MOODY'S
INVESTORS SERVICE

Rating Action: Moody's downgrades Direct Line's IFSR to A2, stable outlook

20 September 2023

London, September 20, 2023 – Moody's Investors Service ("Moody's") has downgraded to A2 from A1 the insurance financial strength rating (IFSR) of U K Insurance Limited, the key operating entity of Direct Line Insurance Group plc (DLG). In the same action, Moody's also downgraded DLG's subordinated debt rating to Baa2(hyb) from Baa1(hyb) and its restricted tier 1 securities – preferred stock non-cumulative rating – to Ba1(hyb) from Baa3(hyb). The outlooks on both issuers have been changed to stable from negative.

RATINGS RATIONALE

The rating downgrade reflects Moody's expectation that DLG will not restore its profitability 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.

While historical performance has been strong, supported by consistent reserve releases, DLG was negatively impacted in 2022 by difficult operating conditions in the UK personal lines property and casualty (P&C) market, especially motor. While negative trends affected the whole market, DLG has greater concentration in these lines than a number of peers who are either more diversified by line of business or have material other income streams such as those from non-insurance operations or reinsurance and coinsurance commissions. The 7 September announcement of the disposal of its brokered commercial lines business (NIG) to Intact Financial Corporation's subsidiary Royal & Sun Alliance Insurance Limited (A2, stable), while positive for capital, also increases DLG's concentration towards UK personal lines P&C. Furthermore, Moody's believes 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.

DLG has also been subject to 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.

Performance issues, property devaluations and widening credit spreads during 2022 led to DLG's capitalisation reducing substantially, towards the bottom end of its target range, and the suspension of the group's final dividend. The announced disposal of DLG's NIG business will improve DLG's Solvency II coverage, in excess of 190% on completion from 147% as at 30 June 2023. However, Moody's expects the group to maintain its Solvency II capitalisation towards the middle of its 140-180% target range over the longer term following its capital rebuild. While the transaction is credit positive for capitalisation, the rating agency views the disposal of a profitable business and resulting reduction in diversification as credit negative.

Factors supporting U K Insurance Limited's A2 IFSR include its strong position in the UK personal lines P&C market, improved solvency position, its relatively conservative investment portfolio and low financial leverage.

Moody’s notes that while management has taken action to resolve issues relating to regulatory investigations, capitalisation and profitability, the group’s exposure to governance risk has increased as a result of recent developments. Reflecting Moody’s views of the aforementioned moderate governance risks, the governance issuer profile has been changed to G-3 from G-2 and the credit impact score has been changed to CIS-3 from CIS-2 to reflect the negative impact this risk has had on its ratings. The appointment of a CEO with a track record in UK personal lines business, who will take the role in 2024, is considered a positive development.

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 OR DOWNGRADE OF THE RATINGS

Moody’s said that the following factors could lead to an upgrade of DLG’s rating: (1) Profitability sustainably restored to historical levels, evidenced by return on capital in excess of 10%; (2) Strengthening of the group's franchise, evidenced by improved market share, and materially lower concentration in UK personal lines; (3) Maintenance of the group’s Solvency II ratio towards the upper end of its 140-180% target range; and (4) Adjusted financial leverage consistently below 25%.

Conversely, the following factors could lead to a downgrade of DLG’s rating: (1) Ongoing weak profitability of the business, evidenced by return on capital consistently below 5%; (2) Material weakening of the group's franchise; and (3) Solvency II ratio remaining consistently towards the lower end of group's 140-180% target range.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Property and Casualty Insurers Methodology published in January 2023 and available at https://ratings.moodys.com/rmc-documents/397707. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For further specification of Moody’s key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody’s Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

For ratings issued on a program, series, category/class of debt or security this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series, category/class of debt, security or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the issuer/deal page for the respective issuer on https://ratings.moodys.com.

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The ratings have been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

These ratings are solicited. Please refer to Moody's Policy for Designating and Assigning Unsolicited Credit Ratings available on its website https://ratings.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1288235.

At least one ESG consideration was material to the credit rating action(s) announced and described above.

The Global Scale Credit Rating on this Credit Rating Announcement was issued by one of Moody's affiliates outside the EU and is endorsed by Moody's Deutschland GmbH, An der Welle 5, Frankfurt am Main 60322, Germany, in accordance with Art.4 paragraph 3 of the Regulation (EC) No 1060/2009 on Credit Rating Agencies. Further information on the EU endorsement status and on the Moody's office that issued the credit rating is available on https://ratings.moodys.com.

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