MOODY'S INVESTORS SERVICE

Credit Opinion: Direct Line Insurance Group plc

Global Credit Research - 13 Jun 2014

United Kingdom

Ratings

Category	Moody's Rating
Rating Outlook	STA

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Key Indicators

Direct Line Insurance Group plc[1][2]

	2013	2012	2011	2010	2009
As Reported (British Pound Millions)					
Total Assets	11,788	12,698	13,770	13,817	13,186
Shareholders' Equity	2,790	2,832	3,871	3,482	3,581
Net Income (Loss) Attributable to Common Shareholders	313	184	249	- 272	133
Gross Premiums Written	3,835	4,001	4,168	4,971	5,291
Net Premiums Written	3,467	3,636	3,911	4,788	5,092
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	7.8%	4.7%	2.8%	3.0%	3.0%
Reinsurance Recoverable % Shareholders' Equity	35.4%	38.4%	21.8%	22.0%	17.2%
Goodwill & Intangibles % Shareholders' Equity	28.2%	25.3%	18.7%	18.2%	18.9%
Gross Underwriting Leverage	3.3x	3.5x	2.9x	3.7x	3.4x
Return on Capital (1 yr)	8.3%	4.5%	6.1%	-7.0%	NA
Sharpe Ratio of ROC (5 yr avg)	NA	NA	NA	NA	NA
Adv (Fav) Loss Dev % Beginning Reserves (1 yr)	-9.1%	-6.7%	-3.6%	5.2%	-2.4%
Financial Leverage	18.7%	25.3%	14.7%	16.4%	15.5%
Total Leverage	22.1%	28.7%	14.7%	16.4%	15.5%
Earnings Coverage (1 yr)	9.6x	9.0x	67.2x	-71.6x	17.4x
Cash Flow Coverage (1 yr)	NA	NA	NA	NA	NA

[1] Information based on IFRS and financial statements as of Fiscal YE December 31 [2] Certain items may have been relabeled and/or reclassified for global consistency

Opinion

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 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, albeit mitigated to a certain extent by recent legal reforms and DLG's claims improvements.

Following the launch of a new corporate identity, DLG, from 1 July 2012, has been operating on a substantially stand-alone basis with corporate functions and governance independent of Royal Bank of Scotland Group plc ("RBSG"). DLG will be fully operationally independent from RBSG once it has migrated its IT applications, a process it expects to be substantially complete by the end of 2014. Furthermore, DLG has now completed its required divestment from RBSG ahead of the YE14 deadline; RBSG's shareholding in DLG now amounts to only 0.3%.

UKI, which is 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 YE13, DLG's business, which is UK Motor orientated, was split on a GWP basis: 37% UK personal Lines Motor, 25% UK personal lines Home, 10% UK personal lines rescue & other, 12% UK Commercial and 16% International.

[Note: Information in the key financial indicators and scorecard for YE13 to YE11 is based on IFRS financial statements and the information for 2010 and 2009 is 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, and also, for reserve metrics, information derived from Price Range Prospectus dated 28 September 2012].

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

Rating Outlook

The rating outlook is stable.

What to Watch For:

-Pricing in very competitive UK Motor and Home markets

-Further legal developments in the UK Motor market such as the outcome of the competition commission's investigation into the private motor insurance market including its probe into credit hire and garage repair costs

-Reinsurance renewal rates for the UK personal motor market

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

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.

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 PERSONAL LINES MARKET POSITION EXPECTED TO REMAIN VERY STRONG

We view DLG's market position as excellent. As at YE12, it was the largest (Source: Association of British Insurers) 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.

PRODUCT RISK & DIVERSIFICATION: Baa - RELATIVELY WEAK GEOGRAPHIC AND BUSINESS DIVERSIFICATION WILL LIKELY CONTINUE

DLG writes non-life business, split approximately 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 YE13 and by GWP was split: UK Motor (37%), UK Home (25%), UK Rescue & Other (10%), UK Commercial (12%) and International (16%). 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.

ASSET QUALITY: A - RELATIVELY CONSERVATIVE INVESTMENT PORTFOLIO, ALTHOUGH HIGH WEIGHTING TO CORPORATE BONDS A FEATURE

We view overall asset quality as good. DLG has a relatively conservative investment portfolio, with 97% invested in bonds and cash as at YE13 (YE12: 99%), although the high weighting to corporate bonds has been a recent feature (57% at YE13). The YE13 high risk assets as a % of equity (which for the purposes of our metrics includes equity credit from the Group's subordinated debt) ratio was very low, albeit slight up at 7.8% (YE12: 4.7%) and DLG currently has no equities exposure.

The credit quality of the fixed income portfolio is very good, with around 83% of the fixed income portfolio rated A or higher at YE13, although during 2013 DLG has increased the weighting to BBB credit (to 17% from 10% at YE12) and decreased the weighting to AAA credit (to 13% from 41% at YE12). At YE13, DLG had only a £20.4m (0.7% of adjusted equity) exposure to Italian sovereign debt and a total of £105m (3.6%) exposure to peripheral European debt, the majority of which relates to corporate bonds. However, there is concentration risk in the government bond portfolio via its significant proportion of UK gilts, and within the corporate bond portfolio there remains significant exposure to the banking sector.

In recent years, DLG has repositioned the credit part of its investment portfolio and at YE13, the credit allocation had increased to 63% (YE12: 57%) with corporate bonds representing 57% (YE12: 48%) of invested assets, which is significantly larger than a number of UK/European P&C peers. The Group has also invested around 5% of invested assets in securitised credit and plans to continue to diversify its investment portfolio further in 2014 with investment in infrastructure debt and high yield securities.

DLG's asset quality benefits from its relatively low, albeit increased level of reinsurance recoverables, which at YE13 were 35% of equity (YE12: 38% and YE11: 22%), and still low though increasing level of reported goodwill & intangible assets (including DAC) which at YE13 were c.28% of equity (YE12: 25%).

CAPITAL ADEQUACY: A - GOOD CAPITALISATION NOTWITHSTANDING REDUCED EQUITY LEVEL

We view overall capital adequacy as good. Following improved capitalisation in 2011, reported total equity, in line with our expectations, reduced by 27% to £2,832m in 2012 following the £1bn dividend payment to RBSG and the reclassification (and subsequent repayment in January 2013) of the TPF non-controlling interest of £259m. As such, Moody's gross underwriting leverage metric, which was relatively low at 2.9x at YE11, increased to 3.5x at YE12 although has since reduced to 3.3x at YE13 notwithstanding a 2% fall in equity. The IGD coverage ratio improved during 2013 and is high at 292% (YE12: 279%) albeit reduced from 319% at YE11.

The Group's risk-based solvency coverage ratio increased during 2013 to 149% (YE12: 145%) post final and second special interim dividend payments (regular dividend is 50% of earnings from ongoing operations) and is at the upper end of DLG's target range of 125-150%..

We note that DLG's risk management and modelling capabilities continue to be developed. DLG continues to enhance 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.

PROFITABILITY: A - UNDERWRITING PERFORMANCE CONTINUES TO IMPROVE, BUT THE HIGHLY COMPETITIVE UK MOTOR MARKET IS A CHALLENGE

We view overall profitability as good. Aided by further benefits from its claims transformation programme and cost savings, DLG is targeting a 15% RoTE from ongoing operations, and is aiming for a 95-97% combined operating ratio for 2014, assuming a normal level of weather claims.

Despite DLG's significant exposure to the very competitive UK personal motor market, its underwriting performance continued to improve during 2013. At YE13, DLG reported an annualised Return on Tangible Equity (RoTE) from ongoing operations of 16% (YE12: 13.4% on a pro-forma basis), net income of £313m (£184m), and a combined operating ratio of 96.1% (99.2%), its lowest level for 5 years, and thereby continuing its journey of consistent improvement. 2013 benefitted from lower weather claims, and like 2012, substantial reserve releases.

Profitability from 2009-2011 was mixed. DLG's results were impacted in 2009, and especially 2010, by significant UK Motor bodily injury reserve strengthening. But performance significantly improved during 2011, with DLG returning to profit and recording a Moody's return on capital metric of 6.1% (YE10: -7.0%), and reporting an improved overall combined ratio (COR) of 102% (YE10: 121%) for its ongoing business.

Going forward, we expect DLG to benefit, albeit to a lesser extent, from it maintaining momentum on claims transformation, and from parts of its business yielding income but with no underwriting risk. We also note that the performance of its UK Home and Rescue books has been generally good in recent years. This will help off-set the challenge of sustaining performance improvements as a result of headwinds from : 1) our expectation that the UK personal motor market will remain inherently very competitive; 2) uncertainty as a result of regulatory probes into UK motor business; and 3) pricing pressure in other (ie non-UK motor) lines of business.

RESERVE ADEQUACY: A - SUBSTANTIAL RESERVE RELEASES HAVE BEEN A RECENT FEATURE, BUT INHERENT CHALLENGE OF BODILY INJURY CLAIMS

During 2012 and 2013, DLG reported substantial reserve releases amounting to £322m (6.7% of opening net reserves) and £435m (9.1%). We expect DLG to remain prudent in its reserving of current accident years and therefore expect reserve releases to remain a meaningful contributor to operating profit, but not to the same extent as the exceptional level in 2013. 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.

At 5%, DLG has reported a small, albeit increased, surplus position on average from 2013-2009. However this average is affected by prior years reserves strengthening during 2009 and 2010, driven by respective £96m and £398m increases for UK Motor reserves, excluding TPF, 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 for an amount of £227m (YE10: -£285m). At YE13, DLG released reserves of £322m, driven mainly by its Motor division where it has seen favourable development on Motor bodily injury claims.

FINANCIAL FLEXIBILITY: A - FINANCIAL LEVERAGE EXPECTED TO REMAIN RELATIVELY LOW, AND EARNINGS COVERAGE GOOD, ALTHOUGH FINANCIAL FLEXIBILITY SOMEWHAT CONSTRAINED

We view DLG's overall financial flexibility as good. Adjusted financial leverage at YE13 was relatively low and decreased to 18.7% (YE12: 25.3%) benefitting from the repayment of the TPF subordinated loan. Going forward, we expect DLG's financial leverage to remain relatively low in relation to UKI's A2 IFSR.

DLG's debt comprises nominal £500m lower Tier 2 capital in the form of dated subordinated notes, issued in April 2012, which qualify for 25% equity credit from Moody's, together with bank debt and an operating lease expense which increased significantly during 2012.

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, finance costs have increased significantly - £29m for 2012 and £37.7m for YE13 - but we expect earnings coverage, which at YE13 improved to around 9.6x (YE12: 9.0x), to be good going forward.

Financial flexibility is somewhat constrained by DLG's limited record in accessing capital markets as a result of its ownership history. However, we regard the IPO, following the raising of lower Tier 2 capital in April 2012, as successfully demonstrating DLG's stand-alone financial flexibility, and we see RBSG's divestment as benefitting the Group's financial flexibility.

Rating Factors

Direct Line Insurance Group plc[1][2]

Financial Strength Rating Scorecard	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				**32.4%**					

Written									
Product Focus and Diversification (10%)								**Baa**	**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	**7.8%**								
- Reinsurance Recoverable % Shareholders' Equity		**35.4%**							
- Goodwill & Intangibles % Shareholders' Equity		**28.2%**							
Capital Adequacy (15%)								**A**	**A**
- Gross Underwriting Leverage			**3.3x**						
Profitability (15%)									**A**
- Return on Capital (5 yr avg)									
- Sharpe Ratio of ROC (5 yr avg)									
Reserve Adequacy (10%)								**Aa**	**A**
- Adv (Fav) Loss Dev % Beginning Reserves (5 yr. wtd avg)		**-5.0%**							
Financial Flexibility (15%)								**Aa**	**A**
- Financial Leverage		**18.7%**							
- Total Leverage		**22.1%**							
- Earnings Coverage (5 yr avg)			**6.3x**						
- Cash Flow Coverage (5 yr avg)									
Operating Environment								**Aaa - A**	**Aaa - A**
Aggregate Profile								**A1**	**A2**

[1] Information based on IFRS and 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

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