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Credit Opinion: U K Insurance Limited

Global Credit Research - 20 Dec 2012

Leeds, United Kingdom

Ratings

Category	Moody's Rating
Rating Outlook	STA
Insurance Financial Strength	A2

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Key Indicators

U K Insurance Limited[1]

	2011	2010	2009
Total Assets (£ Mil.)	£ 13,770	£ 13,817	£ 13,186
Equity (£ Mil.)	£ 3,871	£ 3,482	£ 3,581
Net Income (£ Mil.)	£ 249	-£ 272	£ 133
Gross Premiums Written (£ Mil.)	£ 4,168	£ 4,971	£ 5,291
Net Premiums Written (£ Mil.)	£ 3,911	£ 4,788	£ 5,092
High Risk Assets % Shareholders' Equity	2.6%	2.8%	2.8%
Reinsurance Recoverables % Shareholders' Equity	17.0%	17.3%	12.7%
Goodwill & Intangibles % Shareholders' Equity	17.5%	16.8%	17.6%
Gross Underwriting Leverage	2.7x	3.4x	3.1x
Return on Capital (1 yr.)	6.2%	-7.1%	3.4%
Sharpe Ratio of ROC (3 yr.)	12.3%	0.0%	—
Adv/(Fav) Dev. % Beg. Reserves (1 yr.)	-3.6%	5.2%	-2.4%
Adjusted Financial Leverage	14.7%	16.4%	15.5%
Total Leverage	14.7%	16.4%	15.5%
Earnings Coverage (1 yr.)	34.6x	-36.1x	10.5x

[1] Information based on historical DLG Group financial statements as per Direct Line Insurance Group plc, Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012, and also, for reserve metrics, information derived from Price Range Prospectus dated 28 September 2012

Opinion

SUMMARY RATING RATIONALE

Moody's A2, stable outlook, insurance financial strength rating (IFSR) on U K Insurance Limited ("UKI") reflects Direct Line Insurance Group plc's ("DLG") very strong position in the UK personal lines market, a relatively conservative investment portfolio, good capitalisation, and relatively low financial leverage. These strengths are off-set by relatively weak geographic and business diversification, and the challenge of sustaining recent performance improvements within the very competitive UK Motor market which remains vulnerable to bodily injury claims inflation. DLG also has to execute a successful divestment from its current owner, the Royal Bank of Scotland Group plc ("RBSG", Baa1 Senior debt rating, negative outlook), by the end of 2014. Following the launch of a new corporate identity, Direct Line Group, DLG, from 1 July 2012, has been operating on a substantially standalone basis with corporate functions and governance independent of RBSG.

To comply with EC State Aid requirements, RBSG must cede control of DLG by 31 December 2013 and have divested its entire interest by 31 December 2014. In line with this requirement, DLG effected an IPO in October 2012, following which 34.5% of its shares now trade on the London Stock Exchange with RBSG owning 65.3% of the shares. In light of this divestment requirement, which is encompassed within our rating on UKI, UKI's IFSR was not impacted by Moody's downgrade by one notch of RBSG's ratings on June 21, 2012. Following the IPO we see DLG as less constrained by its current ownership, but going forward, UKI's rating could be negatively impacted in the event of 1) a delay to the divestment from RBSG, and 2) a material weakening of RBSG's credit profile as reflected in any further downgrade of RBSG's ratings.

UKI, which is now DLG's main (UK) operating subsidiary, underwrites over 85% of DLG's gross written premium (GWP). Via a Part VII transfer effected in December 2011, UKI received almost all of the assets and liabilities of Direct Line Insurance Ltd (established by RBS in 1985), Churchill Insurance Company Ltd (established in 1989 and acquired by DLG in 2003), and the National Insurance and Guarantee Corporation Ltd (NIG, established in 1894 and acquired by Churchill in 2000). DLG also manages relatively small Italian and German insurance businesses. At YE11, DLG's business, which is UK Motor orientated, was split on a GWP basis: 42% UK personal Lines Motor, 25% UK personal lines Home, 8% UK personal lines rescue & other, 10% UK Commercial, 14% International and 1% other (predominantly personal lines brokers in run-off).

Credit Strengths

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

-Low exposure to product risk with a personal lines orientation

-Relatively conservative investment portfolio

-Good capitalisation

-Relatively low financial leverage

Credit Challenges

-Relatively weak geographic and business diversification; UK and Motor business predominate

-Sustaining performance improvements and growing profitably in very competitive UK Motor market

-Bodily injury claims inflation in UK Motor market which led to significant reserve strengthening in 2010 and 2009

-Enhancing contribution of Commercial and International businesses to overall operating profit

-Successful divestment from RBS Group

Rating Outlook

The rating outlook is stable.

What to Watch For:

-Further reduction in RBSG's shareholding in DLG

-UK Motor pricing environment, including impact of removal of gender-based pricing from December 2012

-Legal developments in UK Motor re claimants' compensation

What Could Change the Rating - Up

-Average return on capital through the cycle of at least 8% with combined ratio consistently below 100% and stable reserving

-Sustained gross underwriting leverage of 3x or below

-Profitable development of non-UK businesses

What Could Change the Rating - Down

-Average return on capital through the cycle below 6%

-Adjusted financial leverage in excess of 30%

-Earnings coverage below 6x

-Meaningful deterioration in capital adequacy either from an economic or an IGD perspective.

Recent Results and Developments

- At 9m 2012, DLG reported net income of £142m (9m 11: £223m) with an annualised Return on Tangible Equity (RoTE) and pro-forma (assuming that capital actions taken by DLG occurred on 1/1/12) RoTE of 10.6% and 13.5% respectively, net income of £247m for ongoing operations (£247m), a combined operating ratio of 99.7% (101.9%), and net assets of £2.8bn (YE11: £3.6bn) with a further dividend of £200m paid to RBSG in September taking the total dividend paid, as planned, to RBSG during the year to £1bn. The operating profit was negatively affected by adverse weather claims, £50m worse than normal, but benefited from reserve releases of £352m from prior years.

-As part of DLG's IPO announcement in September 2012, it was stated that DLG is 1) targeting a 15% return on tangible equity from ongoing operations; 2) targeting a 98% combined operating ratio for the 2013 financial year from ongoing operations; 3) targeting £100 million of gross annual cost savings in 2014; 4) expecting its pro-forma full year dividend pay-out ratio for the 2012 financial year to be between 50-60% of any consolidated post-tax profit from the Group's ongoing business, with a progressive dividend policy thereafter; 5) targeting a capital coverage ratio in the range of 125-150% of risk-based capital.

-In April 2012, DLG issued £500m of lower Tier 2 dated subordinated notes.

-At YE11, DLG reported net income of £249m (YE10: loss of £272m), an ongoing business combined ratio of 102% (121%), ongoing gross written premium of £4,125m (£4,095m), and shareholders' equity of £3,612m (£3,223m).

DETAILED RATING CONSIDERATIONS

Moody's rates UKI A2 (stable outlook) for insurance financial strength which is in line with the adjusted rating indicated by the Moody's insurance financial strength rating scorecard.

Insurance Financial Strength Rating

The key factors currently influencing the rating and outlook are:

Factor 1 - Market Position, Brand and Distribution (Aa)

We view DLG's market position as excellent. As at YE11, it was the largest (Source: Association of British Insurers (ABI)) personal Motor and Home lines writer in the UK, and its brands, especially Direct Line and Churchill, are very powerful. DLG is also a meaningful player in the direct Motor markets in Germany and Italy, but its overall market position in these countries is very small.

DLG's UK market share has been declining recently as a result of exiting unprofitable business, de-risking the book, re-pricing, and the cessation of the Tesco Personal Finance (TPF) joint venture. Furthermore, in our opinion, its market share, especially in Motor, has been negatively impacted by the strong market growth in price comparison websites ("PCW") which encourage switching and in which, in our view, DLG has been relatively underweight, although Direct Line branded business is deliberately not quoted on PCWs. However, going forward, we expect DLG's personal lines market position to remain very strong.

DLG's 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. The much smaller Commercial insurance also benefits from some direct distribution, although the vast majority of business is accessed via brokers. However, given the direct/personal lines focus of the book, and DLG's inherent scale advantages, the underwriting expense ratio is viewed as relatively high, although we expect this ratio to improve via the implementation of efficiency programs.

Factor 2 - Product Risk and Diversification (Baa)

DLG writes non-life business, split 90% personal lines, 10% commercial lines, with the main classes of business being Motor and Property. Management view the business on a divisional basis, which at YE11 and by GWP was split: UK Motor (42%), UK Home (25 %), UK Rescue & Other (8%), UK Commercial (10%), International (14%) and other, predominantly the personal lines broker book in run off (1%). DLG's product risk is considered low given the preponderance of personal lines risks, and although the business is exposed to windstorm and flood catastrophe risk, DLG purchases significant reinsurance cover.

However, business line diversification is viewed as relatively limited in light of the preponderance of personal lines Motor and Home business, and geographically the book is dominated by UK business. Going forward, geographic diversification could improve as DLG looks to grow organically its international business, but we expect the proportion of UK business to remain very significant for the foreseeable future.

Factor 3 - Asset Quality (A)

We view overall asset quality as good. DLG has a relatively conservative investment portfolio, with 99% invested in bonds and cash as at 30 September 2012 (YE11: 93%). High risk assets as a % of equity is very low - DLG currently has no equities exposure.

The credit quality of the fixed income portfolio is very good, with around 93% of the corporate bond (44% of total invested assets) and government bond (29% of total invested assets) portfolio rated A or higher. DLG has no exposure to peripheral European sovereign debt and only £52m of corporate bond exposure to Ireland, Italy and Spain. However, there is concentration risk in the government bond portfolio via its significant proportion of UK gilts, and within the corporate bond portfolio there is significant though reduced exposure to the banking sector. Going forward, there is some transition risk as DLG, which has now adopted an independent (of RBSG) investment management and treasury function, looks to further reposition its investment portfolio with a maximum allocation to corporate bonds of 60%.

DLG's asset quality benefits from its low level of reinsurance recoverables which at H1 12 were 28% of equity (YE11: 17%), and low level of reported goodwill & intangible assets (including DAC) which at H1 12 were c.23% of equity (YE11: 17%).

Factor 4 - Capital Adequacy (A)

We view overall capital adequacy as good. Capitalisation improved in 2011 reflecting lower business volumes as a result of exiting certain lines, and an increase in total equity of around 11% following the 3% decrease in 2010. Moody's gross underwriting leverage metric has also improved and was relatively low at 2.7x YE11, although this increases to 2.9x if we exclude from equity the TPF non-controlling interest amount of £259m which DLG intends repaying in 2013, and the IGD coverage ratio at YE11 was a high and significantly improved 319% (YE10: 227%). However, capital adequacy has weakened somewhat during 2012 with dividend payments, as planned, from DLG to RBSG of £1 billion negatively impacting shareholders' equity which has reduced by around 22% during 2012 YTD. The Group's solvency coverage ratios have also reduced during 2012, but to a lesser extent, with IGD and risk-based capital coverage ratios of 306% and 160% (YE11: 169.5%), the latter still higher than DLG's target range of 125-150%.

We note that DLG's risk management and modelling capabilities continue to be developed. DLG is currently enhancing its economic capital model, which is used to calibrate ICA, to meet Solvency II requirements, and is aiming to fully embed ERM throughout the business in the near to medium term.

Factor 5 - Profitability (A)

We view overall profitability as good. Profitability from 2007-2011 (see note 1 below) has been mixed, with very good return on capital performance in 2007 and 2008. However, DLG's results were impacted in 2009, and especially 2010, by significant UK Motor bodily injury reserve strengthening. In these years, DLG reported very high combined ratios for its ongoing UK Motor business of 126% and 144% respectively, with overall combined ratios of 110% and 121%. But performance significantly improved during 2011, with DLG returning to profit and recording a Moody's return on capital metric of 6.2% (YE10: -7.1%), and reporting an improved overall combined ratio of 102% for its ongoing business. The reported UK personal lines Motor combined ratio also improved to 106% in 2011.

The UK Motor book benefited in 2011 from significant rate increases, new pricing models and engines, de-risking, exiting unprofitable lines, claims systems improvements, and the non-repeat of 2010 reserve strengthening.

Furthermore, we note that DLG materially benefits from additional income generated from its own brand Motor policies, and the performance of its UK Home and Rescue books has been generally good in recent years.

Aided by further benefits from its claims transformation programme and cost savings, DLG is targeting a 15% RoTE from ongoing operations, and a 98% combined operating ratio for 2013 with a further improvement in the performance of its UK personal lines Motor book. And in this regard we note the improved underwriting performance during 2012YTD. However, a key challenge is that DLG is heavily reliant for its profits on UK Motor which remains a highly competitive market and vulnerable to bodily injury claims inflation, and which in recent years DLG has under-performed.

(Note 1: 2011-2009 figures derived from Direct Line Insurance Group plc, Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012. 2008 and 2007 figures derived from RBS Group Annual Reports.)

Factor 6 - Reserve Adequacy (A)

The reserve adequacy metric score is driven by a small surplus position on average from 2011-2007 (see note 2 below). However, reserves for prior years were strengthened during 2009 and 2010, driven by respective £96m and £398m increases for UK Motor reserves, excluding TPF, with high inflation in bodily injury claims a feature of the UK Motor market. Aside from reserve strengthening with reserves including an additional margin beyond the actuarial best estimate, DLG's remedies, from 2009/2010, have also included de-risking, re-pricing, and new tools.

DLG returned to a prior year reserve release during 2011 for an amount of £227m (YE10: -£285m), and has also released reserves of £352m during 2012YTD. Furthermore, we note that the Group's estimated reserve margin above Towers Watson's independent actuarial best estimate at 30 June 2012 was 7.1%. However, 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.

(Note 2: 2011-2009 figures derived from Direct Line Insurance Group plc's Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012, and Price Range Prospectus dated 28 September 2012. 2008 and 2007 figures derived from RBS Group Annual Reports.)

Factor 7 - Financial Flexibility (A)

We view DLG's overall financial flexibility as good. Adjusted financial leverage at YE2011 remained relatively low, reducing to 14.7% (YE2010: 16.4%) driven by increased equity. For this metric, we include as debt the TPF non-controlling interest amount of £259m which is in the form of a perpetual subordinated loan and which DLG intends repaying in 2013.

Following the £500m issuance in April 2012 of lower Tier 2 capital in the form of dated subordinated notes which qualify for 25% equity credit from Moody's, together with reduced equity, off-set to an extent by the repayment of of intra-group debt, adjusted financial leverage increased to 20.3% at H1 12. Going forward, we expect DLG's financial leverage to remain relatively low in relation to UKI's A2 IFSR.

Driven by the intra-group nature of financial debt, DLG's finance costs were around a mere £3m in 2010 and 2011. Following the lower Tier 2 issuance, finance costs have increased significantly - £20m at 9m 2012- but we expect earnings coverage, which at 9m 2012 was around 8x, to be good going forward.

Financial flexibility is somewhat constrained by DLG's limited record in accessing capital markets as a result of its current ownership. However, we regard the IPO, following the raising of lower Tier 2 capital in April 2012, as successfully demonstrating DLG's stand-alone financial flexibility, and we see the Group as now less constrained by its current ownership.

Rating Factors

U K Insurance Limited[1]

Financial Strength Rating Scorecard	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adjusted Score

Business Profile								**A**	**A**
Market Position, Brand and Distribution (25%)								**A**	**Aa**
Relative Market Share Ratio		**X**							
Underwriting Expense Ratio % Net Premiums Written					**X**				
Product Risk and Diversification (10%)								**Baa**	**Baa**
Product Risk		**X**				**X**			
P&C Insurance Product Diversification				**X**					
Geographic Diversification									
Financial Profile								**A**	**A**
Asset Quality (10%)								**Aaa**	**A**
High Risk Assets % Shareholders' Equity	**2.6%**								
Reinsurance Recoverables % Shareholders' Equity	**17.0%**								
Goodwill & Intangibles % Shareholders' Equity	**17.5%**								
Capital Adequacy (15%)								**Aa**	**A**
Gross Underwriting Leverage		**2.7x**							
Profitability (15%)								**Ba**	**A**
Return on Capital (3 yr. avg)				**0.9%**					
Sharpe Ratio of ROC (3 yr. avg)					**12.3%**				
Reserve Adequacy (10%)								**Aaa**	**A**
Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. avg.) [2]	**-1.9%**								
Financial Flexibility (15%)								**A**	**A**
Adjusted Financial Leverage	**14.7%**								
Total Leverage	**14.7%**								
Earnings Coverage (3 yr. avg.)				**3.00x**					
Operating Environment (0%)								**Aaa - A**	**Aaa - A**
Aggregate Profile								**A2**	**A2**

[1] Information based on historical DLG Group financial statements as per Direct Line Insurance Group plc, Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012 [2] 5 year average based on 2011 - 2009 reserves information from the Direct Line Insurance Group plc's, Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012, and Price Range Prospectus dated 28 September 2012; and 2008 - 2007 reserves information from the RBS Group annual reports.

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