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CREDIT OPINION
26 September 2023

Update

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RATINGS

Direct Line Insurance Group plc

Domicile	BROMLEY, United Kingdom
Long Term Rating	Baa2
Type	Subordinate - Dom Curr
Outlook	Stable

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

Update following rating downgrade

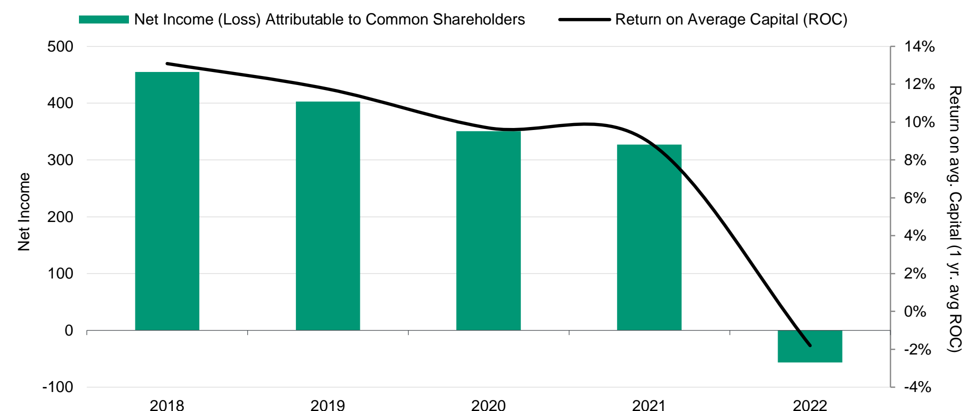
Summary

Direct Line Insurance Group plc (DLG) has powerful brands and a strong position in the UK personal lines property and casualty (P&C) market. Together with the group's improved solvency position (following the announced disposal of its brokered commercial business to RSA), relatively conservative investment portfolio and low financial leverage, this supports the A2 insurance financial strength rating on the group's lead operating entity U K Insurance Ltd (UKI). These strengths are offset by underwriting performance, which while historically strong was negatively impacted by claims inflation and difficult pricing conditions in 2022 (Exhibit 1), and concentration in the UK personal lines P&C market which will grow on disposal of its brokered commercial business.

On 20 Sep 2023, the insurance financial strength rating of UKI was downgraded to A2 from A1. The outlooks on DLG and UKI were both changed to stable from negative. This reflects Moody's expectation that while DLG will return to profitability over the next 12- 18 months it will not rebound to historical levels over the medium term, and concerns around its governance and potential reputational damage related to two past business reviews the group is carrying out.

Direct Line reported under IFRS 17 for the first time at half-year 2023. The Scorecard and Key Indicators in this report use IFRS 4 figures.

Exhibit 1
Return on capital was historically strong but deteriorated in 2022 due to claims inflation and adverse investment experience
Return on capital (%) and net income (£ millions) based on IFRS 4 financials



Source: Company filings and Moody's Investors Service

Credit strengths

» Strong position in the UK personal lines market, with powerful brands

» Generally low product risk, although exposure to inflation and weather events through personal motor and home have weighed on recent results

» Relatively low financial leverage

» Relatively conservative investment portfolio

Credit challenges

» Restoring underwriting performance in a challenging operating environment without material loss of market share

» Heightened regulatory scrutiny by the Financial Conduct Authority, including two past business reviews the group is carrying out in relation to pricing and claims payments

» Growing market share in highly competitive UK personal lines market in light of potential reputational damage

» Concentration in UK personal lines, especially motor

Rating outlook

The stable outlook reflects Moody's expectation that DLG will maintain its capital level at least in the middle of its 140-180% target range and return to profitability over the outlook period while maintaining its strong market position.

Factors that could lead to an upgrade

» Profitability sustainably restored to historical levels, evidenced by return on capital in excess of 10%

» Strengthening of the group's franchise, evidenced by improved market share, and materially lower concentration in UK personal lines

» Maintenance of the group's Solvency II ratio towards the upper end of its 140-180% target range; and

» Adjusted financial leverage consistently below 25%

Factors that could lead to a downgrade

» Ongoing weak profitability of the business, evidenced by return on capital consistently below 5%

» Material weakening of the group's franchise; and

» Solvency II ratio remaining consistently towards the lower end of group's 140-180% target range.

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

Key indicators

Direct Line Insurance Group plc

Direct Line Insurance Group plc [1][2]	2022	2021	2020	2019	2018
As Reported (Pound Sterling Millions)					
Total Assets	8,355	9,309	9,622	9,434	9,535
Total Shareholders' Equity	2,281	2,897	3,046	2,990	2,905
Net Income (Loss) Attributable to Common Shareholders	(56)	327	351	403	455
Gross Premiums Written	3,094	3,172	3,180	3,203	3,212
Net Premiums Written	2,953	2,985	2,949	2,987	2,988
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	27.2%	24.1%	22.2%	23.4%	24.8%
Reinsurance Recoverable % Shareholders' Equity	51.8%	43.6%	39.1%	42.5%	42.4%
Goodwill & Intangibles % Shareholders' Equity	46.1%	35.1%	31.7%	29.6%	25.6%
Gross Underwriting Leverage	3.2x	2.4x	2.3x	2.4x	2.6x
Return on Average Capital (ROC)	-1.8%	8.9%	9.7%	11.7%	13.1%
Sharpe Ratio of ROC (5 yr.)	141.2%	613.3%	548.4%	420.4%	392.1%
Adv. (Fav.) Loss Dev. % Beg. Reserves	-6.4%	-10.0%	-6.5%	-10.2%	-12.9%
Adjusted Financial Leverage	18.3%	19.1%	19.7%	14.4%	15.0%
Total Leverage	28.0%	28.2%	28.3%	23.7%	24.6%
Earnings Coverage	-0.7x	9.4x	10.1x	12.6x	14.3x

[1] Information based on IFRS financial statements as of the fiscal year ended 31 December. [2] Certain items may have been relabeled and/or reclassified for global consistency.
Source: Moody's Investors Service

Profile

DLG, which was listed on the London Stock Exchange in 2012 after being divested from RBS in July 2012, is the UK's largest personal lines property and casualty (P&C) insurer, with leading positions in personal motor and home by inforce policies (IFP).

The Group wrote around £3.1 billion of gross written premiums (GWP) in 2022 (£2.6 billion excluding brokered commercial business) through its highly recognised brands — Direct Line, Churchill, Privilege and Green Flag — and partners, including NatWest Group (A3 stable).

The Group has four core classes of business in the UK P&C insurance market: personal motor (representing 56% of 2022 GWP excluding brokered commercial business), home (20%), rescue & other personal lines (15%), and commercial (9%), which sells insurance solely to small and medium-sized enterprise (SME) businesses. DLG announced on 6th September 2023 that it will dispose of its brokered commercial lines business, NIG, with GWP of around £530 million in 2022, to Royal & Sun Alliance Insurance Limited.

Detailed credit considerations

The A2 IFSR is in line with the adjusted scorecard indicated outcome as shown in the Moody's scorecard (Exhibit 6).

Insurance financial strength rating

The key factors currently influencing the rating and outlook are:

Market position, brand and distribution: Strong position in UK personal lines could come under pressure

As one of the leading personal motor and home underwriters in the UK we consider DLG's market position to be strong, although the group faces headwinds both from the difficult operating environment in UK personal lines, especially motor, and also heightened regulatory scrutiny by the Financial Conduct Authority (FCA), resulting in two past business reviews related to historical pricing and claims payments, which raises concerns around the oversight of frontline business operations from a governance perspective. This could have an adverse impact on the group's franchise, leading to weaker new business and retention of customers.

The group's brands, in particular Direct Line and Churchill, remain very powerful. However, the group has experienced a decline in premiums since 2017 due to distribution partnership exits and difficult pricing conditions. The announced disposal of the group's brokered commercial business, NIG, to RSA Insurance Group Limited will reduce the group's footprint in SME commercial insurance from approximately £749m to £219m based on 2022 figures, although remaining business benefits from direct distribution.

Following a reduction in 2022, DLG grew its GWP in the first half of 2023 driven by pricing improvements offsetting reduced customer volumes in personal motor and price and volume growth in commercial lines business. While operating conditions remain challenging in the UK personal lines market, the pricing outlook has improved. We expect the group will prioritise underwriting results ahead of growth, which could lead to a further reduction in customer numbers during 2023. DLG's partnership with Motability from H2 2023 is forecast to deliver around £700 million of gross premium annually, although with a much lower impact on net written premiums due to 80% of the book being reinsured. We expect DLG's direct commercial segment to continue growing, supported by the group's initiatives and pricing momentum, however the contribution to overall group GWP is now less than 10%.

We view DLG's distribution as strong, with leading direct to consumer propositions. Personal lines products are sold directly by phone, over the internet, through online aggregators and via partnerships, particularly in the home segment. DLG continues to improve its distribution capabilities by investing in new websites, digital propositions (e.g. Darwin, which targets PCW customers using an alternative pricing system) and by targeting less traditional partnerships. Following the disposal of its brokered commercial business, all commercial business benefits from direct distribution (via Direct Line for Business, “DL4B”) and through the PCW channel (via Churchill for Business).

Despite the Group's inherent scale advantages, its expense ratio is relatively high and above its personal-lines orientated peers, driven by high marketing costs associated with the Group's direct brand propositions. However, despite the inflationary backdrop the Group has controlled its expenses, which were around £700 million in 2022 excluding one-offs and restructuring. The group remains focussed on efficiency, but its expense base is subject to inflationary pressure.

In our view, DLG's multichannel distribution strategy, powerful brands, recent technology investments and strong financial resources position the Group well to adapt to cyclical and longer-term changes in the market place, particularly as increasing car safety features, electric cars and eventually autonomous vehicles, start to transform the traditional risk pool. Recent challenges, however, may have a medium term negative impact on the group's franchise.

Product risk and diversification: Relatively low product risk, but disposal of brokered commercial business further reduces diversification

In our view, product line diversification will be limited once the group has disposed of its brokered commercial business, with personal motor accounting for around 57% of GWP in 1H23 on a pro-forma basis (excluding brokered commercial business). The Group's relative dependence on the UK personal lines insurance market (91% GWP 1H23 pro-forma, excluding brokered commercial business, and including run-off partnerships in personal lines) was a driver of poor underwriting results in 2022 with most major lines, especially motor, experiencing adverse pricing conditions and high claims inflation.

Despite poor market conditions in 2022, we consider DLG's product risk to be low as a result of its focus on generally high frequency, low severity, personal lines business, as well as its focus on lower volatility SME clients within the commercial business. The Group

is however exposed to large bodily injury claims volatility and windstorm and flood catastrophe risk which DLG mitigates using reinsurance.

Asset quality: Relatively conservative investment portfolio, notwithstanding relatively high exposure to credit versus peers

We view DLG's asset quality as good, supported by the Group's relatively conservative investment portfolio, which the group further de-risked during 2022, and low reinsurance recoverables as a percentage of shareholders' equity, despite relatively higher levels of goodwill and other intangible assets.

At 1H23, the vast majority of the group's investment portfolio is invested mainly in fixed-income securities and cash, with around 2% held in government bonds, 51% in corporate bonds, 2% in investment-grade private placement, 5% in Infrastructure debt, 4% in commercial real estate loans and 31% in cash.The Group's high risk assets as a percentage of shareholders' equity ratio stood at around 27% at YE22, primarily comprising property investments and high yield bonds. DLG also has some exposure to UK infrastructure, which supports its asset strategy backing longer-dated periodical payment order liabilities (PPOs), as well as commercial real estate loans. Net investment income increased to £78m in 1H23 from £53.8m in 1H22 under IFRS 9/17 (1H22: £54.5m under IFRS 4/IAS 39), primarily driven by yield improvements in variable rate asset classes following UK base rate increases.

The credit quality of the fixed income portfolio remains good. At 1H23, around 90% of the portfolio is investment grade (including investment grade private placements) and 58% is rated A or higher, with a well-diversified portfolio by sector. The average interest rate duration of the group's debt securities was 2.4 years at 1H23 (YE22: 2.3 years), comprised almost entirely of corporate bonds. Corporate bonds represented a material c.94% of debt securities as at 1H23, which is significantly higher than a number of its UK/European P&C peers.

Capital adequacy: Disposal restores Solvency II capitalisation

The sale of the group's brokered commercial business will lead to Solvency II capitalisation in excess of 190%, compared to 147% reported at half-year 2023. Over time we expect capitalisation to revert to the middle of the group's 140-180% target range, although resumption of dividends is contingent on motor business returning to a position of organic capital generation which we view as demonstrating an appetite for prudence. We do not expect further material management actions in respect of capitalisation, but there are a number of tailwinds which can generate an additional 4-7ppts of capitalisation by year-end 2023 such as the reversal of unrealised losses on maturing fixed income investments and changes in risk margin calculation under Solvency UK reforms.

DLG's available capital was eroded in 2022 by underwriting losses, widening credit spreads, losses on the sale of long duration credit and a reduction in the value of the group's property investments. This more than offset the decline in capital requirements relating to the sale of longer duration credit, other capital management actions taken during the period and the suspension of the group's final dividend.

The Group's quality of capital was good at 1H23. Eligible tier 1 capital amounted to 76% (YE22: 75%) of own funds and 113% own fund of Solvency II capital requirements (YE22: 110%). Tier 3 capital remains 10% of own funds. The group breached eligibility limits for both its RT1 and Tier 3 capital at 1H23, however we expect that the capital rebuild will improve headroom.

Profitability: Results will lag historical levels at least over the medium term

DLG reported under IFRS 17 for the first time at half-year 2023. The group has changed its KPI for underwriting profitability to net insurance margin (NIM, defined as net insurance service result over net insurance contract revenues). Its guidance of a NIM in excess of 10% equates roughly to a COR better than 96% under IFRS 4, which is higher than group's historical guidance of a 93%-95% COR.

Half-year performance in motor remained weak, evidenced by a COR of 125.6% (2022: 104.8% under IFRS 17, 114.7% under IFRS 4) and a NIM of -25.6% driven in part by reserve strengthening. Although other lines performed to target, motor performance led to an overall loss. While we expect improvement by year-end, due to the earn through of pricing actions and the run-off of business written during 2022, we still see execution risk in restoration of margins towards historical levels which is heightened by the disposal of profitable commercial business. We believe that DLG's underestimation of motor claims inflation in 2022 will drag underwriting earnings for longer than previously expected, making it less likely that profitability will be restored to historical levels over the medium term.

The group's profitability came under pressure in 2022 driven mainly by deterioration in combined ratio, but also losses on investments. Motor, home and exited partnerships produced losses, which were only partially offset by profitable performance in commercial and other personal lines.

DLG's historical performance is strong, evidenced by a five-year average ROC (calculated on a Moody's basis) for the period 2017-2021 of 11.2%. Prior to 2022, the group consistently met or exceeded its internal combined ratio target of 93%-95% and return on tangible equity (RoTE) of at least 15%.

Reserve adequacy: Reserve releases trending down; reserving risk is relatively low although long-tail motor bodily injury claims add risk

Reserves were strengthened in aggregate in the first half of 2023, with favourable development in other lines offset by increased inflation assumptions in respect of prior year motor claims. DLG reported significant prior-year reserve releases to 2022, reflected in favourable five-year weighted-average loss development, as a percentage of opening reserves, of 8.3% (2018-2022).

We expect reserve releases to remain heavily muted in 2023 as motor business written in 2022 develops unfavourably, offsetting potential pockets of favourable development in other lines. We note that DLG is reviewing historical underpayments on total loss claims in its motor portfolio from September 2017 to August 2022. DLG fully provided for the expected cost of these claims in its 2022 reserves. Furthermore, DLG has added approximately £30 million provision in 1H23 in relation to the two past business reviews and redesigned its process for estimation and settlement of such claims.

Over the medium-to-long-term we expect reserve releases to return to being a contributor to operating profit. Overall reserving risk is considered moderate although some volatility will likely remain a feature stemming from large bodily injury claims, which take longer to settle and typically involve court proceedings.

Claims inflation is an inherent reserving risk for DLG and the wider P&C market, heightened in the current environment. Motor claims inflation is being driven by higher used car costs, rising repair costs, as vehicles are fitted with more advanced technology, as well as elevated repair times owing to supply chain disruption leading to longer credit hire costs

Financial flexibility: Leverage expected to remain relatively low but earnings coverage muted by underwriting performance

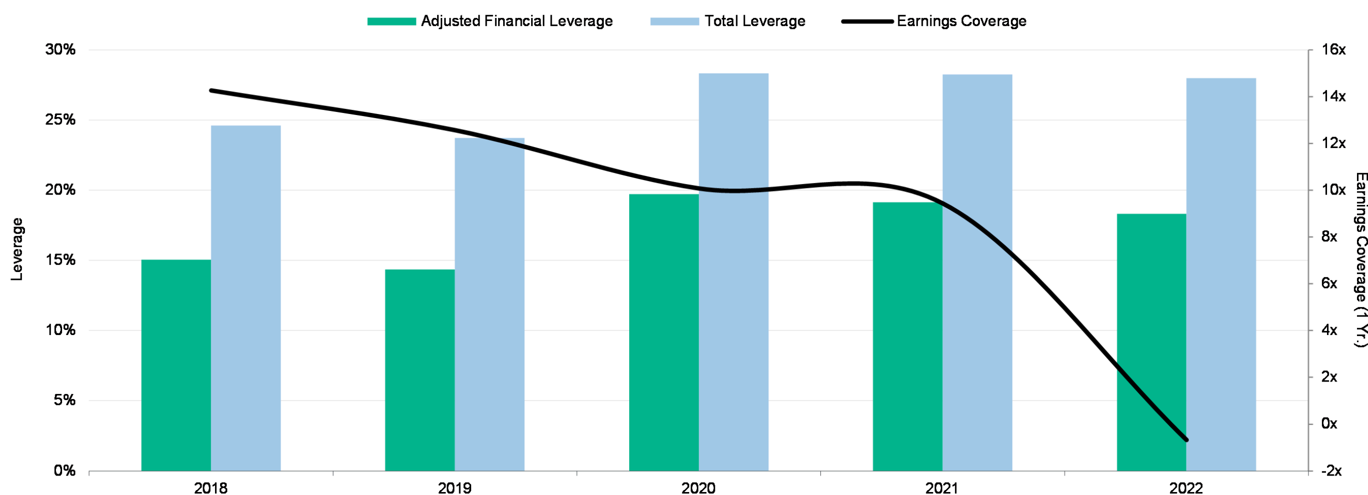
We view DLG's overall financial flexibility as good, supported by relatively low financial leverage, which has been sustainably below 20%, and good earnings coverage, which averaged around 11x between 2017 and 2021 (Exhibit 3). However, the group's earnings coverage metrics deteriorated in 2022 owing to poor performance and remain negative for the first half of 2023. Financial leverage (Moody's basis based on IFRS 4 financials) decreased to 18.3% in 2022 (2021: 19.1%) due to the repayment of the £250 million subordinated bond despite a reduced equity base from unrealised investment losses, dividends and share buybacks.

Direct Line's reported leverage on an IFRS 17 basis was 25.3% at half-year 2023, consistent with 24.7% at year end 2022 restated under IFRS 17 (2022 under IFRS 4 was 23.8%). We expect leverage to reduce as a result of the sale of DLG's brokered commercial business, although debt issuance capacity will increase due a higher proportion of Solvency II capital being Tier 1.

Exhibit 3

Leverage and earnings coverage have been deteriorated

Adjusted financial leverage, total leverage and earnings coverage of interest



Source: Moody's Investors Service; Company Filings

The prospect of weaker and more volatile performance over the short-to-medium term, together with the suspension of the group's final dividend, may, at least temporarily, reduce the group's access to external capital markets. At HY23, the group had outstanding £260 million of T2 subordinated debt (4.0% due 2032) and £350 million of Restricted Tier 1 securities (4.75%, perpetual), which Moody's considers eligible for equity credit.

ESG considerations

Direct Line Insurance Group plc's ESG Credit Impact Score is Moderately Negative CIS-3

Exhibit 4

ESG Credit Impact Score

CIS-3

Moderately Negative

NEGATIVE IMPACT

POSITIVE IMPACT

For an issuer scored CIS-3 (Moderately Negative), its ESG attributes are overall considered as having a limited impact on the current rating, with greater potential for future negative impact over time. The negative influence of the overall ESG attributes on the rating is more pronounced compared to an issuer scored CIS-2.

Source: Moody's Investors Service

Direct Line's **CIS-3** reflects the limited impact of ESG considerations on the current rating, with potential for greater impact over time, mainly due to moderate governance risks. These relate to recent poor financial performance and heightened regulatory scrutiny by the Financial Conduct Authority, including two past business reviews the group is carrying out in relation to pricing and claims payments. The group is also exposed to environmental and social risks, in particular customer relations risk and physical climate risk, which are mitigated by effective risk management and governance, along with good capitalization and use of reinsurance.

Exhibit 5
ESG Issuer Profile Scores

Source: Moody's Investors Service

Environmental
Direct Line Group is moderately exposed to environmental risks, in particular physical climate risk related to the effects of natural catastrophes on its P&C insurance operations. The company has a good track record of managing this risk through pricing and reinsurance. As the frequency and severity of natural catastrophes increase over time, Direct Line and its peers could find mitigating this risk more challenging.

Social
Direct Line is moderately exposed to social risk, most notably with respect to customer relations and changing societal and demographic trends in its personal P&C business. Customer relations risk are elevated in relation to the group's personal P&C insurance products and significant interactions with retail customers, particularly against a background of an increasing focus by the UK regulator on the fair treatment of customers and heightened regulatory scrutiny by the Financial Conduct Authority, including two past business reviews the group is carrying out in relation to pricing and claims payments. This is mitigated by well-developed policies and procedures. Changes in societal attitudes and the legal environment can impact P&C claims costs and reserve development, particularly in motor lines. Changing motor usage patterns and the rise of autonomous vehicles, which could reduce the demand for motor insurance. Rising digitization and interconnectedness of devices will increase customer privacy and data security risks, although these are mitigated by a strong technology risk framework, while also presenting business risks and opportunities for Direct Line.

Governance
Direct Line faces moderate governance risks, primarily related to its financial strategy and risk management along with management credibility and track record. These risks arise as a result of recent poor performance and heightened regulatory scrutiny by the Financial Conduct Authority, including two past business reviews the group is carrying out in relation to pricing and claims payments. This has raised concerns surrounding the level of oversight of frontline operations. Aside from the recent challenges, the group had demonstrated a long track record of consistently meeting objectives and financial targets, which are well articulated by the group, and regulatory compliance. The group’s strong risk management, policies and procedures, along with good board oversight, position it to overcome these more recent challenges.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Support and structural considerations
The subordinated notes issued by DLG in June 2020, which are eligible as Tier 2 Solvency II capital, are rated Baa2(hyb). The rating is derived from the A2 IFSR of UKI and the three notch differential reflects Moody's standard notching practices for an insurance holding company domiciled and operating in jurisdictions where group regulation is in effect, and also reflects the structural and contractual subordination of the notes. The group's Restricted Tier 1 Notes (RT1) take into account the IFSR of UKI and the Solvency II ratio of DLG.

Rating methodology and scorecard factors

Exhibit 6

Direct Line Insurance Group plc

Financial Strength Rating Scorecard [1][2]	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adj Score
Business Profile								A	A
Market Position, Brand and Distribution (25%)								A	A
-Relative Market Share Ratio			X						
-Underwriting Expenses % Net Premiums Written			26.2%						
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		27.2%							
-Reinsurance Recoverable % Shareholders' Equity		51.8%							
-Goodwill & Intangibles % Shareholders' Equity				46.1%					
Capital Adequacy (15%)								A	A
-Gross Underwriting Leverage			3.2x						
Profitability (15%)								A	A
-Return on Capital (5 yr. avg.)		8.3%							
-Sharpe Ratio of ROC (5 yr.)				141.2%					
Reserve Adequacy (10%)								Aaa	A
-Adv. (Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd. avg.)	-8.3%								
Financial Flexibility (15%)								Aa	A
-Adjusted Financial Leverage		18.3%							
-Total Leverage		28.0%							
-Earnings Coverage (5 yr. avg.)		9.1x							
-Cash Flow Coverage (5 yr. avg.)									
Operating Environment								Aaa - A	Aaa - A
Preliminary Standalone Outcome								A1	A2

[1] Information based on IFRS financial statements as of fiscal year ended December 31, 2022. [2] The Scorecard rating is an important component of the company's published rating, reflecting the standalone financial strength before other considerations (discussed above) are incorporated into the analysis.

Source: Moody's Investors Service

Ratings

Exhibit 7

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	STA
Subordinate	Baa2 (hyb)
Pref. Stock Non-cumulative	Ba1 (hyb)
U K INSURANCE LIMITED	
Rating Outlook	STA
Insurance Financial Strength	A2

Source: Moody's Investors Service

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