

Research Update:

# Fairfax Financial Holdings Ltd. Outlook Revised To Stable From Positive; Ratings Affirmed On Strong Capitalization

April 3, 2020

## Overview

- Our positive outlook was predicated on Fairfax Financial Holdings Ltd. achieving a redundant capitalization at the 'AA' confidence level.
- While capital management actions are supportive, robust business growth, investment redeployment, and financial markets volatility will make it difficult for the company to achieve the 'AA' capitalization level over the next 12 months.
- Therefore, we are revising our outlook to stable from positive and affirming all of our ratings on Fairfax and its operating subsidiaries. The stable outlook reflects our view that Fairfax will maintain strong business and financial risk profiles supported by improving re/insurance pricing.

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## Rating Action

On April 3, 2020, S&P Global Ratings revised its outlook to stable from positive on Fairfax Financial Holdings Ltd. (TSX:FFH) and affirmed its 'BBB-' long-term issuer credit rating on the company. At the same time, S&P Global Ratings affirmed its 'A-' long-term financial strength and issuer credit ratings on the group's core operating subsidiaries.

## Outlook

The outlook is stable. Fairfax is well placed to capitalize on the firming re/insurance pricing and the ongoing investment portfolio repositioning should provide a boost to its investment income. This should lead to a steady improvement in debt service and help achieve 'AA' capitalization in the next two years. In addition, we expect Fairfax will build on its strong competitive position, leveraging further the strength of its combined re/insurance operating platforms. We also expect the group's risk management practices will continue developing, reflecting a large and complex organization.

## Upside scenario

We could raise our ratings on the company in the next two years if Fairfax is able to:

- Strengthen its risk-adjusted capitalization and maintain redundancy at the 'AA' confidence level;
- Sustain strong earnings in line with those of higher-rated peers; and
- Keep a fixed-charge coverage ratio sustainably above 4x and financial leverage (excluding nonrecourse debt held at non-insurance operations) less than 35%.

## Downside scenario

We could lower the ratings in the next two years if, contrary to our expectations:

- Capitalization declines sustainably below the 'A' confidence level; or
- The volatility profile changes due to an increase in risk tolerance or shifts in investment or business mix resulting in high-risk exposure.

## Rationale

The outlook revision reflects our view that Fairfax's capitalization will likely remain below the 'AA' confidence level this year despite active capital management actions and strong earnings over the past two years. Although capital grew in this period, robust insurance business growth, investment repositioning, financial markets volatility, and interest rate declines diminish S&P Global Ratings' view of total available capital relative to increased capital requirements.

Fairfax's proportion of risky assets (equities, non-investment-grade bonds, and alternative investments) is relatively high compared with that of peers and stood at 36.9% of total consolidated investments (including cash) at year-end 2019. This investment allocation exposes the company's capital to market volatility. Even though its investments in associates (including private equity), which represented 12.4% of its total investments, are not exposed to mark-to-market volatility, the underlying economic trends will equally affect such holdings as well. However, the company's large holdings of cash and short-duration securities partially mitigate the risk from the recent increase in credit spreads. The company's consolidated investment portfolio of \$39 billion as of Dec. 31, 2019, is composed of bonds (41.8%), public and private equity investments (29.1%), short-term investments (16.3%), and cash and cash equivalents (11.1%). Of the bonds holdings of \$16.3 billion, investment-grade securities constituted 85.3% (includes 'BBB' rated securities, which were 19.7% of the total).

At year-end 2019, about half of Fairfax's investment portfolio was invested in cash and cash equivalents, short-term investments, and bonds with maturity of less than a year. The company will start deploying its cash as opportunities arise as a result of the current financial markets turmoil. This investment strategy might help improve investment returns, but it's still early to quantify the impact on the bottom line. Furthermore, Fairfax will benefit from improving re/insurance pricing. For now, it seems that COVID-19-related insurance potential losses are manageable for the company. We expect the full year combined ratio of 95%-98%, including 3-4 points of catastrophe load and assuming no outsize losses from the COVID-19 outbreak, and capitalization at the 'A' confidence level. We believe management is committed to 'AA'

capitalization, which is achievable over the next two years accounting for earnings accrual and management's actions such as partial sale of the RiverStone Group, depending on the financial markets' recovery.

## Ratings Score Snapshot

	To	From
<b>Business Risk Profile</b>	<b>Strong</b>	<b>Strong</b>
Competitive position	Strong	Strong
IICRA	Intermediate	Intermediate
<b>Financial Risk Profile</b>	<b>Strong</b>	<b>Strong</b>
Capital and earnings	Very Strong	Very Strong
Risk exposure	Moderately High	Moderately High
Funding structure	Neutral	Neutral
Anchor*	a-	a-
<b>Modifiers</b>		
Governance	Neutral	Neutral
Liquidity	Adequate	Adequate
Comparable ratings analysis	0	0
<b>Financial Strength Rating</b>	<b>A-/Stable</b>	<b>A-/Positive</b>

IICRA--Insurance Industry and Country Risk Assessment. \*This is influenced by Fairfax's somewhat constrained, albeit improving, investment earnings and recent volatility in capital and earnings.

## Related Criteria

- Criteria | Insurance | General: Insurers Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Principles For Rating Debt Issues Based On Imputed Promises, Dec. 19, 2014
- Criteria | Insurance | General: 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

## Related Research

- Economic Research: It's Game Over For The Record U.S. Run; The Timing Of A Restart Remains Uncertain, March 27, 2020
- Robust Capitalization Makes The COVID-19 Fallout Manageable For North American Property/Casualty Insurers And Reinsurers, March 25, 2020

- Fairfax Financial Holdings Ltd. 'BBB-' Ratings And Core Subsidiaries 'A-' Ratings Affirmed; Outlook Remains Positive, July 24, 2019

## Ratings List

### Ratings Affirmed

#### Fairfax Financial Holdings Ltd.

Senior Unsecured	BBB-
Preferred Stock	BB
Preferred Stock	P-3

#### Allied World Assurance Company Holdings Ltd

#### Fairfax (US) Inc.

Senior Unsecured	BBB-
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#### Odyssey Group Holdings, Inc

#### Zenith National Insurance Capital Trust I

Preferred Stock	BB
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### Ratings Affirmed; Outlook Action

	To	From
<b>Fairfax Financial Holdings Ltd.</b>		
Issuer Credit Rating	BBB-/Stable/--	BBB-/Positive/--

Allied World Assurance Co. (Europe) Ltd.
Zenith Insurance Co.
ZNAT Insurance Co.
United States Fire Insurance Company
The North River Insurance Company
Seneca Specialty Insurance Company
Seneca Insurance Company Inc.
Odyssey Reinsurance Co.
Northbridge General 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.
American Underwriters Insurance Co.
Allied World National Assurance Co.
Allied World Assurance Company, AG
Allied World Assurance Co. U.S. Inc.
Allied World Assurance Co. Ltd.
Issuer Credit Rating
Local Currency      A-/Stable/--      A-/Positive/--

Allied World Assurance Co. (Europe) Ltd.

Zenith Insurance Co.

ZNAT Insurance Co.

United States Fire Insurance Company

The North River Insurance Company

Seneca Specialty Insurance Company

Seneca Insurance Company Inc.

Odyssey Reinsurance Co.

Odyssey Re Europe S.A.

Northbridge General 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.

American Underwriters Insurance Co.

Allied World National Assurance Co.

Allied World Assurance Company, AG

Allied World Assurance Co. U.S. Inc.

Allied World Assurance Co. Ltd.

Financial Strength Rating

Local Currency      A-/Stable/--      A-/Positive/--

Allied World Assurance Company Holdings, GmbH

Zenith National Insurance Corp.

Odyssey Group Holdings, Inc

Crum & Forster Holdings Corp.

Issuer Credit Rating

Local Currency      BBB-/Stable/--      BBB-/Positive/--

Allied World Insurance Co.

Issuer Credit Rating      A-/Stable/--      A-/Positive/--

Financial Strength Rating      A-/Stable/--      A-/Positive/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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