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CREDIT OPINION
12 December 2018

Update

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RATINGS

Direct Line Insurance Group plc

Domicile	United Kingdom
Long Term Rating	Ba1
Type	Pref. Stock Non-cumulative - Dom Curr
Outlook	Positive(m)

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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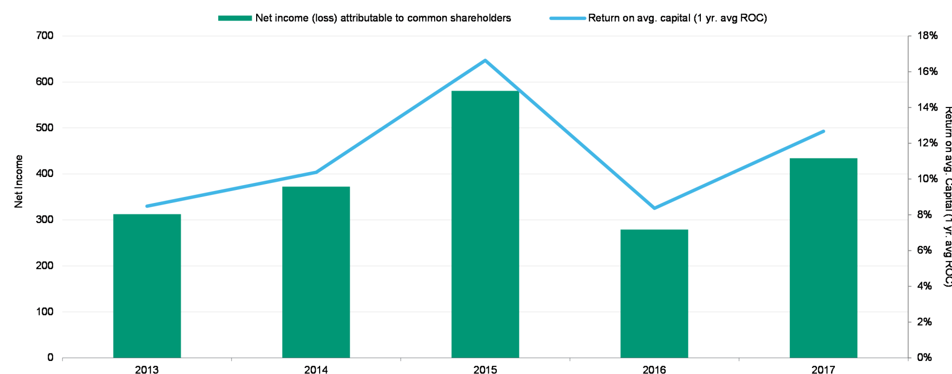
Direct Line Insurance Group plc

Semi-annual update

Summary

Direct Line Insurance Group plc's (DLG) main operating entity U K Insurance Limited (UKI) is rated A2 for insurance financial strength. The rating outlook was changed to positive from stable on 13 November 2017 and reflects DLG's track record of reporting consistently strong return on capital (ROC) and underwriting results over the last four years, which we consider to be sustainable (see Exhibit 1). We also view DLG's very strong position in the UK P&C sector; powerful brands, including Direct Line, Churchill and Green Flag; and diverse distribution strategy as its key credit strengths.

Exhibit 1
DLG's net income and ROC



Sources: Company reports, Moody's Investors Service

The rating and outlook are also underpinned by the group's (1) relatively conservative investment portfolio, with high-risk assets (HRA) expected to be around 30% of shareholders' equity; (2) good capitalisation, reflected in the group's estimated post-dividend Solvency II ratio of 169% at H1 18; and (3) relatively low financial leverage of 14.6% as of YE17. In our view, these very good financial fundamentals more than offset the group's limited geographical diversification and dependence on the very competitive, highly regulated and dynamic UK personal motor market.

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
- Robust profitability, which has improved annually and exceeded internal targets
- Good capitalisation, reflected in the group's Solvency II ratio
- Relatively low financial leverage and excellent earnings coverage of interest

Credit challenges

- Limited geographical and business line diversification in which motor business predominates
- Growing premiums following the termination of the home Nationwide and Sainsbury's distribution agreements
- Sustaining recent underwriting performance in the very competitive UK personal lines market and as the contributions from prior-year reserve releases reduce
- Enhancing contributions from non-motor businesses to overall operating profit
- Navigating and adapting to changes in the highly regulated and dynamic UK personal motor market

Rating outlook

The outlook is positive, which reflects our expectation that the company will sustain its underwriting performance while maintaining its very strong position in the UK personal lines property and casualty (P&C) market and continuing to modestly grow its premium base. The change of outlook to positive from stable is also underpinned by our expectation that the group will maintain its relatively conservative investment portfolio and that capitalisation will remain robust with no material increases in financial leverage.

Factors that could lead to an upgrade

- Sustaining ROC through the cycle of at least 8% while modestly growing the premium base
- Continued profitable development of the commercial and personal lines rescue and other businesses
- A Solvency II ratio sustainably within the group's target range of 140%-180%
- Adjusted financial leverage remaining below 25% and earnings coverage above 8x through the cycle

Factors that could lead to a downgrade

A rating downgrade is unlikely in light of the positive outlook. However, the ratings could be affirmed with a stable outlook in the event of:

- The group's combined ratio continuously exceeding 95% as the expected reduction in reserve releases is not sufficiently offset by improvements in the current year loss ratios and a lower expense ratio
- A meaningful deterioration in capital adequacy as reflected in the group's Solvency II ratio falling sustainably well below 160%
- Adjusted financial leverage exceeding 25%, with earnings coverage falling below 8x

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 2

KeyIndicators_FY2017

Direct Line Insurance Group plc [1][2]	2017	2016	2015	2014	2013
As Reported (Pound Sterling Millions)					
Total Assets	9,948	10,122	9,957	11,226	11,788
Total Shareholders' Equity	3,062	2,522	2,630	2,811	2,790
Net income (loss) attributable to common shareholders	434	279	580	373	313
Gross Premiums Written	3,392	3,274	3,153	3,099	3,230
Net Premiums Written	3,184	3,068	2,961	2,917	3,071
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	23.1%	29.1%	25.1%	20.4%	7.8%
Reinsurance Recoverable % Shareholders' Equity	38.8%	51.6%	36.6%	29.3%	35.4%
Goodwill & Intangibles % Shareholders' Equity	21.6%	26.8%	26.4%	24.7%	28.2%
Gross Underwriting Leverage	2.6x	3.1x	2.9x	2.7x	3.1x
Return on avg. capital (1 yr. avg ROC)	12.7%	8.4%	16.6%	10.4%	8.5%
Sharpe Ratio of ROC (5 yr. avg)	327.2%	219.5%	197.6%	66.4%	NA
Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg)	-12.9%	-8.1%	-11.5%	-9.5%	-9.1%
Financial Leverage	14.6%	19.3%	18.4%	18.1%	18.7%
Total Leverage	23.8%	23.4%	22.3%	21.8%	22.1%
Earnings Coverage (1 yr.)	13.3x	9.2x	16.7x	11.8x	9.5x

[1] information based on ifrs financial statements as of fiscal ye december 31. [2] certain items may have been relabeled and/or reclassified for global consistency.
Source: Moody's Investors Service, Company Filings

Profile

DLG is the UK's largest personal lines property and casualty (P&C) insurer, with leading positions in personal motor and home by in-force policies (IFP). The group underwrites around £3.4 billion of gross written premiums (GWP) through its highly recognised brands — Direct Line, Churchill, Privilege and Green Flag — and partners, including Royal Bank of Scotland (RBS) (baa2 positve, baa3), NatWest and Prudential (A2 long term rating, stable).

The group has four core classes of business — personal motor (representing 49% of premiums in 2017), home (24%), rescue and other personal lines (12%), and commercial (15%). Following the disposal of its international operations in 2015, the group focuses exclusively on the UK P&C market.

The group was listed on the London Stock Exchange in 2012 after divesting from RBS in July 2012.

Detailed credit considerations

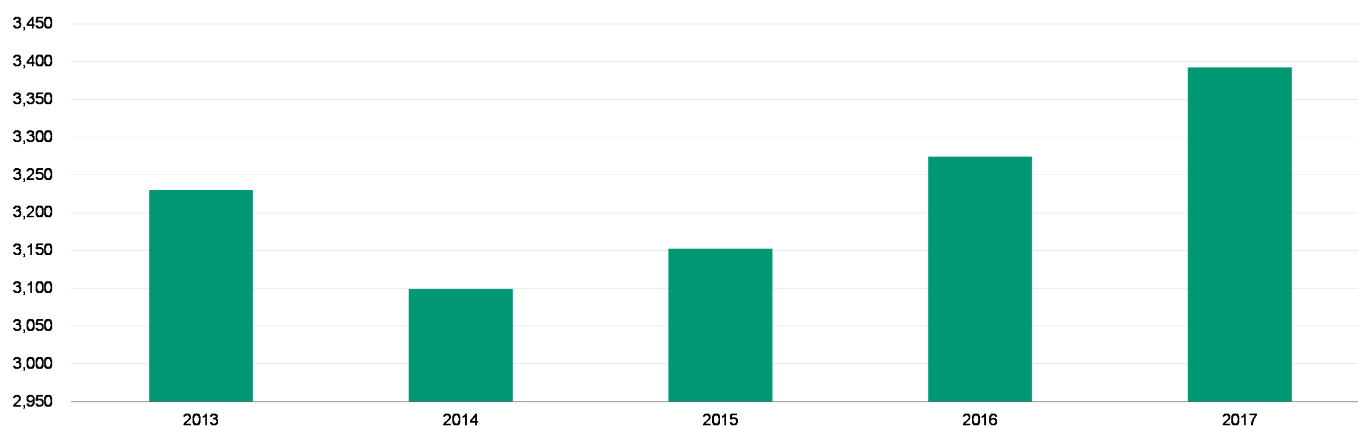
Insurance financial strength rating

Market position, brand and distribution: Very strong position in the UK personal lines market, modest growth to continue through own brands

As the largest personal motor and home lines writer in the UK, we consider DLG's market position to be very strong and its brands, in particular Direct Line and Churchill, to be very powerful. We expect DLG's personal lines market position to remain very strong. DLG's small and medium-sized enterprise commercial business is growing, but its overall market share remains relatively modest at this stage.

In 2015, DLG started to modestly grow its premiums base after several years of decline (see Exhibit 3), which reflected management's action to improve performance and difficult pricing conditions. This growth trend continued into 2017, with GWP from ongoing operations up around 4% in 2017, primarily relating to an increase in Motor and Home own brands and helped by rising motor rates. The group's total IFP reduced slightly during 2017 because growth in its own brands was offset by reductions across the group's partnership arrangements, particularly in the home segment. This reduction in partnership IFP has continued in 2018 following the termination of DLG's distribution agreement with Nationwide in December 2017, and overall GWP at H1 18 reduced by 5% driven by the reduction in Home partnerships.

Exhibit 3
DLG's GWP evolution
£ million



Sources: Company reports, Moody's Investors Service

Overall, we view DLG's personal lines distribution as strong, with products sold directly by phone, over the internet, through online aggregators, as well as via partnerships particularly in the home segment. To improve efficiency and effectiveness, DLG has been re-establishing its partnership capabilities, including exiting a number of partnerships and has renegotiated existing deals. For example, in 2018 the group signed a minimum 5 year partnership deal with Volkswagen, and again extended its travel agreement with Nationwide until 2023. In 2016, it signed a three-year extension with RBS for home and private insurance, and extended its Prudential partnership in home and motor for a further two years. With regard to the Prudential partnership, the Prudential brand is used for renewals, and the Churchill brand for new business. The commercial division also benefits from some direct distribution, although the majority of premiums are still accessed via brokers. DLG also continues to improve its distribution capabilities by investing in new websites, digital propositions and by targeting less traditional partnerships.

The group's underwriting expense ratio remains relatively high and above its personal-lines-orientated peers, despite the group's inherent scale advantages. However, it reduced to 34.4% in 2017 (2016: 36.8%), mostly reflecting lower profit share payments to Home policies distribution partners. Going forward, we expect the group's expense ratio to continue to continue to reduce, via (1) the implementation of ongoing efficiency programme initiatives; (2) a reduction in business distributed through partnerships, which typically include high commissions; and (3) top-line growth.

Product risk and diversification: Relatively low product risk, offset by limited business diversification and dependence on the UK
DLG writes in the UK non-life business only, split 85% personal lines and 15% commercial lines. DLG has four main business segments, including motor (49% of GWP and 60% of operating profit in 2017), home (24% and 21%), rescue and other (12% and 7%), and commercial (15% and 12%). In our view, product line diversity is, therefore, relatively limited in light of the preponderance of personal motor, especially as the home segment shrinks.

More positively, DLG's product risk is considered low as a result of this preponderance of personal lines. Although the business is exposed to large bodily injury claims volatility, windstorm and flood catastrophe risk, DLG purchases significant reinsurance cover.

Asset quality: Conservative investment portfolio, notwithstanding relatively high exposure to credit versus peers
We view DLG's asset quality as good. The group has a relatively conservative investment portfolio, with 87% held in fixed income securities and cash. In recent years, the group has undertaken some re-risking actions, reflected in the rise in DLG's HRA as a percentage of shareholders' equity ratio to around 23% as of YE17 from 8% as of year-end 2013, although the ratio reduced from 29% at YE16. DLG continues to have no exposure to, or appetite for, equities, with HRA primarily comprising property investments and high yield bonds. Since 2014, DLG also has had an exposure to UK infrastructure, which supports the asset strategy backing periodical payment order liabilities.

As of H1 18, DLG's invested assets comprised 72% fixed income securities, 15% cash and cash equivalents, 5% property investments, 5% infrastructure debt, and 3% commercial real estate loans with an overall duration of 2.5 years.[1] DLG has also repositioned its

credit portfolio. Corporate bonds represented 70% of invested assets as of H1 18, which is significantly higher than a number of its UK/European P&C peers. However, the credit quality of the fixed income portfolio is very good, with around 66% of fixed income assets rated A or higher with a well-diversified portfolio by sector. However, DLG has increased its exposure to high-yield credit, which as of H1 18, amounted to around 6% of invested assets, in line with the group's target. Over the next 12-18 months, we expect only modest tweaks to the group's investments as the group continues to shift its portfolio towards its targets.

DLG's overall asset quality also benefits from a low level of reported goodwill and intangible assets (including Deferred Acquisition Costs) of 21.6% as of YE17 (YE16: 26.8%). Reinsurance recoverables have historically been low, and reduced to 38.8% at YE17, in line with the typical 30%-40% over the last few years. In 2016, the ratio rose to 52%, largely driven by outstanding recoverables related to the Ogden rate impact.

Capital adequacy: Good capitalisation; Solvency II ratio relatively insensitive to market movements

DLG's capital adequacy and quality of capital are good. The Prudential Regulation Authority (PRA) approved DLG's internal model in June 2016, and the group's post-dividend Solvency II ratio was 169% as of H1 18 (YE17: 165%, YE16: 165%). We expect the ratio to converge towards the group's target coverage of 160% and we note the group's general strategy to return excess capital to shareholders via special dividends. Notwithstanding the recent rebasing of the group's ordinary dividend and progressive dividend strategy, we expect DLG's Solvency II ratio to remain robust and within its target range of 140%-180% for the foreseeable future.

With regard to capital sensitivities, the group has disclosed that its greatest exposures are a change in reserving basis for motor Periodic Payment Orders (PPOs) to use a real discount rate of -1% and a 100bp increase in credit spreads, which would reduce the Solvency II ratio by 10 and 11 ppt resepctively as of H1 18. A large catastrophe loss, equivalent to the 1990 storm and extensive flooding of the river Thames, would also have a meaningful 9 ppt impact. Given the group's relatively conservative investment portfolio and lack of equities exposure, DLG's Solvency II ratio is relatively insensitive to market movements.

The group's quality of capital is very good. As of H1 18, 87% (after foreseeable dividends) of the group's own available funds comprised Tier 1 capital, split between £1.73 billion of unrestricted Tier 1 capital and £0.35 billion of restricted Tier 1 notes issued in December 2017. Tier 1 capital represents 148% of the Solvency Capital Requirement (SCR). DLG used the proceeds of the restricted Tier 1 issuance to repay £250 million of subordinated Tier 2 debt. As a consequence, Tier 2 capital has reduced and relates solely to the group's £0.26 billion subordinated debt and accounts for 11% of the group's own funds, with only 2% in the form of Tier 3 capital. DLG's Tier 2 and Tier 3 capital are, therefore, materially below the amounts permitted under Solvency II regulations.

Given the reduction in shareholders' equity since 2011, total equity as a percentage of net written premiums has declined. However, gross underwriting leverage, which historically has averaged around 3x, declined to 2.6x at YE17 (YE16: 3.1x) driven by higher equity and lower reserves.

Profitability: Profitability targets met once again for year-end 2017, but the highly competitive and dynamic UK personal market remains a problem

In 2017, the group achieved a return on tangible equity (RoTE) of 21.7%, a combined ratio (COR) of 91.8% (below the group's ongoing 93%-95% target range), a 2.5% investment yield and a further reduction in the expense ratio in 2017. This strong set of results for 2017 benefited from top line growth and a strong improvement in underwriting profit, with the COR improving by 5.9 ppt. although the 2016 COR was also 91.8% if adjusted for the Ogden impact.

With regard to our scorecard metrics, DLG's five-year average ROC improved to 11.3% (YE16: 9.7%), and the Sharpe ratio of ROC improved to 327.2% (YE16: 219.4%). These results reflect the group's disciplined approach to underwriting in a competitive environment, aided by benefits from the group's claims transformation programme and cost savings.

At H1 18, the group's operating profit fell by 13% to £303 million, negatively impacted by higher weather-related claims of £75 million (H1 17: £9 million), with the COR increasing to 93% (H1 17: 88.6%). The RoTE reduced but remained high at 21.8% (H1 17: 26.6%).

Despite localised competitive pressures, our expectation of higher claims inflation and lower reserve releases, and persistently low investment rates, we believe DLG's return and underwriting targets are achievable. We believe DLG's (1) focus on its own brands' growth, (2) investments in technology to improve customer experience, (3) pricing capabilities, and (4) value enhancement of

its propositions should continue to stimulate overall top-line growth and expense reductions, and thereby safeguard the group's profitability.

Reserve adequacy: Reserve releases expected to reduce but remain a feature, notwithstanding the inherent challenge of motor bodily injury claims

DLG has reported significant prior-year reserve releases since 2011, as reflected in the five-year weighted-average favourable loss development as a percentage of opening reserves, of 10.6% (2017-2013). These reserve releases were driven mainly by the group's motor division in relation to favourable developments in bodily injury claims.

Notwithstanding the market impact of the Ogden rate cut, for 2016, the group still recognised strong overall reserve releases of £290 million (2015: £449 million). Excluding the impact of the Ogden rate cut, prior-year reserve releases would have been £205 million higher than reported. In 2017 and H1 18, reserve releases were £435 million and £207 million.

Given the group's prudent reserving approach of current accident years, we expect reserve releases to remain a material contributor to future operating profit. However, we expect releases to trend downward following the Group's decision in 2015 to no longer add a margin above its actuarial best estimate for current years, coupled with the reduction in reinsurance retentions, together with motor claims inflation at the top of the group's 3%-5% long-term range. Motor claims inflation is driven by the rising cost of damages from repair costs because vehicles are fitted with more advanced technology, used car prices and credit hire costs. During 2017, there was also a rise in home claims inflation related to the escape of water, although DLG has taken a number of significant actions across pricing, underwriting and claims management to mitigate escape of water inflation henceforth.

Furthermore, some volatility will likely remain a feature particularly within the UK motor portfolio. We will continue to monitor the impact of any future outcome of the latest Ogden rate consultation, as well as changes in periodical payment order award propensities and large bodily injury claims.

Financial flexibility: Strong capital generation track record with relatively low leverage and excellent earnings coverage

We view DLG's overall financial flexibility as very good. Adjusted financial leverage as of YE17 fell to 14.6% (YE16: 19.3%), including £265 million of dated subordinated notes and £347 million of restricted tier 1 securities, which qualify for equity credit from us, together with bank debt and an operating lease expense adjustment. Following the rebasing of the ordinary dividend and our expectation of special dividend payments (based on the group's expected solvency coverage ratio under normal conditions), leverage will likely increase but remain relatively low in relation to the A2 IFSR at around 20%.

Earnings coverage is excellent, averaging around 12.1x over the past five years at YE17.

As a result of its historic ownership, DLG has a more limited record in accessing capital markets versus some of the largest European insurers. However, we regard the restricted Tier 1 issuance and the IPO, following the lower Tier 2 debt issuance in April 2012, as evidence that DLG can successfully access the capital markets.

Structural considerations

The guaranteed subordinated notes issued by DLG in April 2012 are rated Baa1(hyb). The rating reflects the fact that the notes are unconditionally and irrevocably guaranteed by UKI on a subordinated basis and reflect standard notching (versus the senior rating) for subordinated debt that lacks a mandatory trigger we consider to be "meaningful".

Rating methodology and scorecard factors

Exhibit 4

Scorecard FY2017

Financial Strength Rating Scorecard [1][2]	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adj Score
Business Profile								A	A
Market Position and Brand (25%)								A	Aa
- Relative Market Share Ratio		X							
- Underwriting Expense Ratio % Net Premiums Written				30.0%					
Product Focus and Diversification (10%)								A	Baa
- Product Risk		X							
- P&C Insurance Product Diversification		X							
- Geographic Diversification						X			
Financial Profile								Aa	A
Asset Quality (10%)								Aa	A
- High Risk Assets % Shareholders' Equity	23.1%								
- Reinsurance Recoverable % Shareholders' Equity		38.8%							
- Goodwill & Intangibles % Shareholders' Equity		21.6%							
Capital Adequacy (15%)								Aa	A
- Gross Underwriting Leverage		2.6x							
Profitability (15%)								Aa	A
- Return on Capital (5 yr. avg)		11.3%							
- Sharpe Ratio of ROC (5 yr. avg)		327.2%							
Reserve Adequacy (10%)								Aaa	A
- Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd avg)	-10.6%								
Financial Flexibility (15%)								Aa	A
- Financial Leverage	14.6%								
- Total Leverage		23.8%							
- Earnings Coverage (5 yr. avg)	12.1x								
- Cash Flow Coverage (5 yr. avg)									
Operating Environment								Aaa - A	Aaa - A
Aggregate Profile								Aa2	A2

[1] information based on ifrs financial statements as of fiscal ye december 31. [2] the scorecard rating is an important component of the company's published rating, reflecting the stand-alone financial strength before other considerations (discussed above) are incorporated into the analysis.

Source: Moody's Investors Service, Company Filings

Ratings

Exhibit 5

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	POS(m)
U K INSURANCE LIMITED	
Rating Outlook	POS
Insurance Financial Strength	A2

Source: Moody's Investors Service

Moody's related research

- » Proposed personal injury and whiplash reforms are credit positive for UK insurers, March 2018
- » UK Property & Casualty Insurers: Outlook stable reflecting healthy capitalisation and profitability, Oct 2017
- » Claims-inflating Ogden discount rate is credit negative for UK motor insurers and reinsurers, March 2017
- » Ratings unaffected by Ogden rate cut despite material one-off reserving hit, March 2017

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.

Endnotes

1 Excluding cash and cash equivalents, property, infrastructure loans and commercial real estate loans.

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