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Research Update:

U K Insurance Ltd. Ratings Affirmed At 'A' Following Review; Outlook Stable

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Overview

- Following our review of U.K.-based non-life insurer U K Insurance Ltd. (UKI), we are affirming our 'A' insurer financial strength and counterparty credit ratings on the group.
- We continue to regard UKI's financial risk profile as very strong. Consistent with our previous expectations, we forecast a gradual reduction of capital adequacy to the 'AA' level in 2014-2015, from a 'AAA' level at year-end 2013.
- We continue to regard UKI's business risk profile as strong, reflecting the group's strong competitive position despite challenges in growing its business profitably in the highly competitive U.K. general insurance market.
- The stable outlook reflects our view that UKI will maintain at least a strong capital and earnings profile, alongside a strong competitive position in the U.K. insurance market.

Rating Action

On May 9, 2014, Standard & Poor's Ratings Services affirmed its 'A' insurer financial strength and counterparty credit ratings on U.K.-based non-life insurer U K Insurance Ltd. (UKI). The outlook is stable.

Rationale

The affirmation follows our review of UKI, the main operating insurance subsidiary of Direct Line Group (DLG), and best known through its Direct Line brand. The ratings reflect our view of the group's very strong financial risk profile, which continues to be supported by very strong capital adequacy, a good earnings stream, and its strong business risk profile. UKI's strong business risk profile mainly reflects the group's strong competitive position in the mature and highly competitive U.K. general insurance market.

We combine these factors to derive an anchor of 'a' for UKI. This is the lower of two possible anchors. Despite DLG's divestment from Royal Bank of Scotland (RBS), we continue to assign UKI the lower anchor because we remain concerned that the group may manage its capital at lower levels in future, albeit at least comfortably at the 'A' level. UKI continues to benefit from a strong competitive position despite challenges in growing its share of the highly competitive U.K. general insurance market. UKI is one of the leaders in the personal lines market in the U.K., and has about a 10% share of the general insurance market (based on reported Association of British Insurers data). UKI has particularly strong positions in the motor and home insurance segments.

We assess UKI's capital and earnings as very strong. The group's capital adequacy was at the 'AAA' level as of Dec. 31, 2013, but under our base-case scenario, we expect it to gradually weaken to a 'AA' level in 2014-2015 due to lower retained earnings. For example, in 2013, UKI announced two special interim dividends, in addition to scheduled and final dividend payments. Furthermore, we expect that increasing credit and market risk charges as the result of planned investments in infrastructure and high-yield bonds will weaken capital further over 2014-2016. In 2013, DLG's net income of £312 million and net combined (loss and expenses) ratio of 93% were well in excess of our expectations. However, DLG's net combined ratio was boosted by significant reserve releases of about £400 million. Our base-case scenario envisages a net combined ratio of 97%-99% in 2014-2015, and net income in excess of £185 million in 2014 and in excess of £220 million in 2015.

In our view, UKI's risk position is intermediate. While the group benefits from the diversity of its investment portfolio and minimal exposure to employee postemployment defined benefits obligations, this is offset by the cyclicality of the U.K. motor market, which increases the volatility of capital and earnings. We expect UKI's management team to remain committed to its conservative investment strategy, despite some increased credit risk taking.

We continue to view UKI's financial flexibility as adequate, reflecting its good earnings stream; very strong, albeit reducing, capital adequacy; and still low, but potentially increasing, financial leverage ratio. As of Dec. 31, 2013, DLG's financial leverage was 19%, with healthy fixed-charge coverage of 9x. For 2014-2015, we expect leverage to be around 20% and fixed-charge coverage to be 6x-7x. As part of DLG's divestment from RBS, the group has demonstrated its ability to tap equity and bond markets. However, in our view, it does not have as long a capital market track record as its competitors, to which we assign the highest financial flexibility assessment.

UKI's enterprise risk management (ERM) and management and governance practices are neutral factors for the ratings. UKI's management and governance is satisfactory, and it has successfully executed key strategic priorities over the past two years. We consider UKI's ERM as adequate with strong risk controls, and it is becoming more embedded in the organization. In particular, we think UKI has made strong progress in developing its internal risk models and using ERM in various strategic decisions since 2012.

Outlook

The stable outlook reflects our view that UKI will continue to maintain at least strong capital and earnings, with capital adequacy at least comfortably at the 'A' level. We also expect that UKI will maintain stable earnings, a conservative investment profile, and a strong competitive position in the U.K.

insurance market.

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 shrank unexpectedly in a competitive market environment.

We consider an upgrade to be unlikely, but we may raise the ratings if UKI maintains its capital consistently at the 'AAA' level, or if its ERM processes strengthen further while it operates in a more complex risk environment.

Rating Score Snapshot

Financial Strength Rating	A/Stable
SACP	a
Anchor	a
Business Risk Profile	Strong
IICRA	Intermediate Risk
Competitive Position	Strong
Financial Risk Profile	Very Strong
Capital & Earnings	Very Strong
Risk Position	Intermediate Risk
Financial Flexibility	Adequate
Modifiers	0
ERM and Management	0
Enterprise Risk Management	Adequate With Strong Risk Controls
Management & Governance	Satisfactory
Holistic Analysis	0
Liquidity	Exceptional
Support	0
Group Support	0
Government Support	0

IICRA--Insurance industry and country risk assessment.

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 List

Ratings Affirmed

U K Insurance Ltd.	
Counterparty Credit Rating	A/Stable/--
Financial Strength Rating	A/Stable/--
Direct Line Insurance Group PLC	
Junior Subordinated*	BBB+

*Guarantor: U K Insurance Ltd.

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