

ISSUER IN-DEPTH

4 July 2019

 Rate this Research

RATINGS

Direct Line Insurance Group plc

Backed subordinate	A3(hyb)
Pref. stock non-cumulative	Ba1(hyb)

UK Insurance Limited

Insurance financial strength	A1
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Source: Moody's Investors Service

KEY METRICS:

GBP million

	2018	2017	2016
Net income - Shareholders	457	434	279
Total Shareholders' Equity	2,920	3,062	2,522
Gross Premiums Written	3,212	3,392	3,274

Source: Direct Line statements as of Fiscal YE December 31

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Direct Line Insurance Group plc

FAQ: Direct Line to maintain profitability despite competition, change in profit drivers

We believe that UK non-life insurer Direct Line will maintain its strong profitability despite its dependence on the very competitive and highly regulated UK personal motor market, where claims inflation is increasing, and there is uncertainty around the outcome of a regulatory review of pricing practices. Our view takes into account a far-reaching technology transformation at Direct Line, and a change in its profitability drivers. In May 2019, our views led us to [upgrade](#) the insurance financial strength rating (IFSR) of Direct Line Insurance Group plc's (Direct Line or Group) main operating subsidiary, UK Insurance Limited (UKI), to A1 from A2.

Below we answer frequently asked questions regarding Direct Line, and the factors affecting our assessment of its credit strength.

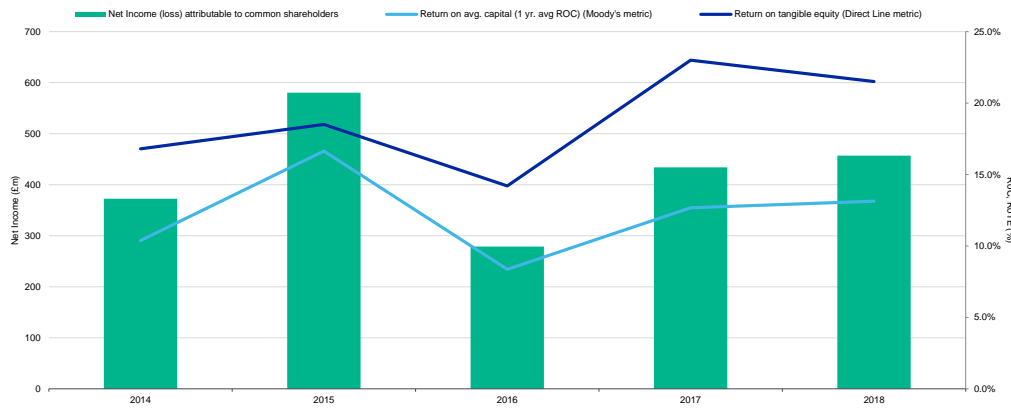
Will Direct Line maintain its strong profitability, given intense UK motor market competition?

We expect Direct Line to counter headwinds in the UK personal lines motor and home markets by continuing to prioritize target loss ratios over premium volumes. This disciplined approach should allow the group to continue to meet its return on tangible equity (RoTE) and underwriting targets. The company will also benefit from its strong brands, and from its efforts to combat fraud and reduce costs.

Furthermore, Direct Line's reported expense ratio (see Exhibit 2) fell by 4.9 percentage points to 29.9% in 2018 (2017: 34.8%). The ratio remains relatively high, but we expect it to continue falling thanks to a combination of top-line growth and ongoing efficiency initiatives. Direct Line aims to reduce operating expenses to below £700 million in 2019.

Direct Line's track record of strong profitability is a supportive factor in estimating its future performance. In 2018, the company's return on capital (ROC, Moody's definition) improved to c.13% from an average of 12% over the 2014-2018 period, helped by the Group's second highest after tax profit in the last 10 years. Direct Line has also consistently exceeded its return on tangible equity (RoTE) target of >15% (see Exhibit 1).

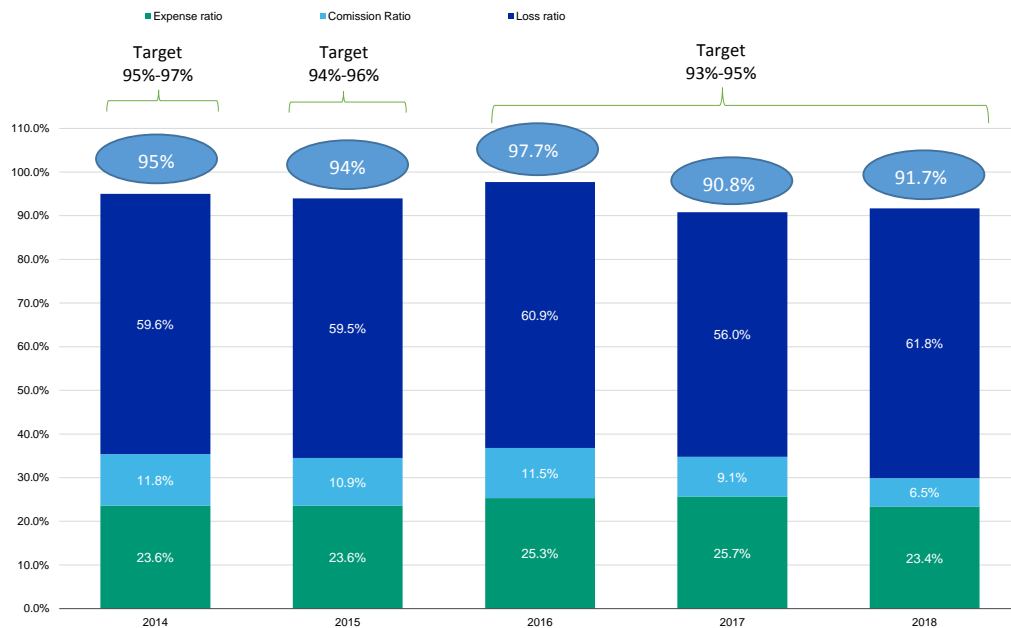
Exhibit 1
Direct Line's Net Income, Return on Capital (1 yr. avg.) and Return on Tangible Equity



Source: Moody's Investors Service, Direct Line Group

From an underwriting perspective, the Group has met or improved on its target combined ratio (COR - net claims and expenses as a proportion of net earned premium) each year since 2013, excluding the impact in 2016 of a change in the Ogden discount rate used to calculate bodily injury awards (See Exhibit 2). Direct Line's combined ratio target is currently 93-95%. In 2018, a reversal of the benign motor conditions in 2017 helped contribute to an increase in the loss ratio as did a reduction in Home partnership business although the reduction of this business in turn helped reduce the commission ratio.

Exhibit 2
Direct Line's combined operating ratio, 2014-2018



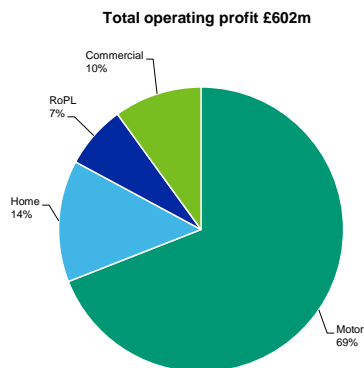
Source: Direct Line Group

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What are the headwinds Direct Line faces in the UK personal lines markets?

Direct Line's focus on the UK's extremely competitive and highly regulated personal lines motor market exposes it to significant headwinds. Direct Line is, and we believe will remain, dependent on this market, which accounted for 69% of its 2018 operating profit (see Exhibit 3).

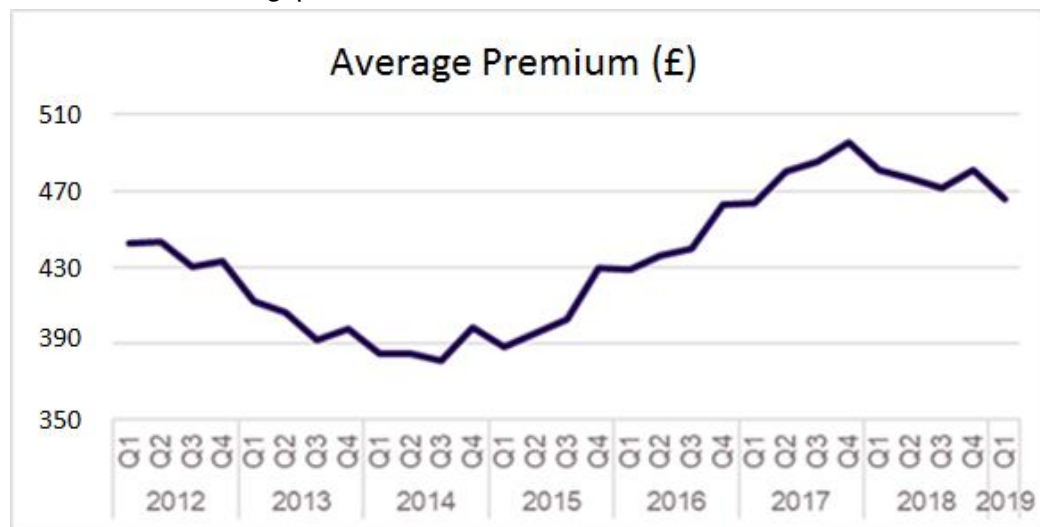
Exhibit 3
Direct Line's YE18 operating profit by segment



Source: Direct Line Group

The UK personal lines motor market has been characterised by intense competition and underwriting losses over many years. However, the rise of price comparison websites (PCWs), which now account for most motor insurance sales, have recently exacerbated this competitive pressure, and we also note the increased presence of large and efficient players such as Allianz in the UK P&C market including motor. High claims inflation, estimated by Direct Line at 3-5% annually over the long-term, is a further headwind. This is due to increased repair costs as a result of the growing complexity of in-car technology, and a weaker pound, which drives up the cost of imported vehicle parts. Direct Line and its peers face the challenge of increasing their prices sufficiently to outweigh rising claims within an inherently competitive market and where premiums have been under pressure (See Exhibit 4).

Exhibit 4
UK motor insurance average premium, 2012 - Q1 2019



Source: ABI

The UK motor market is also subject to significant regulatory change. There is particular uncertainty around the final outcome of an ongoing review of the Ogden rate, and of a Financial Conduct Authority (FCA) inquiry into general insurance pricing practices (See Exhibit 5).

The FCA, due to announce its views on pricing this summer, may propose restrictions on the widespread industry practice of charging lower prices to new customers than to existing policyholders. We expect any measure that restricts back-book profit margins to result in higher prices for new customers. The net impact on Direct Line, which has a mature home insurance book, is uncertain.

Exhibit 5

Pending regulatory reforms are a wild card

FCA market study on pricing practices	Delayed whiplash reforms	Ogden discount rate to be finalised
<ul style="list-style-type: none"> » In summer 2019, the regulator may decide to propose restrictions on insurers charging different prices to new and existing customers (“dual pricing”) » We expect insurers to remain disciplined, with any actions to curtail back-book profit margins resulting in new business price rises. But the net impact is uncertain, especially for insurers with mature home insurance books 	<ul style="list-style-type: none"> » The implementation of reforms to reduce the number of fraudulent and exaggerated whiplash claims has been delayed by one year until April 2020 » While the reforms are credit positive, the delay heightens pricing risk and adds pressure on motor profit margins, as insurers have already passed some cost savings to customers by lowering rates 	<ul style="list-style-type: none"> » In 2018, the UK government proposed to raise the Ogden discount rate, used to calculate insurance awards in serious bodily injury cases, to between 0% and 1%, having lowered it to minus 0.75% in 2017 » A higher rate may enable insurers to release some of the additional reserves set aside in 2017 and will help alleviate claims inflation

Source: Moody's UK P&C Insurance Outlook, February 2019

What are the key risks to Direct Line's profitability targets?

An anticipated decline in prior year reserve releases, which accounted for close to 70% of group operating profit in 2018 and 2017 (see Exhibit 6), poses a potential threat to Direct Line's earnings performance.

Exhibit 6

Composition of Direct Line's operating result, 2016-2019 (£m)

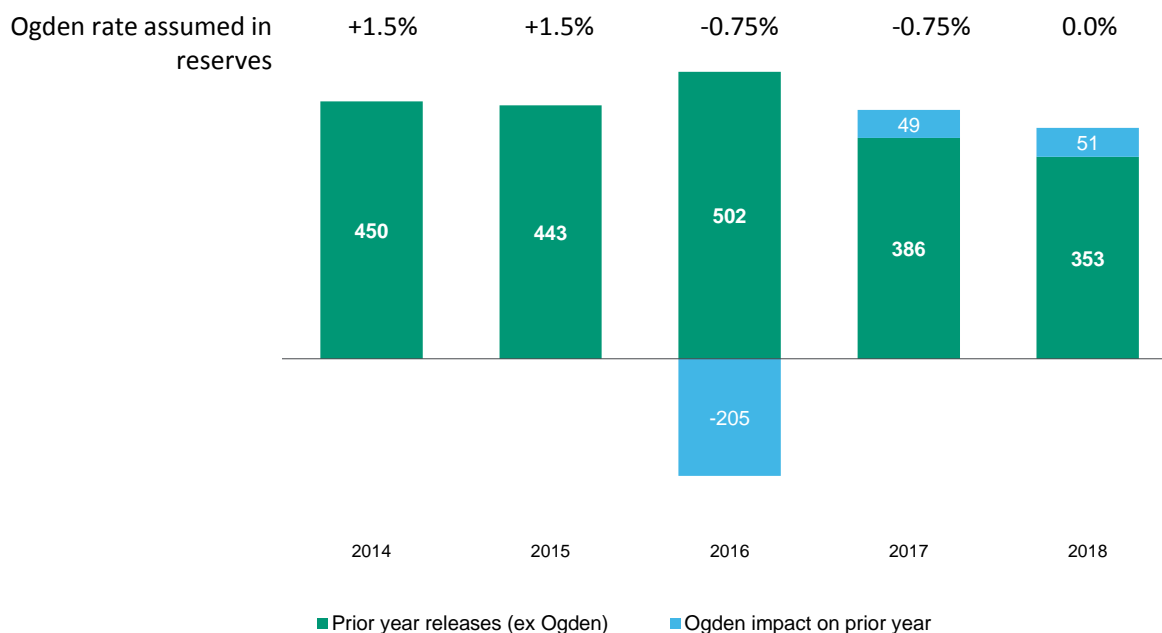


Source: Direct Line Group

In 2018, the Group's prior year releases fell to £404 million, or £353 million excluding the impact of a change in the Ogden rate assumption, from £435 million the previous year (see Exhibit 7). In future, releases will likely fall further, in line with a recent increase in Direct Line's level of excess of loss reinsurance to cover potentially costly bodily injury claims. Increased use of reinsurance means that Direct Line relies less on its own capital to cover such claims, reducing the level of net reserves which need to be set aside.

Exhibit 7

Direct Line's prior year release amounts, 2014-2018 (£m)



Source: Direct Line Group

For a Group whose operating profit has historically been heavily supported by a large annual contribution from prior year releases, this shift is significant. Although the pace of the slowdown in reserve releases is likely to vary year by year, and will be offset in part by the benefit to current year underwriting results of enhanced reinsurance protection, it puts Direct Line under pressure to achieve counterbalancing improvements in its current year loss, expense and commission ratios. The company will also likely seek additional growth via its new PCW trading hub, and its rescue and direct SME commercial businesses.

A further challenge is that Direct Line's investment income continues to decline, falling to £155 million in 2018 from £175 million the previous year. The company's investment performance will remain under pressure in 2019, with the Group projecting a flat yield of 2.0% and gains significantly lower than 2018. Direct Line benefits from a relatively stable and low-risk source of revenue in the form of instalment income (interest charged on insurance premiums paid in instalments, which many of the Group's policyholders elect to do). This accounts for about 20% of operating profit. If the Group can grow its personal lines business, ensuing growth in instalment income will help compensate for lower investment income.

Direct Line's profitability could get a further boost from an ongoing programme to upgrade its major IT systems, and better integrate them within its technology infrastructure. Its successful completion would deliver:

- > Additional pricing sophistication
- > Further reduction in fraud
- > Improved efficiency via digitalisation
- > Improved customer experience
- > Price comparison website growth

The programme is ambitious and large in scale, but is thus far going to plan.

Will the expected reduction in prior year reserve releases weaken Direct Line's reserve adequacy?

The anticipated decline in Direct Line's reserve releases will have a negative impact on our reserve adequacy metric. However, as confirmed by the company during its YE18 analysts call, its reserving philosophy is still to set its initial reserves at the prudent end of the best estimate range.

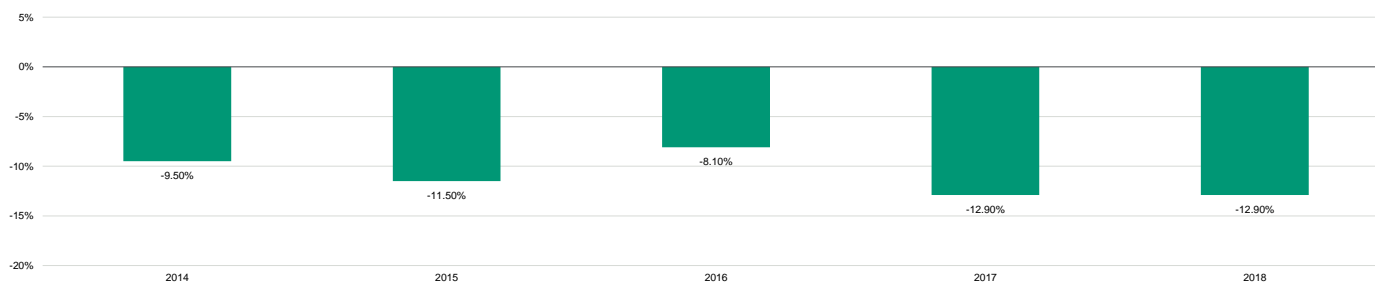
In view of this, and given Direct Line's prudent reserving approach in current accident years, we expect reserve releases to remain a material contributor to operating profit, and for reserve adequacy to remain one of the company's relative strengths. This is reflected in our adjusted reserve adequacy score of Aa.

Even so, volatility will likely remain a characteristic of Direct Line's UK motor portfolio. We will monitor the outcome of the latest Ogden rate consultation, as well as any changes in the frequency of periodical payment order (PPO) awards by the UK courts. Under a PPO, the insurer must pay compensation to bodily injury claimants at regular intervals rather than in a lump sum, bearing responsibility for investment, inflation and longevity risk. PPOs can be more onerous than lump sum payments, as they are sensitive to the choice of inflation and discount rate used, with small rate changes resulting in material valuation differences.

Direct Line has consistently reported significant prior-year reserve releases since 2011 (see Exhibit 8), as reflected in its 5-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.

Exhibit 8

Direct Line's 1-year reserve releases as a % of opening net reserves, 2014-2018 (Moody's metric)



Source: Moody's Investors Service, company filings

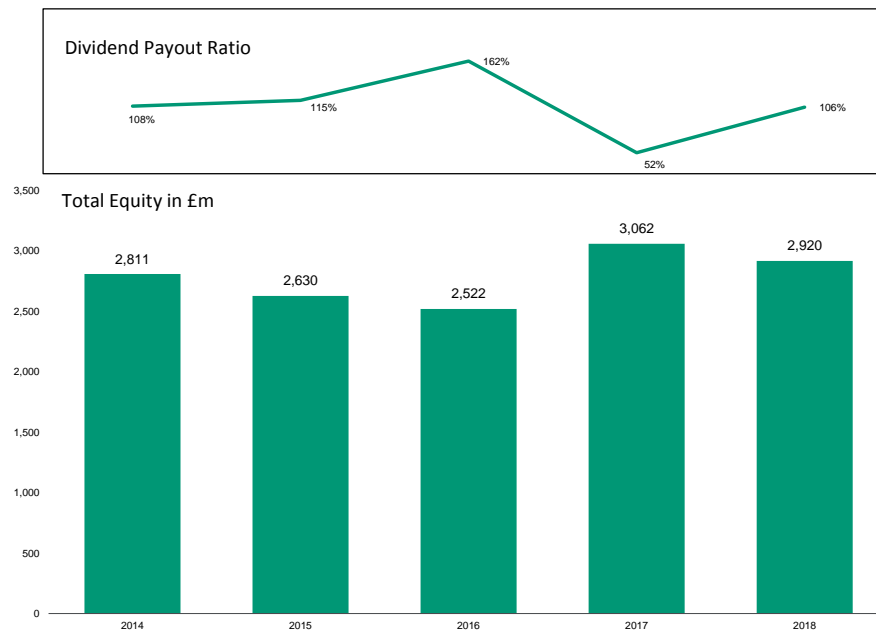
To what extent will Direct Line's dividend policy pressure its capitalisation and financial leverage?

Direct Line's total equity fell by around 5% to £2.9 billion in 2018, weighed by dividend payments of £504 million, exceeding the company's profit for the year of £474 million. This confirms a trend, with the company paying out more to shareholders than it earned in four of the last five years. Total shareholder payouts exceeded net income by an average of 9% during the 2014-2018 period, partly fuelled by special dividends in every year except 2017 (see Exhibit 9).

We expect a continuation of this general strategy, negatively affecting shareholders' equity, and potentially pressuring a number of our financial metrics.

Exhibit 9

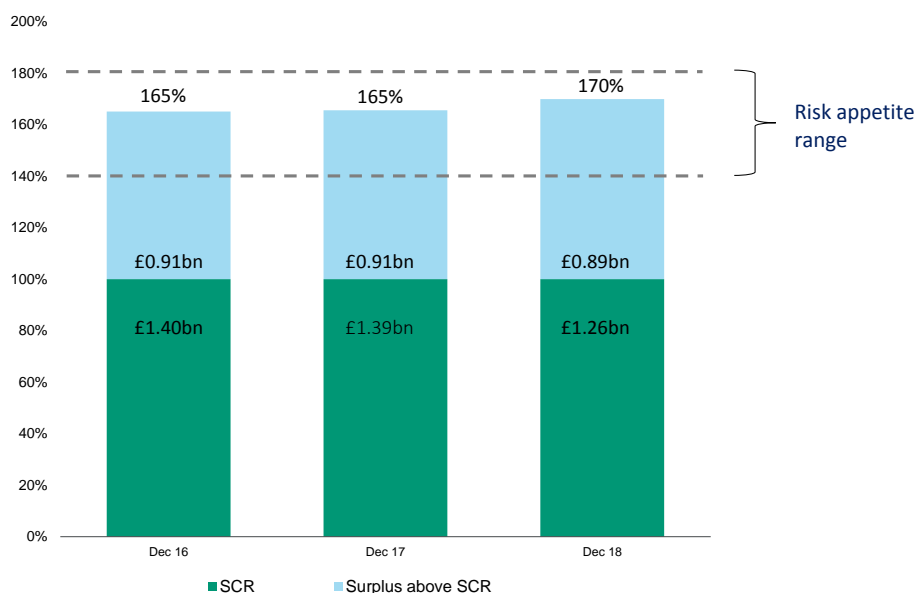
Direct Line's total equity development, and dividend payout ratio, 2014-2018



Source: Direct Line Group, Moody's Investors Service

Nevertheless, we expect Direct Line's Solvency II ratio to remain robust. At YE18, the post-dividend ratio was 170% (see Exhibit 10), reflecting the group's policy of remaining towards the upper end of its 140-180% target range, given current political and economic uncertainty. Over the short-to-medium term, we expect the ratio to move towards the middle of the range. While Direct Line's own funds will fall as a result of dividend payments, the decline will be partly offset by the solvency capital requirement benefiting from lower net reserve risk because of the greater level of reinsurance cover.

Exhibit 10
Direct Line's Solvency II ratios YE16-YE18

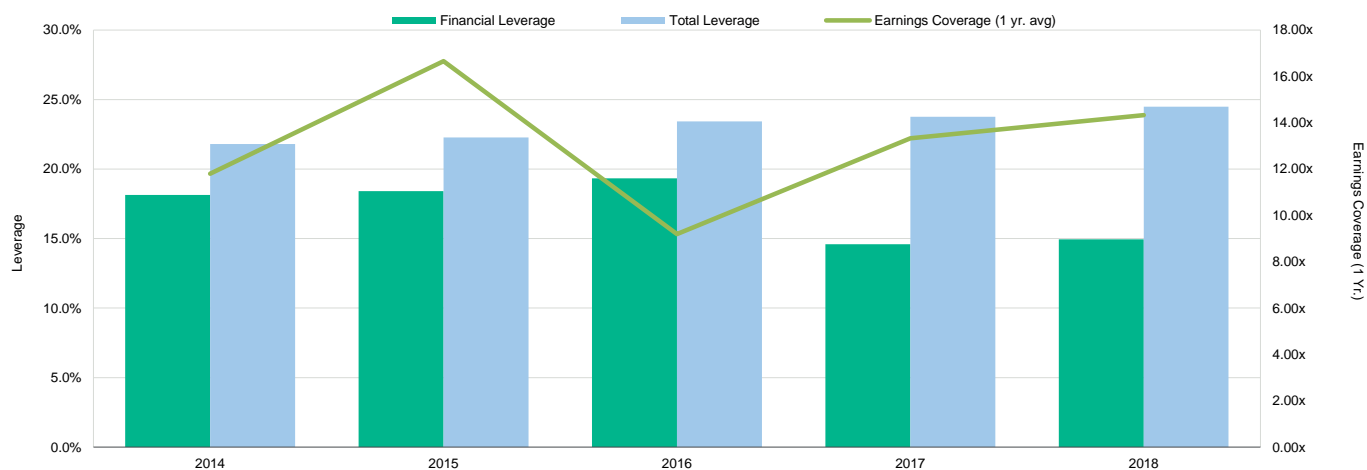


Source: Direct Line Group

Direct Line's solvency also benefits from the good quality of its capital, with 84% (after foreseeable dividends) of Solvency II own funds made up of Tier 1 instruments (split 81% unrestricted, 19% restricted). The company's Solvency II ratio is also relatively insensitive to market movements, given its relatively conservative investment portfolio, and its lack of exposure to equities.

Direct Line's dividend policy will also likely put pressure on its leverage ratio. However, the company's YE18 adjusted financial leverage was low at c.15% (see Exhibit 11), a credit positive. Its leverage includes £260 million of dated subordinated notes as well as £347 million of restricted tier 1 securities, to which we give a 75% equity credit. Going forward, we expect the Group's leverage to remain relatively low in relation to the A1 IFSR, and for its earnings coverage, which averaged around 13x over the past five years at YE18, to remain strong.

Exhibit 11
Direct Line's financial leverage and earnings coverage, 2014-2018 (Moody's metrics)



Source: Moody's Investors Service, company filings

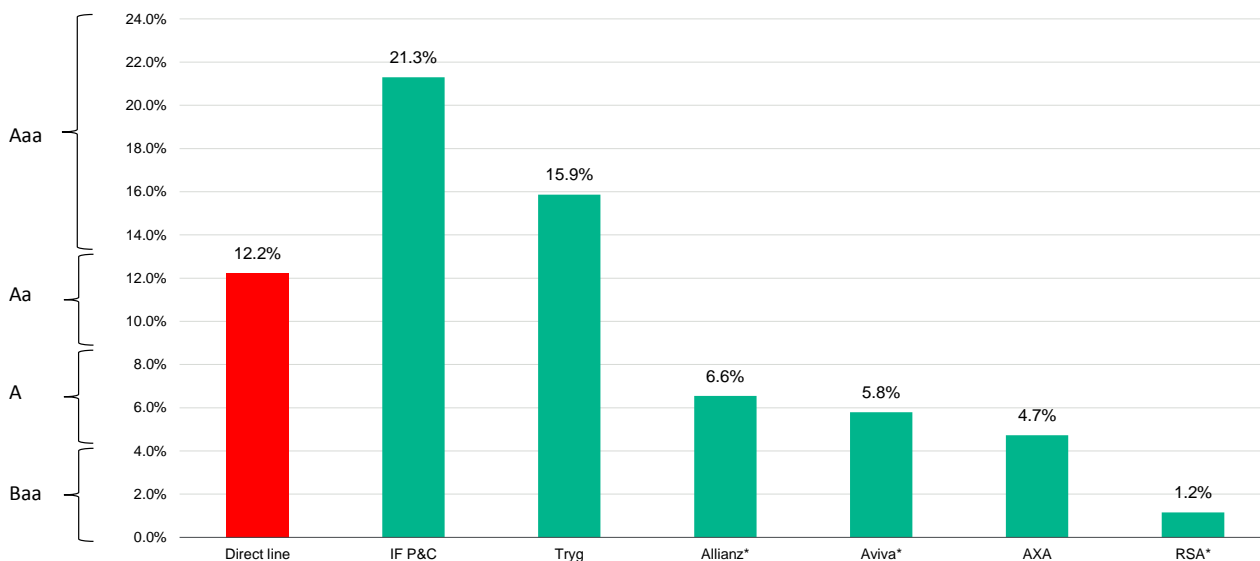
What are Direct Line's relative credit strengths and weaknesses when compared to other A1 IFSR companies?

Nordic non-life insurers If P&C (If) and Tryg Forsikring (Tryg) are similar in size and business profile to Direct Line. Like their UK peer, the two Nordic insurers are focused on personal lines/SME commercial business, report annual gross written premiums (GWP) of below £4 billion, and have A1 insurer financial strength ratings (IFSRs). While all three insurers have strong market positions, strong profitability, robust capitalisation and low financial leverage, their credit profiles differ in a number of areas.

Direct Line's 5-year average (2014-2018) return on capital (ROC) of 12.2% compares well with its wider peer group, and is one of the company's relative credit strengths (see Exhibit 12). However, the ROC performances of If P&C and Tryg are better still, with averages of c.21% and 16% respectively. Both score Aa for profitability.

Exhibit 12

Moody's 5-year average return on capital for selected European Groups



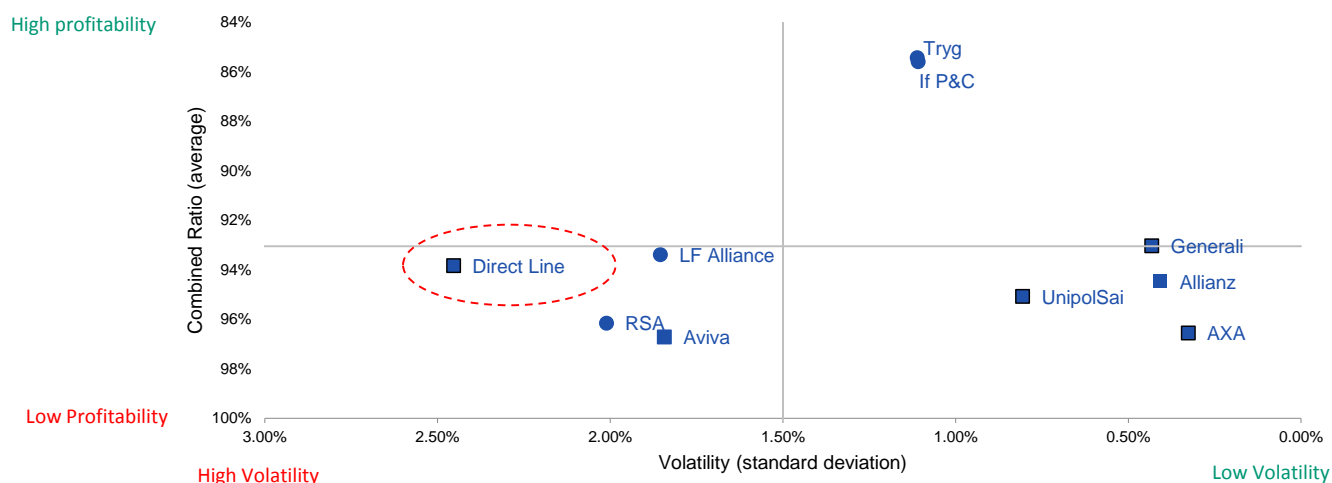
*The 5-year average return on capital for RSA, Allianz and Aviva are calculated for the period 2013-2017

Source: Moody's Investors Service, company filings

If and Tryg's underwriting performance has also been much stronger than that of most peers. Both have reported average combined ratios of around 85% over the last five years, compared with around 94% for Direct Line. Their underwriting income has also been consistently less volatile (see Exhibit 13).

Exhibit 13

Combined ratio (2014 - 2018 average) and standard deviation for selected European P&C insurers



Source: Moody's Investors Service, company filings

This track record of superior profitability, which we expect to continue, reflects If and Tryg's strong underwriting discipline and cost efficiency. This is illustrated by their low expense ratios of 16.4% and 14.4% respectively, well below Direct Line's ratio of 29.9%. If and Tryg also benefit from their geographic focus on the generally stable Nordic insurance markets, where competitive pressure is less intense than in UK motor.

However, while both If and Tryg have conservative reserving approaches, Direct Line's reserve adequacy metric is far stronger (see Exhibit 14), even if we expect it to decline going forward.

Exhibit 14

Moody's 5-year weighted average loss development as a % of opening reserves 2014-2018 for selected European P&C insurers



* Reserve movement for RSA and Aviva are calculated for the period 2013-2017

Source: Moody's Investors Service, company filings

Direct Line also has a more conservative investment portfolio. This is reflected in the UK insurer's relatively low ratio of high risk assets (i.e. equities, real estate, below investment grade/unrated fixed-income securities) to equity of c.25% at YE18. This is far below If and Tryg's corresponding ratios of 100% and 39% respectively.

Direct Line, If and Tryg's credit profiles all benefit from their strong market positions. However, Direct Line, as the leading personal lines insurer in the much larger UK insurance market, and If, with its top-tier position in three Nordic markets, both score Aa for this factor. A further relative strength for all three companies is relatively low financial leverage and strong earnings coverage of interest.

Why wasn't Direct Line's Tier 1 debt rating upgraded in line with the Group's other ratings in May 2019?

When we upgraded Direct Line's IFSR in May 2019, we also upgraded the rating on the company's subordinated notes to A3(hyb) from Baa1(hyb). These notes are unconditionally and irrevocably guaranteed by UKI on a subordinated basis, and the rating reflects our standard notching for debt issued by operating companies.

In contrast, we affirmed the Ba1(hyb) rating on Direct Line's perpetual restricted Tier 1 contingent convertible notes. This is because we use, as a starting point only, a model-based approach rather than a notching approach to rate Tier 1 securities. Direct Line's IFSR is one of the key inputs into the model, but the company's Solvency II ratio is another key driver of the notes' rating, and our expectations regarding this ratio have not changed since we originally [assigned the rating](#).

Moody's related publications

- » [Direct Line Insurance Group plc: Update following rating action](#), May 2019
- » [Global Property and Casualty Insurers Methodology](#), May 2018
- » [UK P&C Insurance - 2019 Outlook remains stable as robust capital offsets profit pressure from claims inflation and possible regulatory costs](#), February 2019
- » [IFRS 17 will transform insurance accounting, but is unlikely to alter our credit view](#), May 2019
- » [European Insurance: CFO survey - Subdued growth is European insurance CFOs' key concern in 2019](#), April 2019
- » [UK P&C insurers face mixed credit impact from regulation-driven price shift](#), December 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.

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