MOODY'S
INVESTORS SERVICE

Credit Opinion: U K Insurance Limited

Global Credit Research - 25 Jun 2012

Leeds, United Kingdom

Ratings

Category	Moody's Rating
Rating Outlook	STA
Insurance Financial Strength	A2

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Key Indicators

U K Insurance Limited[1]

	2011	2010	2009
Total Assets (£ Mil.)	£ 13,770	£ 13,817	£ 13,186
Equity (£ Mil.)	£ 3,871	£ 3,482	£ 3,581
Net Income (£ Mil.)	£ 249	-£ 272	£ 133
Gross Premiums Written (£ Mil.)	£ 4,168	£ 4,971	£ 5,291
Net Premiums Written (£ Mil.)	£ 3,911	£ 4,788	£ 5,092
High Risk Assets % Shareholders' Equity	2.6%	2.8%	2.8%
Reinsurance Recoverables % Shareholders' Equity	17.0%	17.3%	12.7%
Goodwill & Intangibles % Shareholders' Equity	17.5%	16.8%	17.6%
Gross Underwriting Leverage	2.7x	3.4x	3.1x
Return on Capital (1 yr.)	6.2%	-7.1%	3.4%
Sharpe Ratio of ROC (3 yr.)	12.3%	0.0%	---
Adv/(Fav) Dev. % Beg. Reserves (1 yr.)	-3.6%	3.5%	-2.6%
Adjusted Financial Leverage	14.7%	16.4%	15.5%
Total Leverage	14.7%	16.4%	15.5%
Earnings Coverage (1 yr.)	34.6x	-36.1x	10.5x

[1] Information 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

Opinion

SUMMARY RATING RATIONALE

Moody's A2, stable outlook, insurance financial strength rating on U K Insurance Limited ("UKI") reflects Direct Line Insurance Group plc's ("DLG") 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. DLG also has to execute a successful divestment from its current owner, the Royal Bank of Scotland Group plc

("RBSG", Baa1 Senior debt rating, negative outlook), by the end of 2014. DLG is progressing in separating its business from RBSG including the launch of a new corporate identity - Direct Line Group.

To comply with EC State Aid requirements, RBSG must cede control of DLG by 31 December 2013 and have divested its entire interest by 31 December 2014. In line with this requirement, RBSG is planning the commencement of an IPO for DLG in H2 2012, subject to market conditions. In light of this divestment requirement, UKI's IFSR is not impacted by Moody's downgrade by one notch of RBSG's ratings on June 21, 2012. However, going forward, UKI's rating could be negatively impacted in the event of 1) a delay to the divestment from RBSG, and 2) a material weakening of RBSG's credit profile as reflected in any further downgrade of RBSG's ratings.

UKI, which is now DLG's main (UK) operating subsidiary, 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). DLG also manages relatively small Italian and German insurance businesses. At YE11, DLG's business, which is UK Motor orientated, was split on a GWP basis: 42% UK personal Lines Motor, 25% UK personal lines Home, 8% UK personal lines rescue & other, 10% UK Commercial, 14% International and 1% other (predominantly personal lines brokers in run-off).

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 geographic and business diversification; UK and Motor business predominate

Sustaining performance improvements and growing profitably in very competitive UK Motor market

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

Enhancing contribution of Commercial and International businesses to overall operating profit

Successful divestment from RBS Group via a planned IPO

Rating Outlook

The rating outlook is stable.

What to Watch For:

-Commencement of planned IPO in H2 2012, subject to market conditions

-UK Motor pricing environment

-Legal developments in UK Motor re claimants' compensation

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 non-UK businesses

-Successful divestment from RBSG

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.

Recent Results and Developments

- As part of RBSG's Q1 12 IMS reporting, an operating profit of £84m (Q1 11: £67m), and a combined operating ratio of 106% (Q1 11: 107%) was reported for the insurance business. The operating profit was negatively affected by adverse weather, but benefited from reserve releases from prior years.

-In April 2012, DLG issued £500m of lower Tier 2 dated subordinated notes.

-At YE11, DLG reported net income of £249m (YE10: loss of £272m), an ongoing business combined ratio of 102% (121%), ongoing gross written premium of £4,125m (£4,095m), and equity of £3,871m (£3,482m).

-As part of RBSG's YE11 reporting on 23/2/12, it was announced that RBSG's insurance business had changed its name to Direct Line Insurance Group plc, and that RBSG continues to plan an IPO for DLG in H2 2012, subject to market conditions.

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.

Insurance Financial Strength Rating

The key factors currently influencing the rating and outlook are:

Factor 1 - Market Position, Brand and Distribution (Aa)

We view DLG's market position as excellent. As at YE10, it was the largest (Source: Association of British Insurers (ABI) personal Motor and Home lines writer in the UK, and its brands, especially Direct Line and Churchill, are very powerful. DLG is also a meaningful player in the direct Motor markets in Germany and Italy, but its overall market position in these countries is very small.

DLG's UK market share has been declining recently as a result of exiting unprofitable business, de-risking the book, re-pricing, and the cessation of the Tesco Personal Finance (TPF) joint venture. Furthermore, in our opinion, its market share, especially in Motor, has been negatively impacted by the strong market growth in price comparison websites ("PCW") which encourage switching and in which, in our view, DLG has been relatively underweight, although Direct Line branded business is deliberately not quoted on PCWs. However, going forward, we expect DLG's personal lines market position to remain very strong.

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 much smaller Commercial insurance also benefits from some direct distribution, although the vast majority of business is accessed via brokers. However, 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.

Factor 2 - Product Risk and Diversification (Baa)

DLG writes non-life business, split 90% personal lines, 10% commercial lines, with the main classes of business being Motor and Property. Management view the business on a divisional basis, which at YE11 and by GWP was split: UK Motor (42%), UK Home (25 %), UK Rescue & Other (8%), UK Commercial (10%), International (14%) and other, predominantly the personal lines broker book in run off (1%). 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.

However, business line diversification is viewed as relatively limited in light of the preponderance of personal lines Motor and Home business, and geographically the book is dominated by UK business. Going forward, geographic diversification could improve as DLG looks to grow organically its international business, but we expect the proportion of UK business to remain very significant for the foreseeable future.

Factor 3 - Asset Quality (A)

We view overall asset quality as good. DLG has a relatively conservative investment portfolio, with 93% of its core investment portfolio invested in bonds and cash as at 31 December 2011. High risk assets as a % of equity is very low - DLG currently has no equities exposure.

The credit quality of the fixed income and cash portfolio is very good, with 95% of the core portfolio rated A or higher. DLG has no exposure to peripheral European sovereign debt and a limited amount of corporate bond exposure to Ireland, Italy and Spain. However, there is concentration risk in the government bond portfolio via its significant proportion of UK gilts, and within the corporate bond portfolio there is significant exposure to the banking sector. Going forward, there is some transition risk as DLG adopts an independent (of RBSG) investment management and treasury function, and looks to reposition its investment portfolio.

DLG's asset quality benefits from its low level of reinsurance recoverables which at YE11 were 17% of equity, and low level of reported goodwill & intangible assets (including DAC) which at YE11 were c.18% of equity.

Factor 4 - Capital Adequacy (A)

We view overall capital adequacy as good. Capitalisation improved in 2011 reflecting lower business volumes as a result of exiting certain lines, and an increase in shareholders' equity of around 11% following the 3% decrease in 2010. Moody's gross underwriting leverage metric has also improved and was relatively low at 2.7x YE11, and the IGD coverage ratio at YE11 is a high and significantly improved 319% (YE10: 227%). However, capital adequacy could weaken somewhat during 2012, with proposed dividend payments from DLG to RBSG in the range of £500 million - £1 billion, of which £300 million was paid in March 2012, negatively impacting equity.

We note that DLG's risk management and modelling capabilities continue to be developed. DLG is currently enhancing 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.

Factor 5 - Profitability (A)

We view overall profitability as good. Profitability from 2007-2011 (see note 1 below) has been mixed, with very good return on capital performance in 2007 and 2008. However, DLG's results were impacted in 2009, and especially 2010, by significant UK Motor bodily injury reserve strengthening. In these years, DLG reported very high combined ratios for its ongoing UK Motor business of 126% and 144% respectively, with overall combined ratios of 110% and 121%. But performance significantly improved during 2011, with DLG returning to profit and recording a Moody's return on capital metric of 6.2% (YE10: -7.1%), and reporting an improved overall combined ratio of 102% for its ongoing business. The reported UK personal lines Motor combined ratio also improved to 106% in 2011.

The UK Motor book benefited in 2011 from significant rate increases, new pricing models and engines, de-risking, exiting unprofitable lines, claims systems improvements, and the non-repeat of 2010 reserve strengthening. Furthermore, we note that DLG materially benefits from additional income generated from its own brand Motor policies, and the performance of its UK Home and Rescue books has been generally good in recent years.

Going forward, DLG is targeting further improvement in the performance of its UK personal lines Motor book. However, a key challenge is that DLG is heavily reliant for its profits on UK Motor which remains a highly competitive market and vulnerable to bodily injury claims inflation, and which in recent years DLG has under-performed.

(Note 1: 2011-2009 figures derived from Direct Line Insurance Group plc, Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012. 2008 and 2007 figures derived from RBS Group Annual Reports.)

Factor 6 - Reserve Adequacy (A)

The reserve adequacy metric score is driven by a small surplus position on average from 2011-2007 (see note 2 below). However, reserves, excluding TPF, were strengthened during 2009 and 2010, driven by respective £391m and £420m (see note 3 below) increases for UK Motor bodily injury reserves 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.

DLG returned to a prior year reserve release during 2011. However, volatility still remains within the external Motor market with large bodily injury claims continuing to be an industry-wide issue, and the number of Periodical Payment Order (PPO) awards continues to increase.

(Note 2: 2011-2009 figures derived from Direct Line Insurance Group plc, Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012. 2008 and 2007 figures derived from RBS Group Annual Reports.)

(Note 3: Divisional IMS numbers derived from RBS Insurance Investor Roundtable presentation, 7 October, 2011)

Factor 7 - Financial Flexibility (A)

We view DLG's overall financial flexibility as good. Adjusted financial leverage at YE2011 remained relatively low, reducing to 14.7% (YE2010: 16.4%) driven by increased equity. For this metric, we include the TPF non-controlling interest amount of £259m which is in the form of a perpetual subordinated loan and which DLG intends repaying in 2013. Following the £500m issuance in April 2012 of lower Tier 2 capital in the form of dated subordinated notes which qualify for 25% equity credit from Moody's, together with the proposed repayment in 2012 of £248m of intra-group debt, adjusted financial leverage on a pro-forma YE2011 basis increases slightly to 16.7% but remains low compared to peers. Going forward, we expect DLG's financial leverage to remain relatively low.

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, interest costs will increase significantly going forward, but we expect earnings coverage going forward to be good.

Financial flexibility is somewhat constrained by DLG's limited record in accessing capital markets as a result of its current ownership. However, DLG successfully passed its first test in this regard, namely raising the lower Tier 2 capital. RBSG's targeted commencement of its IPO of DLG in H2 2012, subject to market conditions, will be another major and larger test of stand-alone financial flexibility.

Rating Factors

U K Insurance Limited[1]

Financial Strength Rating Scorecard	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adjusted Score
Business Profile								**A**	**A**
Market Position, Brand and Distribution (25%)								**A**	**Aa**
Relative Market Share Ratio		**X**							
Underwriting Expense Ratio % Net Premiums Written					**X**				
Product Risk and Diversification (10%)								**Baa**	**Baa**
Product Risk		**X**				**X**			
P&C Insurance Product Diversification				**X**					
Geographic Diversification									

Financial Profile								A	A
Asset Quality (10%)								Aaa	A
High Risk Assets % Shareholders' Equity	2.6%								
Reinsurance Recoverables % Shareholders' Equity	17.0%								
Goodwill & Intangibles % Shareholders' Equity	17.5%								
Capital Adequacy (15%)								Aa	A
Gross Underwriting Leverage		2.7x							
Profitability (15%)								Ba	A
Return on Capital (3 yr. avg)				0.9%					
Sharpe Ratio of ROC (3 yr. avg)					12.3%				
Reserve Adequacy (10%)								Aaa	A
Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. avg.) [2]	-2.4%								
Financial Flexibility (15%)								A	A
Adjusted Financial Leverage	14.7%								
Total Leverage	14.7%								
Earnings Coverage (3 yr. avg.)				3.00x					
Operating Environment (0%)								Aaa - A	Aaa - A
Aggregate Profile								A1	A2

[1] Information 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 [2] 5 year average based on 2011 - 2009 reserves information from the Direct Line Insurance Group plc, Fixed/Floating rate guaranteed subordinated Notes due 2042, Prospectus dated 25 April 2012; and 2008 - 2007 reserves information from the RBS Group annual reports

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