Direct Line Insurance Group PLC

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Major Rating Factors

Strengths	Weaknesses
• Leading position in the U.K. personal lines market. • Very strong capital position backed by consistent underwriting profits.	• Relatively undiversified outside of the U.K. personal lines market. • Significant competitive pressures in its key markets, U.K. motor and home insurance.

Rationale

S&P Global Ratings' rating on Direct Line Insurance Group (DLG, or the group) reflects the group's dominant position in the U.K. personal lines insurance market and its very strong capital adequacy under our risk-based capital model. The rating also reflects the consistent underwriting profits DLG's management has delivered since the group listed on the London Stock Exchange in 2012.

U K Insurance Ltd. (UKI) is the main operating insurance subsidiary of the group and is best known for its Direct Line brand. The group recorded £3.2 billion (2017: £3.4 billion) of gross premium written (GPW) in 2018, primarily sourced directly from customers but also through partnerships with well-known U.K. businesses, such as Royal Bank of Scotland Group plc. The U.K. motor insurance business accounted for 52% of its premium in 2018, U.K. home 19%, and U.K. commercial 16%. DLG operates its business in the U.K. under well-known, market-leading brands such as Direct Line, Direct Line for Business, Churchill, Privilege, NIG, and Green Flag.

Outlook: Stable

The stable outlook reflects S&P Global Ratings' view that DLG will continue to maintain capital adequacy at least comfortably at the 'A' level over the next 24 months, under our risk-based capital model. We also expect that DLG 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
- DLG'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 DLG'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 2.1% over 2019-2021.
- 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

- The group will return top-line growth in 2019-2020 with growth of around 3% per year.
- Current major partnership agreements to be retained.
- Reserve releases to fall below 10% as a percentage of net premium in 2020.

Key Metrics

	2020F	2019F	2018	2017	2016	2015
GPW	~3,450	~3,300	3,212	3,392	3,274	3,153
Net income	>390	>380	474	434	279	580
EBITDA fixed-charge coverage (x)	~12	~12	13.6	6.81	10.88	16.94
Financial leverage (%)	~25	~25	25.1	20.86	22.23	22.08
ROE (%)	>15	>15	15.8	15.6	10.8	21.3
S&P Global Ratings capital adequacy	Very strong	Very strong	Very Strong	Very strong	Very strong	Very strong
Net investment yield (%)	~2.5	~2.5	2.46	2.5	2.5	2.4
Net combined ratio (%)	88-92	88-92	89.2	86.4	94	89.9
Return on revenue (%)	>15	>15	18	18.55	11.9	22.5

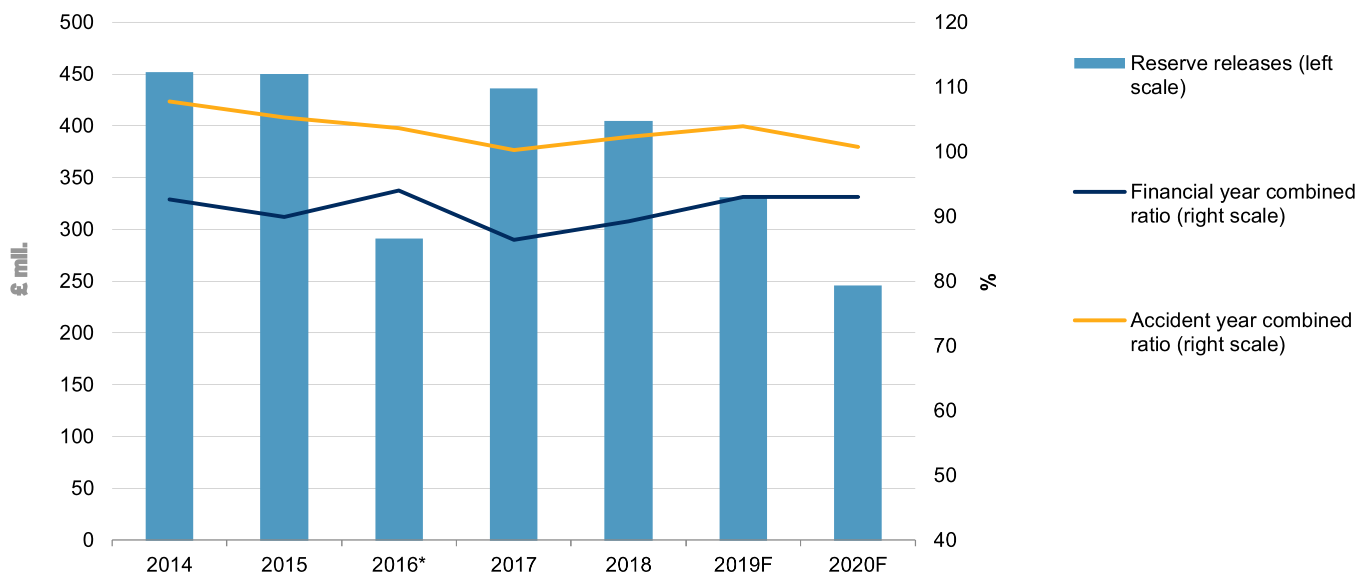
F--Forecast. GPW--Gross premium written. ROE--Return on equity.

Business Risk Profile: Strong

The group has demonstrated strong operating performance since its listing in 2012, reflecting its strong position in the U.K. personal lines market. In 2018, the group recorded a £583 million profit before tax (2017: £539 million) and a combined ratio of 89.2% (2017: 86.4%). The 2018 earnings figure was boosted by reserve releases from the prior year's underwriting to the value of £404 million, partly as a result of the group's conservative reserving practice. 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 combined ratio range of 93%-95%, based on DLG's calculation that does not exclude depreciation and amortisation) and profits before tax in excess of £500 million. However, we expect that the group will become less reliant on prior year releases (in the last five years these averaged 13% of the combined ratio), which will fall below £300 million in 2020.

Chart 1

Direct Line's underwriting profits to become less reliant on prior year reserve releases



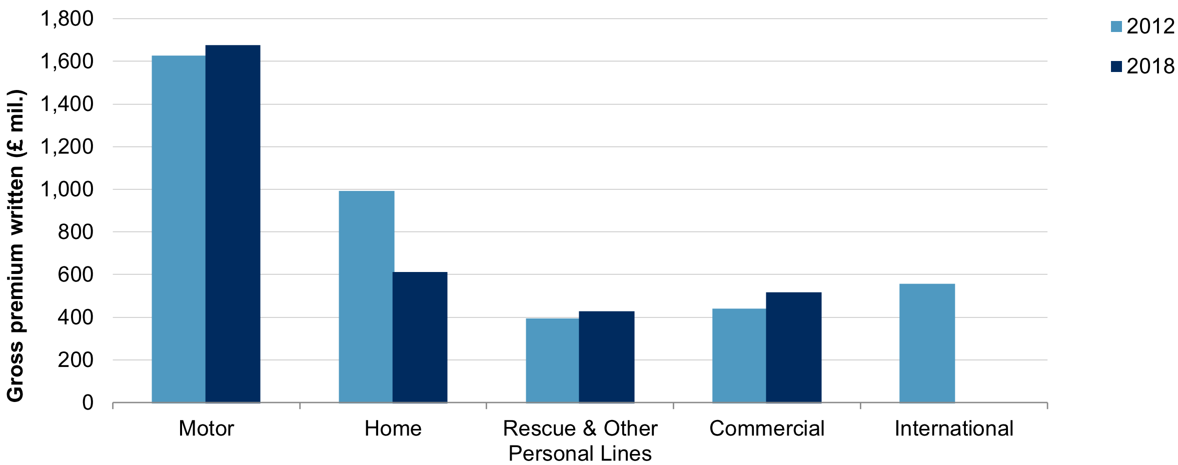
*The reserve release in 2016 was significantly lower than other years due to the change in Ogden discount rate.

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 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 volatility in 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 because Direct Line has already started reserving on the basis of a 0% Ogden rate. 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 in 2020. 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, thereby having a muted impact on earnings.

All of DLG'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 outlays in terms of advertising and marketing.

Chart 2

Direct Line's breakdown of premium



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 10% of operating profit in 2018. 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.

Financial Risk Profile: Very Strong

We assess UKI's capital and earnings as very strong. Its capital adequacy, under our risk-based capital model, is 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 now stands at 25%, in line with the majority of its 'A' rated peers. The group's fixed charge coverage ratio is a healthy 13.6x, reflecting the group's strong cash generation.

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 the 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

DLG's top management team has changed in recent years with Paul Geddes and John Reizenstein, the previous CEO and CFO, moving on. Penny James, who replaced John Reizenstein as CFO, has taken over as CEO with the CFO position still to be filled. However, we expect the new team will continue to exhibit a focused strategy and maintain DLG's 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.

Other Considerations

Group ratings methodology

We assign a core group status to UK Insurance Ltd., the group's main operating subsidiary, in accordance with our group rating methodology. This means that it shares the same rating as DLG's 'a' group credit profile. The holding company Direct Line Insurance Group PLC is rated two notches below the group to reflect its structural subordination.

Related Criteria

- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- Criteria | Insurance | Property/Casualty: Assessing Property/Casualty Insurers' Loss Reserves, Nov. 26, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Insurance | General: Enterprise Risk Management, May 7, 2013
- Criteria - Insurance - 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
- Criteria | Insurance | General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Criteria | Financial Institutions | General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers, Feb. 10, 2010
- Criteria | Financial Institutions | 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
- Criteria | Insurance | 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 16, 2019)*	
Direct Line Insurance Group PLC	
Issuer Credit Rating	
Local Currency	BBB+/Stable/--
Subordinated	BB
Related Entities	
U K Insurance Ltd.	
Financial Strength Rating	
Local Currency	A/Stable/--
Issuer Credit Rating	
Local Currency	A/Stable/--
Domicile	United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.