

Corporate governance report

The UK Corporate Governance Code

The following report details how the Board has applied the principles and provisions in the FRC's UK Corporate Governance Code 2012 (the "Code") as required by the UK Listing Rules. See also the statement on page 100 of the Directors' report.

Throughout the year, Direct Line Insurance Group plc (the "Company") has complied with the principles and provisions of the Code. A copy of the Code is available from www.frc.org.uk.

Leadership

The role of the Board

The role of the Board is to organise and direct the affairs of the Group in a manner that is most likely to promote its long-term success for the benefit of its shareholders as a whole. It has oversight of the Group's operations, ensuring it is effectively managed and that there are appropriate controls in place to assess and manage the Group's risks.

The Board has set the Group's strategy of continuing on the transformation path required to bring us closer to our ambition to be Britain's best retail general insurer. Set out on page 58 are the Board's objectives for 2013, the actions the Board has undertaken during the year and our objectives for 2014.

The specific duties of the Board are clearly set out in the Schedule of Matters Reserved to the Board (the "Schedule") within the Board's terms of reference. The Schedule lists those items that are specifically reserved for consideration and decision by the Board. These include:

- the establishment of the Group's strategy and oversight of the business and affairs of the Group;
- the raising and allocation of capital;
- setting the Group's risk appetite;
- ensuring the maintenance of a sound system of internal control and risk management;
- approval and oversight over execution and delivery of major capital projects, contracts which are material strategically and major investments;
- communication and meetings with shareholders;
- changes to the structure, size and composition of the Board and Board Committees, following recommendations from the Nomination Committee;
- determining the remuneration policy for Directors and Senior Executives and the introduction of new share incentive plans or major changes to existing plans;
- delegation of authority;
- corporate governance matters; and
- approval of formal Group policies.

The Board is the main decision-making forum for the Group.

Division of responsibilities

The roles and responsibilities of the Chairman and the Chief Executive Officer are clearly differentiated. The division of responsibilities at the top of a company is required by the Code to ensure that no one person may exert absolute control. The role statements of both the Chairman and the Chief Executive Officer were approved by the Board on 21 September 2012.

The Chairman's responsibility is to provide leadership of the Board and ensure its effectiveness, whilst the Chief Executive Officer develops and delivers the Group's strategy within the policies and values established by the Board.

The Non-Executive Directors provide constructive challenge and help to develop proposals on strategy.

In addition, the Senior Independent Director's role is to provide a sounding board for the Chairman and to serve as an intermediary for the other Directors when necessary. His responsibilities include the evaluation of the performance of the Chairman and he is also available as an additional point of contact for shareholders.

The Board of Directors

The Board currently comprises the Chairman, who was independent on his appointment to the Board, two Executive Directors, five independent Non-Executive Directors and one non-independent Non-Executive Director, Mark Catton. Mark Catton is not an independent Non-Executive Director under the Code by virtue of being nominated by The Royal Bank of Scotland Group plc. However, he demonstrates a level of independent challenge at Board meetings, which has led the Nomination Committee to determine that he is independent in character and judgement.

The names of the Directors who served as at the end of the year, together with their biographical details and other information, are shown on pages 52 to 53.

There were no new appointments during the year; however, Mark Catton resigned from the Board in April 2013 and re-joined the Board in October 2013 when Bruce Van Saun resigned. The respective dates are shown in the notes to the table opposite.

Meetings of the Board

The Board met regularly during 2013; no further ad hoc meetings were required in addition to the 11 scheduled meetings. The Directors received Board papers and had the opportunity to comment on them in advance. Details of attendance at Board and Board Committee meetings by Directors during the year are set out below and on pages 65 to 74.

	Scheduled meetings ¹
Chairman	
Mike Biggs	11 of 11
Senior Independent Non-Executive Director	
Glyn Jones ⁴	10 of 11
Non-Executive Directors	
Mark Catton ²	8 of 8
Jane Hanson ⁴	10 of 11
Andrew Palmer	11 of 11
Clare Thompson	11 of 11
Priscilla Vacassin	11 of 11
Bruce Van Saun ^{3,4}	7 of 8
Executive Directors	
Paul Geddes	11 of 11
John Reizenstein	11 of 11

Notes:

1. Attendance is expressed as the number of meetings attended out of the number of meetings possible or applicable for the Director to attend.
2. Mark Catton resigned as a Director of the Board on 26 April 2013 and rejoined the Board on 1 October 2013.
3. Bruce Van Saun resigned as a Director of the Board on 1 October 2013.
4. Glyn Jones, Jane Hanson and Bruce Van Saun were each unable to attend a scheduled Board meeting during 2013 due to other commitments.

The Board programme for 2013, achievements and objectives for 2014

What did the Board say it would do?	What has the Board overseen, challenged and supported?	What will the Board focus on?
Our objectives for 2013	Highlights of 2013	Our objectives for 2014
<ul style="list-style-type: none"> • Support the vision of becoming Britain's best retail general insurer 	<ul style="list-style-type: none"> • Continued oversight of the development of claims capability, including the roll-out of initiatives to Home and approved the establishment of DLG Legal Services • Approved the Group's commercial strategy and received regular progress reports from each of the principal businesses • Considered capital management policy • Approved capital allocation to the Group's investment strategy • Considered the technology environment in which the Group operates • Considered the impact of emerging global economic conditions, regulatory developments and the outlook for the industry • Considered and approved the sale of the Life business 	<ul style="list-style-type: none"> • Continue to pursue improvements in our claims and pricing capabilities • Consider the strategic development of Commercial and International in the context of the Group's RoTE target • Oversee the substantial migration of Direct Line Group's IT infrastructure away from RBS Group • Monitor change from regulatory, legal and market pressures facing the industry and mitigate against potential risk of adverse reserve development • Monitor implementation of the Group's transformation plan • Review the appropriateness of the Group's capital basis in the context of the current environment
<ul style="list-style-type: none"> • Oversee the Group's progress in pursuit of its targets, including those relating to COR and RoTE 	<ul style="list-style-type: none"> • Oversaw the £100 million cost transformation plan delivered by management • Supported decisions enabling COR and RoTE targets to be met 	<ul style="list-style-type: none"> • Oversee the Group's pursuit of its strategic objectives • Oversee the Group's total cost base¹ reduction to approximately £1,000 million in 2014
<ul style="list-style-type: none"> • Set the tone and culture of the Group, focusing on behaviours to help achieve the strategic objectives • Review the Board's policy on gender diversity to consider how more women can be promoted to senior and executive management roles 	<ul style="list-style-type: none"> • Reviewed the results of an Employee Opinion Survey and challenged management on the actions to be taken • Considered the means by which cultural indicators can be measured and improved • Board at 33% women 	<ul style="list-style-type: none"> • Oversee programmes to invest in the Group's people and culture
<ul style="list-style-type: none"> • Give our customers fair outcomes 	<ul style="list-style-type: none"> • Oversaw new customer propositions, including the launch of telematics products in June • Approved the next phase of the Group's transformation plan, in particular, focusing on customer facing systems • Considered metrics to show performance for customers • Supported the ABI's negotiations with Government to create a not-for-profit fund to insure the highest flood risk properties in the UK 	<ul style="list-style-type: none"> • Promote a focus on better customer experience • Introduce new customer metrics
<ul style="list-style-type: none"> • Review the main elements of governance architecture to ensure that they are fit for purpose for the newly listed entity 	<ul style="list-style-type: none"> • Reviewed and sharpened the Group's corporate governance arrangements • Reviewed the Group's risk appetite statements 	<ul style="list-style-type: none"> • Embedding the corporate governance arrangements of the Group
<ul style="list-style-type: none"> • Conduct a full Board evaluation, since the Board will have been in place for sufficient time to make such a review appropriate 	<ul style="list-style-type: none"> • Undertook a performance evaluation of the Board and its Committees and reviews of the Matters Reserved to the Board and Committees' terms of reference 	

Note:

1. See note 2 on page 2

Board Committees

The Board has established its Committees to assist it in meeting its responsibilities. Each Committee plays a vital role in ensuring that the Board operates efficiently and gives appropriate consideration to matters. The governance structure illustrating the relationship between the Board and its Committees is set out below. The composition, attendance, role and focus of each Committee are set out on pages 65 to 74.

The Board and Committee governance structure



Authority delegated to the Chief Executive Officer

Although the Board is ultimately responsible for the success of the Company, Paul Geddes, the Chief Executive Officer, has received delegated authority from the Board to manage the Group's day-to-day operations.

In turn, the senior executives who report to him take responsibility for managing the businesses and functions within the Group, and each member of the Executive Committee has the financial and other authorities needed to manage their respective areas.

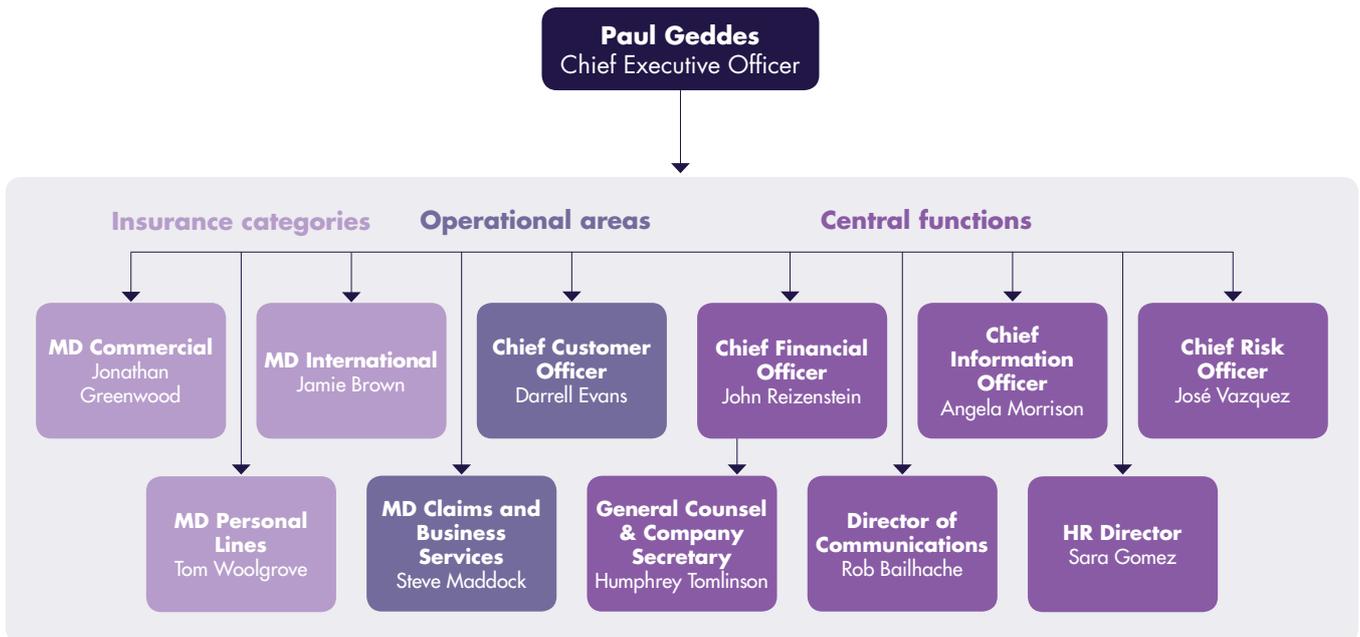
Paul Geddes and these senior executives are supported by the functional departments of the Group.

Executive Committee

The Executive Committee is the principal management committee that assists the Chief Executive Officer in the day-to-day management of the Group as a whole. It supports him in setting performance targets and in implementing the Group's strategy and direction as determined by the Board. The Committee assists him to monitor key objectives and commercial plans to meet the Group's targets. It also helps him to evaluate new business initiatives and opportunities, and receives and considers reports on operational matters, where these are material to the Group or have cross-company implications.

The diagram 'Direct Line Group's Executive Committee' below illustrates the management governance framework.

Direct Line Group's Executive Committee



Governance review

During 2013, the Board oversaw a review of the governance framework within which the Group operates, taking into account that the Company had listed on the London Stock Exchange and the shareholdings in the Company by RBS Group had decreased significantly.

Whilst this review confirmed that the Group's governance framework dealt with such areas as would be expected and necessary, nonetheless the opportunity was taken to improve the control environment whilst making its administration and operation more transparent and cost effective.

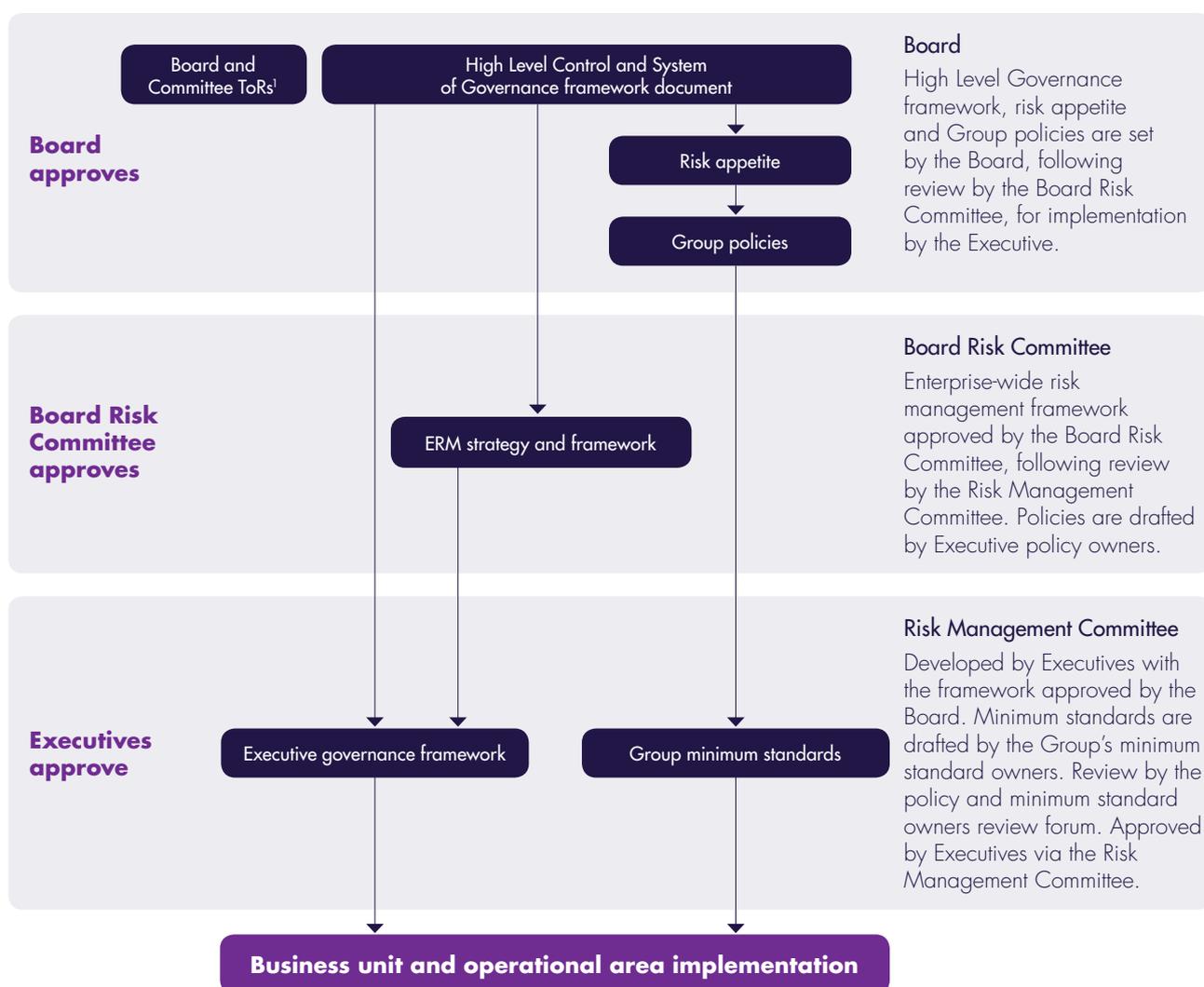
The review covered the entire Group and was primarily led by the Company Secretariat, Legal and Risk functions.

The overall objective of the project was to clarify and simplify the Group's governance framework in order to help and improve its day-to-day operation whilst maintaining appropriate controls.

The review resulted in a significant revision to the High Level Controls and System of Governance Document, the creation of an Enterprise-wide Risk Management framework and an Executive Governance framework. In addition Policies and Minimum Standards were revised and clarified and various business and project approval processes and procedures were also reviewed in conjunction with the Delegated Authority framework.

The diagram below summarises the split of responsibilities for the different aspects of the governance framework.

Direct Line Group overall governance and policy framework



Note:

1. Terms of reference

Board effectiveness

Structure of the Board

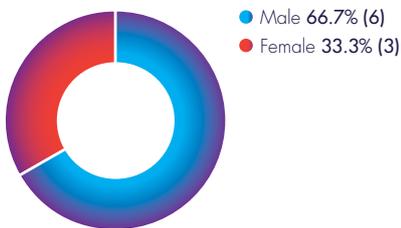
As part of the process of helping to ensure a Code-compliant Board, the Company focused on obtaining the elements considered necessary to maximise the Board's effectiveness. Consequently, the Board and its Committees have been constructed with a view to ensuring that an appropriate balance of skills, experience, independence, knowledge of the sector and diversity exists to enable the Directors to discharge their duties and responsibilities effectively.

In assessing the independence of each Director, we considered whether each was independent in character and judgement and particularly whether there were relationships or circumstances which were likely to affect his or her judgement.

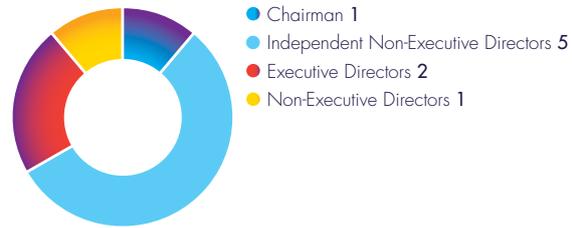
The individuals' attributes were established as part of the selection procedure. Please see the section "Appointment of Directors" for the desired attributes of our Directors and a description of the selection process.

In addition, the Company employs a process of reviewing independence from management and invites the declaration of any conflict of interest that could interfere with each Director's ability to act in the best interests of the Group. UK company law allows the Board to authorise a situation in which there is, or may be, a conflict between the interests of the Group and the direct or indirect interests of a Director or between the Director's duties to the Group and to another person. The Board has adopted procedures for ensuring that its powers to authorise conflicts operate effectively. For this purpose a register of conflicts, and of any authorisation of a conflict granted by the Board, is maintained by the General Counsel and Company Secretary and regularly reviewed by the Board. Mark Catton is a non-independent Non-Executive Director by virtue of being nominated for appointment to the Board by RBS Group, the Company's largest shareholder. RBS Group has committed to the European Commission to sell Direct Line Group as a condition of its receipt of state aid in 2009. To comply with this requirement, RBS Group has reduced its shareholding in the Group to 28.5% and must divest its entire interest by the end of 2014.

Gender diversity of Board members



Balance of Board members



Appointment of Directors

The Company did not appoint any new members to the Board in 2013 as all Non-Executive Directors were appointed very recently. Mark Catton, who had been a Non-Executive Director until April, re-joined the Board as the nominated Director of RBS Group upon the resignation of RBS Group's nominated Director Bruce Van Saun. The Group's key competencies for Board members are as follows:

Experience

- Significant Board experience in major listed businesses (perceived as advantageous)
- Extensive knowledge and operational experience in insurance at a senior level (perceived as advantageous)
- Experience and appreciation of businesses with customer service at their core (perceived as advantageous)
- Likely to have had executive experience

Attributes

- Widely recognised as an individual of high repute and integrity who can rapidly gain Executive and Non-Executive colleagues' respect and trust
- An independent thinker who is able to engage constructively and add real value to Board discussions
- Well organised and committed, an individual who takes his or her Non-Executive role seriously
- Robust, straight talking, open and approachable with a non-emotional and calm demeanour
- Supportive of the executive team while being able to challenge constructively
- A team player and a good listener with the style and ability to be a highly constructive member of the Board
- A sound understanding of the requirements of good public reporting and the ability to identify whether what is being presented in meetings stands up against reporting standards
- Strong communication and presentation skills, with the ability to get under the skin of the business and a strong desire to gain a deep understanding of what is going on in and around the Group

Corporate governance report continued

The selection procedure included a number of interviews and meetings with existing Board members. The Company also obtained a range of references for each candidate.

The Nomination Committee will adopt an approach modelled on this selection procedure for future appointments.

Duration of appointment

The Directors may appoint additional members to the Board during the year. Subsequently, in accordance with a provision of the Code and the Company's Articles of Association, the Group submits Directors for re-election on an annual basis, subject to the Group's independence criteria where appropriate, ongoing commitment to Group activities and satisfactory performance.

In line with these arrangements, all Directors will be subject to re-election by shareholders at our Annual General Meeting ("AGM") on 15 May 2014.

Non-Executive Directors are normally expected to serve two fixed terms of three years, but may be invited to serve a third term of three years.

Commitment from Board members

All our Directors, including the Chairman, have indicated that they are able to allocate sufficient time to the work of the Group to enable them to discharge their respective duties and responsibilities effectively. Directors' appointment letters contain a provision to this effect.

Our Directors have had a considerable workload during 2013 and showed great commitment to meeting the requirements of the business in a year of transformation. In all, 11 Board meetings were held during the year, all of which were scheduled meetings.

Board induction

On appointment, each Director takes part in a tailored induction programme, which is designed to give him or her an understanding of the Company's business, governance and shareholders. Mark Catton resigned as Non-Executive Director in April 2013 and was subsequently re-appointed in October 2013. As there was only a short time between his resignation and re-appointment, it was not considered necessary for Mark Catton to undergo an additional induction programme on his re-appointment.

Resources and training provided to the Board

The Chairman, with the aid of the Company Secretary, ensures that the Board is kept abreast of any changes in the legal and regulatory environment in which the business operates. The Company believes it is crucial to provide Directors with adequate resources and training, and devoted considerable time during the year to ensure that all Directors received training and education to help them understand their duties, responsibilities and develop knowledge of the business as quickly as possible. These sessions were developed to supplement the comprehensive technical acclimatisation programme conducted in 2012 and specifically to meet the needs of the Directors, with individual Directors provided with bespoke training, as indicated in the following diagram.

Our 2013 training and education programme included

Internal sessions focusing on the following topics

- Strategy and change
- Risk appetite, compliance risk and capital management
- Capital modelling, ICAS+ and Solvency II
- Pricing conduct
- Engagement and culture within the workforce
- Periodic payment orders
- Telematics

Site visits

- Bristol – customer relations, telephony trading operations, business support, commercial
- Bromley – the impact of digital technology
- Glasgow – fraud, home claims, field force technology
- Italy and Germany – International market overview, international operations, international strategy, international risk, legal and compliance
- Leeds – customer relations, complaint management, claims and call centre handling

External training sessions

- Accounting and corporate governance developments
- Home and motor insurance markets – overview including regulatory reforms

30

During the year in excess of 30 training sessions, including site visits and Internal sessions on the Group's divisions and functions, were held. In addition, the Non-Executive Directors had a number of meetings with members of the Executive committee throughout the year.

Board effectiveness review

Review of the effectiveness of the Board and its Committees

We conducted our first Board effectiveness review in 2013 to evaluate the effectiveness of the Board, its six committees and individual Directors. The evaluation process was initiated by the Chairman and facilitated by Edis-Bates Associates Limited, an independent corporate governance consultancy, with no other connection with the Company.

Each of the Company's Executive and Non-Executive Directors, together with the General Counsel and Company Secretary, participated in the effectiveness review process, which involved questionnaires, one-to-one interviews and a review of Board processes.

The process took place between September and December 2013. The review of the Board included:

- the role of the Board (including Directors' input into group strategy and risk management);
- information provided to Directors (including induction, continuing professional development and familiarity with group businesses);
- people issues (including Directors' skills, Board and committee composition, diversity, succession planning and time commitment); and
- Board environment and processes (including working relationships, Board papers and Board support).

Similar themes were raised in relation to the Board's committees, as well as committee-specific questions.

Following the conclusion of the evaluation process, the responses and comments were analysed and summarised in a report. The report was discussed initially with the Chairman and then circulated to the full Board. The report concluded that the Board is operating effectively.

The Chairman held one-to-one meetings with each of the other Directors, providing them with feedback on their performance and contributions. Feedback on his own performance and contribution was provided by the Senior Independent Director, who had previously held discussions with the remaining Non-Executive Directors.

Based on the Board effectiveness review report, the Directors are satisfied that the Board has operated effectively during 2013. The Board considered the review in the December Board meeting and matters arising from the report will be further considered and where appropriate actions will be implemented in 2014.

Direct Line Group's approach to diversity

The Board carefully considered the diversity of its members from a variety of perspectives and sought to ensure that Directors had the relevant range of knowledge, skills, experience and, where necessary, independence to help the Group deliver its strategy.

As the composition of the Board shows, with three of its nine members being women, the Company is committed to the merits of diversity. However, whilst the Board will take care to consider gender diversity of its members when selecting new members, it is committed to appointing the most appropriate candidate and therefore no targets have been set against which to report.

To improve the governance of our gender-diversity programme, the Company has included an appropriate remit in the terms of reference of the Nomination Committee. In this, diversity, including gender diversity, features as one of the criteria for the selection of Directors to the Board. Further information regarding this diversity policy may be found in the Nomination Committee report on page 72.

Also, the Corporate Social Responsibility Committee considers the issue in the context of ensuring the diversity of the Group talent pipeline for future requirements, with mentoring schemes for high-potential candidates and associated training and development programmes. Numerical data relating to the gender diversity of the Board, senior managers and the employees may be found on page 47.

Accountability

Financial and business reporting

The Board is responsible for providing shareholders with a fair, balanced and understandable assessment of the Company's position and prospects.

An explanation from the Directors of their responsibility for preparing the financial statements is set out in the statement of Directors' responsibilities on page 103. The statement by our auditors explaining their responsibilities is on page 107.

We meet specific responsibilities placed on the Board under the provisions of the Code as follows:

- an explanation of how the Company generates value over the long term is included within the business model on page 6 and the strategy for delivering Company objectives on page 18;
- how the Board has concluded that the business remains a going concern is discussed on page 102;
- the arrangements established by the Board for the application of risk management and internal control principles are detailed below; and
- the Board has delegated to the Audit Committee oversight of the management of the relationship with the Company's auditors. The Audit Committee report on page 65 provides details of its role, activities and relationship with the internal and external auditors.

Risk management and internal control system

The Board acknowledges that it has overall responsibility for the Group's risk management and internal control system, and has complied with the Code by establishing a continuous process for identifying, evaluating and managing the significant risks the Group faces. This process includes risks arising from social, environmental and ethical matters.

The Group's risk assessment process includes output from a system for reporting on all the significant risks that stand in the way of achieving Group objectives. The system also reports on the nature and effectiveness of the controls and other management processes that manage these risks. The system also sets risk appetites for key categories of quantifiable risk. It additionally encompasses self-assessment of controls by risk owners throughout the Group, whose assertions are independently challenged by the 2nd line of defence and 3rd line of defence.

The Board Risk Committee regularly reviews significant risks, their potential impact on the Group's financial position, variations from agreed risk appetites and the actions taken to manage those risks.

Internal systems of control

The Board has put in place a management structure with defined lines of responsibility and clear delegation of authority. This control framework cascades down through the divisions and central functions, showing clear responsibilities for ensuring that appropriate controls are in place at an operational level, including those that relate to the financial reporting process.

The Group Audit function supports the Board by providing an independent and objective assurance of the adequacy and effectiveness of the Group's operations. It brings a systematic and disciplined approach to evaluating and improving the effectiveness of its risk management, control and governance frameworks and processes.

The Directors are aware that any system of internal control is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and can only provide reasonable, and not absolute, assurance against material misstatement or financial loss.

The Audit Committee, on behalf of the Board, regularly reviews the effectiveness of the Group internal control systems. Its monitoring covers all material controls, based principally on reviewing reports from management, the Group Audit function and external auditors, so that it may consider how to manage or mitigate risk in line with the Group's risk strategy. The Committee did not identify or report any serious failings or weaknesses to the Board in 2013.

Remuneration

The Board has delegated responsibility to the Remuneration Committee for the remuneration arrangements of the Executive Directors and senior executives of the Group. Please refer to the Directors' remuneration report on page 76.