MOODY'S
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CREDIT OPINION
10 July 2023

Update

RATINGS

Direct Line Insurance Group plc

Domicile	BROMLEY, United Kingdom
Long Term Rating	Baa1
Type	Subordinate - Dom Curr
Outlook	Negative

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.

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Direct Line Insurance Group plc

Update to credit analysis

Summary

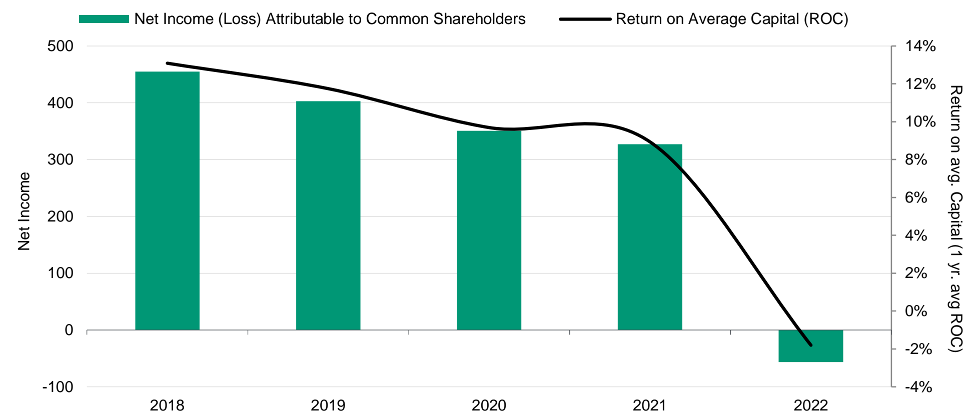
Direct Line Insurance Group plc's (DLG) has powerful brands and a top tier position in the UK retail property and casualty (P&C) market, together with a growing share of the UK SME commercial market. This, together with the group's relatively conservative investment portfolio, low financial leverage and historically strong returns on capital until 2022 (Exhibit 1) support the A1 insurance financial strength rating on the group's lead operating entity U K Insurance Ltd. These strengths are offset by the deterioration in DLG's profitability and capital adequacy during YE2022, combined with negative pressure from claims inflation and difficult pricing conditions in the UK retail P&C market.

On 16 January 2023, the ratings outlook was changed to negative from stable. This reflects the risk that it could take the group longer than anticipated to rebuild its capital resilience.

Exhibit 1

Return on capital was historically strong but deteriorated in 2022 due to claims inflation and adverse investment experience

Return on capital (%) and net income (£ millions)



Source: Company filings and Moody's Investors Service

Credit strengths

» Strong position in the UK personal lines market, with powerful brands

» Low exposure to product risk, with a personal lines orientation

» Relatively low financial leverage and good average earnings coverage of interest

» Relatively conservative investment portfolio

» Consistent track record of strong returns on capital and underwriting results between 2017-2021, albeit deteriorated in 2022

Credit challenges

» Restoring underwriting performance in a very challenging operating environment without a material loss of market share

» Rebuilding the Solvency II ratios towards 160% and the resilience of internal capital generation to fund business growth and dividends

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

Rating outlook

The outlook is negative, reflecting the deterioration in DLG's profitability during YE2022 combined with our expectation of further earnings headwinds, which could arise from high claims inflation and difficult pricing conditions in the UK retail P&C market.

The negative outlook also reflects the risks that it could take the group longer than anticipated to rebuild its capital resilience. The group's YE2022 Solvency II ratio was 147%, towards the bottom end of DLG's target range of 140% to 180%. We view positively the actions taken by the Group to restore its balance sheet strength, but the suspension of the final YE2022 dividend, coupled with a challenging earnings outlook, could, at least temporarily, adversely impact the group's access to external market funding.

Factors that could lead to an upgrade

Given the negative outlook, there is limited upward pressure on the ratings, but the outlook could revert to stable over the outlook horizon in case of:

» DLG's underwriting earnings improving in line with management plans, without a meaningful loss of market share;

» The restoration of the group's Solvency II ratio to around 160%; and

» The group maintains its financial leverage below 25% (calculated based on IFRS4 equity)

Factors that could lead to a downgrade

» DLG is not able to restore its internal capital generation capabilities and underwriting profitability to towards the group's medium-term combined ratio target (under IFRS4)

» It becoming apparent that DLG's franchise is weakening; and/or

» The group's Solvency II ratio remaining consistently below 160%, the middle of the group's risk appetite range

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on https://ratings.moodys.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 2
Direct Line Insurance Group plc

Direct Line Insurance Group plc [1][2]	2022	2021	2020	2019	2018
As Reported (Pound Sterling Millions)					
Total Assets	8,355	9,309	9,622	9,434	9,535
Total Shareholders' Equity	2,281	2,897	3,046	2,990	2,905
Net Income (Loss) Attributable to Common Shareholders	(56)	327	351	403	455
Gross Premiums Written	3,094	3,172	3,180	3,203	3,212
Net Premiums Written	2,953	2,985	2,949	2,987	2,988
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	27.2%	24.1%	22.2%	23.4%	24.8%
Reinsurance Recoverable % Shareholders' Equity	51.8%	43.6%	39.1%	42.5%	42.4%
Goodwill & Intangibles % Shareholders' Equity	46.1%	35.1%	31.7%	29.6%	25.6%
Gross Underwriting Leverage	3.2x	2.4x	2.3x	2.4x	2.6x
Return on Average Capital (ROC)	-1.8%	8.9%	9.7%	11.7%	13.1%
Sharpe Ratio of ROC (5 yr.)	141.2%	613.3%	548.4%	420.4%	392.1%
Adv. (Fav.) Loss Dev. % Beg. Reserves	-6.4%	-10.0%	-6.5%	-10.2%	-12.9%
Adjusted Financial Leverage	18.3%	19.1%	19.7%	14.4%	15.0%
Total Leverage	28.0%	28.2%	28.3%	23.7%	24.6%
Earnings Coverage	-0.7x	9.4x	10.1x	12.6x	14.3x

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

Profile

DLG, which was listed on the London Stock Exchange in 2012 after being divested from RBS in July 2012, is one of the UK's largest personal lines P&C insurers, with top tier positions in personal motor and home by in-force policies (IFP).

The Group underwrites around £3.1 billion of gross written premiums (2022 GWP) through its highly recognised brands — Direct Line, Churchill, Privilege and Green Flag — and partners.

The Group has four core classes of business in the UK P&C insurance market: personal motor (representing 46% of GWP in 2022), commercial (24%), home (17%), rescue & other personal lines (9%) and exited rescue & other personal lines (4%). DLG's commercial business is focussed solely on small and medium-sized enterprise (SME) businesses.

Detailed credit considerations

The A1 IFSR is in line with the adjusted scorecard indicated outcome as shown in the Moody's scorecard (Exhibit 6).

Insurance financial strength rating

The key factors currently influencing the rating and outlook are:

Market position, brand and distribution: Strong position in UK personal lines could come under pressure

As one of the leading personal motor and home underwriters in the UK, we consider DLG's market position to be strong. Notwithstanding the decline in premiums since 2017, on the back of distribution partnership exits and difficult pricing conditions, the group's brands, in particular Direct Line and Churchill, remain very powerful. DLG's SME commercial business continues to grow profitably, supported by the Group's investments in risk selection and pricing capabilities. DLG's estimated share of SME commercial insurance market is around 7%, although the Group has a relatively modest position in the overall UK commercial insurance sector.

The Group's adjusted gross written premiums (GWP), which excludes exited partnerships in the rescue and other personal lines segment, reduced by around 3% in 2022 driven predominantly by lower volumes across Motor and Home. This is a result of pricing actions taken in response to the FCA's general insurance pricing practices reforms which came into force on 1 January 2022 together with pricing actions in Motor to address claims inflation which led to a reduction in the Group's competitiveness. The fall in retail home and motor GWP of 8% and 10%, respectively, was largely offset by continued strong growth in commercial lines, with GWP up 15%.

While premiums increased in Q1 2023, and continued to in April across Motor and Home thanks to the continued pricing action, trading conditions remain challenging. We expect the group will prioritise underwriting results ahead of growth, which could lead to a further reduction in volumes during 2023. Medium-term, we expect premiums to stabilise and begin to grow, supported by the group's new technology-enabled underwriting capabilities and by launching new propositions. DLG's ten-year partnership with Motability from H2 2023 will also deliver growth, adding roughly £500 million per annum to motor GWP from YE24 onwards, although with a much lower impact on net written premiums. DLG's commercial segment should continue growing, supported by both the Group's initiatives and good pricing momentum.

We view DLG's distribution as strong, with leading direct to consumer propositions. Personal lines products are sold directly by phone, over the internet, through online aggregators and via partnerships, particularly in the home segment. DLG continues to improve its distribution capabilities by investing in new websites, digital propositions (e.g. Darwin, which targets PCW customers using an alternative pricing system) and by targeting less traditional partnerships.

The commercial division also benefits from some direct distribution (via Direct Line for Business, “DL4B”) and through the PCW channel (via Churchill for Business), although the majority of premiums are still written via brokers.

Despite the Group’s inherent scale advantages, its historic expense ratio has been relatively high and above its personal-lines orientated peers, driven by high marketing costs associated with the Group's direct brand propositions. However, despite the inflationary backdrop the Group has controlled its expenses, which were around £700 million in 2022 excluding one-offs and restructuring. The group remains focussed on efficiency, but its expense base is subject to inflationary pressure.

In our view, DLG's multichannel distribution strategy, powerful brands, recent technology investments and strong financial resources will enable the Group to adapt to cyclical and longer-term changes in the market place, particularly as increasing car safety features, electric cars and eventually autonomous vehicles, start to transform the traditional risk pool.

Product risk and diversification: Relatively low product risk, but personal lines focus led to weak results in difficult market conditions

In our view, product line diversification is relatively limited, with personal motor accounting for 46% of GWP in 2022. The Group's relative dependence on the UK personal lines insurance market (76% GWP) was a driver of poor underwriting results in 2022, with most major lines, especially motor, experiencing adverse pricing conditions and high claims inflation. However, the Group's commercial business is growing, and accounted for 24% of GWP and contributed an operating profit of £58 million in 2022, up from 15% of GWP for YE16, benefitting from its technology transformation and favourable pricing conditions in recent years. Growth in the commercial segment has helped absorb some of the deterioration in underwriting results in retail segments during 2022.

Despite poor market conditions in 2022, we consider DLG's product risk to be low as a result of its focus on generally high frequency, low severity, personal lines business, as well as its focus on lower volatility SME clients within the commercial business. The Group is however exposed to large bodily injury claims volatility and windstorm and flood catastrophe risk which DLG mitigates using reinsurance.

Asset quality: Relatively conservative investment portfolio, notwithstanding relatively high exposure to credit versus peers
We view DLG's asset quality as good, supported by the Group's relatively conservative investment portfolio, which the group further de-risked during 2022, and low reinsurance recoverables as a percentage of shareholders' equity, despite relatively higher levels of goodwill and other intangible assets.

At YE22, the vast majority of the group's investment portfolio is invested mainly in fixed-income securities and cash, with around 10% held in government bonds, 54% in corporate bonds, 2% in investment-grade private placement, 5% in Infrastructure debt, 4% in commercial real estate loans and 19% in cash. The Group's high risk assets as a percentage of shareholders' equity ratio stood at around 27% at YE22, primarily comprising property investments and high yield bonds. DLG also has some exposure to UK infrastructure, which supports its asset strategy backing longer-dated periodical payment order liabilities (PPOs), as well as commercial real estate loans. During 2022, DLG reported realised and unrealised losses resulting from £39.1 million fair value adjustments to commercial property and £24.9 million of realised losses from disposals of longer duration US dollar credit relating the actions to de-risk its investment portfolio.

The credit quality of the fixed income portfolio remains good. Around 92% of the portfolio is investment grade (including investment grade private placements) and 63% is rated A or higher, with a well-diversified portfolio by sector. The average interest rate duration of the group's debt securities was 2.3 years at YE22 (2021: 2.5 years), comprised almost entirely of corporate bonds. Corporate bonds represented a material c.83% of debt securities as at YE22, which is significantly higher than a number of its UK/European P&C peers.

Capital adequacy: Solvency II ratio fell during 2022 but management is prioritising capital rebuild
Financial market volatility, together with weak performance during 2022 driven by claims inflation in motor and severe weather in home, led to an erosion of the group's capitalisation and resulted in DLG's decision to suspend its final dividend payment. The group's regulatory solvency ratio, which stood at 147% at YE22 and broadly unchanged at 31 March 2023, is towards the bottom end of the group's target operating range of 140%-180%.

DLG's available capital was eroded by underwriting losses, widening credit spreads, losses on the sale of long duration credit and a reduction in the value of the group's property investments. This more than offset the decline in capital requirements relating to the sale of longer duration credit and other capital management actions taken during the period.

Compared to its year-end Solvency II ratio of 147%, DLG expects mechanical tailwinds to contribute 7-15ppts of Solvency by year-end 2023, and potential management actions up to a further 15ppts of benefit. Mechanical tailwinds include the unwind of valuation losses on maturing fixed income, a reduction in ineligible capital, risk margin reforms and potential tax carry-backs. Management actions include margin restoration in motor and exited partnerships which are already being pursued, and the potential for further asset de-risking and reinsurance purchasing such as extending current covers or pursuing legacy solutions such as adverse development cover.

While management has identified numerous tailwinds and possible actions, there remains execution risk in its rebuild of capital. Organic capital generation from underwriting, which we expect to remain below historic levels in 2023 as 2022 business continues to earn through, was historically the primary contributor to maintaining DLG's solvency margins.

The Group's quality of capital remains good. As at YE22 eligible tier 1 capital amounted to 75% (2021: 71%) of own funds and 110% of Solvency II capital requirements (2021: 126%). Tier 3 capital was 10% of own funds, and increase from 6% in 2021. The group breaches eligiblity limits for both its RT1 and Tier 3 capital, by a greater degree than in 2022 as Tier 1 capital reduced from underwriting losses and SCR reduced from the quota share and rising interest rates.

Profitability: Historically strong profitability disrupted in 2022. We expect weak results until earned margins converge with written margins
DLG's five-year average ROC (calculated on a Moody's basis) for the period 2018-2022 was strong albeit reduced to 8.3% (2017-2021 average: 11.2%). This, together with a sharpe ratio of ROC of 141.2% in 2022 (2021: 613.3%), showcases the impact of recent volatily on the group's historically strong performance which was supported by conservative underwriting and low investment risk. Prior to

2022, the group consistently met or exceeded its internal combined ratio target of 93%-95% and return on tangible equity (RoTE) of at least 15%.

In 2022 the group's operating profits came under pressure, reducing from £581.1 million in 2021 to £20.6 million in 2022. This was driven mainly by deterioration in combined ratio (COR) to 105.8% from 90.1% in 2021, but also losses on investments discussed in the asset quality section. Motor, home and exited partnerships produced operating losses, which were only partially offset by profitable performance in commercial and other personal lines.

Motor reported a combined ratio of 114.7% in 2022, compared to 92.4% in 2021. 5ppts of this increase was driven by the unwinding of COVID-driven frequency benefits in 2021 and the remainder by claims inflation rising significantly faster than pricing. This was a trend experienced throughout the UK personal motor market, however we consider that DLG underestimated claims inflation to a greater degree than some of its peers. Management is prioritising the turnaround of motor profitability. While DLG has made progress towards writing 2023 new business to target margins, we expect business written in 2022 will suppress results as it earns through.

Home reported a combined ratio of 106.9% in 2022, compared to 80.1% in 2021. Around 20ppts of this increase was driven by elevated weather related losses, which amounted to £119 million in home and £149 million in total, well above the group's £73 million budget and the highest level since their IPO. Excluding weather related losses, home was profitable on underlying basis having experienced more benign claims inflation.

While we expect written profitability to improve in 2023, reported results will likely remain weak. Improvements will be driven by improved pricing, lower technology investment spend, lower operating expense and higher investment returns on the back of rising interest rates. From 2024, the group should also start to benefit from its new tech-enabled pricing capabilities and its partnership with Motability Operations Ltd, which will add around £500m of annual GWP to its motor operations, whilst adding further scale to DLG's claims management service.

The group will report under IFRS17 at half-year 2023. While we do not expect a material impact on scorecard metrics from adoption, the group has changed its KPI for underwriting profitability to net insurance margin (NIM, defined as net insurance service result over net insurance contract revenues). Its target NIM of 10% equates roughly to a 96% COR under IFRS 4, which is higher than group's historical guidance of a 93%-95% COR.

Our negative outlook reflects the risk that it could take materially longer for the group to rebuild its earnings power owing to the difficult trading conditions in the UK retail P&C market, to which the group is highly exposed. High levels of competition together with high inflation and the cost-of-living crisis may result in the group sacrificing volume and market position to protect its combined ratio.

Reserve adequacy: Reserve releases trending down; reserving risk is relatively low although long-tail motor bodily injury claims add risk

DLG has reported significant prior-year reserve releases since 2011, as reflected in favourable five-year weighted-average loss development, as a percentage of opening reserves, of 8.3% (2018-2022). Reserve releases reduced to £163.2 million during 2022 from £258.1 million in 2021. Releases were lower across all lines, but most material in motor and home.

We expect reserve releases to be heavily muted in 2023 as motor business written in 2022 develops unfavourably, offsetting potential pockets of favourable development in other lines. We note that DLG has been ordered to review historical underpayments on total loss claims in its motor portfolio from September 2017 to August 2022. DLG fully provided for the expected cost of these claims in its 2022 reserves and has redesigned its process for estimation and settlement of such claims.

Over the medium-to-long-term we expect reserve releases to return to being a material contributor to operating profit. Overall reserving risk is considered moderate although some volatility will likely remain a feature stemming from large bodily injury claims, which take longer to settle and typically involve court proceedings.

Claims inflation is an inherent reserving risk for DLG and the wider P&C market, heightened in the current environment. Motor claims inflation is being driven by higher used car costs, rising repair costs, as vehicles are fitted with more advanced technology, as well as elevated repair times owing to supply chain disruption leading to longer credit hire costs.

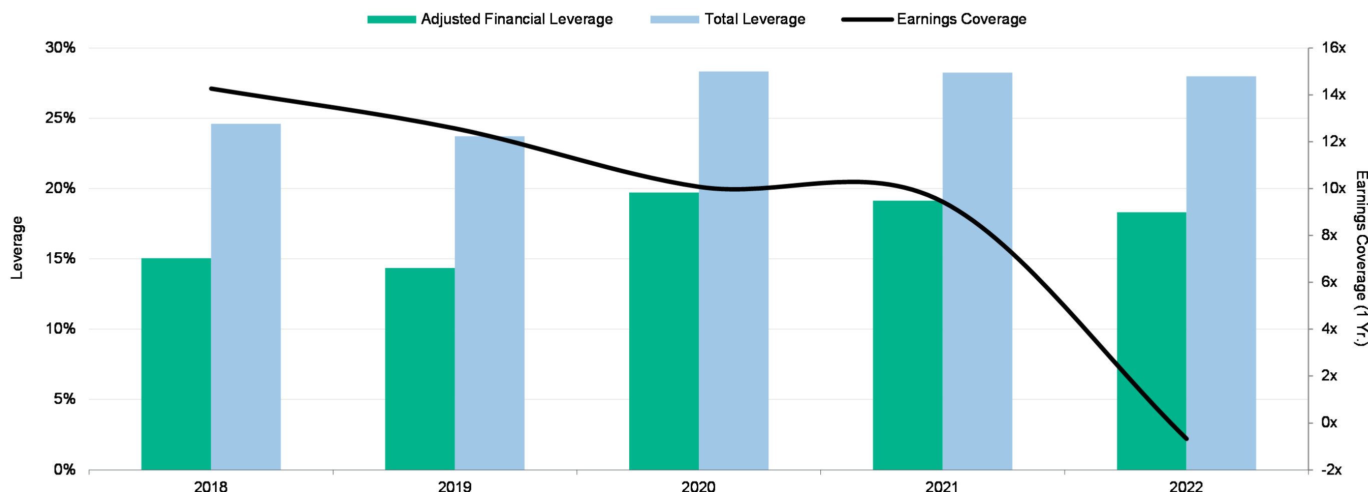
Financial flexibility: Leverage expected to remain relatively low but earnings coverage will weaken

We view DLG's overall financial flexibility as good, supported by relatively low financial leverage, which has been sustainably below 20%, and good earnings coverage, which averaged around 11x between 2017 and 2021 (Exhibit 3). However, the group's earnings coverage metrics deteriorated for YE2022 owing to poor performance. Equity has also fallen in the period, driven predominantly by unrealised investment losses, dividends and share buybacks, but financial leverage decreased to 18.3% at YE22 (YE21: 19.1%) due to the repayment of the £250 million subordinated bond.

Exhibit 3

Leverage and earnings coverage have been deteriorated

Adjusted financial leverage, total leverage and earnings coverage of interest



Source: Moody's Investors Service; Company Filings

The prospect of weaker and more volatile performance over the short-to-medium term, together with the suspension of the group's final dividend, may, at least temporarily, reduce the group's access to external capital markets.

As at YE2022, the group had outstanding £260 million of T2 subordinated debt (4.0% due 2032) and £350 million of Restricted Tier 1 securities 4.75%, perpetual), which Moody's considers eligible for equity credit.

ESG considerations

Direct Line Insurance Group plc's ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 4

ESG Credit Impact Score

CIS-2

Neutral-to-Low

NEGATIVE IMPACT

POSITIVE IMPACT

For an issuer scored CIS-2 (Neutral-to-Low), its ESG attributes are overall considered as having a neutral-to-low impact on the current rating; i.e., the overall influence of these attributes on the rating is non-material.

Source: Moody's Investors Service

Direct Line's ESG Credit Impact Score of (**CIS-2**) reflects a limited impact from environmental and social factors on the rating to date. The group's strong risk management and effective governance, along with good capitalization and use of reinsurance, mitigate its exposure to environmental and social risks, in particular customer relations risk and physical climate risk.

Exhibit 5
ESG Issuer Profile Scores

Source: Moody's Investors Service

Environmental

Direct Line Group is moderately exposed to environmental risks, in particular physical climate risk related to the effects of natural catastrophes on its P&C insurance operations. The company has a good track record of managing this risk through pricing and reinsurance. As the frequency and severity of natural catastrophes increase over time, Direct Line and its peers could find mitigating this risk more challenging.

Social

Direct Line is moderately exposed to social risk, most notably with respect to customer relations and changing societal and demographic trends in its personal P&C business. Customer relations risk are elevated in relation to the group's personal P&C insurance products and significant interactions with retail customers, particularly against a background of an increasing focus by the UK regulator on the fair treatment of customers. This is mitigated by well-developed policies and procedures. Changes in societal attitudes and the legal environment can impact P&C claims costs and reserve development, particularly in motor lines. Changing motor usage patterns and the rise of autonomous vehicles, which could reduce the demand for motor insurance. Rising digitization and interconnectedness of devices will increase customer privacy and data security risks, although these are mitigated by a strong technology risk framework, while also presenting business risks and opportunities for Direct Line.

Governance

Direct Line faces low governance risks, and its risk management, policies and procedures are in line with industry best practices. The management team has a strong track record in consistently meeting objectives and financial targets, which are well articulated within the group's multiyear strategy to improve efficiency and effectiveness supported by technology. The group also benefits from a strong board and a good track record of regulatory compliance and consistently low leverage levels.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Support and structural considerations

The subordinated notes issued by DLG in June 2020 are rated Baa1(hyb). The rating is derived from the A1 IFSR of UKI and the three notch differential reflects Moody's standard notching practices for an insurance holding company domiciled and operating in jurisdictions where group regulation is in effect, and also reflects the structural and contractual subordination of the notes.

Rating methodology and scorecard factors

Exhibit 6

Direct Line Insurance Group plc

Financial Strength Rating Scorecard [1][2]	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adj Score
Business Profile								A	A
Market Position, Brand and Distribution (25%)								A	Aa
-Relative Market Share Ratio			X						
-Underwriting Expenses % Net Premiums Written			26.2%						
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		27.2%							
-Reinsurance Recoverable % Shareholders' Equity		51.8%							
-Goodwill & Intangibles % Shareholders' Equity				46.1%					
Capital Adequacy (15%)								A	A
-Gross Underwriting Leverage			3.2x						
Profitability (15%)								A	A
-Return on Capital (5 yr. avg.)		8.3%							
-Sharpe Ratio of ROC (5 yr.)				141.2%					
Reserve Adequacy (10%)								Aaa	Aa
-Adv. (Fav.) Loss Dev. % Beg. Reserves (5 yr. wtd. avg.)	-8.3%								
Financial Flexibility (15%)								Aa	A
-Adjusted Financial Leverage		18.3%							
-Total Leverage		28.0%							
-Earnings Coverage (5 yr. avg.)		9.1x							
-Cash Flow Coverage (5 yr. avg.)									
Operating Environment								Aaa - A	Aaa - A
Preliminary Standalone Outcome								A1	A1

[1] Information based on IFRS financial statements as of fiscal year ended December 31, 2022. [2] The Scorecard rating is an important component of the company's published rating, reflecting the standalone financial strength before other considerations (discussed above) are incorporated into the analysis.
Source: Moody's Investors Service

Ratings

Exhibit 7

Category	Moody's Rating
DIRECT LINE INSURANCE GROUP PLC	
Rating Outlook	NEG
Subordinate	Baa1 (hyb)
Pref. Stock Non-cumulative	Baa3 (hyb)
U K INSURANCE LIMITED	
Rating Outlook	NEG
Insurance Financial Strength	A1

Source: Moody's Investors Service

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