MOODY'S
INVESTORS SERVICE

CREDIT OPINION
19 October 2016

Update

Rate this Research

RATINGS

Direct Line Insurance Group plc

Domicile	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.

Contacts

Helena Kingsley-Tomkins 44-20-7772-1397
Assistant Vice President
helena.kingsley-tomkins@moodys.com

Charles Isselin-Pontet 44-20-7772-5573
Associate Analyst
charles.isselin-pontet@moodys.com

Antonello Aquino 44-20-7772-1582
Associate Managing Director
antonello.aquino@moodys.com

Direct Line Insurance Group plc

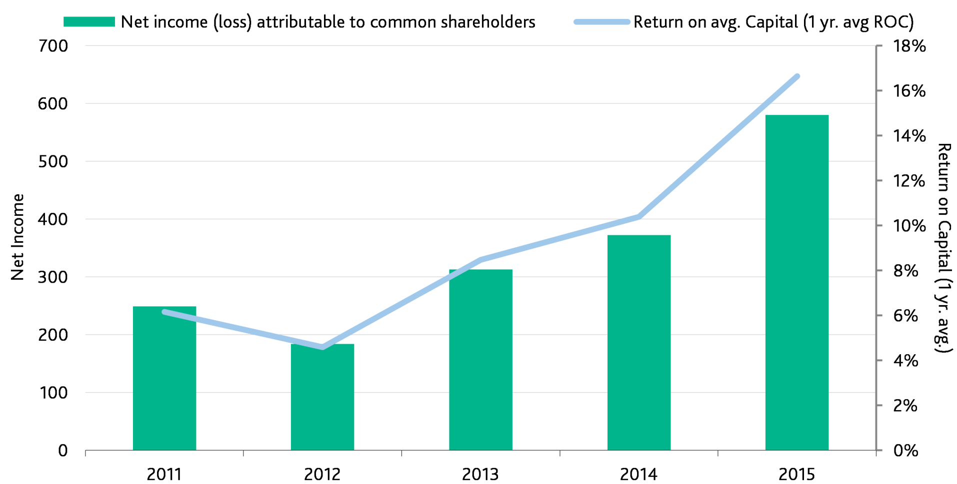
Semi-Annual Update

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 somewhat offset by the group's limited geographic and business line diversification, the challenge of sustaining recent performance (see exhibit 1) in the very competitive UK general insurance market and execution risk associated with the group's ongoing restructuring program.

Exhibit 1

Direct Line Group's Net Income and 1-year Average Return on Capital



Source: Company reports and Moody's Investors Service

Previously part of the Royal Bank of Scotland Group plc (RBS), DLG launched its new corporate identity in July 2012 the point at which it became legally and operationally independent and underwent an IPO in October 2012. In 2014, DLG reached a binding agreement with Spanish based insurance company Mapfre S.A for the sale of its international operations for total cash sale proceeds of EUR550m. At H116 gross written premiums (GWP) from DLG's ongoing operations were split: 47% UK personal lines motor, 25% UK personal lines home, 12% UK rescue and other personal lines and 16% UK commercial.

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 profitability, which has been improved year-on-year and has exceeded internal targets

» Good capitalisation as measured by Solvency II and relatively low financial leverage

Credit Challenges

» Sustaining the premium base following the loss of the Nationwide and Sainsbury's distribution agreements

» Limited geographic and business line diversification in which motor business predominates

» Sustaining recent underwriting performance in the very competitive UK personal lines market and as the contribution from prior year reserve releases reduces

» Enhancing contribution of the Commercial business to overall operating profit

» Execution risk associated with the group's on-going restructuring program and balancing investments into new technologies with expense reductions

Rating Outlook

The outlook is stable reflecting Moody's expectation that the group will sustain its recent financial performance and that its on-going investment and change initiatives will continue to stimulate modest growth and further reduce expenses. However, tough trading conditions in the UK personal lines general insurance market are expected to remain a constraint in this regard.

What to Watch For:

» Pricing trends in the very competitive UK Motor and Home markets

» Further regulatory developments in the UK personal lines insurance market

» UK weather losses

» Development of DLG's Solvency II capital coverage ratio, particularly in light of market volatility following Brexit decision

Factors that Could Lead to an Upgrade

» Average return on capital through the cycle of at least 8% with modest premium growth

» Sustained gross underwriting leverage of 3x or below

» Profitable development of the Commercial and Personal Lines Rescue & Other businesses

Factors that Could Lead to a Downgrade

» Material reduction in premiums resulting in a material loss of market share

» Average return on capital through the cycle below 6%

» Adjusted financial leverage in excess of 30% with earnings coverage below 6x

» Meaningful deterioration in capital adequacy

Key Indicators

Exhibit 2

Direct Line Insurance Group plc[1][2]	2015	2014	2013	2012	2011
As Reported (British Pound Millions)					
Total Assets	9,957	11,226	11,788	12,698	13,770
Total Shareholders' Equity	2,630	2,811	2,790	2,832	3,871
Net income (loss) attributable to common shareholders'	580	373	313	184	249
Gross Premiums Written	3,153	3,099	3,230	4,001	4,168
Net Premiums Written	2,961	2,917	3,071	3,636	3,911
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	25.1%	20.4%	7.8%	4.7%	2.8%
Reinsurance Recoverable % Shareholders' Equity	36.6%	30.4%	35.4%	38.4%	21.8%
Goodwill & Intangibles % Shareholders' Equity	26.4%	24.7%	28.2%	25.3%	18.7%
Gross Underwriting Leverage	2.9x	2.7x	3.1x	3.5x	2.9x
Return on avg. Capital (1 yr. avg ROC)	16.6%	10.4%	8.5%	4.6%	6.2%
Sharpe Ratio of ROC (5 yr. avg)	197.5%	66.4%	NA	NA	NA
Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg)	-11.5%	-9.5%	-9.1%	-6.7%	-3.6%
Financial Leverage	18.3%	18.1%	18.7%	21.7%	14.4%
Total Leverage	22.2%	21.8%	22.1%	25.2%	14.4%
Earnings Coverage (1 yr.)	16.7x	11.8x	9.5x	8.9x	88.5x
Cash Flow Coverage (1 yr.)	NA	NA	NA	NA	NA

[1] Information based on IFRS financial statements as of Fiscal YE December 31.
[2] Certain items may have been relabeled and/or reclassified for global consistency.
Source: Company reports and Moody's Investors Service

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

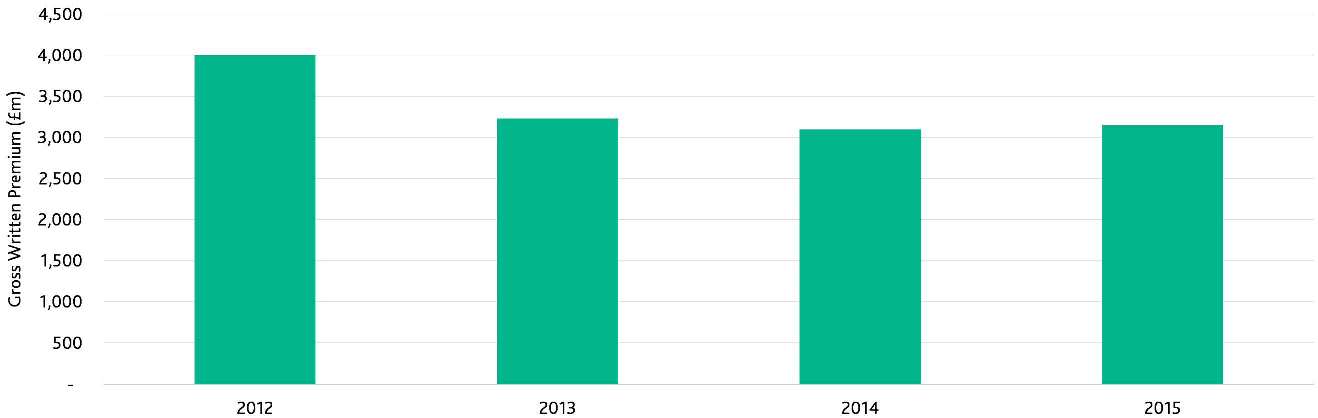
Moody's rates UKI A2 (stable outlook) for insurance financial strength, which is in line with the adjusted rating indicated by the Moody's insurance financial strength rating scorecard. The key factors currently influencing the rating and outlook are:

MARKET POSITION, BRAND AND DISTRIBUTION: Aa - VERY STRONG POSITION IN THE UK PERSONAL LINES MARKET

As the largest personal motor and home lines writer in the UK, we consider DLG's market position to be very strong and its brands, in particular Direct Line and Churchill, are very powerful. DLG's SME commercial business is growing, but its overall market share remains relatively modest at this stage.

We expect DLG's personal lines market position to remain very strong going forward. In 2015, for the first time after several years of decline, GWP from ongoing operations grew by 2%, helped by an increase in both motor rates and volume of motor and home own brand policies. During the first half of 2016 GWP continued to grow by 3.9% vs H115, driven predominantly by price increases in Motor and supported by modest policy growth in Motor, Home own brands, Green Flag and DL4B. The reduction in home GWP reflects a lower risk mix and a reduction in partnership policy numbers. The termination of DLG's distribution agreement with Nationwide, which accounts for a material portion of the group's home premium base, will begin to reflect in the Group's top line from 2017.

Exhibit 3
Direct Line Group's Gross Written Premiums



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 PCWs as well as via partnerships. With regard to DLG's partnerships, we note that the group has recently extended its travel agreement with Nationwide until 2018 and has signed a 3 years extension with RBS for Home and Private Insurance. The Commercial division also benefits from some direct distribution, although the majority of premiums are accessed via brokers. DLG also continues to improve its distribution capabilities by investing in new websites and digital propositions.

More negatively, DLG's underwriting expense ratio remains relatively high and above personal-lines-orientated peers, despite the group's inherent scale advantages. However, the expense ratio reduced to 34.5% in 2015 (YE14: 35.4%) in line with the reduction of the group's cost base to below its target £1bn. In H116 DLG's expense ratio rose to 36.2% as a result of £24m Flood Re levy. Excluding the levy, DLG's expense ratio in H116 would have stayed roughly stable at 34.6% despite a 7% increase in marketing spend. We expect the group's expense ratio to continue to improve via (i) the implementation of efficiency programs initiatives; (ii) the reduction of business distributed through partnerships, which typically include high commissions; and (iii) top line growth.

PRODUCT RISK & DIVERSIFICATION: Baa - RELATIVELY LOW PRODUCT RISK OFFSET BY LIMITED BUSINESS DIVERSIFICATION & DEPENDENCE ON THE UK

DLG writes UK non-life business, split 84% personal lines and 16% commercial lines. In H116 the business was split into motor (47%), home (25%), rescue & other (12%) and commercial (16%) by GWP. In our view product line diversity is therefore relatively limited in light of the preponderance of personal motor and home lines.

More positively, DLG's product risk is considered low as a result of this preponderance of personal lines. Although the business is exposed to large bodily injury claims volatility, windstorm and flood catastrophe risk, DLG purchases significant reinsurance cover. In this regard, we note that despite DLG's 2015 loss ratio being adversely affected by both an uptick in large bodily claims frequencies and severe flood losses, the group's combined ratio remained within its 92-94% upgraded range target for 2015.

ASSET QUALITY: A - RELATIVELY CONSERVATIVE INVESTMENT PORTFOLIO NOTWITHSTANDING INCREASING HIGH RISK ASSETS

We view DLG's asset quality as good. The group has a relatively conservative investment portfolio, with 89% held in fixed income securities and cash, but continues to undertake some re-risking actions. This is reflected in the gradual increase in DLG's high risk assets (HRA) as a % of shareholders' equity ratio to an estimated 26.4% at H116 from 7.8% at YE13. DLG continues to have no exposure to, or appetite for equities and, as such, HRA are primarily comprised of property investments and high yield bonds. DLG did however start investing into UK infrastructure during 2014 to support the asset strategy backing PPO liabilities.

As at H116, DLG's invested assets comprised of 74.2% fixed income securities, 15% cash and cash equivalents, 5.3% property investments and , 5.2% infrastructure debt with an overall duration of 1.8 years (excluding property). In addition, from 27 June, a modest 0.3% of the portfolio is invested in the group's new asset class- commercial real estate loans. DLG also continued to reposition the credit part of its portfolio. Corporate bonds represented 62.5% of invested assets at H116 and 60.5% at YE15 (vs the group's target of 64.0%), which is significantly higher than a number of UK/European P&C peers. However, the credit quality of the fixed income portfolio is very good, with around 71% of the fixed income portfolio rated A or higher as at H116 with a well-diversified portfolio by sector. However, we note that DLG is increasing its exposure, albeit modestly, to high yield credit (5.4% of invested assets at H116 vs target of 6.0%).

DLG's overall asset quality also benefits from its relatively low level of reinsurance recoverables at 34.1% of equity at H116 (YE15: 36.6%), and a low level of reported goodwill & intangible assets (including DAC) at 26.6% at H116 (YE15: 26.4%).

CAPITAL ADEQUACY: A - GOOD CAPITALISATION NOTWITHSTANDING REDUCED SHAREHOLDERS' EQUITY

We view DLG's overall capital adequacy and quality of capital as good. Notwithstanding the reduction in shareholders' equity since 2011, we note that total equity as a % of net written premiums has been stable during this period and gross underwriting leverage (GUL) remains around 3x, which is in line with our expectation for a personal lines player at the current rating level.

Following the approval of its internal model by the PRA in June 2016, DLG's estimated Solvency II ratio (under the partial internal model) as at 30 June 2016 was 184% after dividends (199% pre-dividends). As expected, this coverage ratio is materially higher than the 147% reported at YE15 under the standard formula, driven by a material reduction in the group's capital requirements under its partial internal model.

With regard to sensitivities, the group has disclosed that its greatest exposures include: a large cat loss equivalent to the 2007 floods, 10% motor premium rate reductions and a material increase in PPO propensities. Given the group's relatively conservative investment portfolio and lack of equities exposure, DLG's Solvency II ratio is relatively insensitive to market movements including changes in credit spreads and interest rates.

Following transition to its internal model, DLG has updated its risk appetite range to 140-180% of its solvency capital requirement. As such, DLG also announced a special interim dividend of 10p with the regular interim dividend up by 6.5% to 4.9p.

We view the quality of DLG's capital as good, with 73% of the group's own available funds comprised of Tier 1 capital in the form of shareholders' equity (after foreseeable dividends). Tier 2 capital relates solely to the group's £0.5bn subordinated debt and accounts for 24% of the group's own fund, with the remaining 4% in the form of Tier 3 capital.

PROFITABILITY: A - PROFITABILITY TARGETS HAVE BEEN EXCEEDED ONCE AGAIN, BUT THE HIGHLY COMPETITIVE UK PERSONAL MARKET REMAINS A HEADWIND

Going forward, we expect DLG's bottom line profitability to remain relatively stable as lower expenses (which were down 4.6% in 2015) and modest top line growth offset claims inflation and the reduction in prior year reserve releases. We also believe that DLG's on-going invested asset portfolio changes and investments into technological distribution, pricing capabilities and other initiatives can help offset headwinds from our expectation that the UK personal motor and home market will remain inherently very competitive, which will continue to curb price increases in personal lines.

Despite DLG's significant exposure to the very competitive UK personal motor market, its underwriting performance continued to improve in 2015 and has been sustained in the first 6 months of 2016. This is reflected in the group's combined operating ratio (COR), which remained stable at 89.6% (H115: 89.4%), with improvements in the motor loss ratio and ongoing material reserve releases offsetting the Flood Re levy and higher weather claims. The group maintains its 2016 target COR within the 93-95% range, and expects to reach the lower end of this range assuming normal weather losses.

Less positively, DLG reported a 3.6% reduction in operating profit from ongoing operations to £324m for HY16, as a result of lower investment returns, following the one off realised gains in HY15, partially offset by an increase in instalment and other recurring income by 8% to £78m. Nevertheless, at HY16, DLG's reported Return of Tangible Equity of 23.1% (YE15: 18.5%) was well ahead of its 15% target.

With regard to Moody's scorecard metrics, DLG's 5 year average return on capital (ROC) doubled to 9.3% (YE14: 4.5%) and the Sharpe ratio of ROC improved to 197.3% (YE14: 66.0%), reflecting the year-on-year improvement in performance since 2011, aided by benefits from the group's claims transformation programme, cost savings and disciplined approach to underwriting.

RESERVE ADEQUACY: A - RESERVE RELEASES EXPECTED TO REDUCE BUT REMAIN A FEATURE, NOTWITHSTANDING INHERENT CHALLENGE OF BODILY INJURY CLAIMS

DLG has reported significant prior year reserve releases since 2011, as reflected in the 5 year weighted average favourable loss development as % of opening reserves, of 9.6% (2015-2011). These reserve releases were driven mainly by the group's motor division in relation to favourable development on bodily injury claims.

For HY16, the group recognised overall reserve releases of £258.1m. Total ongoing releases were up 10% to £236.1m, partly due to an increase in home due to releases in respect of the storms and floods in 4Q 2015. This was partially offset by an 8% reduction in motor releases to £134m, which is in line with management guidance as a result of lower volumes and changes to the Group's reinsurance program. Nevertheless we expect DLG to remain prudent in its reserving of current accident years and therefore expect reserve releases to remain a material contributor to future operating profit.

Volatility still remains within the UK motor market as the stock of Periodical Payment Order (PPO) awards continues to increase and with large bodily injury claims continuing to be an industry-wide issue. Furthermore, there has also been an increase in the cost of damage claims from increased repair costs, used car prices and credit hire costs, which is increasing claims inflation.

FINANCIAL FLEXIBILITY: A - RELATIVELY LOW LEVERAGE AND EXCELLENT EARNINGS COVERAGE PARTIALLY OFFSET BY DLG'S LIMITED RECORD IN ACCESSING CAPITAL MARKETS

We view DLG's overall financial flexibility as good. Adjusted financial leverage at H116 remained relatively low at 18.7% (YE15: 18.3%), including £500m of dated subordinated notes, which qualify for some equity credit from Moody's, together with bank debt and an operating lease expense adjustment. Following the ordinary and special dividend payments in 2016, leverage has likely increased, but we expect it to remain below 20% going forward, i.e. relatively low in relation to the A2 IFSR.

Earnings coverage has been excellent and continued to improve in H116 to 14.8x (YE15: 12.6x). We note that the earnings coverage metric at H116 is more in line with the level we expect for the group going forward, compared to the 27x at YE15, which was distorted by the intra-group nature of finance costs prior to the debt issuance in 2012.

As a result of its historic ownership, DLG has a somewhat limited record in accessing capital markets. However, we regard the IPO, following the lower Tier 2 debt issuance in April 2012, as evidence that DLG can successfully access capital markets on a standalone basis.

Rating Methodology and Scorecard Factors

Exhibit 4

Financial Strength Rating Scorecard [1][2]	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 Written				32.4%					
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		25.1%							
- Reinsurance Recoverable % Shareholders' Equity		36.6%							
- Goodwill & Intangibles % Shareholders' Equity		26.4%							
Capital Adequacy (15%)								Aa	A
- Gross Underwriting Leverage		2.9x							
Profitability (15%)								A	A
- Return on Capital (5 yr. avg)		9.3%							
- Sharpe Ratio of ROC (5 yr. avg)				197.5%					
Reserve Adequacy (10%)								Aaa	A
- Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd avg)	-9.3%								
Financial Flexibility (15%)								Aa	A
- Financial Leverage		18.3%							
- Total Leverage		22.2%							
- Earnings Coverage (5 yr. avg)	27.1x								
- Cash Flow Coverage (5 yr. avg)									
Operating Environment								Aaa - A	Aaa - A
Aggregate Profile								Aa3	A2

[1] Information based on IFRS 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.
Source: Company reports and Moody's Investors Service

Ratings

Exhibit 5

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	STA
U K INSURANCE LIMITED	
Rating Outlook	STA
Insurance Financial Strength	A2

Source: Moody's Investors Service

REPORT NUMBER 1045016