

CREDIT OPINION

13 December 2021

Update

✓ Rate this Research

RATINGS

Direct Line Insurance Group plc

Domicile	BROMLEY, 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

Update to credit analysis

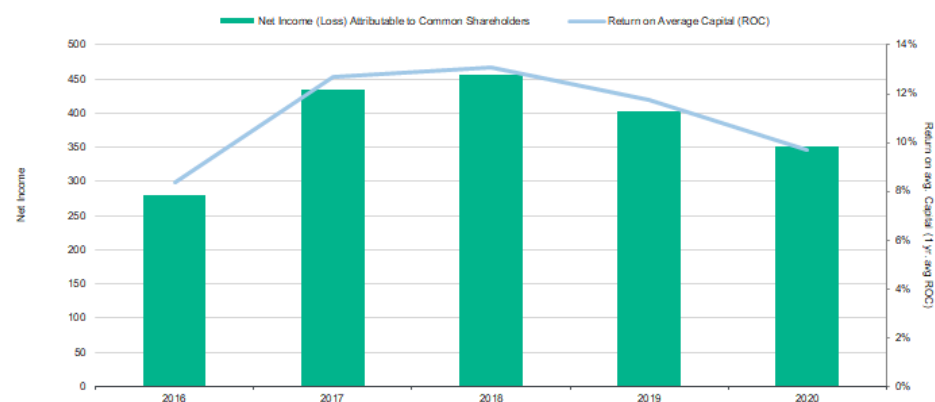
Summary

Direct Line Insurance Group plc's (DLG) main operating entity UK Insurance Limited (UKI) is rated A1 for insurance financial strength with a stable outlook. The rating reflects DLG's (i) consistently strong return on capital (ROC, Exhibit 1) and underwriting results, (ii) very strong position in the UK personal lines general insurance market, (iii) relatively conservative investment portfolio and relatively low financial leverage, and (iv) good capitalisation.

These strengths more than offset the Group's dependence on the very competitive and highly regulated UK personal motor insurance market. While we believe the Group's earnings are sustainable, there is some execution risk around the change in drivers of future profitability, and the Group's technology transformation although with the roll-out of the new motor technology platform the programme is now largely complete.

Exhibit 1

Net income and return on capital (1yr avg)



Source: Company reports and Moody's Investors Service

This report was republished on 13 December with a correction in the rating table on page 9.

Credit strengths

- » Very strong position in the UK personal lines market, with powerful brands
- » Low exposure to product risk, with a personal lines orientation
- » Consistent track record of strong returns on capital and underwriting results
- » Relatively low financial leverage and strong earnings coverage of interest
- » Relatively conservative investment portfolio

Credit challenges

- » Enhancing contributions, both from a premium and profitability perspective, from non-personal lines motor businesses (e.g. commercial and rescue segments)
- » Successfully execute the roll out of the new technology systems and convert efficiency gains into a lower cost base
- » Sustaining recent underwriting performance in the very competitive UK personal lines market and as the contributions from prior year reserve releases reduces
- » Navigating and adapting to changes, including the FCA's pricing measures, in the highly regulated and dynamic UK personal lines market
- » Limited geographical and business line diversification in which motor business predominates

Rating outlook

The rating outlook is stable reflecting primarily our expectation that the company will sustain its strong profitability both from a return on capital and underwriting perspective, while maintaining its very strong position in the UK personal lines general insurance market. The stable outlook is also underpinned by our expectation that the Group will maintain its relatively conservative investment portfolio, good capitalisation and relatively low financial leverage

Factors that could lead to an upgrade

- » Enhanced capital adequacy with gross underwriting leverage of below 2x and Solvency II coverage above 200%;
- » Average ROC (Moody's definition) through the cycle above 15% and a reported combined ratio consistently around 90%;
- » Adjusted financial leverage consistently below 10%;
- » Continued profitable development of non-motor business

Factors that could lead to a downgrade

- » A material reduction in premiums resulting in a material loss of market share; and/or
- » Average return on capital through the cycle below 8%; and/or
- » Adjusted financial leverage in excess of 25% with earnings coverage below 8x; and/or
- » Meaningful deterioration in capital adequacy as reflected in the Group's Solvency II ratio falling sustainably well below 160%

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 www.moody's.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 2

Direct Line Insurance Group plc Key Financial Indicators

Direct Line Insurance Group plc [1][2]	2020	2019	2018	2017	2016
As Reported (Pound Sterling Millions)					
Total Assets	9,622	9,434	9,535	9,948	10,122
Total Shareholders' Equity	3,046	2,990	2,905	3,062	2,522
Net Income (Loss) Attributable to Common Shareholders	351	403	455	434	279
Gross Premiums Written	3,180	3,203	3,212	3,392	3,274
Net Premiums Written	2,949	2,987	2,988	3,184	3,068
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	21.9%	23.0%	24.8%	23.1%	29.1%
Reinsurance Recoverable % Shareholders' Equity	39.0%	42.5%	42.4%	38.8%	51.6%
Goodwill & Intangibles % Shareholders' Equity	31.7%	29.6%	25.6%	21.6%	26.8%
Gross Underwriting Leverage	2.3x	2.4x	2.6x	2.6x	3.1x
Return on avg. Capital (1 yr. avg ROC)	9.7%	11.8%	13.1%	12.7%	8.4%
Sharpe Ratio of ROC (5 yr. avg)	549.5%	422.0%	393.0%	327.2%	219.5%
Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg)	-6.5%	-10.2%	-12.9%	-12.9%	-8.1%
Adjusted Financial Leverage	19.7%	14.4%	15.0%	14.6%	19.3%
Total Leverage	28.3%	23.7%	24.6%	23.8%	23.4%
Earnings Coverage	10.1x	12.6x	14.3x	13.3x	9.2x

[1] Information based on IFRS financial statements as of the fiscal year ended 12/31/2020. [2] Certain items may have been relabeled for global consistency.

Source: Company filings and 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 underwrites around £3.2 billion of gross written premiums (GWP) through its highly recognised brands — Direct Line, Churchill, Privilege and Green Flag — and partners, including [NatWest Group](#) (Baa2 positive).

The Group has four core classes of business in the UK P&C insurance market: personal motor (representing 50% of premiums for 9 months 2021), home (18%), rescue & other personal lines (12%), and commercial (20%), which sells insurance solely to small and medium-sized enterprise (SME) businesses.

Detailed credit considerations

The A1 IFSR is in line with the adjusted scorecard-indicated outcome as shown in the Moody's scorecard (Exhibit 5).

Insurance financial strength rating

The key factors currently influencing the rating and outlook are:

Market position, brand and distribution: Very strong position in UK personal lines; market remains very competitive

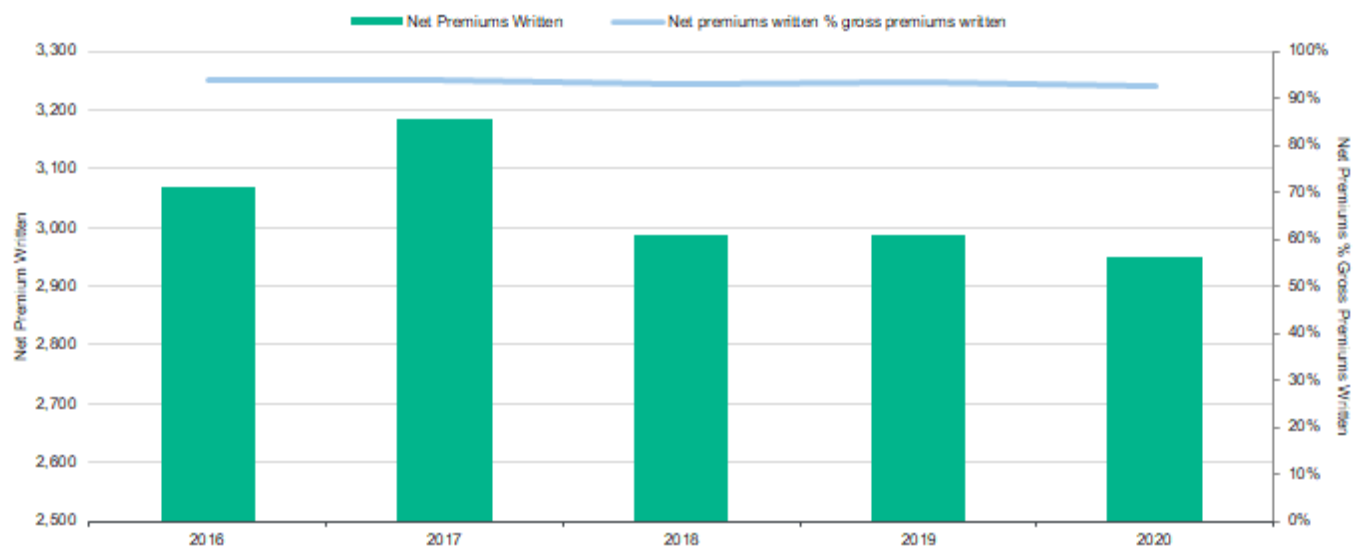
As the largest personal motor underwriter in the UK, as well as a leading home insurer, we consider DLG's market position to be very strong. Its brands, in particular Direct Line and Churchill, are also very powerful. Notwithstanding the decline in total net written premiums (NWP) since 2017, we expect DLG's personal lines market position to remain very strong benefiting from planned growth via its direct brands, price comparison website (PCW) presence and its rescue (via Green Flag) business.

DLG's SME commercial business continues to grow profitably, supported by the Group's investments into risk selection and pricing capabilities. DLG's estimated share of SME commercial insurance market is now around 7%, although the Group has a relatively modest position in the overall UK commercial insurance sector. We expect DLG's commercial segment to continue growing, supported by both the Group's initiatives as well as the underlying expansion of the SME market.

The Group's NWP have declined by 7% to £3.2 billion between 2017 and 2020 (Exhibit 3), largely as a result of exiting of a number of Home distribution partnerships, as well as difficult pricing conditions and the negative impact of COVID-19 on sale volumes in 2020. While the impact of the Coronavirus-induced economic slowdown continued into the first half of 2021, there has been greater premium stability with gross written premiums down only 0.8% for the first 9 months of 2021 (9M21).

Exhibit 3

Net premiums written



Source: Company reports and Moody's Investors Service

Overall, we view DLG's personal lines distribution as strong, with products sold directly by phone, over the internet, through online aggregators, as well as via partnerships particularly in the home segment. To improve efficiency and effectiveness, DLG has reestablished its partnership capabilities in recent years, including exiting and renegotiating a number of existing deals. The commercial division also benefits from some direct distribution (via Direct Line for Business, "DL4B") and some through the PCW channel (via Churchill for Business), although the majority of premiums are still accessed via brokers.

DLG continues to improve its distribution capabilities by investing in new websites, digital propositions (e.g. Darwin, which targets PCWs customers using an alternative pricing system) and by targeting less traditional partnerships. In our view, DLG's multi-channel distribution strategy, powerful brands and financial resources will enable the Group to adapt to 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.

Despite the Group's inherent scale advantages, at around 30% DLG's underwriting expense ratio remains relatively high and above its personal-lines-orientated peers. However, we note that this is driven in part by high marketing costs associated with the Group's direct brand propositions and DLG's ownership of its own garage repair network, which we view as favorable. Going forward, we expect the Group's expense ratio to reduce, via the implementation of ongoing efficiency programme initiatives, including investments in technology, and top-line growth. DLG is aiming to improve its operating expense ratio (excluding commissions) to 20% by YE23 (H121: 25.6%).

Product risk and diversification: Relatively low product risk, offset by limited business diversification and dependence on the UK

In our view, product line diversity is relatively limited in light of the Group's dependence on the UK P&C insurance market as well as the preponderance of personal motor, which accounted for 51% of GWP and 70% of operating profit in 2020. However, the Group's commercial business is growing, and accounted for 20% of Group premiums for 9M21, up from 15% for YE2016, benefitting from its technology transformation.

More positively, DLG's product risk is considered low as a result of this preponderance of personal lines, which accounted for 80% of 9M21 premiums as well as the focus on SME clients within the commercial business. The Group is however exposed to large bodily injury claims volatility, windstorm and flood catastrophe risk, although DLG purchases significant reinsurance cover to mitigate these risks.

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, low reinsurance recoverables as a percentage of shareholders' equity and low levels of goodwill and other intangible assets relative to equity.

As at HY21, c.95% of the Group's assets were held in fixed income securities and cash. The Group has undertaken some re-risking actions in recent years, reflected in the rise in DLG's HRA as a percentage of shareholders' equity ratio to around 23% as of HY21 from 8% as of year-end 2013. However, DLG continues to have no exposure to equities, with HRA primarily comprising property investments and high yield bonds. Since 2014, DLG also has had an exposure to UK infrastructure, which supports the asset strategy backing longer-dated periodical payment order (PPO) liabilities.

As at HY21, DLG's invested assets comprised: 72% fixed income securities, 14% cash and cash equivalents, 5% property investments, 4% infrastructure debt, and 4% commercial real estate loans with an average asset duration of 2.7 years. Corporate bonds represented a material c.71% of invested assets as at HY21, which is significantly higher than a number of its UK/European P&C peers reflecting in part the consequences of not investing in equities. However, the credit quality of the fixed income portfolio is good, with c.78% of fixed income assets rated A or higher, with a well-diversified portfolio by sector. Over the next 12-18 months, we expect only modest tweaks to the Group's investments as the Group continues to shift its portfolio towards its targets.

Capital adequacy: Good capitalisation notwithstanding dividend pay-outs

DLG's capital adequacy is good. The Group has a proven track record in strong internal capital generation. This was reflected in the HY21 regulatory solvency ratio, which increased to 195% (YE20: 191%) as capital generation outweighed the negative impact of dividends, share buybacks and capital expenditure.

We expect DLG's Solvency II ratio to remain robust, but to decline over the coming years and converge towards the middle of its target range of 140%-180%. The Group has a general strategy of returning excess capital to shareholders via special dividends or share buybacks, which will reduce shareholders' equity. In 2020, the Group announced and subsequently completed a £100 million share buyback program. Moreover, the Group's Solvency II ratio will decline if, as expected, DLG redeems its Tier 2 debt (nominal value of £250 million), which has a first call date during the first half of 2022.

With regard to capital sensitivities, the Group has disclosed that its greatest exposures are: (1) a change in the reserving basis for motor PPOs to use a real discount rate of -1%; (2) a 100bp credit spreads increase; and (3) a large catastrophe loss, equivalent to the 1990, which would all individually reduce the Solvency II ratio by 9ppts as at HY21. Given the Group's relatively conservative investment portfolio and lack of equities exposure, DLG's Solvency II ratio is relatively insensitive to market movements aside from those related to credit spreads.

Profitability: Profitability targets likely exceeded for YE21, but the highly competitive, regulated and dynamic UK personal insurance market is a challenge

In 2020, the Group achieved a return on tangible equity (RoTE) of 19.9%, a combined ratio (COR) of 91.0% (below the Group's ongoing 93%-95% target range), and a 2.1% investment yield. This good set of results benefited from a strong underwriting profit notwithstanding reductions in prior year reserve releases and investment return, which has come under more pressure with the fall in interest rates over the years. With regard to our scorecard metrics, DLG's five-year average ROC remained strong at YE20 although reduced to 11.1% (YE19: 12.5%), and the Sharpe ratio of ROC improved to 550% (YE19: 422%).

For the first 6 months of 2021, the Group's operating profit increased by a significant 40% to £370 million. This was mainly due to non-repeat COVID-19 travel claims incurred in 6M20, higher investment gains (£17 million gain in 6M21 vs a £14 million loss for 6M20), lower motor claims frequencies due to lock-down restrictions, benign weather (£3 million of costs for 6M20 vs £30 million for the prior period) and strong prior year reserve releases of £153 million (£123 million for 6M20). Normalised for weather, the Group's COR improved by 4ppts to 86%, benefitting also from the lower motor claims frequency.

However, profit after tax for 6M21 was up a more modest 6% to £204 million, reflecting £91 million of restructuring and one-off costs related to the Group's site strategy as well as an increase of £17 million in finance costs due to the addition interest on the Tier 2 debt issued in June 2020. Nevertheless, this translated to an annualised RoTE of 30%, 15ppt ahead of the Group's target.

We expect DLG's performance to continue to benefit from its disciplined approach to underwriting and claims management, its pricing capabilities supported by its strong brand differentiation, ongoing cost reduction initiatives and revenue growth thereby enabling it to continue to meet, or exceed, its 15% RoTE and underwriting targets. This is notwithstanding the extremely competitive nature of the UK personal lines market, which makes it more difficult for price increases to match claims inflation. The Group also faces some execution risk in (1) the continued roll out of its new technology systems in order to gain efficiency, capability, and flexibility improvements; and (2) maintaining current year contribution to operating profits at more than 50%, to offset the decline in recent years in motor prior year reserve releases.

Reserve adequacy: Reserve releases trending down but to remain a feature, notwithstanding the inherent challenge of motor bodily injury claims

DLG has reported significant prior-year reserve releases since 2011, as reflected in the five-year weighted-average favourable loss development as a percentage of opening reserves, of 9.7% (2020-2016). These reserve releases were driven mainly by the Group's motor division in relation to favourable developments in bodily injury claims.

Given the Group's prudent reserving approach of current accident years, we expect reserve releases to remain a material contributor to future operating profit. However, as expected releases have been trending downward driven predominantly by increasing levels of reinsurance purchased by the Group. Also, motor claims inflation, for which the Group has a 3%-5% long-term range, remains an inherent reserving risk for the market. Motor claims inflation is driven by the rising cost of damages from repair costs because vehicles are fitted with more advanced technology, used car prices and credit hire costs. During 2017, there was also a rise in home claims inflation related to the escape of water, although DLG has taken a number of significant actions across pricing, underwriting and claims management to manage escape of water claims costs.

Furthermore, some volatility will likely remain a feature particularly within the UK motor portfolio. We will continue to monitor changes in PPO propensities and large bodily injury claims although in this regard DLG has excess of loss reinsurance protection above a £1 million retention.

Financial flexibility: Leverage increased in 2020 but expected to remain relatively low, and strong earnings coverage

We view DLG's overall financial flexibility as very good with financial leverage typically below 20% and strong earnings coverage, averaging around 12x over the past five years at YE20 (Exhibit 4).

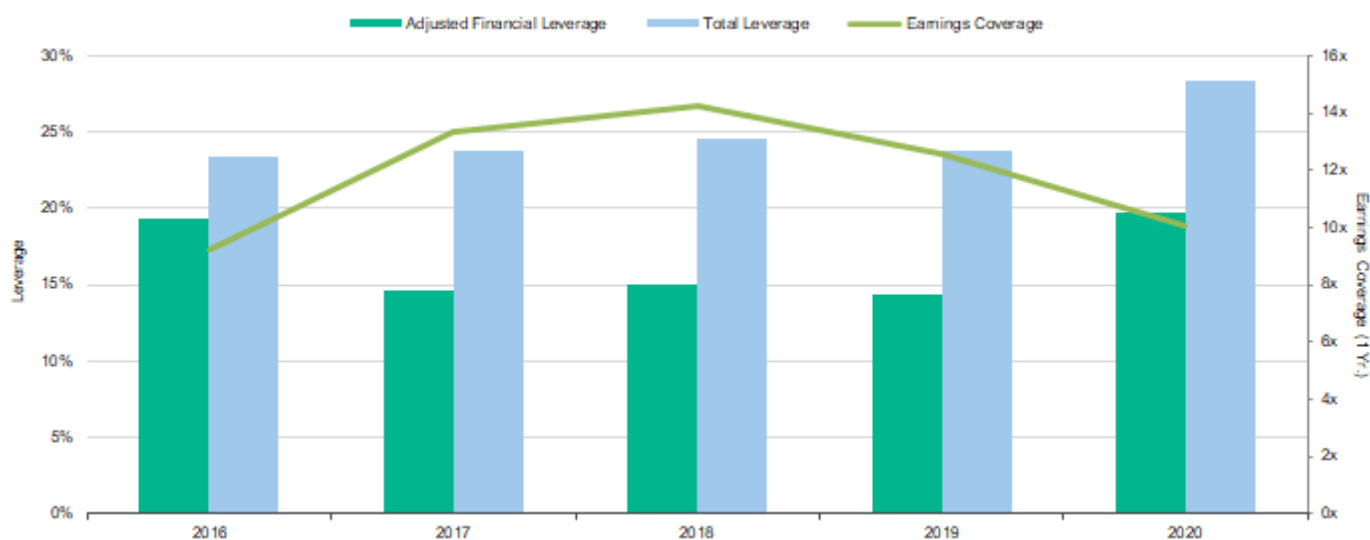
Adjusted financial leverage increased to c.20% at YE20 (YE19: c.14%) driven by the issuance of £260 million of dated subordinated Tier 2 notes in June 2020. Going forward, leverage will also likely be pressured by the Group's dividend policy and future buyback schemes. However, we expect leverage to remain relatively low in relation to the A1 IFSR with financial leverage falling back down to c.15% in

2022 as a result of the Group's acquisition of its Bromley office lease (February 2021), and if, as we expect, DLG redeems its Tier 2 subordinated debt instrument (nominal value of £250 million), which has a first call date in the first half of 2022.

In addition to the two aforementioned dated Tier 2 subordinated notes, the Group has also issued £347 million of restricted tier 1 securities, which qualify for equity credit from us. The Group's borrowings also including bank overdrafts and an operating lease liability.

Exhibit 4

Leverage and earnings coverage



Source: Company reports and Moody's Investors Service

As a result of its historic ownership, DLG has a more limited record in accessing capital markets versus some of the largest UK/European insurers. However, we regard the restricted Tier 1 issuance in December 2017 and the IPO, following the lower Tier 2 debt issuance in April 2012, together with the most recent debt issuance in June 2020 as evidence that DLG can successfully access the capital markets.

ESG considerations

Environmental

Like its P&C insurance peers, DLG is exposed to the economic consequences of climate change, primarily through the unpredictable effect of climate change on the frequency and severity of weather-related catastrophic events, such as floods and storms. However, in the ordinary course of its business, the Group undertakes a number of steps to manage these risk exposures, including the purchase of significant reinsurance cover and the regular reassessment of external catastrophe models to ensure they fully capture climate-related risk.

Furthermore, DLG is focusing increasingly on climate change, with related risk management activity and has published a Task Force on Climate-related Financial Disclosures ("TCFD") Report, which provides the Group with a roadmap to strengthen its strategic response in tackling climate change. Within the Group's sustainability report, DLG has also outlined its commitments to set Science Based Targets to help reduce the Group's carbon footprint as well as various investment strategies to support the Group's long-term aim to achieve carbon neutrality without offsetting.

Social

Like its P&C peers, DLG's social risks arise primarily from underwritten exposures to liability claims against individuals and small businesses.

Governance

Like all other corporate credits, the credit quality of DLG is influenced by a wide range of governance-related issues, relating to financial, managerial, ownership or other factors, all of which can be exacerbated by regulatory oversight and intervention.

While a number of DLG's risk exposures are complex, the Group has a comprehensive risk management framework in place that mitigates various governance risks. Furthermore, DLG operates within a strong regulatory environment, being overseen by the UK's PRA, FCA and other regulatory and industry bodies.

Support and structural considerations

The subordinated notes issued by DLG in June 2020 are rated Baa1(hyb). The rating is derived from the A1 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 guaranteed subordinated notes issued by DLG in April 2012 are rated A3(hyb). The rating reflects the fact that the notes are unconditionally and irrevocably guaranteed by UKI on a subordinated basis and reflect standard notching (versus the senior rating) for subordinated debt that lacks a mandatory trigger we consider to be "meaningful".

Rating methodology and scorecard factors

Exhibit 5

Direct Line Insurance Group plc

Financial Strength Rating Scorecard [1][2]	Aaa	Aa	A	Baa	Ba	B	Caa	ScoreAdj	Score
Business Profile								A	A
Market Position, Brand and Distribution (25%)								A	Aa
-Relative Market Share Ratio			X						
-Underwriting Expenses % Net Premiums Written				30.3%					
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	21.9%								
-Reinsurance Recoverable % Shareholders' Equity		39.0%							
-Goodwill & Intangibles % Shareholders' Equity			31.7%						
Capital Adequacy (15%)								Aa	A
-Gross Underwriting Leverage		2.3x							
Profitability (15%)								Aa	A
-Return on Capital (5 yr. avg.)			11.1%						
-Sharpe Ratio of ROC (5 yr.)	549.5%								
Reserve Adequacy (10%)								Aaa	Aa
-Adv. (Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd. avg.)	-9.7%								
Financial Flexibility (15%)								Aa	A
-Adjusted Financial Leverage		19.7%							
-Total Leverage		28.3%							
-Earnings Coverage (5 yr. avg.)		11.9x							
-Cash Flow Coverage (5 yr. avg.)									
Operating Environment								Aaa - A	Aaa - A
Preliminary Standalone Outcome								Aa3	A1

[1] Information based on IFRS financial statements as of fiscal year ended 12/31/2020. [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 6

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	STA
Subordinate	Baa1 (hyb)
BACKED Subordinate	A3 (hyb)
U K INSURANCE LIMITED	
Rating Outlook	STA
Insurance Financial Strength	A1

Source: Moody's Investors Service

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