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Ratings

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U K Insurance Ltd.

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U K Insurance Ltd.

SACP* Assessments	
Anchor	a
Business Risk	Strong
Financial Risk	Very Strong

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Modifiers	0
ERM and Management	0
Holistic Analysis	0

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SACP*	a
Liquidity	0
Sovereign Risk	0

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Support	0
Group Support	0
Gov't Support	0

=

Ratings
Financial Strength Rating
A/Stable/--

*Stand-alone credit profile.
See Ratings Detail for a complete list of rated entities and ratings covered by this report.

Rationale

Business Risk Profile: Strong

- No. 1 motor and household insurer in the U.K., with well-known brands in the U.K. market.
- Profile now wholly concentrated in the U.K. non-life sector.

Financial Risk Profile: Very Strong

- Very strong capital and earnings supported by improving underwriting performance.
- Intermediate risk position, reflecting a well-diversified and relatively conservative investment portfolio.

Outlook: Stable

The stable outlook reflects S&P Global Ratings' view that U K Insurance Ltd. (UKI) will continue to maintain capital adequacy at least comfortably at the 'A' level over the next 24 months, per our risk-based capital model. We also expect that UKI will maintain stable earnings during this period, a conservative investment profile, and a strong competitive position in the U.K. non-life market

Downside scenario

We consider a downgrade to be unlikely in the next two to three years, but we could lower the ratings if capital adequacy falls below the 'A' level, or earnings materially fail to meet our expectations. We could also lower the ratings if UKI's leading positions in motor and household insurance shrink unexpectedly in a competitive market environment.

Upside scenario

We could raise the rating if UKI's management committed to maintaining its capital consistently at the 'AAA' confidence level and the group demonstrated the strength of its competitive position by returning to growth in its core markets.

Base-Case Scenario

Macroeconomic Assumptions

- We forecast U.K. real GDP to increase by an annual average of 2.1% over 2016-2017.
- Although in the longer run we would expect a correlation between GDP and non-life premium growth, over our two-year rating horizon, we anticipate that internal industry dynamics in the U.K. insurance market will prove a stronger determinant of sector profitability and growth than these macroeconomic trends.
- Government yields to gradually increase over the next three years, but to remain below long-term historical norms.
- For detailed macroeconomic assumptions, see the related industry and country risk assessment reports below.

Company-Specific Assumptions

- Gross premium written to decline in 2016-2017 due to loss of key distribution partnerships.
- Capital adequacy to be managed to at least the 'A' confidence level, per our model.
- Reserve releases to continue in the future, but at a lower level.
- Net income after tax to be about £250 million-£350 million in 2016-2017.
- The combined ratio to remain at 90%-95% in 2016-2017.
- Financial leverage to remain close to 20% and fixed-charge coverage to range between 8x-10x.

Key Metrics

(Mil. £)	2017f	2016f	2015*	2014*	2013
Gross premiums written	3,075.0	3,075.0	3,153.0	3,099.0	3,834.5
Change in gross premiums written (%)	0.0	(3.0)	1.7	(19.2)	(4.2)
Net income (attributable to all shareholders)	>250	>250	580.4	373.0	312.8
Return on revenue (%)	>10	>10	22.5	14.5	11.1
Return on shareholders' equity (%)	>10	>10	21.3	13.3	11.1
Net combined ratio§ (%)	90-95	90-95	89.92	92.69	92.99

f--forecast. *2015 and 2014 financials reflect only continuing business and exclude Direct Line's Italian and German operations, which were sold to Mapfre Group in 2015. §Pre-2014 combined ratios include run-off business, while 2014-2015 and forecasted ratios exclude run-off business. DLG's reported combined ratio includes depreciation and amortization; our calculation excludes these items.

Company Description

UKI is the main operating insurance subsidiary of Direct Line Group (DLG) and best known for its Direct Line brand. DLG's continuing business operations wrote gross premiums in 2015 of £3.2 billion (2014: £3.1 billion), primarily directly and through partnerships with well-known businesses. The U.K. motor business accounted for 45% of its premium in 2015, U.K. home for 27%, and U.K. commercial for 15%. In 2015, DLG sold its international business in Italy and Germany to Mapfre S.A., meaning the group now operates solely in the U.K. DLG operates its business in the U.K. under well-known, market-leading brands like Direct Line, Direct Line for Business, Churchill, Privilege, NIG, and Green Flag.

Table 1

Industry And Country Risk

Insurance sector	IICRA	Business mix*
U.K. property and casualty	Intermediate risk	100%

*Includes continuing operations only.

Business Risk Profile: Strong

We assess UKI's business risk profile as strong, based on its strong competitive position in the mature and highly competitive U.K. non-life insurance market.

Insurance industry and country risk

All of UKI's business stems from the large and mature U.K. non-life insurance market, where we consider industry and country risks to be intermediate (see "U.K. Property/Casualty Insurance Sector Carries An Intermediate Industry And Country Risk Assessment," published on May 11, 2015). Our intermediate assessment is based on our assessment of industry risk for the U.K. P/C insurance sector as moderate, which is higher than many other corresponding developed insurance markets. The assessment is dragged down by the low operational and regulatory barriers to entry in the U.K. retail non-life market and by the recent volatility of motor liability claims.

Entry to personal lines business has relatively few restrictions in the U.K. because of the sector's bias toward distribution through aggregator sales channels. The need to build a network of offices, salesmen, or broker contacts remains much more significant for commercial than for personal lines in the U.K. We consider legal and regulatory barriers to entry to be low as insurers regulated elsewhere in the EU can access the U.K. market through branches. Ease of entry to the U.K. market, compared with peer markets, leads to a corresponding oversupply of capacity at most stages of the pricing cycle.

Over the past decade, the U.K. motor market has seen a rapid rise in the cost of bodily injury claims. The incidence of liability claims to motor accidents has become significantly higher than in other European markets, as has the proportion of legal costs within the overall claims bill.

UKI is therefore exposed to cyclicality, competitiveness, and possible legislative changes in its single market.

Competitive position

UKI has a strong competitive position. It has a leading market share in both private motor and household insurance in the U.K. (based on the Association of British Insurer's data for 2014). In our view, the group has a sustainable competitive advantage through economies of scale in pricing and wider costs. Historical claims data on such a large scale enables UKI to price effectively and has helped the group improve its operating performance since 2010. The group's sale of its international operations had little impact on our view of DLG's competitive position because these operations formed only a small part of the group. However our assessment is somewhat constrained by DLG's dependence on the U.K. non-life market.

In our base-case scenario, we expect UKI's gross written premium to shrink in 2016 and 2017 but remain above £3 billion. Most of the fall in premiums will be as a result of the loss of some key partnership agreements with Nationwide Building Society and J Sainsbury PLC. The loss of these partnerships will likely be most felt in DLG's household segment, where premiums could fall by around 25%. We expect that UKI's motor line will grow at a steady pace to produce £1.5 billion worth of GPW by 2018. We expect DLG's brands to remain leaders in U.K. retail non-life segment and for the company to focus on improving the efficiencies of its U.K. businesses. We consider that recent increases in IPT (insurance premium tax) will cause customer loyalty to reduce, but lost policies should be offset by new business gains.

Table 2

U K Insurance Ltd. Competitive Position

	--Year-ended Dec. 31--				
(Mil. £)	**2015**	**2014**	**2013**	**2012**	**2011**
Gross premiums written	3,153	3,099	3,835	4,001	4,168
Change in gross premiums written (%)	1.7	(19.2)	(4.2)	(4.0)	(16.1)
Net premiums written	2,961	2,917	3,467	3,636	3,911
Change in net premiums written (%)	1.5	(15.9)	(4.7)	(7.0)	(18.3)
P/C: reinsurance utilization - premiums written (%)	6.1	5.9	9.6	9.1	6.2

Financial Risk Profile: Very Strong

Our view of UKI's very strong financial risk profile is driven by our very strong capital and earnings assessment.

We assess UKI's capital and earnings as very strong. Its capital adequacy, as of Dec. 31, 2015, was well in excess of the 'A' confidence level, per our risk-based capital model. We expect this position will be maintained in the long term, with the group likely to return excess capital to shareholders through special dividends in the next two or three years. We expect management will at least maintain capital adequacy at the upper end of our 'A' confidence level through 2016-18.

UKI's earnings have improved since the company listed on the London Stock Exchange. The company has recorded combined ratios below 100% since 2012 and its 2015 combined ratio of 89.9% placed it closer to the leading companies in its peer group. (Lower combined ratios indicate better profitability. A combined ratio of greater than 100% signifies an underwriting loss.) This was despite flood events in late 2015 in the U.K., which resulted in claims of £130 million. The 2015 result did benefit from significant prior-year reserve releases of £449 million (2014: £451 million), making up 75% of the operating profit for continuing operations. We don't expect such large releases to form so large a part of earnings going forward. Although the loss of partnership agreements will have a significant impact on the top line, we anticipate that profitability will be less affected because of the large amount of commission paid out to partners in this type of agreement.

We therefore expect DLG to continue to record combined ratios of about 90%-95%. DLG's increased net income in 2015 of £580 million (2014: £373 million) was largely the result of the gain on disposal of its Italian and German businesses. We do not expect DLG to be making any similar-sized disposals going forward. We therefore expect net income in 2016-2017 to be £250 million-£350 million. Investment income has remained subdued, given the low interest rates, with a yield of 2.4% (2014: 2.2%). We do not expect to see a significant movement in yield in the next three years.

Table 3

U K Insurance Ltd. Capitalization Statistics					
	--Year-ended Dec. 31--				
(Mil. £)	**2015**	**2014**	**2013**	**2012**	**2011**
Common shareholders' equity	2,630	2,811	2,790	2,832	3,871
Change in common shareholders' equity (%)	(6.42)	0.73	(1.47)	(26.86)	11.18

Table 4

U K Insurance Ltd. Earnings Statistics					
	--Year-ended Dec. 31--				
(Mil. £)	**2015**	**2014**	**2013**	**2012**	**2011**
Total revenue	3,241	3,310	3,892	4,120	4,737
EBITDA adjusted	826	568	490	258	360
Net income (attributable to all shareholders)	580	373	313	184	249
Return on revenue (%)	22.46	14.46	11.11	4.95	6.53

Table 4

U K Insurance Ltd. Earnings Statistics (cont.)

	--Year-ended Dec. 31--				
(Mil. £)	**2015**	**2014**	**2013**	**2012**	**2011**
Return on shareholders' equity (reported) (%)	21.34	13.31	11.13	5.50	6.77
P/C: net expense ratio (%)*	32.86	34.85	31.85	33.69	30.71
P/C: net loss ratio (%)	57.07	57.84	61.14	65.13	69.77
P/C: net combined ratio (%)*	89.92	92.69	92.99	98.82	100.48

*DLG's reported expense and combined ratios include depreciation and amortization; our calculations exclude these items.

Risk position

In our view, UKI's risk position is intermediate. It benefits from the diversity of its investment portfolio and minimal exposure to employee postemployment defined benefits obligations. The credit quality of the investment portfolio is gradually reducing in response to a low interest rate environment and a desire to match asset-liability risk better, but still remains strong. Nearly 90% of UKI's investment portfolio is concentrated in bonds and cash. We expect UKI's management team to remain committed to its conservative investment strategy and strictly monitor its exposure and adhere to its credit benchmarks and limits allocated.

However, the cyclicality of the U.K. motor market may increase the volatility of capital and earnings in the future, if the level of volatility we observed in 2009-2010, when the group had to significantly strengthen reserves because of high industrywide increases in bodily injury costs and soft market conditions, repeats.

Table 5

U K Insurance Ltd. Risk Position

	--Year-ended Dec. 31--				
(Mil. £)	**2015**	**2014**	**2013**	**2012**	**2011**
Total invested assets	6,925.7	7,149.0	8,572.9	9,438.8	10,929.6
Net investment income	169.1	176.0	188.6	199.3	243.6
Net investment yield (%)	2.4	2.2	2.1	2.0	2.2
Portfolio composition (% of General account invested assets)					
Cash and short term investments (%)	13.9	12.3	10.6	16.0	26.3
Bonds (%)	75.7	81.6	81.7	75.8	69.6
Real estate (%)	5.0	4.3	2.6	1.4	0.6
Mortgages (%)					
Loans (%)	0.6	0.8	5.1	6.8	0.0
Other investments (%)	4.8	1.1	0.0	0.0	3.5

Financial flexibility

UKI has adequate financial flexibility, in our view, thanks to its good earnings stream, capital held at least in the 'A' range confidence level, a satisfactory level of financial leverage (at about 20%), a healthy level of fixed-charge coverage (9x-10x) in 2016-2017, and the successful flotation/sale of its shares in difficult market conditions in 2013 and 2014. It has also successfully issued junior subordinated debt of £500 million.

In our view, however, UKI's capital market track record is not as long as that of its competitors, to which we assign the highest financial flexibility assessment.

Other Assessments

We consider that UKI's adequate with strong risk controls enterprise risk management (ERM), and satisfactory management and governance assessments, are neutral for the rating. Liquidity is exceptional.

Enterprise risk management

UKI's ERM framework reflects our positive views of the overall risk controls, risk model and strategic risk management. In our opinion, the importance of ERM to the rating is low as it operates in a less complex risk environment than the companies to which we assign a high level of ERM importance. That said, we do not expect the group to experience losses outside its risk tolerance.

Management and governance

We consider that the executive team, headed by Paul Geddes, established a track record following a notable turnaround in DLG's operating performance, successful issuance of junior subordinated debt in April 2012, and oversubscribed flotation and subsequent follow-on sale of 99.7% of DLG's shares. In our view, the management team has a very clear strategy and focus on profitability, and is working hard to sustain a strong performance in difficult market conditions. DLG's strategy appears to be well-thought-out and consistent with its organizational capabilities, taking into account market developments.

Liquidity

DLG's liquidity ratio is more than 200%, based on the strength of available sources, mainly the group's regular inflow of premium income and highly liquid asset portfolio.

Related Criteria And Research

Related Criteria

- Insurers: Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7 2013
- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings Detail (As Of June 21, 2016)	
Operating Company Covered By This Report	
U K Insurance Ltd.	
Financial Strength Rating	
Local Currency	A/Stable/--
Counterparty Credit Rating	
Local Currency	A/Stable/--

Ratings Detail (As Of June 21, 2016) (cont.)	
Junior Subordinated	BBB+
Domicile	United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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