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CREDIT OPINION
26 April 2016

Update

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RATINGS

Direct Line Insurance Group plc

Domicile	United Kingdom
Long Term Rating	Baa1
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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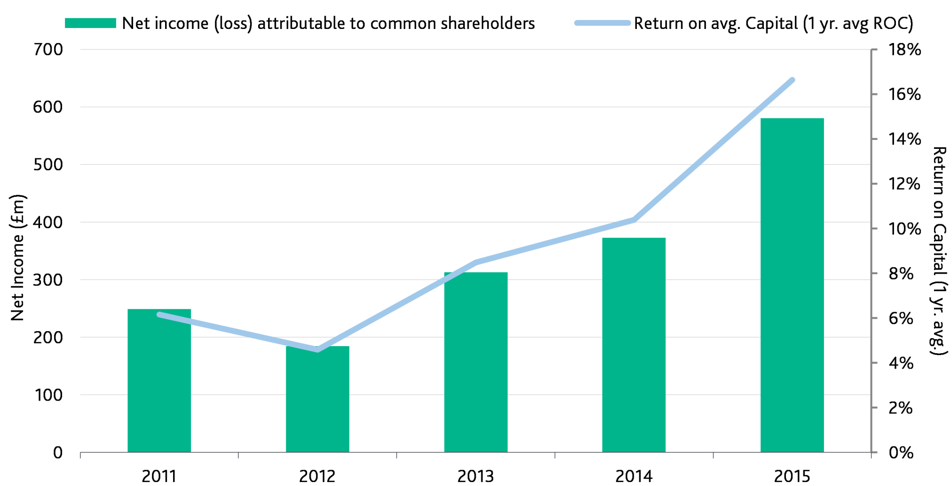
Direct Line Insurance Group plc

Semi-Annual Update

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 somewhat offset by the group's limited geographic and business line diversification, the challenge of sustaining recent performance trends (see exhibit 1) in the very competitive UK general insurance market and execution risk associated with the group's ongoing restructuring program.

Exhibit 1
Direct Line Group's Net Income and 1-year Average Return on Capital



Source: Company reports and Moody's Investors Service

Previously part of the Royal Bank of Scotland Group plc (RBS), DLG launched its new corporate identity in July 2012 the point at which it became legally and operationally independent and underwent an IPO in October 2012. In 2014, DLG 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. At YE15 gross written premiums (GWP) from DLG's ongoing operations, excluding International, were split: 45% UK personal lines motor, 27% UK personal lines home, 13% UK rescue and other personal lines and 15% UK commercial.

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 profitability, which has been improving year-on-year and has exceed internal targets

» Good capitalisation as measured by Solvency II and relatively low financial leverage

Credit Challenges

» Sustaining the premium base following the loss of the Nationwide and Sainsbury's distribution agreements and as price continue to decline in home and remain under pressure in SME commercial

» Limited geographic and business line diversification in which motor business predominates

» Sustaining recent underwriting performance trends in the very competitive UK personal lines market and as the contribution from prior year reserve releases reduces

» Enhancing contribution of the commercial business to overall operating profit

» Execution risk associated with the group's on-going restructuring program and balancing investments into new technologies with expense reductions

Rating Outlook

The outlook is stable reflecting Moody's expectation that the group will sustain its recent financial performance and that its on-going investment and change initiatives will stimulate modest growth and further reduce expenses. However, tough trading conditions in the UK personal lines general insurance market are expected to remain a constraint in this regard.

What to Watch For:

- Pricing in very competitive UK Motor and Home markets

- Further regulatory developments in the UK personal lines insurance market

- UK weather losses

- DLG's Solvency II capital coverage ratio, following the transfer to the group's internal capital model

Factors that Could Lead to an Upgrade

» Average return on capital through the cycle of at least 8% with modest premium growth

» Sustained gross underwriting leverage of 3x or below

» Profitable development of the Commercial and Personal Lines Rescue & Other businesses

Factors that Could Lead to a Downgrade

» Continued reduction in premiums resulting in a material loss of market share

» Average return on capital through the cycle below 6%

» Adjusted financial leverage in excess of 30% with earnings coverage below 6x

» Meaningful deterioration in capital adequacy

Key Indicators

Exhibit 2

Direct Line Insurance Group plc[1][2]	2015	2014	2013	2012	2011
As Reported (British Pound Millions)					
Total Assets	9,957	11,226	11,788	12,698	13,770
Total Shareholders' Equity	2,630	2,811	2,790	2,832	3,871
Net income (loss) attributable to common shareholders'	580	373	313	184	249
Gross Premiums Written	3,153	3,099	3,230	4,001	4,168
Net Premiums Written	2,961	2,917	3,071	3,636	3,911
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	25.1%	20.4%	7.8%	4.7%	2.8%
Reinsurance Recoverable % Shareholders' Equity	36.6%	30.4%	35.4%	38.4%	21.8%
Goodwill & Intangibles % Shareholders' Equity	26.4%	24.7%	28.2%	25.3%	18.7%
Gross Underwriting Leverage	2.9x	2.7x	3.1x	3.5x	2.9x
Return on avg. Capital (1 yr. avg ROC)	16.6%	10.4%	8.5%	4.6%	6.2%
Sharpe Ratio of ROC (5 yr. avg)	197.5%	66.4%	NA	NA	NA
Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg)	-11.5%	-9.5%	-9.1%	-6.7%	-3.6%
Financial Leverage	18.3%	18.1%	18.7%	21.7%	14.4%
Total Leverage	22.2%	21.8%	22.1%	25.2%	14.4%
Earnings Coverage (1 yr.)	16.7x	11.8x	9.5x	8.9x	88.5x
Cash Flow Coverage (1 yr.)	NA	NA	NA	NA	NA

[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: Company reports and Moody's Investors Service

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:

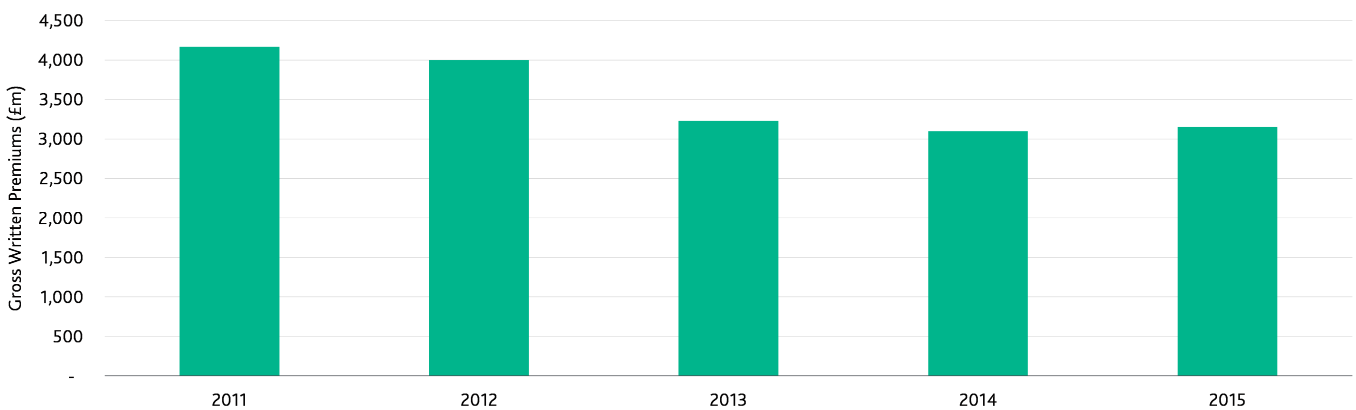
MARKET POSITION, BRAND AND DISTRIBUTION: Aa - VERY STRONG POSITION IN UK PERSONAL LINES MARKET

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, especially Direct Line and Churchill, are very powerful. DLG's SME commercial business is growing, but its overall market share remains relatively modest at this stage.

We expect DLG's personal lines market position to remain very strong going forward. In 2015, for the first time after several years of decline, GWP from ongoing operations grew by 2%, helped by an increase in both motor rates and volume of motor and home own brand policies. We expect that the termination of the Sainsbury's distribution agreement will have only a moderate impact on premiums and will be broadly offset by growth in own brands; and that further pricing pressure in home and SME commercial lines will be partially offset by continued price inflation in the motor segment. While DLG's distribution agreement with Nationwide accounts for a material portion of the group's premium base, we note that its termination will begin to reflect in the Group's top line in 2017.

Exhibit 3

Direct Line Group's Gross Written Premiums



Source: Company reports

Overall we view DLG's personal lines distribution as strong, with products sold directly by phone, over the internet, through PCWs as well as via partnerships including RBS/NatWest. The Commercial division also benefits from some direct distribution, although the majority of premiums are accessed via brokers. DLG also continues to improve its distribution capabilities by investing in new websites and digital propositions.

More negatively, DLG's underwriting expense ratio remains relatively high and above personal-lines-orientated peers, despite the group's inherent scale advantages. However, the expense ratio reduced to 32.4% in 2015 (YE14: 35.7%) in line with the reduction of the group's cost base to below its target £1bn. We expect this ratio to continue to improve via (i) the implementation of efficiency programs initiatives; and (ii) as DLG continues to reduce the portion of business it distributes though partnerships, which typically include high commissions.

PRODUCT RISK & DIVERSIFICATION: Baa - RELATIVELY LOW PRODUCT RISK OFFSET BY LIMITED BUSINESS DIVERSIFICATION & DEPENDENCE ON THE UK

DLG writes UK non-life business, split 85% personal lines and 15% commercial lines. In 2015 the business was split into motor (45%), home (27%), rescue & other (13%) and commercial (15%) by GWP. In our view product line diversity is therefore relatively limited in light of the preponderance of personal motor and home lines.

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, and windstorm and flood catastrophe risk, DLG purchases significant reinsurance cover. In this regard, we note that despite DLG's 2015 loss ratio being adversely affected by both an uptick in large bodily claims frequencies and severe flood losses, the group's combined ratio remained within its 92-94% upgraded range target for 2015.

ASSET QUALITY: A - RELATIVELY CONSERVATIVE INVESTMENT PORTFOLIO NOTWITHSTANDING INCREASING HIGH RISK ASSETS

We view DLG's asset quality as good. The group has a relatively conservative investment portfolio, with 90% held in fixed income securities and cash, but continues to undertake some re-risking actions. This is reflected in the high risk assets (HRA) as a % of shareholders' equity ratio, which has gradually increased to 25.1% at YE15 from 7.8% at YE13. DLG continues to have no exposure to, or appetite for, equities and as such, HRA are primarily comprised of property investments and high yield bonds. DLG did however start investing into UK infrastructure during 2014 to support the asset strategy backing PPO liabilities.

With regard to the main changes in the asset mix during 2015, DLG decreased its investments in sovereign bonds by £551m to 6.4% of total invested assets and increased its exposure to infrastructure by £253m to 4.8%. DLG also continued to repositioned the credit part of its portfolio, such that corporate bonds now represent 60.5% of invested assets (YE14: 58.0%), 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 74.2% of the fixed income portfolio rated A or higher as at YE15, although DLG is increasing its exposure to below investment grade securities .

DLG's overall asset quality also benefits from its relatively low, albeit somewhat increased, level of reinsurance recoverables at 36.6% of equity at YE15, and a low level of reported goodwill & intangible assets (including DAC) at c.26.4% at YE15.

CAPITAL ADEQUACY: A - GOOD CAPITALISATION NOTWITHSTANDING REDUCED EQUITY LEVEL

We view DLG's overall capital adequacy and quality of capital as good. In line with our expectations, reported total equity reduced by 32% to £2,630m since 2011 following the £1bn dividend payment to RBSG in 2012; the reclassification and subsequent repayment of the TPF non-controlling interest of £259m in 2013; and special dividend payments in 2014 and 2015. However, we note that total equity as a % of net written premiums has been stable during this period. Furthermore, Moody's gross underwriting leverage (GUL) metric, which adjusted for the sale of International in 2014 remains around 3x, and is in line with our expectation for a personal lines player at the current rating level.

In terms of regulatory coverage, DLG has reported a solvency II ratio of 147.4% as at YE15 under the standard formula (post the announced second special dividend of £121m), which is – as expected – broadly in line with the group's YE14 pro-forma risk-based solvency coverage ratio of 148.2%. The group aims to move to its internal model during 2016, subject to regulatory approval. Under the internal model, DLG expects an increase in the coverage ratio, albeit no step change in the capital requirements. At this stage, the group will therefore review and recalibrates its risk appetite and target coverage range and may announce a further special dividend.

PROFITABILITY: A - PROFITABILITY TARGETS HAVE BEEN EXCEEDED ONCE AGAIN, BUT THE HIGHLY COMPETITIVE UK PERSONAL LINES MARKET REMAINS A CHALLENGE

Going forward, we expect DLG's bottom line profitability to remain relatively stable as lower expense (which were down 4.6% in 2015) and lower current year claims offset any premium reduction and the reduction of prior year reserve releases. We also believe that DLG's on-going invested asset portfolio changes and investments into technological distribution, pricing capabilities and other initiatives can help offset headwinds from our expectation that (i) the UK personal motor and home market will remain inherently very competitive; and (ii) pricing pressure witnessed in personal home lines during 2015 will continue into 2016.

Despite DLG's significant exposure to the very competitive UK personal motor market, its underwriting performance continued to improve in 2015 with underwriting profit up 18%. In 2015, DLG reported operating profit from ongoing operations up 3% to £521m as underwriting improvements were partially offset by lower investment returns. Net income increased by 56% to £850m, benefitting from the £167m gain from the disposal of the International division and £30m of realised investment gains.

The combined operating ratio (COR) for ongoing operations improved to 94% (2014: 95%), helped by another year of very strong prior year reserve releases and improved operational efficiency. We also note that the 94% COR incorporates weather losses, which were 2ppts higher compared to DLG's budget for the year, and the group has lowered its 2016 target combined ratio to 93-95%.

With regard to Moody's scorecard metrics, DLG's 5 year average return on capital (ROC) doubled to 9.3% (YE14: 4.5%) and Sharpe ratio of ROC improved to 197.3% (YE14: 66.0%), reflecting the year-on-year improvement in performance since 2011, aided by benefits from the group's claims transformation programme, cost savings and disciplined approach to underwriting.

RESERVE ADEQUACY: A - RESERVE RELEASES EXPECTED TO REDUCE BUT REMAIN A FEATURE, NOTWITHSTANDING INHERENT CHALLENGE OF BODILY INJURY CLAIMS

DLG has reported significant prior year reserve releases since 2011, as reflected in the 5 year weighted average favourable loss development as % of opening reserves, of 9.6% (2015-2011). Reserve releases have been driven mainly by the group's motor division in relation to favourable development on bodily injury claims, a trend which had continued into 2015, with the group recognising overall reserve releases of £378.9m, above DLG's initial expectations.

Notwithstanding the change in DLG's reserving methodology, whereby the group no longer automatically books a margin on motor current year claims, we expect DLG to remain prudent in its reserving of current accident years and therefore expect reserve releases to remain a material contributor to future operating profit, albeit not to the same extent as the exceptional levels in 2013, 2014 and 2015.

Volatility still remains within the UK 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 the higher than expected large bodily injury claims trend experienced in 2014. Furthermore, there has also been an increase in the cost of damage claims from increased repair costs, used car prices and credit hire costs, which is increasing claims inflation.

FINANCIAL FLEXIBILITY: A - RELATIVELY LOW LEVERAGE AND EXCELLENT EARNINGS COVERAGE PARTIALLY OFFSET BY DLG'S LIMITED RECORD IN ACCESSING CAPITAL MARKETS

We view DLG's overall financial flexibility as good. Adjusted financial leverage at YE15 remained relatively low at 18.3% (YE14: 18.1%) and comprises £500m of dated subordinated notes, which qualify for some equity credit from Moody's, together with bank debt and an operating lease expense adjustment. Following the special dividend payments related to the sale of International and build-up of surplus capital, leverage has likely increased, but we expect it to remain below 20% going forward, i.e. relatively low in relation to the A2 IFSR.

Earnings coverage has been excellent and continues to improve to 16.7x for 2015 (based on profits from ongoing operations) from 11.8x at YE14. However, the 27x average earnings coverage metric per Moody's scorecard is distorted by the intra-group nature of finance costs prior to the debt issuance in 2012.

As a result of its historic ownership, DLG has a somewhat limited record in accessing capital markets. However, we regard the IPO, following the lower Tier 2 debt issuance in April 2012, as evidence that DLG can successfully access capital markets on a standalone basis.

Rating Methodology and Scorecard Factors

Exhibit 4

Financial Strength Rating Scorecard [1][2]	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%)								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		25.1%							
- Reinsurance Recoverable % Shareholders' Equity		36.6%							
- Goodwill & Intangibles % Shareholders' Equity		26.4%							
Capital Adequacy (15%)								Aa	A
- Gross Underwriting Leverage		2.9x							
Profitability (15%)								A	A
- Return on Capital (5 yr. avg)		9.3%							
- Sharpe Ratio of ROC (5 yr. avg)				197.5%					
Reserve Adequacy (10%)								Aaa	A
- Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd avg)	-9.3%								
Financial Flexibility (15%)								Aa	A
- Financial Leverage		18.3%							
- Total Leverage		22.2%							
- Earnings Coverage (5 yr. avg)	27.1x								
- Cash Flow Coverage (5 yr. avg)									
Operating Environment								Aaa - A	Aaa - A
Aggregate Profile								Aa3	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: Company reports and Moody's Investors Service

Ratings

Exhibit 5

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	STA
U K INSURANCE LIMITED	
Rating Outlook	STA
Insurance Financial Strength	A2

Source: Moody's Investors Service

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