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U K Insurance Ltd.

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U K Insurance Ltd.

Major Rating Factors

Strengths:

- Extremely strong capital adequacy, as measured by our model.
- Strong competitive position.
- Conservative investment strategy.

Operating Company Covered By This Report
Financial Strength Rating
Local Currency
A/Stable/--

Weaknesses:

- Historically volatile operating performance.
- Execution risk of divestment from RBS Group (RBSG) which could weaken financial flexibility and capitalization.

Rationale

The ratings reflect our view of U K Insurance Ltd.'s (UKI's) extremely strong capital adequacy ratio (measured by our capital model), strong competitive position, and conservative investment strategy. These factors are offset by its historically volatile operating performance, the execution risk inherent in the divestment from RBS Group (RBSG), and operating cash flows that are strong, but have historically been volatile. We view UKI as "not strategically important" to RBSG under our group ratings methodology and therefore equalize its financial strength and issuer credit ratings with its 'a' stand-alone credit profile (SACP) and the 'A' long-term counterparty credit ratings on RBSG's core banks. This implies that the ratings on UKI are capped at the level of RBSG's core banks under our group ratings methodology; therefore while RBSG remains its majority owner, any negative rating action on RBSG may be replicated on UKI.

Overall capitalization is very strong. UKI's capital adequacy at year-end 2010 and its estimated capital adequacy at year-end 2011, based on Standard & Poor's capital model, are extremely strong. The very strong level of capitalization is supported by a strong level of reserving and what appears to be an adequate level of reinsurance coverage. It is, however, offset by the execution risk of the divestment of Direct Line Insurance Group PLC (DLG) from RBSG and the potential negative impact of this on DLG's financial flexibility and capitalization.

DLG's competitive position is strong and supports the rating. The group is one of the market leaders in the personal lines sector in the U.K.; its 2010 market share was about 11%, based on reported Association Of British Insurers data. It also has strong positions in its motor and home segments. DLG's leadership and significant market share in these lines of business reflect the strength of its brands and direct multichannel distribution, complemented by multi-year partnership agreements with similarly well-known brands and financial industry leaders. DLG's reliance on a mature, saturated, and highly competitive U.K. personal lines market with limited growth potential is a relative weakness, compared with its international peers. Premium income also fell in 2006-2008, partly because of greater competition through aggregators (Web sites that collect and distribute information about competing insurance products).

The ratings on DLG also benefit from a conservative investment strategy; nearly 93% of its investment portfolio was invested in high-quality bonds and cash as of Dec. 31, 2011. Of the portfolio, 95% is invested in bonds rated 'A' or higher or held as cash. There is currently no exposure to peripheral European sovereign debt. In addition, there is currently no equity exposure in the investment portfolio, limiting market risk; we view this positively.

Standard & Poor's views DLG's historical operating performance as good and expects it to improve over the medium term. However, the operating performance has also historically been volatile and this is a weakness for the rating. The company was hit by the industrywide increase in bodily injury costs and by soft market conditions; as a result, net combined operating ratios were 112% in 2009 and 121% in 2010. However, we consider that it has conservatively reserved these accident years. In addition, portfolio actions to reduce exposure to worst-performing risks and repricing of the motor account are reflecting in a 2011 net combined operating ratio of 100%. (A combined operating ratio is a company-defined measure of underwriting profitability. Like combined ratios, lower combined operating ratios indicate better profitability and a ratio of greater than 100% signifies an underwriting loss.) Low interest rates have also cut into DLG's investment income. We expect improved underwriting performance to lead to net combined operating ratios of around 95%-98% for the overall portfolio from 2012 onward.

Outlook

The stable outlook is based on our expectation that UKI will continue to maintain at least a very strong capital adequacy ratio, measured by our capital model, and a strong competitive position that will help it improve its operating performance in line with our expectations above.

We consider that a positive rating action is unlikely in the medium term due to the execution risk inherent in DLG's divestment from RBSG and establishment as a stand-alone entity. All these actions could weaken capitalization and damage its market-leading franchise.

We could take a negative rating action if the capital adequacy ratio measured by our capital model falls below the 'AA' range, and operating performance does not improve in line with the expectations we outlined above.

As UKI progressively separates itself from RBSG (financially and operationally) we will continue to assess it against the insulated subsidiary criteria (see "Group Rating Methodology And Assumptions," published on Nov. 9, 2011) and consider if the ratings on UKI should be progressively or partly delinked from those on RBSG.

Corporate Profile: Largest Personal Lines Insurer In The U.K. For Motor, Home, And Overall Personal Lines

UKI is the main operating insurance subsidiary of the Direct Line Insurance Group PLC (DLG). UKI had premium income of about £3.8 billion (based on 2010 year-end data) following the Part VII transfer of Churchill Insurance Company Ltd., Direct Line Insurance Ltd., and The National Insurance and Guarantee Corporation Ltd. in December 2011. We will use the UKI and DLG names interchangeably in this report. DLG is owned by Royal Bank of Scotland Group PLC (RBSG). RBSG plans to commence divestment of DLG in 2012 and fully divest its ownership by the end of 2014. According to the Association of British Insurers' 2010 rankings, DLG was the largest private motor writer, the largest household insurer, and the largest non-life insurer in the U.K. overall, with £4.5 billion premium income in 2010 and a reported 11% share of the market.

Personal lines business accounts for 90% and commercial for 10% of DLG's premium income. For 2011, DLG reported gross written premium income of £4.1 billion, with 42% from personal lines motor (UK), 25% personal lines home (UK), 8% rescue and other personal lines, 11% commercial (UK), and 14% international. DLG operates in the U.K. under well-known, market-leading brands like Direct Line, Direct Line for Business, Churchill, Privilege, The National Insurance and Guarantee Corp. Ltd. (NIG), and Green Flag. DLG also owns the largest direct insurer in Italy and the third-biggest direct insurer in Germany, although these are small in absolute terms.

Table 1

Total Gross Written Premium

Ranking		Premium (Mil.£)		
2010	(2009)		2010	2009
1	(1)	Direct Line Group	4,537	4,705
2	(2)	Aviva	4,460	3,934
3	(3)	AXA Insurance	3,035	2,666
4	(5)	RSA Insurance Group	3,014	2,102
5	(4)	Zurich Financial Services	2,811	2,156
6	(6)	Munich Re	2,000	1,730
7	(8)	AIG	1,916	1,407
8	(9)	Allianz	1,770	1,390
9	(7)	BUPA	1,638	1,612
10	(10)	Lloyds Banking Group	1,220	1,278

Source: Association of British Insurers.

Competitive Position: Strong Competitive Position Is Underpinned By Direct Multichannel Distribution And A Leading Position In The U.K. Personal Lines Market

We believe that DLG's competitive position is strong and supports the rating. The group is one of the market leaders in the personal lines sector in the U.K. and has strong positions in its motor and home segments. DLG's leadership and significant market share in these lines of business reflects the strength of its brands and direct multichannel distribution, complemented by multi-year partnership agreements with similarly well-known brands and financial industry leaders. DLG's international presence is limited, especially now that it has disposed of its Spanish operations; it now operates only in the U.K., Germany, and Italy. Although DLG operates in the German and Italian direct markets, it lacks scale in these markets and in the broader international non-life market. In our view, DLG's reliance primarily on a mature, saturated, and highly competitive U.K. personal lines market with limited growth potential, is a relative weakness, compared with its international peers. It therefore limits our assessment of its competitive position to "strong." We expect DLG to maintain its strong competitive position in the U.K. personal markets, regardless of economic conditions and industry cycle. We do not factor the potential for growth in its international markets into our assessment of DLG's competitive position as we do not anticipate that these operations will grow materially over the rating and outlook horizons.

Table 2

Income Statement

(Mil. £)	2011	2010	2009	2008
Gross written premium	4,098	4,298	4,480	4,384
Growth in gross written premium (%)	(5)	(4)	2	N/A
Net premium income	3,969	4,311	4,354	4,306
Growth in net written premium (%)	(8)	(1)	1	N/A
Operating result	454	(295)	58	584

Source: RBS Group Annual Results (2008-2011) and RBS Group Financial Supplements (core insurance business only). N/A--not applicable.

Market leadership and scale advantages

As one of the market leaders in the personal lines markets, DLG gains sustainable competitive advantage through its scale (operational scale, claims purchasing power, and data scale), in our view. These advantages enable the group to exercise economies of scale in pricing, claims management procurement, and wider costs. Historical claims data on such a large scale also enables DLG to price more accurately.

Diversity of its strong brands, multi-channel distribution, and comprehensive product range.

DLG's strong competitive position in the U.K. benefits from a diversity of its well-known brands within particular segments of population or market, like Churchill (in personal lines), Direct Line (in both personal and commercial lines), and NIG (in commercial lines), and a strong distribution network dominated primarily by its own brands.

Brand Finance PLC, a brand valuation consultancy, published its Brand Value Tables in the Post Top 100 U.K. Insurers Supplement on Sept. 29, 2011; in this publication, Direct Line's brand was ranked fifth, Churchill's sixth, U K Insurance 13th, and NIG 20th among the top 50 brands. Direct Line and Churchill were awarded Brand Finance's highest score.

Even in the commoditized, price-focused market where aggregators are increasingly influential, we believe that brands can remain a differentiating factor. DLG's competitive position is further supported through strong multi-year partnerships with companies including RBS/NatWest, Prudential, Sainsbury's, and Nationwide. The company has also established strong working relationships with the broker community through the NIG brand, which caters for the commercial segment. This brand and distribution channel diversity is further complemented by a comprehensive product range.

Lower acquisition costs compared to peers

We believe that market-leading brands and direct distribution channels create material competitive advantages for DLG by enabling it to lower its acquisition costs below those of its peers. This is, however, partly offset by a significant marketing spend. Furthermore, quotes and purchase data obtained by DLG through multiple brands and channels gives DLG greater understanding of its customer behavior, enabling it to improve segmentation and develop better pricing.

High retention levels

Through DLG's strong market segmentation and its customers' brand loyalty, DLG's competitive position benefits from a good customer retention level in the competitive U.K. motor market. This has helped the company to lower its acquisition costs and maintain market share in its major motor and property markets.

Competitive position relative to other international insurers

In our view, DLG's competitive position is somewhat weaker than the global multiline insurers, like Aviva, RSA, Allianz, AXA, and Zurich, due to its concentration in the non-life segment and its limited geographic scale. The group is also much smaller in absolute terms than these peers.

Table 3

Peer Comparison

(Mil. £)	RBS Insurance (Core)*	Royal & Sun Alliance Insurance PLC	Allianz Holdings PLC	Aviva PLC	AXA	Zurich Financial Services	Allianz SE
2010 gross premium written	4,298	8,448	1,664	36,274	73,509	31,823	58,720
2009 gross premium written	4,480	7,744	1,588	34,690	73,219	34,276	55,730

*RBS Insuance results are taken from RBG Group Annual Results (2010-2011) and cover only the core insurance business. Source: Standard & Poor's.

Prospective

We expect DLG to maintain its strong competitive position over the rating horizon. This is despite ongoing competition in the U.K. mature personal lines market, and economic conditions that continue to restrict growth. The home account is also seeing increasing pressure on pricing, which could threaten DLG's competitive position. However, we expect DLG to exercise disciplined growth in its profitable segments and achieve average premium growth of 7%-8% year on year in 2012-2014. This reflects premium rate increases at least in line with claims inflation and targeted organic growth in profitable segments through partnership agreements. U.K. motor insurers' underwriting performance looks set to improve in 2012 following substantial price increases, but we don't expect it to break even and anticipate that the improvement will be short-lived. The underwriting cycle may already have passed its peak because price increases have nearly stopped and claims costs are still rising.

We do not anticipate that UKI will make any material acquisitions over the rating horizon.

Management And Corporate Strategy: Strong Management Team With Well-Thought-Out, If Unproven, Strategy

We believe that the executive team, headed by Paul Geddes, is convincingly establishing a track record following a notable turnaround in DLG's operating performance in 2011 after it reported poor results in 2009 and 2010. It is building a stable foundation for the group to continue as a stand-alone enterprise after divestment from RBSG. In our view, the new management team has a very clear strategy and focus on profitability, and is making every effort to restore performance to its historical levels.

Strategy

The management team is concentrating its strategy on delivering a sustainable profitable operating performance through underwriting excellence and a strong grip on costs going forward. Looking forward, the priority for management is to deliver the business strategy and to lead the company through the proposed divestment in very testing capital market conditions and separate its operating structure from RBSG. While its strategy appears to be well thought out, it has yet to be proven.

We do not anticipate that DLG's strategy will change materially from that publically announced in the next 12-24 months. We also believe that DLG, as it currently stands, is capable of delivering on its stretching, but achievable, targets thanks to its executive management team's "depth and breadth." The economic and market conditions are outside management's control, however, and may cause the group to miss some targets. We anticipate that the group will deliver on its operating performance targets throughout 2012-2014.

Operational management

DLG's senior management team is relatively new, but all members of the team have extensive industry experience and an established track record of achievements in their previous jobs. As a major non-life insurer, DLG can attract high-quality employees. It also places significant emphasis on the training and development of its employees. We anticipate that management will also face the operational challenges and potential costs of divestment, particularly with regard to establishing stand-alone information technology and operating systems.

Financial management

DLG's financial management is appropriate, in our view. In our opinion, the group maintains an adequate reinsurance program, conservative reserving, and an appropriate investment strategy. DLG has outlined comprehensive and sophisticated financial standards and risk tolerances; these are in the process of being embedded while it establishes itself as a stand-alone group. DLG has predetermined limits for all significant risks and detailed guidelines for effective operational management of the business. At present, DLG has very little debt, but we would expect to see additional financial leverage within DLG's capital structure in the next 12-24 months.

Enterprise Risk Management: Adequate, With Strong Risk Controls

We believe that DLG is in the process of developing and embedding what we expect to be a "strong" stand-alone enterprise risk management (ERM) framework based on adequate risk culture, and strong overall risk controls. The implementation of its stand-alone framework commenced in Q1 2012. Given the issues surrounding substantial reserve increases in 2009 and 2010, we view ERM as being of high importance.

In our opinion, DLG's risk culture is "adequate," supported by a demonstrated commitment to risk management by the board of directors and a robust governance structure which is being embedded in the business through high-level controls documents, risk committees, roles and responsibilities and regular reporting. The ERM function and the chief risk officer (CRO) have significant influence. The framework still needs to be fully embedded before we can score it as "strong."

Standard & Poor's scores overall risk controls at DLG as "strong" due to strong scores for controls related to individual risks, underwriting, reserving, and risk models in particular. The group's strong reserving process is somewhat offset by the reserve increases in 2009 and 2010.

Accounting And Financial Reporting: Confidential Management Accounts

We have based our analysis on a combination of the company's consolidated management accounts, regulatory returns, and publicly available financial information provided in divisional reporting in RBSG accounts. As a result, we have included only limited financial tables in this report. We have derived key performance indicators such as the ratios, including the combined operating ratios, from publically available information.

Standard & Poor's made the following material adjustments to reported and projected shareholders' equity to calculate total available capital (TAC) as of Dec. 31, 2010, estimated for 2011 and 2012:

- The discounted non-life loss and unearned premium reserves added to TAC;
- A net charge made for a one-in-250-year property aggregate catastrophe loss;
- A 50% credit given quantitatively in the capital model for reserve prudence; and
- Capital movements and dividend payments used in our projections were as projected by the company.

Operating Performance: Operating Performance Is A Weakness For The Rating

Standard & Poor's views DLG's historical operating performance as good, and expects it to improve over the medium term. However, the operating performance has also historically been volatile and this is a weakness for the ratings. It will remain so until the company can demonstrate a profitable, sustainable trend compared with peers over the cycle. Underwriting and operating results fell sharply in 2009 and 2010; reported operating loss was £295 million in 2010. It was hit by the industrywide increase in bodily injury costs and by soft market conditions; as a result, net combined operating ratios were 112% in 2009 and 121% in 2010. However, we consider that it has conservatively reserved these accident years. In addition, portfolio actions to reduce exposure to worst-performing risks and repricing of the motor account are reflecting in a 2011 net combined operating ratio of 100%. Low interest rates have also cut into DLG's investment income.

Historically, DLG has demonstrated strong underwriting performance on its home (UK) account (25% of GPW) and on its rescue and other (UK) account (8% of GPW). However, this was offset by a weak underwriting performance on its motor (UK) account (42% of GPW); commercial account (11% of GPW); and international account (14% of GPW). Motor performance was weak in absolute terms and compared with the overall U.K. market in 2010, but improved significantly in 2011. The performance of the motor account was primarily hampered by industry-related rising bodily injury claim costs and strengthening of reserves, which added about 20 points to DLG's net combined ratio for 2009 and 2010. We do believe, however, that it has reserved conservatively on these accident years.

Table 4

Performance Ratios For Core Business

(%)	2011	2010	2009	2008
Loss ratio	70	91	83	70
Commission ratio	10	10	8	10
Expense ratio	20	20	21	14
Combined operating ratio†	100	121	112	94

Source: RBS Group Annual Results (2008-2011) and RBS Group Financial Supplements (core insurance business only).

DLG delivered an adequate return on revenue (calculated as operating result/(earned premium income+other underwriting income+ investment income) of 4% on average over 2008-2011.

Prospectively, we expect the improved underwriting performance to lead to net combined operating ratios of around 95%-98% for the overall portfolio from 2012 onward. The improvement follows the company's strong action to increase motor pricing, reduce risk in the book, and exit from unprofitable businesses in motor in 2010 and 2011. Underwriting profitability will also be supported by tight cost control following site rationalization, relocation of non-customer-facing operations off shore, and other efficiency initiatives undertaken in 2010 and 2011 and continuing in 2012.

Investments: Conservative Investment Portfolio, With 93% Being Invested In High-Quality Bonds And Cash

In our opinion, DLG's investment portfolio (£9.8 billion) is conservative; nearly 93% of its investment portfolio was concentrated in high-quality bonds and cash as of Dec. 31, 2011. Of the portfolio, 95% is invested in bonds rated 'A' or higher. There is currently no exposure to peripheral European sovereign debt. In addition, there is currently no equity exposure, limiting market risk; we view this positively. As the investment portfolio is so low-risk, it is yielding low returns.

DLG's asset and liability management is good, in our opinion. The average duration of the investment portfolio was 2.2 years at Dec. 31, 2011, which broadly matches the average duration of claims. DLG, however, has a material exposure to RBSG through its investment portfolio which is being managed down. The group's periodic payment orders are a known mismatch. At present, DLG does not have a portfolio to match these long-tail liabilities, but it is taking action to address this mismatch.

DLG has a clear investment strategy. It sets maximum limits for each counterparty, sector, etc.

RBSG's treasury is still very actively involved in managing DLG's investment strategy and portfolio. DLG is in the process of transferring its portfolio of assets to four external funds managers--its in-house investment team will manage cash and gilts.

We do not expect any material changes in the investment strategy going forward.

Liquidity: Strong, Positive Cash Flow, And Liquid Portfolio

We regard UKI's liquidity as strong, although at the lower side of the range. We have noted volatility in historical operating cash flow, which had a negative influence on our assessment of overall liquidity. UKI has positive cash flows and a high proportion of liquid assets compared with the maximum net underwriting exposure for one-in-200-year events. We do not expect any material changes in liquidity over the rating horizon. UKI has a nil appetite for liquidity risk. The business has some small overdrafts.

Capitalization: Expected To Remain At Least Very Strong

Overall capitalization is very strong. UKI's capital adequacy at year-end 2010 and its estimated capital adequacy at year-end 2011, based on Standard & Poor's capital model, are extremely strong. The very strong level of capitalization is supported by a strong level of reserving and what appears to be an adequate level of reinsurance coverage. It is, however, offset by the execution risk of the divestment of DLG from RBSG and the potential for this to weaken DLG's financial flexibility and capitalization.

Capital adequacy

As of Dec. 31, 2011, the EU Insurance Groups Directive solvency coverage ratio was reportedly at 306%. We have also estimated the capital adequacy ratio for 2012, assuming various dividend payments, incorporating profit for the year and the company's capital plans. UKI has capacity to issue hybrid equity within total adjusted capital, according to Standard & Poor's capital model. The capital adequacy ratio calculated by our capital model appears to be resilient to various movements in shareholders' funds. An aggregate property catastrophe charge at a one-in-250-year return period has been included in the model, but total adjusted capital is relatively insensitive to this number.

Reserves

Reserves are considered strong. In our opinion, UKI factors a prudential margin into the reserves in 2010, following the need for reserve strengthening of the bodily injury reserves in 2009/2010. In 2011, reserves remained stable. Reserving governance is endorsed by external peer review by an independent actuarial consulting firm. The board and the reserving review committee are involved in the reserving process throughout the year.

Reinsurance

The reinsurance protection is considered adequate for the business profile. UKI's catastrophe cover (at a return period of 200 years; windstorm and coastal inundation loss; includes property and motor own physical damage) for 2011 implies a maximum net loss (including reinstatement premium) which equates to a single digit percentage point when compared to capital which we view as prudent. The quality of reinsurers in our opinion is also high.

Financial Flexibility: Strong, But Unproven

We believe that UKI has strong financial flexibility based on its good and prospectively improving earnings, very strong level of capitalization, limited usage of reinsurance and low levels of financial leverage. UKI's ability to raise additional funds or have access to liquidity lines after divestment from RBSG is unproven. We do not anticipate, however, any material capital repatriation, or dividend payouts in excess of those planned and budgeted for by DLG ahead of divestment, nor do we factor in any support from RBSG before the divestment. UKI's ability to access capital markets is unproven, but we see no reason to expect that it will be unsuccessful.

Ratings Detail (As Of March 7, 2012)	
Operating Company Covered By This Report	
U K Insurance Ltd.	
Financial Strength Rating	
Local Currency	A/Stable/--
Counterparty Credit Rating	
Local Currency	A/Stable/--
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.

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