

Research Update

Research Update:

Fairfax Financial Holdings Ltd. And Subsidiaries Ratings Affirmed On Criteria Review; Outlook Revised To Stable From Pos

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Overview

- Following a review under our revised insurance criteria, we are affirming our ratings on Fairfax and its core subsidiaries.
- The ratings predominantly reflect our view of the group's strong business and financial risk profiles, based on its strong competitive position and very strong capital and earnings.
- We have revised our outlook to stable from positive based on our view that Fairfax will gradually improve its underwriting results and fixed-charge coverage metrics but not enough to warrant an upgrade in the near term.

Rating Action

On July 31, 2013, Standard & Poor's Ratings Services affirmed its 'BBB-' long-term counterparty credit rating on Fairfax Financial Holdings Ltd. and its 'A-' financial strength rating on Fairfax's core subsidiaries. We have revised the outlook to stable from positive.

We also affirmed the core group status of Hong Kong-based property casualty insurer Falcon Insurance Co. Ltd. (Falcon). Falcon's group status is supported by a guarantee provided by U.S.-based Odyssey Reinsurance Co. (Odyssey Re) that meets our criteria, so the ratings on Falcon will move in tandem with those on Odyssey Re.

At the request of the company we are withdrawing our 'BB+' long-term ratings on TIG Insurance Co., Fairmont Insurance Co., Fairmont Premier Insurance Co., and Clearwater Insurance Co.

Rationale

The ratings reflect our view of the group's strong business risk profile (BRP) and strong financial risk profile (FRP). We view the company's BRP as strong, built on its strong competitive position, large geographic presence, and sector diversification. Our view of the FRP is based on Fairfax's very strong capital and earnings, offset somewhat by its moderate risk position. Under our criteria, these factors lead to a possible anchor of either 'a' or 'a-'. We assigned the latter because we believe the group's strong financial risk profile somewhat overstates its contribution to overall creditworthiness in

light of Fairfax's historically weaker underwriting performance relative to peers' and its significant dependence on consistently generating capital gains from its investment portfolio to maintain very strong capital and earnings.

For Fairfax we apply the standard notching for predominantly U.S. insurance groups between the long-term ratings on the operating companies and the holding company. This reflects the Canadian holding company's dependence on dividends from its predominantly U.S.-based operating subsidiaries and the ability of state insurance regulators to prohibit those dividends.

Fairfax faces intermediate industry and country risk driven by low country risk and intermediate industry risks for its nonlife primary insurance and reinsurance operations. We view country risk as relatively low, given Fairfax's globally diversified book of business, mainly in developed countries. We believe that Fairfax's nonlife primary and reinsurance operations are exposed to intermediate industry risks because of the inherent product risk and consequent susceptibility to reserve and property catastrophe volatility. The litigious environment tied to the U.S. book of business also affects claims amounts and payment patterns. However, the stability of the global (re)insurance markets' profitability, market growth prospects, and overall institutional framework offset this weakness.

Fairfax has a strong competitive position in our view, mainly stemming from its sizable geographic footprint and sector diversification. The group has become a significant international player in the global insurance and reinsurance markets: the U.S. and Canada represent about 52% and 17% of total gross premiums written (GPW), respectively; Asia-Pacific 11%; and other regions of the world account for the remaining 20%. About 50% of GPW was casualty writings, 36% property writings, and 10% specialty insurance writings. Fairfax writes primary insurance and reinsurance business, representing approximately 66% and 34% of its total GPW, respectively. We expect Fairfax to maintain its strong competitive position. We expect GPW in 2013 to increase by about 5% and the group to exhibit discipline through the underwriting cycle.

We assess Fairfax's capital and earnings as very strong, which we expect to continue in our base-case economic scenario despite the current low interest rates. Its capital adequacy according to our proprietary capital model is currently at the lower end of the 'AA' category, which is somewhat lower than historically mainly because of the reduction in interest rates used to discount loss reserves. The group's exposure to natural peril and man-made catastrophes and uncertainty related to its substantial casualty reserves (both ongoing and runoff) translate into a moderate risk position score, partially offsetting its very strong capital adequacy. Shareholders' equity (including preferred shares) totaled \$8.9 billion as of year-end 2012, up from \$8.4 billion as of year-end 2011. We expect Fairfax to maintain its capital adequacy at an 'AA' level.

We believe property casualty underwriting performance will remain the primary determinant of earnings, with combined (loss and expense) ratios on an IFRS

basis between 100% and 103%, which is better than its average combined ratio of 105% from 2008 to 2012. We expect catastrophe losses to contribute around eight percentage points on average to the loss ratio. We expect improved underwriting performance to result in higher operating and net income during the projection period.

We regard Fairfax's risk position as moderate. The group has minimal exposure to employee benefit liabilities. Although its exposure to high risk assets is at 70% of total adjusted capital, Fairfax carries substantial cash and liquid fixed-income securities to counterbalance the volatility of equities. About 75% of the portfolio is invested in cash and fixed-income securities with a weighted average rating of 'A+'. But we are concerned about potential capital and earnings volatility due to its exposure to property catastrophe losses, its willingness to take significant concentrated investment positions to achieve above-average returns, and its asbestos and environmental exposure.

Financial flexibility is adequate in our opinion. The group has demonstrated access to capital markets, access to bank credit facilities, and low reinsurance utilization. Fixed-charge coverage (FCC) has in recent years been low for the rating level. This is the result of several factors, including relatively weak underwriting results, an investment strategy focused on total return rather than on investment income, and relatively high financial leverage. FCC (excluding realized capital gains/losses) improved to 1.1x in 2012 from a negative number in 2011, and we expect this ratio to improve to 2x-3x by 2015. Financial leverage for year-end 2012 is 34% and we expect this ratio to remain in the 30%-35% range. Mitigating factors include the company's track record of generating significant realized capital gains and the substantial amount of liquid assets held by the holding company.

We regard Fairfax's enterprise risk management (ERM) and management and governance practices as consistent with the ratings. We view the group's ERM, which we regard as important to the rating, as adequate, reflecting our view of the risk-management culture, investment risk controls, and strategic and emerging risk management of this organization. We recognize the advancements the group has made in its ERM framework, governance structures, and the level of sophistication that some of the operating companies have achieved, and we expect Fairfax to continue enhancing its ERM framework.

Fairfax's management and governance is satisfactory in our opinion. The group bases its strategy on a total return philosophy combining disciplined underwriting with value investing. Management at the holding company and operating subsidiaries has been very stable. Internal candidates have generally filled occasional changes in senior management. The group is globally focused on property/casualty insurance and reinsurance, and has recently considerably enhanced its international presence.

We regard Fairfax's liquidity as exceptional, owing to the strength of its available liquid sources, including access to a \$300 million credit facility and no significant imminent debt maturities. Fairfax held about \$8.1 billion in cash, cash equivalents, and short-term investments as of year-end 2012. The

cash held at the operating companies is more than enough to cover the company's gross aggregate property catastrophe exposure at a return period of 250 years. The holding company maintained about \$1.2 billion of its own cash and marketable securities as of year-end 2012. The 2013 dividend capacity of the operating insurance and reinsurance subsidiaries is approximately \$555 million.

Outlook

The outlook is stable. We could lower the ratings if, contrary to our expectations, capital adequacy decreases and remains consistently below the 'AA' rating level, or if its competitive position deteriorates.

We could raise the ratings if underwriting performance shows sustained improvement, leading to stronger operating performance and fixed-charge coverage measures.

Rating Score Snapshot

Holding Company Rating	BBB-/Stable/--
Financial Strength Rating	A-/Stable/--
BRP/FRP Anchor	a-
Business Risk Profile	Strong
IICRA	Intermediate Risk
Competitive Position	Strong
Financial Risk Profile	Strong
Capital & Earnings	Very Strong
Risk Position	Moderate Risk
Financial Flexibility	Adequate
Modifiers	0
ERM and Management	0
Enterprise Risk Management	Adequate
Management & Governance	Satisfactory
Holistic Analysis	0
Liquidity	Exceptional
Support	0
Group Support	0
Government Support	0

Related Criteria And Research

- Insurance Rating Methodology, May 7, 2013
- Enterprise Risk Management, May 7, 2013
- Group Rating Methodology, May 7, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Principles Of Credit Ratings, Feb. 16, 2011
- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Fairfax Financial Holdings Ltd. Crum & Forster Holdings Corp. Odyssey Re Holdings Corp. Counterparty Credit Rating	BBB-/Stable/--	BBB-/Positive/--

American Underwriters Insurance Co.
United States Fire Insurance Company
The North River Insurance Company
Seneca Specialty Insurance Company
Seneca Insurance Company Inc.
Odyssey Reinsurance Co.
Northbridge Indemnity Insurance Corp.
Northbridge General Insurance Corp.
Northbridge Commercial Insurance Corp.
Hudson Specialty Insurance Co.
First Mercury Insurance Co.
Federated Insurance Co. of Canada
Crum and Forster Insurance Company
Crum & Forster Specialty Insurance Co.
Crum & Forster Indemnity Co.
Counterparty Credit Rating
Local Currency

A-/Stable/--	A-/Positive/--
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American Underwriters Insurance Co.
United States Fire Insurance Company
The North River Insurance Company
Seneca Specialty Insurance Company
Seneca Insurance Company Inc.
Odyssey Reinsurance Co.
Northbridge Indemnity Insurance Corp.

Northbridge General Insurance Corp.		
Northbridge Commercial Insurance Corp.		
Hudson Specialty Insurance Co.		
First Mercury Insurance Co.		
Federated Insurance Co. of Canada		
Falcon Insurance Co. (Hong Kong) Ltd.		
Crum and Forster Insurance Company		
Crum & Forster Specialty Insurance Co.		
Crum & Forster Indemnity Co.		
Financial Strength Rating		
Local Currency	A-/Stable/--	A-/Positive/--
Ratings Withdrawn		
	To	From
Clearwater Insurance Co.		
TIG Insurance Co.		
Fairmont Premier Insurance Co.		
Fairmont Insurance Co.		
Counterparty Credit Rating		
Local Currency	NR	BB+/Stable/--
Financial Strength Rating		
Local Currency	NR	BB+/Stable/--
Ratings Affirmed		
TIG Holdings Inc.		
Counterparty Credit Rating		
Local Currency	BB/Stable/--	
Fairfax Financial Holdings Ltd.		
Senior Unsecured	BBB-	
Preferred Stock	BB	
Preferred Stock	P-3	
Crum & Forster Holdings Corp.		
Senior Unsecured	BBB-	
Odyssey Re Holdings Corp.		
Senior Unsecured	BBB-	
Preferred Stock	BB	
TIG Capital Trust I		
Preferred Stock	BB	

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