MOODY'S
INVESTORS SERVICE

Credit Opinion: Direct Line Insurance Group plc

Global Credit Research - 18 Dec 2014

United Kingdom

Ratings

Category	Moody's Rating
Rating Outlook	STA
U K Insurance Limited	
Rating Outlook	STA
Insurance Financial Strength	A2

Contacts

Analyst	Phone
Dominic Simpson/London	44.20.7772.5454
Helena Pavicic/London	
Simon Harris/London	

Key Indicators

Direct Line Insurance Group plc[1][2]

	2013	2012	2011	2010	2009
As Reported (British Pound Millions)					
Total Assets	11,788	12,698	13,770	13,817	13,186
Shareholders' Equity	2,790	2,832	3,871	3,482	3,581
Net Income (Loss) Attributable to Common Shareholders	313	184	249	- 272	133
Gross Premiums Written	3,835	4,001	4,168	4,971	5,291
Net Premiums Written	3,467	3,636	3,911	4,788	5,092
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	7.8%	4.7%	2.8%	3.0%	3.0%
Reinsurance Recoverable % Shareholders' Equity	35.4%	38.4%	21.8%	22.0%	17.2%
Goodwill & Intangibles % Shareholders' Equity	28.2%	25.3%	18.7%	18.2%	18.9%
Gross Underwriting Leverage	3.3x	3.5x	2.9x	3.7x	3.4x
Return on Capital (1 yr)	8.3%	4.5%	6.1%	-7.0%	NA
Sharpe Ratio of ROC (5 yr avg)	NA	NA	NA	NA	NA
Adv (Fav) Loss Dev % Beginning Reserves (1 yr)	-9.1%	-6.7%	-3.6%	5.2%	-2.4%
Financial Leverage	18.7%	25.3%	14.7%	16.4%	15.5%
Total Leverage	22.1%	28.7%	14.7%	16.4%	15.5%
Earnings Coverage (1 yr)	9.6x	9.0x	67.2x	-71.6x	17.4x
Cash Flow Coverage (1 yr)	NA	NA	NA	NA	NA

[1] Information based on IFRS and financial statements as of Fiscal YE December 31 [2] Certain items may have been relabeled and/or reclassified for global consistency

Opinion

SUMMARY RATING RATIONALE

Moody's A2, stable outlook, insurance financial strength rating (IFSR) on Direct Line Insurance Group plc's ("DLG") main operating entity, U K Insurance Limited ("UKI"), reflects DLG's 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, albeit mitigated to a certain extent by recent legal reforms and DLG's claims improvements.

Following the launch of a new corporate identity, DLG, from 1 July 2012, has been operating on a substantially stand-alone basis with corporate functions and governance independent of Royal Bank of Scotland Group plc ("RBSG"). DLG will be fully operationally independent from RBSG once it has migrated its IT applications to new infrastructure, a process it expects to be substantially complete by the end of 2014. Furthermore, RBS completed its required divestment of DLG ahead of the YE14 deadline.

UKI, which is DLG's main (UK) operating subsidiary, currently 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).

Currently, DLG also manages relatively small Italian and German insurance businesses, in relation to which on 25 September 2014, the Group announced that it had reached a binding agreement with Spanish based insurance company Mapfre S.A for the sale of its international operations for total cash sale proceeds of EUR550m. Consequently, at 3Q14 DLG's year to date GWP for ongoing operations (excluding International) were split: 44% UK personal Lines Motor, 30% UK personal lines Home, 12% UK personal lines rescue & other, 14% UK Commercial.

[Note: Information in the key financial indicators and scorecard for YE13 to YE11 is based on IFRS financial statements and the information for 2010 and 2009 is 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].

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 product diversification where motor business predominates, and post the International disposal, DLG will become a pure UK general insurer

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

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

-Enhancing contribution of the Commercial business to overall operating profit

Rating Outlook

The rating outlook is stable.

What to Watch For:

- Completion of International division disposal expected in Q1 2015 and return of substantially all of the net proceeds to shareholders

- Pricing in very competitive UK Motor and Home markets

- Further regulatory developments in the UK personal lines insurance market

- Reinsurance renewal rates for the UK personal motor market

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 the Commercial business

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.

Notching Considerations

The guaranteed subordinated notes issued by Direct Line Insurance Group plc 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 (vs. the senior rating) for subordinated debt that lacks a mandatory trigger we consider to be "meaningful".

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. The key factors currently influencing the rating and outlook are:

MARKET POSITION, BRAND AND DISTRIBUTION: Aa - DECLINING TOP LINE, BUT PERSONAL LINES MARKET POSITION EXPECTED TO REMAIN VERY STRONG

We view DLG's market position as excellent. DLG is the largest personal Motor and Home lines writer in the UK, and its brands, especially Direct Line and Churchill, are very powerful. DLG's SME commercial business is growing, but its market share remains relatively modest at this stage.

We expect DLG's personal lines market position to remain very strong going forward despite the decline witnessed over the last few years as a result of DLG exiting unprofitable business, de-risking the book, re-pricing, the cessation of the Tesco Personal Finance (TPF) joint venture and the strong growth of price comparison websites (PCW).

GWP for ongoing operations were 5% lower for the first 9m of 2014, reflecting increased competition in personal home and the continued reduction in personal motor rates, partially offset by growth in Commercial. Going forward, we expect DLG's top line to decrease further as the Group maintains its disciplined approach to underwriting in a competitive market place.

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 Commercial division also benefits from some direct distribution, although the majority of business is accessed via brokers. DLG continues to improve its distribution capabilities by investing in new websites and digital propositions.

More negatively, 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, which aim to reduce costs to £1bn by YE14, the expense ratio is expected to remain above personal-lines-orientated-peers.

PRODUCT RISK & DIVERSIFICATION: Baa - POST INTERNATIONAL DISPOSAL DLG WILL BE A PURE UK GENERAL INSURER WITH RELATIVELY WEAK BUSINESS DIVERSIFICATION

DLG writes non-life business, split approximately 85% personal lines, 15% commercial lines, with the main classes of business being Motor and Property. Management view the business on a divisional basis, which at YE13, by GWP (excluding international) was split: UK Motor (44%), UK Home (30%), UK Rescue & Other (12%) and UK Commercial (14%).

Business line diversification is viewed as relatively limited in light of the preponderance of personal lines Motor and Home business. Furthermore, following the sale of the International division, DLG will be entirely focused on the UK general insurance market. However, given that the International division was relatively small in the context of the Group, its sale does not have a material impact on our overall view of DLG's product risk and diversification.

More positively, 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.

ASSET QUALITY: A - RELATIVELY CONSERVATIVE INVESTMENT PORTFOLIO, ALTHOUGH HIGH WEIGHTING TO CORPORATE BONDS AND MODEST RE-RISKING A FEATURE

We view overall asset quality as good. DLG has a relatively conservative investment portfolio, but has undertaken some modest re-risking in recent quarters. During the first 9 months of 2014, DLG's UK business invested £234m in securitised credit, £57m in investment property and allocated £286m to short duration high yield investments. The securitised credit and high yield allocations, at 6% and 4% of invested assets respectively, are now in line with target levels and DLG expects investment property to reach its target levels during 2015. The Group has also approved an allocation of 6% to UK infrastructure debt and 4% to investment grade private placements debt, with investments expected to commence in the 4Q14 and 1Q15 respectively.

The high risk assets as a % of equity ratio was very low at YE13 but has increased to around 19% at 3Q14 (YE13: 7.8%) as a result of recent reallocations. High risk assets are primarily comprised of property investments and high yield bonds but DLG continues to have no equities exposure.

At 3Q14, 96% of DLG's UK investments were in bonds and cash (YE13: 97%). However, DLG has repositioned the credit part of its portfolio such that corporate bonds now represent 59% of UK invested assets, which is significantly higher than a number of UK/European P&C peers. The credit quality of the fixed income portfolio is very good, with around 83% of the fixed income portfolio rated A or higher at HY14, although during 2013 DLG increased the weighting to BBB credit (to 17% at HY14 from 10% at YE12) and the weighting to AAA credit has reduced (to 16% at HY14 from 41% at YE12). However, there is concentration risk in the government bond portfolio via its significant proportion of UK gilts, and within the corporate bond portfolio there remains significant, albeit reduced, exposure to the banking sector.

DLG's asset quality benefits from its relatively low, albeit increased level of reinsurance recoverables, which at HY14 were c37% of equity (YE13: 35%), and still low, albeit increased, level of reported goodwill & intangible assets (including DAC) which at remained at c.28% of equity at HY14.

CAPITAL ADEQUACY: A - GOOD CAPITALISATION NOTWITHSTANDING REDUCED EQUITY LEVEL

We view overall capital adequacy as good. Following improved capitalisation in 2011, reported total equity, in line with our expectations, reduced by 27% to £2,832m in 2012 following the £1bn dividend payment to RBSG and the reclassification (and subsequent repayment in January 2013) of the TPF non-controlling interest of £259m. As such, Moody's gross underwriting leverage metric, which was relatively low at 2.9x at YE11, increased to 3.5x at YE12 although has since reduced to 3.3x at YE13 notwithstanding a 2% fall in equity.

In terms of regulatory coverage, the IGD coverage ratio improved during 2013 to 292% and again in first 6m of 2014 to a high 312% (YE12: 279%). The Group's risk-based solvency coverage ratio also increased during 2013 to 149% (YE12: 145%) post final and second special interim dividend payments (regular dividend was 50% of earnings from ongoing operations). At HY14, this ratio remained around 149% and is therefore at the upper end of DLG's target range of 125-150%.

We note that DLG's risk management and modelling capabilities continue to be developed. DLG continues to enhance 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.

PROFITABILITY: A - UNDERWRITING PERFORMANCE CONTINUES TO IMPROVE, BUT THE HIGHLY COMPETITIVE UK PERSONAL LINES MARKET IS A CHALLENGE

We view overall profitability as good. Aided by further benefits from its claims transformation programme and cost savings, DLG is targeting a 15% Return on Tangible Equity (RoTE) from ongoing operations, and is aiming for a 95-97% combined operating ratio (COR) for 2014, assuming a normal level of weather claims.

Despite DLG's significant exposure to the very competitive UK personal motor market, its underwriting performance continued to improve during 2013. At YE13, DLG reported an annualised RoTE from ongoing operations of 16% (YE12 pro-forma: 13.4%), net income of £313m (£184m), and a 96.1% COR (99.2%), its lowest level for 5 years. However, we note that 2013 benefitted from lower weather claims, and like 2012, substantial reserve releases, which contributed to the increase in the Group's return on capital (ROC) from 4.5% at YE12 to 8.3% at YE13.

At HY14, DLG reported RoTE of 15.8%, a 7.8% increase in profit before tax to £225m and a 96.6% COR. However, operating profit was down 13.1% to £249m, reflecting higher weather claims and lower prior year reserve releases. At 3Q14, the Group confirmed its expectations to be within its 95%-97% COR target including the benefits of higher than expected prior year reserve releases, no major weather events in Q3, partially offset by some adverse developments in large bodily injury claims.

Historically, profitability has been mixed. DLG's results were impacted in 2009, and especially 2010, by significant UK Motor bodily injury reserve strengthening. But performance significantly improved during 2011, with DLG returning to profit and recording a Moody's return on capital (ROC) metric of 6.1% (YE10: -7.0%), and reporting an improved overall COR of 102% (YE10: 121%) for its ongoing business.

Going forward, we expect DLG to stabilise as benefits, albeit to a lesser extent, from it maintaining momentum on claims transformation, from parts of its business yielding income but with no underwriting risk and further investments into technological distribution and pricing capabilities are partially offset by headwinds from: 1) our expectation that the UK personal motor market will remain inherently very competitive; 2) uncertainty as a result of increased regulatory scrutiny of UK personal lines; and 3) pricing pressure witnessed in personal home lines continuing.

RESERVE ADEQUACY: A - SUBSTANTIAL RESERVE RELEASES A RECENT FEATURE, BUT INHERENT CHALLENGE OF BODILY INJURY CLAIMS

DLG returned to a prior year reserve release during 2011 for an amount of £227m (YE10: -£285m), and during 2012 and 2013, reported substantial reserve releases amounting to £322m (6.7% of opening net reserves) and £435m (9.1%) driven mainly by its Motor division where it has seen favourable development on Motor bodily injury claims. This trend has continued into 2014, with the Group recognising overall reserve releases of £218m for the first 6 months, which were above DLG's initial expectations, and additional releases in Q3.

We expect DLG to remain prudent in its reserving of current accident years and therefore expect reserve releases to remain a meaningful contributor to operating profit, but not to the same extent as the exceptional levels in 2013 and 2014 YTD. However, volatility still remains within the external Motor market as the stock of Periodical Payment Order (PPO) awards continues to increase and with large bodily injury claims continuing to be an industry-wide issue. In this regard, we note that during 2014 YTD DLG has experiences higher than expected large bodily injury claims.

At 5%, DLG has reported a small, albeit increased, annual reserve release on average from 2013-2009. However this average is affected by prior years reserves strengthening 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.

FINANCIAL FLEXIBILITY: A - FINANCIAL LEVERAGE EXPECTED TO REMAIN RELATIVELY LOW AND EARNINGS COVERAGE GOOD ALTHOUGH FINANCIAL FLEXIBILITY SOMEWHAT CONSTRAINED

We view DLG's overall financial flexibility as good. Adjusted financial leverage at YE13 was relatively low and decreased to 18.7% (YE12: 25.3%) benefitting from the repayment of the TPF subordinated loan. There was a slight uptick at HY14 to around 19.3% but going forward, we expect DLG's financial leverage to remain relatively low in relation to UKI's A2 IFSR.

DLG's debt comprises nominal £500m lower Tier 2 capital in the form of dated subordinated notes, issued in April

2012, which qualify for 25% equity credit from Moody's, together with bank debt and an operating lease expense which increased significantly during 2012.

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 - £29m for 2012 and £37.7m for YE13 - but we expect earnings coverage, which at YE13 improved to around 9.6x (YE12: 9.0x), to be good going forward.

Financial flexibility is somewhat constrained by DLG's limited record in accessing capital markets as a result of its ownership history. 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 RBSG's divestment as benefitting the Group's financial flexibility.

Rating Factors

Direct Line Insurance Group plc[1][2]

Financial Strength Rating Scorecard	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adjusted Score
Business Profile								**A**	**A**
Market Position and Brand (25%)								**A**	**Aa**
- Relative Market Share Ratio		**X**							
- Underwriting Expense Ratio % Net Premiums Written				**32.4%**					
Product Focus and Diversification (10%)								**Baa**	**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	**7.8%**								
- Reinsurance Recoverable % Shareholders' Equity		**35.4%**							
- Goodwill & Intangibles % Shareholders' Equity		**28.2%**							
Capital Adequacy (15%)								**A**	**A**
- Gross Underwriting Leverage			**3.3x**						
Profitability (15%)									**A**
- Return on Capital (5 yr avg)									
- Sharpe Ratio of ROC (5 yr avg)									
Reserve Adequacy (10%)								**Aa**	**A**
- Adv (Fav) Loss Dev % Beginning Reserves (5 yr. wtd avg)		**-5.0%**							
Financial Flexibility (15%)								**Aa**	**A**
- Financial Leverage		**18.7%**							
- Total Leverage		**22.1%**							
- Earnings Coverage (5 yr avg)			**6.3x**						
- Cash Flow Coverage (5 yr avg)									
Operating Environment								**Aaa - A**	**Aaa - A**
Aggregate Profile								**A1**	**A2**

[1] Information based on IFRS and 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

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 http://www.moodys.com for the most updated credit rating action information and rating history.