment from RBS Group (RBSG). UKI is the main operating insurance subsidiary of Direct Line Insurance Group PLC (DLG), formerly 100% owned by RBSG. We use the UKI and DLG names interchangeably in this report. DLG was partially floated in 2012. Under our group ratings methodology, we view UKI as "not strategically important" to RBSG. Therefore its financial strength and issuer credit ratings are in line with its 'a' stand-alone credit profile (SACP). The ratings on UKI remain capped at the level of RBSG's core banks under our group ratings methodology; while RBSG remains its majority owner, any negative rating action on RBSG may be replicated on UKI.

Overall capitalization is very strong, but marginally weakening. UKI's capital adequacy in the first half of 2012 was extremely strong, but under our base-case scenario is expected to weaken gradually over 2013 to a very strong level. Capitalization is also supported by a strong level of reserving and what appears to be an adequate level of reinsurance coverage. That said, it is marginally offset after the partial flotation in 2012 by the remaining execution risk of the full divestment of DLG from RBSG and the potential negative impact of this on the financial flexibility and capitalization of DLG. In our view, UKI has demonstrated a strong financial flexibility by issuing £500 million junior subordinated loan and successfully floating 35% of its shares in difficult market conditions.

DLG's competitive position is strong and supports the rating. The group is one of the market leaders in the personal lines sector in the U.K.; its 2011 market share was about 9%, based on reported Association of British Insurers data. It also has strong positions in the motor and home segments. DLG's leadership and significant market share in these lines of business reflect the strength of its brands and multichannel direct distribution. DLG's reliance on a mature, saturated, and highly competitive U.K. personal lines market with limited growth potential is a relative weakness,

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compared with its international peers. Under our base-case scenario, we expect UKI's gross premium income to continue to decline in 2012 and 2013.

The ratings on UKI also benefit from the very strong credit quality of the investment portfolio, which is in the 'AA' range; the company's conservative investment strategy; and strong asset liquidity. This is marginally offset by unfavorable investment market conditions. We expect continuing low interest rates to cause investment performance and the composition of the investment portfolio to be marginally weaker than previously. Almost all of DLG's investment portfolio was invested in high-quality bonds and cash on Sept. 30, 2012. There is currently no exposure to peripheral European sovereign debt in the investment portfolio, nor is there any equity exposure. This limits market risk and we view it positively.

Standard & Poor's views DLG's operating performance as good and improving, but it remains a weaker component of the ratings. Our base-case scenario envisages net combined ratio in 2012-2014 to be in the range of 99%-101%. We expect the loss ratio to improve significantly to around 66% in 2012 and we expect this ratio to remain at a similar level in 2013-2014. However, we also expect the net expense ratio to remain high, keeping the combined ratio above 100%. This ratio is likely to be higher because of various expenses (excluding exceptional costs) associated with running the company as a stand-alone business, rather than as part of RBSG.

Outlook

The stable outlook is based on our expectation that over our two-year outlook horizon, UKI will continue to maintain capital adequacy that is at least comfortably redundant at the 'A' level, as measured by our capital model, and a strong competitive position that will help it improve and stabilize its operating performance in line with our expectations above.

We are unlikely to take positive rating action during our two-year outlook horizon because to be considered for an upgrade, the company would need to deliver sustainable net combined ratios below 98% while maintaining a growth level above 5% and capital adequacy comfortably redundant at 'A' level; we consider that the company will find it difficult to achieve these simultaneously. Although the execution risk inherent in DLG's divestment from RBSG is reducing, it could still weaken capitalization and damage the company's market-leading franchise. This limits the prospects for an upgrade, although the improvements in operating performance and competitive position cited above would have a far greater effect on upgrade prospects.

We could take a negative rating action if the capital adequacy ratio measured by our capital model falls below the 'A' range, and operating performance does not improve in line with the expectations we outlined above.

As UKI progressively separates itself from RBSG, we will continue to assess it against the insulated subsidiary criteria (see "Group Rating Methodology And Assumptions," published on Nov. 9, 2011) and consider if the ratings on UKI should be progressively or partly delinked from those on RBSG.

Corporate Profile: One Of The Largest Personal Lines Insurers In Personal Lines Market, With A Leading Position In U.K. Motor And Home

UKI is the main operating insurance subsidiary of DLG and is primarily known as "Direct Line Group." It had premium income of £2.1 billion (based on H1 2012; £4.2 billion based on 2011 year-end data). RBSG still owns 65% of UKI after the initial flotation of 35% of its shares in October 2012. RBSG is required to fully divest its ownership by the end of 2014.

U.K. personal lines business accounts for 75.8%, U.K. commercial for 10.5% and international business (Italy and Germany) for 13.7% of DLG's gross premium income in 2011. DLG operates in the U.K. under well-known, market-leading brands like Direct Line, Direct Line for Business, Churchill, Privilege, NIG, and Green Flag. DLG also owns direct insurers in Italy and in Germany, although these are small in absolute terms.

Competitive Position: Strong Competitive Position Is Underpinned By Direct Multichannel Distribution And Leading Position In The U.K. Personal Lines Market

Table 1

U K Insurance Ltd./Competitive Position			
	--Year ended Dec. 31--		
(Mil. £)	**2011**	**2010**	**2009**
Total revenue	4,737	5,538	5,677
Gross premium written	4,168	4,971	5,291
Annual change in gross premium written (%)	(16.15)	(6.05)	N.M.
Net premium earned	4,253	4,974	5,128
Annual change in net premium earned (%)	(14.49)	(3.02)	N.M.
Net premium written	3,911	4,788	5,092
Annual change in net premium written (%)	(18.30)	(5.97)	N.M.

N.M.--Not meaningful.

We consider that DLG's competitive position is strong and supports the rating. The group is one of the market leaders in the personal lines sector in the U.K. and has strong positions in its motor and home segments. DLG's leadership and significant market share in these lines of business reflects the strength of its brands and direct multichannel distribution, complemented by multiyear partnership agreements with well-known brands and financial industry leaders.

In our view, DLG's reliance primarily on a mature, saturated, and highly competitive U.K. personal lines market with limited growth potential, is a relative weakness, compared with its international peers. This therefore limits our assessment of its competitive position to "strong." We expect DLG to maintain its strong competitive position in the U.K. personal lines markets, regardless of economic conditions and industry cycle.

DLG's international presence outside the U.K. is limited--it operates only in Italy and Germany, but lacks scale in these markets. We do not expect DLG's international operations to grow materially over our five-year rating horizon to support material improvement in the competitive position.

Market leadership and scale advantages

As one of the market leaders in the personal lines markets, DLG gains sustainable competitive advantage through its scale (operational scale, claims purchasing power, and data scale), in our view. Although DLG's scale has materially reduced since 2009, we consider it sufficient to gain sustainable competitive advantages. These advantages enable the group to exercise economies of scale in pricing, claims management procurement, and wider costs. Historical claims data on such a large scale also enables DLG to price more accurately.

Diversity of its strong brands, multichannel distribution, and comprehensive product range

DLG's strong competitive position in the U.K. benefits from a diversity of its well-known brands within particular segments of the population or market, like Churchill (in personal lines), Direct Line (in both personal and commercial lines), and NIG (in commercial lines), and a strong distribution network dominated primarily by its own brands.

Even in the commoditized, price-focused market where aggregators are increasingly influential, we believe that brands can remain a differentiating factor. DLG's competitive position is further supported through strong multiyear partnerships with companies including RBS/NatWest, Prudential, Sainsbury's, and Nationwide. The company has also established strong working relationships with the broker community through the NIG brand, which caters for the commercial segment. This brand and distribution channel diversity is further complemented by a comprehensive product range.

Lower acquisition costs, compared with peers

We consider that its market-leading brands and direct distribution channels create material competitive advantages for DLG by enabling it to lower its acquisition costs below those of its peers. This is, however, partly offset by a significant marketing spend. Furthermore, quotes and purchase data obtained by DLG through multiple brands and channels gives DLG greater understanding of its customer behavior, enabling it to improve segmentation and develop better pricing.

High retention levels

DLG's strong market segmentation and its customers' brand loyalty, means that its competitive position benefits from a good customer retention level in the competitive U.K. motor market. This has helped the company to lower its acquisition costs and maintain market share in its major motor and home markets.

Competitive position relative to other international insurers

In our view, DLG's competitive position is somewhat weaker than the global multiline insurers, like Aviva, RSA, Allianz, AXA, and Zurich, due to its concentration in the non-life segment and its limited geographic scale. The group is also much smaller in relative terms than these peers.

Prospective

We expect DLG to maintain its strong competitive position over the rating horizon. This is despite ongoing competition in the U.K. mature personal lines market, and economic conditions that continue to restrict growth. Based on our base-case scenario, we revised our expectations for growth for DLG and anticipate that gross premium income will continue to decline in 2012 and 2013 as management's strategy is value-, rather than volume-driven. This in our view, should not have a negative impact on the competitive position, since we expect a material improvement in loss ratios during the same period arising from a better-quality underwriting portfolio. That said, we expect DLG to return to growth level of about 3%-5% in 2014 to maintain its competitive position going forward.

We do not anticipate that UKI will make any material acquisitions over the rating horizon.

Management And Corporate Strategy: Strong Management Team With Well-Thought-Out Strategy, The Sustainability Of Which Has Yet To Be Proven

We believe that the executive team, headed by Paul Geddes, is convincingly establishing a track record following a notable turnaround in DLG's operating performance in 2011 after it reported poor results in 2009 and 2010, successful issuance of junior subordinated debt in April 2012 of £500 million, and oversubscribed flotation of 35% of DLG's shares in October 2012. It is building a stable foundation for the group to continue as a stand-alone enterprise after final divestment from RBSG before the end of 2014. In our view, the management team has a very clear strategy and focus on profitability, and is making every effort to restore performance to its strong historical levels, which we view positively.

Strategic positioning

The management team is concentrating its strategy on delivering a sustainable profitable operating performance through underwriting excellence and a strong grip on costs going forward. Looking forward, the priority for management is to deliver the business strategy and to lead the company through the proposed divestment of the remaining shares currently owned by RBSG in very testing capital market conditions. In our view, DLG successfully separated itself operationally from RBSG, although the costs of this separation are higher than initially estimated. Its strategy appears to be well-thought-out and consistent with the organization's capabilities, taking into account market developments. However, the sustainability of the strategy has yet to be proven over the next two to three years, particularly with regard to growth targets.

We do not anticipate that DLG's strategy will change materially from that publically announced in the next 12-24 months. We also expect that DLG, as it currently stands, is capable of delivering on its stretching, but achievable, targets thanks to its executive management team's "depth and breadth." The economic and market conditions are outside management's control, however, and may cause the group to miss some targets. We anticipate that the group will deliver on its operating performance targets throughout 2012-2014.

Operational effectiveness

DLG's senior management team is relatively new, but all members of the team have extensive industry experience and an established track record of achievements in their previous jobs. Based on the recent performance of the group, they appear to work well together. As a major non-life insurer, DLG can attract high-quality employees. It also places significant emphasis on the training and development of its employees. In our view, management is also effectively dealing with the operational challenges and potential costs of divestment, particularly with regard to establishing stand-alone information technology and operating systems.

Financial management

DLG's financial management is appropriate, in our view. In our opinion, the group maintains an adequate reinsurance program, conservative reserving, and an appropriate investment strategy. DLG has outlined comprehensive and sophisticated financial standards and risk tolerances; these are in the process of being fully embedded. DLG has predetermined limits for all significant risks and detailed guidelines for effective operational management of the business. Based on our base-case scenario and earnings expectations, we expect DLG to have a financial leverage ratio of about 15% and fixed-charge coverage ratio of about 11x in 2012; both are well in line with its rating level. Fixed-charge coverage is likely to fall to 8x in 2013-2014, but it will remain well in line with interest coverage tolerances in a low interest rate environment for an 'A' rated company.

Enterprise Risk Management: Adequate, With Strong Risk Controls

Given the substantial reserve strengthening in 2009 and 2010, we view enterprise risk management (ERM) as being of high importance to DLG.

We consider that DLG is in the process of embedding what we expect to be a "strong" stand-alone ERM framework based on adequate risk culture, and strong overall risk controls. The implementation of its stand-alone framework commenced in Q1 2012.

In our opinion, DLG's risk culture is "adequate," supported by a demonstrated commitment to risk management by the board of directors and a robust governance structure that is being embedded in the business through high-level controls documents, risk committees, roles and responsibilities and regular reporting. The ERM function and the chief risk officer (CRO) have significant influence. The framework still needs to be fully embedded before we can score it as "strong."

Standard & Poor's scores overall risk controls at DLG as "strong" due to strong scores for controls related to individual risks, underwriting, reserving, and risk models, in particular. The group's strong reserving process is somewhat offset by the reserve increases in 2009 and 2010.

Accounting And Financial Reporting: Conservative, With Very Good Disclosure

UKI produces consolidated financial statements in accordance with International Financial Reporting Standards (IFRS). We consider its disclosure to be very good; it uses channels including the group Web site, interim financial statements, and investor presentations.

Standard & Poor's made the following material adjustments to reported and projected shareholders' equity to calculate total available capital (TAC) as of Jun. 30, 2012, estimated for 2012 and 2013:

- The discounted non-life loss and unearned premium reserves added to TAC;
- A net charge made for a one-in-250-year property aggregate catastrophe loss;
- A 50% credit given quantitatively in the capital model for reserve prudence; and
- Capital movements and dividend payments used in our projections were as projected by the company.

Operating Performance: Operating Performance Is A Weakness For The Rating

Table 2

U K Insurance Ltd./Operating Performance			
	--Year ended Dec. 31--		
(Mil. £)	**2011**	**2010**	**2009**
Return on revenue (%)	6.6	(7.6)	1.5
Return on revenue including realized and unrealized gains/(losses) (%)	7.2	(6.7)	2.4
Return on revenue including realized gains/(losses) (%)	7.5	(6.4)	2.7
Return on equity (%)	6.8	(7.7)	3.7
EBIT adjusted to Total equity adjusted (%)	8.5	(11.9)	2.4
EBITDA adjusted to Capital (%)	9.0	(9.7)	N/A
EBIT	345.6	(375.4)	136.6
EBIT adjusted	313.3	(421.5)	85.3
EBITDA	396.0	(334.0)	237.1
EBITDA adjusted	363.7	(380.1)	185.8
Net loss ratio (%)	69.8	93.1	81.6
Net acquisition expense ratio (%)	12.2	7.6	10.9
Administrative expense ratio (%)	21.0	18.5	18.8
Total net expense ratio (%)	33.2	26.1	29.7
Net combined ratio (%)	103.0	119.1	111.3
Net investment yield (%)	2.2	2.6	N/A

N/A--Not applicable.

Standard & Poor's views DLG's operating performance as good, and expects it to improve over the medium term, based on our base-case earnings forecasts.

Our base-case scenario envisages net combined ratio in 2012-2014 to be in the range of 99%-101%. We expect the loss ratio to improve significantly to about 66% in 2012 and we expect this ratio to remain at a similar level in 2013-2014 due to the company's strong action to increase motor pricing, reduce risk in the book, and exit from unprofitable businesses in motor in 2010 and 2011. However, we expect that net expense ratios, although underpinned by strict cost controls, will continue to keep combined ratios around 100% as the group suffers costs associated with running the company as a stand-alone business, rather than as part of RBSG.

Operating performance was historically volatile. Prospectively, performance may continue to be tested by lower growth prospects, which will put pressure on the expense base and underwriting margins. This is a weakness for the ratings and will remain so until the company can demonstrate a profitable, sustainable trend compared with peers over the cycle. We expect underwriting and operating results to improve, but would require ongoing underwriting discipline and an effective operational base to consider them sustainable. That said, we note that DLG undertook a number of positive steps in 2010-2012; reserving these accident years conservatively, reducing exposure to the worst-performing risks, and repricing its motor account. The above changes were made to enable it to avoid repeating its performance of 2009 and 2010, when it was hit by the industrywide increase in bodily injury costs and by soft market conditions. It posted net combined ratios of 111% in 2009 and 119% in 2010.

Low interest rates have also cut into DLG's investment income and may in our view reduce further as interest rates remain low.

Investments: Conservative Investment Portfolio, With Almost All Being Invested In High-Quality Bonds And Cash

Table 3

U K Insurance Ltd./Liquidity And Investment Statistics			
	--Year ended Dec. 31--		
(%)	**2011**	**2010**	**2009**
Invested assets to total assets	83.89	81.75	79.62
Invested assets to loss and unearned premium reserve	142.24	125.75	127.89
Real estate investments to capital	2.14	2.84	2.53
Total invested assets adjusted (mil. £)	10,930	10,755	10,086
Investment portfolio composition			
Cash and cash equivalents	26.25	26.08	26.39
Total bonds	67.01	65.08	62.39
Real estate	0.64	0.78	0.77
Total mortgages and loans	2.59	4.61	6.80
Other investments	3.50	3.45	3.64
Total portfolio composition	100.00	100.00	100.00

N/A--Not applicable.

In our opinion, DLG's investment portfolio (£9.5 billion as of Sept. 30, 2012) is conservative. Nearly 100% of its investment portfolio was concentrated in high-quality bonds and cash and the weighted-average credit quality of the total portfolio was in the 'AA' range. The very strong quality of the investment portfolio is marginally offset by unfavorable investment market conditions.

Of the portfolio, 74% is invested in bonds, 11% in cash, and 16% in money-market funds. The weighted-average credit quality of the bond portfolio is 'AA' (spread primarily across bonds rated from 'BBB' to 'AAA'. There is a minimal exposure to 'BB' rated bonds. The fixed-income portfolio is also well-diversified across sectors. There is currently no exposure to peripheral European sovereign debt. In addition, there is currently no equity exposure, limiting market risk; we view this positively. As the investment portfolio is low-risk, it is yielding low returns.

DLG's asset and liability management is good, in our opinion. The average duration of the investment portfolio was 2.2 years on Dec. 31, 2011, which broadly matches the average duration of claims. The group's periodic payment orders are a known mismatch. At present, DLG does not have a portfolio to match these long-tail liabilities, but it is taking action to address this mismatch.

We do not expect any material changes in the investment strategy going forward.

Liquidity: Strong, Positive Cash Flow, And Liquid Portfolio

We regard UKI's liquidity as strong, and revised the score upward within the 'A' range. UKI has positive cash flows and a high proportion of liquid assets compared with its maximum net underwriting exposure for one-in-200-year events (where possible maximum loss would be around £200 million versus £2.5 billion invested into cash and money market funds). UKI demonstrates a strong track record of liquidity measured by invested assets/loss and unearned premium reserve (see table 3).

We do not expect any material changes in liquidity over the rating horizon. UKI has a nil appetite for liquidity risk. The business has some small overdrafts.

Capitalization: Expected To Remain At Least Very Strong

Overall capitalization is very strong. UKI's capital adequacy at June 30, 2012 and its estimated capital adequacy at year-end 2012, based on Standard & Poor's capital model, are extremely strong and estimated capital adequacy at year-end 2013 is very strong. The very strong level of capitalization is supported by a strong level of reserving and what appears to be an adequate level of reinsurance coverage. However, it is still offset by the execution risk of the full divestment of DLG from RBSG and the potential for this to weaken DLG's financial flexibility and capitalization.

Capital adequacy

As of June 30, 2012, DLG's risk-based capital coverage ratio was 160%. On an Insurance Group Directive (IGD) basis, it was 306%. We have also estimated the capital adequacy ratio for 2012, assuming various dividend payments, incorporating profit for the year and the company's capital plans. UKI has capacity to issue more hybrid equity within total adjusted capital, according to Standard & Poor's capital model (current hybrid equity ratio is 15.1%). The capital adequacy ratio calculated by our capital model appears to be resilient to various movements in shareholders' funds. An aggregate property catastrophe charge at a one-in-250-year return period has been included in the model, but total adjusted capital is relatively insensitive to this number.

Reserves

Reserves are considered strong. In our opinion, UKI factored a prudential margin into the reserves in 2010, following the need for reserve strengthening of the bodily injury reserves in 2009/2010. In 2011, reserves remained stable.

Reinsurance

The reinsurance protection is considered adequate for the business profile. UKI's catastrophe cover for 2012 implies a maximum net loss (including reinstatement premium) which equates to less than 9 percentage points of capital. We view this as prudent. The catastrophe program has a return period of 200 years. The chief risks covered are windstorm and coastal inundation loss, including includes property and motor damage. The quality of reinsurers, in our opinion, is high.

Financial Flexibility: Strong, But Unproven

In our view, UKI's financial flexibility strengthened further over 2012, based on its good and prospectively improving earnings, very strong level of capitalization, limited usage of reinsurance and low levels of financial leverage. Furthermore, UKI's ability to raise additional funds or access capital markets has been tested and proven in 2012 following the issue of junior subordinated loan and oversubscribed partial flotation of its shares. We see no reason to doubt UKI's ability to successfully access capital markets or to place its remaining shares in the market. We do not anticipate any material capital repatriation, or dividend payouts in excess of those planned and budgeted for by DLG ahead of divestment, nor do we factor in any support from RBSG before the divestment.

Ratings Detail (As Of February 20, 2013)	
Operating Company Covered By This Report	
U K Insurance Ltd.	
Financial Strength Rating	
Local Currency	A/Stable/--
Counterparty Credit Rating	
Local Currency	A/Stable/--
Junior Subordinated	BBB+
Domicile	United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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