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Ratings

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Research Update:

Fairfax Financial Holdings' Re/Insurance Subs Upgraded To 'A+' On Revised Criteria; Off CreditWatch, Outlook Positive

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PRIMARY CREDIT ANALYST

Taoufik Gharib
New York
+ 1 (212) 438 7253
taoufik.gharib
@spglobal.com

SECONDARY CONTACT

Saurabh B Khasnis
Englewood
+ 1 (303) 721 4554
saurabh.khasnis
@spglobal.com

Overview

- On Nov. 15, 2023, we published our revised criteria for analyzing insurers' risk-based capital (see "Insurer Risk-Based Capital Adequacy--Methodology And Assumptions").
- The implementation of the revised capital model criteria had a positive impact on our view of the financial strength of Fairfax Financial Holdings Ltd. and its re/insurance operating entities (collectively, Fairfax).
- Therefore, we raised our ratings on Fairfax's core re/insurance subsidiaries to 'A+' from 'A' and on the holding company, Fairfax Financial Holdings Ltd., to 'BBB+' from 'BBB'.
- The positive outlook signals that we could raise our ratings by one notch in the next 12-24 months if Fairfax successfully manages its capitalization sustainably at the 99.95% confidence level, while meeting or exceeding our expectations of strong and more stable operating earnings, and further reducing its financial leverage.

Rating Action

On May 31, 2024, S&P Global Ratings raised its long-term issuer credit rating on Fairfax Financial Holdings Ltd. to 'BBB+' from 'BBB'. We also raised our long-term issuer credit and financial strength ratings on Fairfax's core re/insurance operating subsidiaries to 'A+' from 'A'. At the same time, we removed all ratings from CreditWatch, where we placed them with positive implications on Dec. 4, 2023. The outlook is positive.

Impact Of Revised Capital Model Criteria

- The implementation of our revised criteria has led to higher levels of capitalization for Fairfax. The company now demonstrates a redundant capital adequacy at the 99.95% confidence level at year-end 2023, and we expect it to remain so through 2026.

- Under our revised criteria, Fairfax enjoys a higher diversification benefit as a global re/insurer, with a diversified business profile, leading to a material reduction in the required risk-based capital.
- The recalibration of our capital charges to higher confidence levels somewhat offsets these improvements.

Credit Highlights

Overview

Key strengths	Key risks
Very strong global competitive position built on organic growth and acquisitions with large, diversified, and well-established P/C re/insurance operations	Investment volatility amplified by material allocation to risk assets, including level 3 securities
Very strong capital adequacy redundant at the 99.95% confidence level at year-end 2023 and expected to remain so through 2026	Cyber insurance writings, mitigated through reinsurance protection
Strong and improving operating earnings owing to increased interest and dividends, and robust underwriting results benefiting from favorable P/C re/insurance pricing	Social and economic inflation risk, although not specific to Fairfax

Outlook

The positive outlook reflects our view that we could raise the ratings on Fairfax if the company maintains its underwriting discipline and meets or exceeds our expectations while executing its strategy.

Upside scenario

We could raise our ratings on Fairfax by one notch in the next 12-24 months if:

- Management is successful in sustainably managing capitalization at the 99.95% level;
- Fairfax further lowers its deconsolidated financial leverage (excluding nonrecourse debt held at noninsurance operations) and maintains it below 25%, with a strong fixed-charge coverage of more than 8x; and
- Fairfax's diverse re/insurance operations continue to leverage market opportunities, with sustained and more stable operating performance in line with higher-rated peers.

Downside scenario

We could revise our outlook to stable or lower our ratings in the next 12-24 months if the company fails to meet our expectations, including if capital adequacy deteriorates below the 99.95% confidence level because of operating losses or capital management activities.

Rationale

The upgrade mainly reflects our view that Fairfax's capital adequacy has materially strengthened at year-end 2023 boosted by strong earnings and diversification credit under our revised criteria. We expect capitalization to remain very strong and redundant at the 99.95% level through 2026.

Fairfax has built a very strong competitive position, through organic growth and strategic acquisitions, based on large and diversified re/insurance operations that are well established in their respective markets. Fairfax is one of the major global P/C re/insurers with $28.9 billion in gross premiums written (GPW) in 2023 (about $31.8 billion on a pro forma basis when including the $2.9 billion of GPW from the Gulf Insurance Group [GIG] acquisition in December 2023). We expect Fairfax's consolidated GPW to increase by about 15% in 2024 mostly driven by the GIG purchase. However, we believe the top line growth will likely moderate to about 5% in 2025-2026, supported by still favorable re/insurance pricing.

In 2023, Fairfax generated strong results with $5.1 billion in net earnings compared with $3.8 billion in 2022. This was achieved while Fairfax's P/C re/insurance operations produced strong underwriting profit of $1.5 billion, together with interest and dividends of about $1.9 billion and continued strength in share of profit of associates of about $1 billion. In 2023, Fairfax produced a combined ratio (undiscounted and including corporate overhead) of 93.9%, despite $897 million of natural catastrophe losses or 4 combined ratio points, compared with a combined ratio of 95.4% in 2022, which absorbed significant catastrophe losses of about $1.3 billion or 6.1 combined ratio points.

These results demonstrate the strength of the underwriting capabilities and the diversity of Fairfax's re/insurance operating subsidiaries that it has built over the years. The positive trend continued in the first quarter of 2024 with a combined ratio of 94.2% compared with 94.6% in the first quarter of 2023. We expect the company to generate an undiscounted combined ratio of 92%-94% in 2024-2026, including natural catastrophe load of 5-6 points.

Fairfax follows a total return investment strategy with a large allocation to risk assets. Fairfax's total investment portfolio fair value of $66.9 billion at year-end 2023 included 41.8% of risk assets (speculative grade and nonrated securities, public and private equities, and alternative investments) and about the same percentage at the end of first-quarter 2024. Furthermore, the company classified 20.2% of its investments as level 3 (hard to value assets with unobservable inputs), which is at the higher end of its peers and drives our view of Fairfax's moderately high risk exposure.

When including investment in associates, level 3 proportion of total invested assets increases to 26.9%. However, included in the level 3 are investments in first mortgage loans of $4.7 billion secured by real estate predominantly in the U.S., Europe, and Canada. These are individually underwritten loans, which relate to multifamily or student housing development projects with the balance being a mix of industrial, hotel, and life science office property development projects, in partnership with Kennedy Wilson Holdings Inc. (manager and co-investor), a global real estate company.

The company's active approach to investments focused on generating long-term gains leads to higher volatility, as demonstrated by large gains and losses in the portfolio. This is reflected in the sizeable net gain on investments of about $2 billion in 2023, as opposed to net losses on investments of about $1.6 billion in 2022. The company continues to adjust its investment mix to take advantage of a more opportune market and deploy its cash. In addition, Fairfax's efforts to monetize some assets could add to earnings and strengthen its capitalization.

Since 2022, Fairfax started to deploy more of its cash and the proceeds from sales and maturities of short-dated investments in U.S. Treasuries and Canadian government bonds with 5-to-7 year terms. This has significantly benefited its net investment income. As a result, the annual interest and dividends run rate jumped to about $1.9 billion in 2023, from about $641 million in 2021, and we project it to be around the same level in 2024-2026.

Overall, we expect earnings to remain strong in 2024-2026, helped by robust underwriting results and interest and dividends. We consider a large transformative merger or acquisition unlikely in the near term, except for potential small bolt-on acquisitions, considering the company's focus on leveraging market opportunities and maintaining capital strength. We believe Fairfax will focus on organic growth, taking advantage of favorable re/insurance pricing, and further lowering its financial leverage.

Fairfax's financial leverage and coverage metrics improved significantly from historical levels. At year-end 2023, the deconsolidated financial leverage was 27.7% compared with 29.4% at year-end 2022. At year-end 2023, fixed-charge coverage stood at 11.5x compared with 15.8x at year-end 2022. We expect Fairfax's capital accretive earnings would drive its financial leverage to below 25% and an EBITDA fixed-charge coverage of at least 8x over the next couple of years.

Fairfax's cyber insurance writings grew over the past few years, benefiting from favorable pricing, though premium rate increases have been decelerating in the past 18 months. While most of the premium growth is driven by rate increases, cyber accumulation may remain in focus as the company is using reinsurance to limit its risk. So far, cyber insurance has been a profitable line of business for Fairfax.

Social and economic inflation could lead to reserve volatility. However, we believe Fairfax's reserving practices are prudent. On a consolidated basis, the company has a consistent record of reserve releases and it benefited the combined ratio by 2.3 points on average in 2019-2023, but these releases have been declining the past few years.

Environmental, social, and governance

Environmental factors are a moderately negative consideration in our credit rating analysis of Fairfax due to earnings and potentially capital's susceptibility to weather-related losses. For instance, natural catastrophe losses added on average 5.2 points to Fairfax's combined ratio in the past five years (2019-2023). However, these catastrophe losses were contained within the company's earnings. Fairfax has a well-diversified global business, strong insurance risk controls, proactive reserving and claims management, and reinsurance protection. In addition, this business is generally repriced annually, which means pricing can adjust to account for changes in views of risk. We consider governance and social risk factors as neutral to the ratings.

Ratings Score Snapshot

	To	From
Holding company issuer credit rating	BBB+/Positive/--	BBB/Watch Pos/--
Financial strength ratings on core operating companies	A+/Positive/--	A/Watch Pos/--
SACP	a+	a
Anchor*	a+	a
Business Risk	Very Strong	Very Strong

	To	From
Competitive position	Very strong	Very strong
IICRA	Intermediate	Intermediate
Financial Risk	Strong	Satisfactory
Capital and earnings	Very Strong	Strong
Risk exposure	Moderately high	Moderately high
Funding structure	Neutral	Neutral
Modifiers	0	0
Governance	Neutral	Neutral
Liquidity	Adequate	Adequate
Comparable ratings analysis	0	0
Support	0	0
Group support	0	0
Government support	0	0

SACP-- Stand-alone credit profile. IICRA--Insurance Industry And Country Risk Assessment. *We selected 'a+' anchor until Fairfax establishes a track record that it will be managing its capitalization at the 99.95% confidence level and meet our other aforementioned expectations.

Related Criteria

- Criteria | Insurance | General: Insurer Risk-Based Capital Adequacy--Methodology And Assumptions, Nov. 15, 2023
- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Insurance | General: Insurers Rating Methodology, July 1, 2019
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Fairfax Ratings Placed On CreditWatch Positive On Potential Impact From Insurance Capital Model Criteria Update, Dec 4, 2023

Ratings List

; CreditWatch/Outlook Action

	To	From
Fairfax Financial Holdings Ltd.		
Preferred Stock	P-2(Low)	P-3(High)/Watch Pos

Upgraded; CreditWatch/Outlook Action

	To	From
Fairfax Financial Holdings Ltd.		
Issuer Credit Rating	BBB+/Positive/--	BBB/Watch Pos/--
Allied World Assurance Co. (Europe) Ltd.		
Zenith Insurance Co.		
ZNAT Insurance Co.		
United States Fire Insurance Co.		
Seneca Specialty Insurance Co.		
Seneca Insurance Co. Inc.		
Odyssey Reinsurance Co.		
Northbridge General Insurance Corp.		
North River Insurance Co. (The)		
Hudson Excess Insurance Co.		
Hilltop Specialty Insurance Co		
First Mercury Insurance Co.		
Federated Insurance Co. of Canada		
Crum and Forster Insurance Co.		
Crum & Forster Specialty Insurance Co.		
Crum & Forster Indemnity Co.		
American Underwriters Insurance Co.		
Allied World National Assurance Co.		
Allied World Assurance Co. U.S. Inc.		
Allied World Assurance Co. Ltd.		
Allied World Assurance Co. AG		
Issuer Credit Rating		
Local Currency	A+/Positive/--	A/Watch Pos/--

Allied World Assurance Co. (Europe) Ltd.		
Zenith Insurance Co.		
ZNAT Insurance Co.		
United States Fire Insurance Co.		
Seneca Specialty Insurance Co.		
Seneca Insurance Co. Inc.		
Odyssey Reinsurance Co.		
Odyssey Re Europe S.A.		
Northbridge General Insurance Corp.		
North River Insurance Co. (The)		
Hudson Excess Insurance Co.		
Hilltop Specialty Insurance Co		
First Mercury Insurance Co.		
Federated Insurance Co. of Canada		
Falcon Insurance Co. (Hong Kong) Ltd.		
Crum and Forster Insurance Co.		
Crum & Forster Specialty Insurance Co.		
Crum & Forster Indemnity Co.		
American Underwriters Insurance Co.		
Allied World National Assurance Co.		
Allied World Assurance Co. U.S. Inc.		
Allied World Assurance Co. Ltd.		
Allied World Assurance Co. AG		
Financial Strength Rating		
Local Currency	A+/Positive/--	A/Watch Pos/--
Allied World Assurance Co. Holdings GmbH		
Zenith National Insurance Corp.		
Odyssey Group Holdings Inc.		
Crum & Forster Holdings Corp.		
Issuer Credit Rating		
Local Currency	BBB+/Positive/--	BBB/Watch Pos/--
Allied World Insurance Co.		
Issuer Credit Rating	A+/Positive/--	A/Watch Pos/--
Financial Strength Rating	A+/Positive/--	A/Watch Pos/--
Fairfax Financial Holdings Ltd.		
Senior Unsecured	BBB+	BBB/Watch Pos
Preferred Stock	BBB-	BB+/Watch Pos
Allied World Assurance Co. Holdings Ltd.		
Senior Unsecured	BBB+	BBB/Watch Pos

Fairfax (US) Inc.		
Senior Unsecured	BBB+	BBB/Watch Pos
Odyssey Group Holdings Inc.		
Preferred Stock	BBB-	BB+/Watch Pos
Zenith National Insurance Capital Trust I		
Preferred Stock	BBB-	BB+/Watch Pos