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Credit Opinion: Direct Line Insurance Group plc

Global Credit Research - 16 Oct 2015

United Kingdom

Ratings

Category	Moody's Rating
Rating Outlook	STA
U K Insurance Limited	
Rating Outlook	STA
Insurance Financial Strength	A2

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Key Indicators

Direct Line Insurance Group plc[1][2]

	2014	2013	2012	2011	2010
As Reported (British Pound Millions)					
Total Assets	11,226	11,788	12,698	13,770	13,817
Total Shareholders' Equity	2,811	2,790	2,832	3,871	3,482
Net income (loss) attributable to common shareholders'	373	313	184	249	(272)
Gross Premiums Written	3,099	3,230	4,001	4,168	4,971
Net Premiums Written	2,917	3,071	3,636	3,911	4,788
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	20.4%	7.8%	4.7%	2.8%	3.0%
Reinsurance Recoverable % Shareholders' Equity	30.4%	35.4%	38.4%	21.8%	22.0%
Goodwill & Intangibles % Shareholders' Equity	24.7%	28.2%	25.3%	18.7%	18.2%
Gross Underwriting Leverage	2.7x	3.1x	3.5x	2.9x	3.7x
Return on avg. Capital (1 yr. avg ROC)	10.4%	8.5%	4.6%	6.2%	-7.0%
Sharpe Ratio of ROC (5 yr. avg)	66.4%	NA	NA	NA	NA
Adv./(Fav.) Loss Dev. % Beg. Reserves (1 yr. avg)	-9.5%	-9.1%	-6.7%	-3.6%	5.2%
Financial Leverage	18.1%	18.7%	21.7%	14.4%	16.0%
Total Leverage	21.8%	22.1%	25.2%	14.4%	16.0%
Earnings Coverage (1 yr.)	11.8x	9.5x	8.9x	88.5x	-98.0x
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

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 somewhat off-set by the group's limited geographic and business line diversification, the challenge of sustaining recent performance trends in the very competitive UK general insurance market and execution risk associated with the group's restructuring program.

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. Consequently, at YE14 gross written premiums (GWP) from DLG's ongoing operations, excluding International, were split: 43% UK personal Lines Motor, 29% 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 capitalisation

-Relatively low financial leverage

Credit Challenges

- Limited geographic and business line diversification where motor business predominates

-Sustaining recent performance trends in the very competitive UK personal lines market

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

-Enhancing contribution of the Commercial business to overall operating profit

-Execution risk associated with the group's on-going restructuring program

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 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 in very competitive UK Motor and Home markets

- Further regulatory developments in the UK personal lines insurance market

- UK weather losses

- DLG's Solvency II capital coverage ratio

What Could Change the Rating - Up

-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

What Could Change the Rating - Down

-Continued 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

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 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, especially 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 despite the decline witnessed over the last few years as a result of DLG exiting unprofitable business, de-risking the book, re-pricing, the cessation of the Tesco Personal Finance (TPF) joint venture and the strong growth of price comparison websites (PCW).

In 2014, GWP from ongoing operations were down 4% vs. the previous year, reflecting increased competition in personal home and the continued market reduction in personal motor rates, partially offset by growth in Commercial. During the first half of 2015, GWP has stabilised in line with our expectations, reflecting further volume reductions in home (driven by the group disciplined approach to underwriting in a competitive market place), offset by growth in motor (benefitting from rate rises), rescue and other personal lines.

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 Sainsbury's. The Commercial division also benefits from some direct distribution, although the majority of premiums are accessed via brokers. DLG continues to improve its distribution capabilities by investing in new websites and digital propositions.

More negatively, DLG's underwriting expense ratio remains relatively high at 35.7% (YE13: 38.1%), despite inherent scale advantages and the reduction of the group's cost base to below its target £1bn. We expect this ratio to continue to improve via the implementation of efficiency programs initiatives but remain above personal-lines-orientated-peers.

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

DLG writes non-life business, split 84% personal lines and 16% commercial lines. Business line diversification is relatively limited in light of the preponderance of personal motor and home lines. The business is split into which UK Motor (43%), UK Home (29%), UK Rescue & Other (12%) and UK Commercial (16%) by GWP (excluding international) in 2014.

Following the sale of the International division, DLG is entirely focused on the UK general insurance market. However, given that the International division was relatively small in the context of the group, its sale does not have a material impact on our overall view of DLG's product risk and diversification.

More positively, DLG's product risk is considered low given the preponderance of personal lines, and although the business is exposed to large bodily injury claims, and windstorm and flood catastrophe risk, DLG purchases significant reinsurance cover.

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

We view overall asset quality as good. DLG has a relatively conservative investment portfolio, but continues to undertake some re-risking actions, as reflected in the high risk assets (HRA) as a % of equity ratio, which stabilised at 19.2% at H1 15 (after increasing to 20.4% at YE14 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.

At H1 15, 92.1% of DLG's investments were in fixed income securities and cash (YE14: 94.6% excluding the international portfolio). With regard to the main changes in the asset mix during the first 6 months of 2015, we note that DLG decreased its investments in sovereign bonds by £322m to 9.8% of total invested assets (YE14: 14.1%) and increased its exposure to infrastructure by £145m to 3.2% (YE14: 1.1%). DLG started investing into UK infrastructure during 2014 to support the asset strategy backing PPO liabilities, and we expect further investments in infrastructure during H2 2015.

DLG also continued to repositioned the credit part of its portfolio in H1 15, such that corporate bonds now represent 59.3% of invested assets (YE14: 58.0%), which is significantly higher than a number of UK/European P&C peers. The credit quality of the fixed income portfolio is very good, with around 77.3% of the fixed income portfolio rated A or higher at H1 15, although DLG is now exposed to below investment grade securities .

DLG's asset quality benefits from its relatively low level of reinsurance recoverables, which were 30.9% of equity at H1 15 (YE14: 30.4%), and a low level of reported goodwill & intangible assets (including DAC) at c.22.7% at H115 (YE14: 24.7%).

CAPITAL ADEQUACY: A - GOOD CAPITALISATION NOTWITHSTANDING REDUCED EQUITY LEVEL

We view overall capital adequacy as good. In line with our expectations, reported total equity reduced by 27% to £2,811m since 2011 following the £1bn dividend payment to RBSG in 2012 and the reclassification and subsequent repayment of the TPF non-controlling interest of £259m in 2013. However, we note that total equity as a % of net written premiums has been stable during this period.

Moody's gross underwriting leverage (GUL) metric, which was relatively low at 2.7x at YE14 is distorted by the sale of the international operations, which are excluded from GWP. Following the payment of the expected special dividend on completion of the sale in 2015, the GUL metric increases to c.3.0x, which is consistent with prior years.

In terms of regulatory coverage, the IGD coverage ratio improved again during 2014 to 347% (YE13: 292%) with a small uptick to 348% as at H1 15. The group's YE14 risk-based solvency coverage ratio on a pro-forma basis following the payment of the final dividend and yearend special dividend was flat at 148.2% (YE13: 148.7%) The group's risk-based solvency coverage ratio (adjusted for the interim dividend) at H1 15 was 155.9% which is above DLG's target range of 125% - 150%.

With regard to the likelihood of further special dividends, we note that the Board is next likely to consider any return of capital at the 2015 full year results. The decision will take into account the group's requirements on a Solvency II basis over a prolonged period. Furthermore, the Board will also consider any changes to its risk-based capital metrics and risk appetite at this time. With regard to Solvency II, DLG plans to use the standard formula for at least six months before transitioning to an internal model.

PROFITABILITY: A - PROFITABILITY TARGETS HAVE BEEN EXCEEDED, BUT THE HIGHLY COMPETITIVE UK PERSONAL LINES MARKET REMAINS A CHALLENGE

DLG's 5 year average return on capital (ROC) at 4.5% and 66.0% Sharpe ratio of ROC are adversely affected by the £272m loss reported in 2010, which was driven by significant UK Motor bodily injury reserve strengthening. However, performance has improved year-on-year since 2011 aided by benefits from the group's claims transformation programme, cost savings and disciplined approach to underwriting. Consequently, we view the group's 3 year average ROC at 7.7% as more representative of future profitability levels.

For 2014, DLG reported a 16.8% Return on Tangible Equity (RoTE) from ongoing operations and 95.0% combined operating ratio (COR) vs. its 15% RoTE and 95-97% COR (assuming a normal level of weather claims) targets for 2014. Furthermore, in 2014 for the first time all of the group's lines of business reported a sub 100% COR such that DLG has reduced its target COR to 94-96% for 2015.

Despite DLG's significant exposure to the very competitive UK personal motor market, its underwriting performance continues to improve. For 2014, DLG reported a 19% increase in net income to £373m, benefitting from higher than expected prior year reserve releases, partially offset by adverse experience in large bodily injury claims on the 2014 accident year. This momentum continues into the first half of 2015 with DLG reporting a 89.4% COR for ongoing operations, benefitting from an absence of major weather claims, higher than expected prior year reserve releases and improved operational efficiency. As a result, DLG has lowered its target 2015 COR to 92%-94% from 94%-96% (normalised for weather). However DLG stated that underlying trends remain broadly in line with its prior expectations.

Profit after tax at £427.8m for H1 15 includes the £181.2m profit from International (including the gain on sale). However, as a result of better underwriting profitability, profit before tax for ongoing operations increased by 49%. Going forward, we expect DLG's bottom line profitability to remain relatively stable as lower expenses and claims offset any premium reductions, and the uptick in investment income (following the aforementioned asset reallocations) helps offset any reductions in credit hire income and referral fees.

We also believe that DLG's on-going asset portfolio changes and investments into technological distribution, pricing capabilities and other initiatives can help offset headwinds from: (i) our expectation that the UK personal motor and home market will remain inherently very competitive; (ii) pricing pressure witnessed in personal home lines continuing; (iii) reductions in instalment and ancillary income; and (iv) uncertainty as a result of increased regulatory scrutiny of UK personal lines.

RESERVE ADEQUACY: A - RESERVE RELEASES EXPECTED TO REMAIN A FEATURE, BUT 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, which averaged 7.1% between 2014 and 2010. Reserve releases have been driven mainly by the group's motor division in relation to favourable development on bodily injury claims, a trend which had continued into 2015, with the group recognising overall reserve releases of £215.1m at H1 15, above DLG's initial expectations.

As part of its YE14 results, DLG updated its reserving methodology. Provided the risk outlook remains stable, going forward the group does not expect to continue to increase the margin above actuarial best estimates, from which recent year prior year reserves releases have arisen. However, 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, albeit not to the same extent as the exceptional levels in 2013, 2014 and H1 15.

However, 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. In this regard, we note that the higher than expected large bodily injury claims trend experienced in 2014 has continued during H115. 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 H1 15 remained relatively low at 17.3% (YE14: 18.1%). Following the special dividend payment in July, related to the sale of International, leverage has likely increased, but we expect it to remain below 20% going forward, i.e. relatively low in relation to the 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 some equity credit from Moody's, together with bank debt and an operating lease expense adjustment.

Following the lower Tier 2 issuance in 2012, finance costs have increased significantly. However, earnings coverage has been excellent and continues to improve to around 15x for H1 15 (based on profits from ongoing operations) from 11.8x at YE14 (YE13: 9.5x). The 5.1x average earnings coverage per the scorecard is distorted by the 2010 net loss and intra-group nature of finance costs prior to the debt issuance in 2012.

Financial flexibility remains somewhat constrained by DLG's limited record in accessing capital markets as a result of its historic ownership. However, we regard the IPO, following the lower Tier 2 debt issuance in April 2012, as successfully demonstrating DLG's stand-alone 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 Written					35.7%				
Product Focus and Diversification (10%)								A	Baa
- Product Risk		X							
- P&C Insurance Product Diversification		X							
- Geographic Diversification						X			
Financial Profile								A	A
Asset Quality (10%)								Aa	A
- High Risk Assets % Shareholders' Equity	20.4%								
- Reinsurance Recoverable % Shareholders' Equity	30.4%								
- Goodwill & Intangibles % Shareholders' Equity		24.7%							
Capital Adequacy (15%)								Aa	A
- Gross Underwriting Leverage		2.7x							
Profitability (15%)								Baa	A
- Return on Capital (5 yr. avg)			4.5%						
- Sharpe Ratio of ROC (5 yr. avg)					66.4%				
Reserve Adequacy (10%)								Aaa	A
- Adv./(Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd avg)	-7.1%								
Financial Flexibility (15%)								A	A
- Financial Leverage		18.1%							
- Total Leverage		21.8%							
- Earnings Coverage (5 yr. avg)			4.1x						
- Cash Flow Coverage (5 yr. avg)									
Operating Environment								Aaa - A	Aaa - A
Aggregate Profile								A1	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

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