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Research Update:

U K Insurance Ltd. Ratings Affirmed At 'A' After Insurance Criteria Change; Outlook Stable

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Overview

- Following a review of U.K.-based non-life insurer U K Insurance Ltd. (UKI) under our revised insurance criteria, we are affirming our 'A' ratings on the company.
- The ratings reflect our view of UKI's very strong financial profile, underpinned by extremely strong capital adequacy, and strong business risk profile, which is based on its strong competitive position.
- The stable outlook reflects our view that UKI will continue to maintain its very strong capital and earnings profile while maintaining its strong competitive position in the U.K. insurance market.

Rating Action

On May 31, 2013, Standard & Poor's Ratings Services affirmed its 'A' insurer financial strength and counterparty credit ratings on U.K.-based non-life insurer U K Insurance Ltd. (UKI). The outlook is stable.

Rationale

UKI is the main operating insurance subsidiary of Direct Line Group (DLG), and is best known through its Direct Line brand. The ratings reflect our view of the group's very strong financial risk profile, which is underpinned by extremely strong capital adequacy and good earnings stream, and its strong business risk profile based on its strong competitive position in the mature and highly competitive U.K. non-life insurance market.

We combine these factors to derive our anchor for UKI of 'a'. This is the lower of two possible anchors; we chose the lower option because of concerns that capital adequacy may be managed at a lower levels after its sell off from Royal Bank of Scotland Group (RBS) and because of the execution risk inherent in DLG's full divestment from RBS and the impact it may have on UKI's financial flexibility. That said, we delinked the ratings on UKI from those on RBS under our group rating methodology after RBS's stake in UKI's issued ordinary share capital reduced to 48.5% in March 2013. Therefore, the ratings on UKI are no longer affected by any changes in the ratings on RBS.

Most of DLG's business stems from the large and mature U.K. insurance market, where we consider industry and country risks to be intermediate. We do not expect to change our assessment of DLG's industry and country risk during 2013-2015 because its international presence outside the U.K. is limited. It has international operations in Italy and Germany, but lacks scale in these

markets. We do not expect DLG's international operations to grow materially over our five-year rating horizon. DLG's dependence primarily on the U.K. market somewhat constrains DLG's overall business risk profile, because its lack of material geographic diversity exposes UKI to cyclicalities, competitiveness, investment climate, and possible legislative changes in its single market.

UKI has a strong competitive position. It is one of the market leaders in the personal lines markets in the U.K. and has about 9% overall market share (based on reported Association of British Insurers data). It also has strong positions in the motor and home segments. In our view, the group gains sustainable competitive advantage through economies of scale in pricing, claims management procurement, and wider costs. Historical claims data on such a large scale also enables DLG to price more accurately and has helped the group improve its operating performance since 2010. Market-leading brands and direct distribution channels create material competitive advantages for DLG by enabling it to lower its acquisition costs below those of its peers.

UKI's capital and earnings are assessed as very strong. Its capital adequacy is currently in the 'AAA' range but under our base-case scenario, we expect it to gradually weaken to a 'AA' level due to lower level of retained earnings. Our capital and earnings view is also limited by the remaining execution risk of the full divestment of DLG from RBS and the potential for this to reduce prospective capital levels. In 2012, UKI's net combined ratio was 98.8% and net income of £184 million. Our base-case scenario envisages net combined (loss and expenses) ratios in 2013-2015 to be 97%-100%. At the same time, we expect the loss ratio to stabilize at around 66%, net income to average over £250 million, and the dividend payout ratio to be 55%. In our view, UKI may also find it difficult to achieve its targeted 15% return on tangible equity as earnings may fall due to an expected fall in ancillary income (such as referral fees). Low interest rates may also cut into UKI's investment income.

In our view, UKI's risk position is intermediate. While it benefits from the diversity of its investment portfolio and minimal exposure to employee postemployment defined benefits obligations, this is offset by cyclicalities of the U.K. motor market increasing the volatility of capital and earnings. We observed this volatility in 2009-2010 when the company had to significantly strengthen reserves because of high industrywide increases in bodily injury costs and soft market conditions.

More than 90% of UKI's investment portfolio was concentrated in high-quality bonds and cash and the weighted-average credit quality of the total portfolio was in the 'AA' range as of Dec. 31, 2012. We expect UKI's management team to remain committed to its conservative investment strategy.

UKI has adequate financial flexibility, in our view, thanks to its good earnings stream, extremely strong level of capital adequacy, low level of financial leverage (17% as of Dec. 31, 2012), healthy level of fixed-charge coverage (7x), and the successful flotation and follow-on sale of 51.5% of its shares in difficult market conditions. It also successfully issued junior

subordinated debt of £500 million. These positive factors are offset by continued execution risk arising from the sale of RBS's remaining stake. The sale may affect DLG's overall franchise and its capitalization levels.

DLG's enterprise risk management (ERM) and management and governance practices are neutral factors for the ratings. DLG's management and governance is satisfactory. We consider that the executive team, headed by Paul Geddes, is convincingly establishing a track record following a notable turnaround in DLG's operating performance, successful issuance of junior subordinated debt in April 2012, and oversubscribed flotation and subsequent follow-on sale of 51.5% of DLG's shares. In our view, the management team has a very clear strategy and focus on profitability, and is working hard to restore performance to its strong historical levels.

DLG's strategy appears to be well-thought-out and consistent with its organizational capabilities, taking into account market developments. However, the sustainability of the strategy has yet to be proven over the next two to three years, particularly with regard to growth targets and the sustainability of net combined ratios. DLG's senior management team is relatively new, but all members of the team have extensive industry experience and an established track record of achievements in their previous jobs.

We consider DLG's ERM as adequate with strong risk controls, based on adequate risk culture and strong overall risk controls. It has been implementing its stand-alone framework since the first quarter of 2012.

In our opinion, DLG's risk culture is adequate, supported by a demonstrated commitment to risk management by the board of directors and a robust governance structure that is being embedded in the business through high-level controls documents, risk committees, roles and responsibilities, and regular reporting. The ERM function and the chief risk officer (CRO) have significant influence. The framework still needs to be fully embedded, however. We assess overall risk controls at DLG favorably due to sound controls related to underwriting and reserving risks. We also consider UKI's risk models favorably. The reserve increases in 2009 and 2010 weigh on our view of the group's sound reserving process.

We view DLG's liquidity as exceptional. Its liquidity ratio is more than 200%, based on the strength of available sources, mainly the group's regular inflow of premium income and highly liquid asset portfolio.

Outlook

The stable outlook reflects our view that UKI will continue to maintain its very strong capital and earnings profile, with a capital adequacy ratio at least in the 'A' range, as measured by our capital model. We also expect it to maintain its stable operating performance, demonstrated by a net combined ratio of 97%-100%, and its strong competitive position in the U.K. insurance market.

We may raise the ratings if the group's financial flexibility improves as execution risk inherent in DLG's full divestment from RBS reduces, or when its ERM framework is fully embedded. The latter should reduce the likelihood of further unexpected reserve increases.

We could lower the ratings if the capital adequacy ratio measured by our capital model falls below the 'A' range, and earnings do not stabilize at the current level, in line with the expectations outlined above.

Rating Score Snapshot

Financial Strength Rating	A/Stable
SACP	a
Anchor	a
Business Risk Profile	Strong
IICRA	Intermediate Risk
Competitive Position	Strong
Financial Risk Profile	Very Strong
Capital & Earnings	Very Strong
Risk Position	Intermediate Risk
Financial Flexibility	Adequate
Modifiers	0
ERM and Management	0
Enterprise Risk Management	Adequate With Strong Risk Controls
Management & Governance	Satisfactory
Holistic Analysis	0
Liquidity	Exceptional
Support	0
Group Support	0
Government Support	0

Related Criteria And Research

Related criteria

- Insurers: Rating Methodology, May 7, 2013
- Group Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012

- Principles Of Credit Ratings, Feb. 16, 2011
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related research

- List Of Issuers With Ratings Under Criteria Observation Due To S&P's New Insurers Rating Methodology, May 7, 2013
- Standard & Poor's Assigns Insurance Industry And Country Risk Assessments, May 7, 2013

Ratings List

Ratings Affirmed

U K Insurance Ltd.

Counterparty Credit Rating

Local Currency

A/Stable/--

Financial Strength Rating

Local Currency

A/Stable/--

Direct Line Insurance Group PLC

Junior Subordinated*

BBB+

*Guaranteed by U K Insurance Ltd.

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