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Odyssey Re Group

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Odyssey Re Group

Major Rating Factors

Strengths:

- Enhanced and well-diversified global footprint in reinsurance and specialty insurance.
- Strong operating performance as a result of disciplined underwriting and successful value investing.
- Strong capitalization.
- Core and largest member of Fairfax group of companies.

Holding Company: Odyssey Re Holdings Corp.
Counterparty Credit Rating
Local Currency
BBB-/Positive/--
Operating Companies Covered By This Report
Financial Strength Rating
Local Currency
A-/Positive/--

Weaknesses:

- Susceptible to earnings volatility because of natural-peril and man-made catastrophes.
- Reserving risk due to long-tail casualty writings.
- High allocation to common stocks, though currently hedged.

Rationale

The insurer financial strength ratings on Odyssey Re Holdings Corp.'s (ORH) operating reinsurance and insurance subsidiaries--Odyssey Reinsurance Co. (ORC) and Hudson Specialty Insurance Co. (collectively referred to as Odyssey Re Group)--are based on their core position as wholly owned subsidiaries of Fairfax Financial Holdings Ltd. (FFH). The ratings are also based on the company's enhanced and well-diversified global footprint in reinsurance and specialty insurance and strong operating performance supported by disciplined underwriting and successful value investing. Offsetting these positive factors are catastrophe exposure that can lead to earnings and capital volatility, high allocation to common stocks, and reserving risk due to long-tail casualty writings. However, these weaknesses are somewhat offset by the insurer's strong capitalization.

Odyssey Re Group's competitive position is strong. Originally known as a casualty treaty reinsurer mostly in the U.S., Odyssey Re Group has gradually changed its business mix and geographic footprint since its formation in 1999. Specialty insurance writings currently represent about 35% of total writings and reinsurance the remaining 65%. Geographically, about 50% of total writings are non-U.S. writings, with the reinsurance segment more global and the insurance segment more U.S.-focused. Long-tail writings account for 46% of total writings but are weighted more toward casualty insurance than casualty reinsurance. The reinsurance segment has shifted away from casualty line of business such as general liability and workers' compensation towards property, surety, and specialty lines of business. The focus of the insurance segment is specialty lines, such as tribal insurance, specialty commercial auto, and crop. In 2010, the company wrote $2.2 billion gross written premiums (GWP) supported by an equity base of about $3.3 billion.

We view Odyssey Re Group's earnings strength as one of the key factors supporting the ratings. From 2006 to 2010, the group reported an average combined ratio of 97%, an average return on revenue (ROR) including realized gains and losses on investments but excluding gains on credit default swaps (CDS) of 22% (15% excluding all

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realized capital gains), and annual return on equity (ROE) of 19%. Given the demonstrated and consistent strategy of Hamblin Watsa Investment Council Ltd. (Hamblin Watsa), the investment arm of FFH, in harvesting capital gains, we analyze the operating performance of FFH's subsidiaries including a share of its realized capital gains and losses in our analysis. Because Hamblin-Watsa is an active investment manager, the investment allocation at FFH and its subsidiaries is subject to a greater amount of change than the asset portfolios of most other insurers, and is currently weighted more toward equities than other property and casualty groups. Odyssey Re Group allocated about 18% of its investments to equities, as of June 30, 2011. The equity allocation was largely hedged by total return swaps, which have been purchased over the past two years to protect the company's capital from a major downturn in equity markets. Nonetheless, the hedge carries basis risk.

Odyssey Re Group's strong capitalization benefits from low operational leverage (i.e. ratio of net premiums written to GAAP equity), negligible intangible assets, high credit quality reinsurance recoverables, and a hedge on its equity holdings. Even though the company still has exposure to pre-1999 liabilities, virtually all of its asbestos and environmental (A&E) liabilities have been transferred to Fairfax effective Jan. 1, 2011, and, henceforth, will cease to be a drag on earnings and capital from Odyssey Re Group. A factor that partially offsets the company's capital adequacy position is uncertainty related to its substantial casualty reserves (about 80% of total reserves), which are usually medium- to long-tail. The group's exposure to natural-peril and man-made catastrophes also offsets its strong capital adequacy.

Standard & Poor's considers Odyssey Re Group to be a core operation of FFH based on its contributions of about 60% of the pretax income before interest expense of FFH's ongoing insurance and reinsurance operations, and about 40% of FFH's gross written premiums. In the past five years, as the largest group in the FFH family, Odyssey Re Group has consistently contributed a strong earnings stream to FFH.

Factors Specific To Holding Company

The counterparty credit rating of ORH reflects Standard & Poor's standard notching for a U.S.-based insurance holding company to the financial strength ratings on its core insurance and reinsurance subsidiaries. The three-notch difference reflects the holding company's dependence on dividends from its operating subsidiaries to meet debt service and preferred dividend obligations. The payment of dividends to ORH by its operating insurance/reinsurance subsidiaries is subject to limitations imposed by law in Connecticut, Delaware, New York, and the U.K.

ORH's assets primarily consist of the shares in ORC. The holding company depends on the available cash resources, liquid investments and dividends, or other distributions from ORC to make payments. ORH received dividends from ORC totaling $512 million in 2010 ($225 million in cash plus a dividend payable of $287 million related to the transfer of Clearwater Insurance Co. [CIC], $200 million in 2009, $410 million in 2008, $155 million in 2007, and $60 million in 2006). ORH primarily used those amounts to pay interest on the company's senior notes and preferred stock, to buy back its common stock, to fund other corporate expenses, and to pay dividends to its ultimate parent, FFH. ORH repurchased approximately $43 million of its outstanding senior notes in the first six months of 2011 and $68 million of its outstanding preferred stock in the forth quarter of 2010.

As of Dec. 31, 2010, the company's financial leverage was conservative for the rating level. Total debt plus hybrid securities to total capital was 11.0%, and fixed-charge coverage was 6.5x. During the first half of 2011, the group's fixed-charge coverage ratios decreased substantially from historical levels, primarily because of high catastrophes. We don't see this reduction as an indication of reduced prospective coverage ratios for the group but more as a

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reflection of lower earnings resulting from a year of high catastrophe losses.

Outlook

Our rating outlook on Odyssey Re Group is positive, reflecting the 1-in-3 likelihood of a one-notch upgrade on FFH's core insurance and reinsurance operating companies in the next 24 months. As a core company of FFH, we only expect to revise our outlook on Odyssey Re Group along with a corresponding revision of our outlook on FFH.

We expect Odyssey Re Group to remain a core member of Fairfax Group, because it is the largest contributor to consolidated profits and premiums. For the full year 2011 and in the absence of major catastrophes for the remainder of 2011 (quarterly catastrophe losses below $65 million), we expect Odyssey Re Group to generate a combined ratio of about 110%. In the absence of major catastrophe losses in 2012 (annual catastrophes losses below $250 million), we expect the combined ratio to be in the range of 94%-98%. Although we expect the company to earn a strong total return on its investments on a multi-year period, the company is not immune to investment losses or depressed investment returns in a single year. Thus, we do expect that ROR in 2012 including realized gains and losses will be at least 15% on average on a three-year rolling basis. We expect premium growth of about 5%-10% in 2011 and 2012, mostly as a result of increases in crop insurance writings, property reinsurance writings, and also reinsurance premiums writings in Canada and Latin America. We expect capital to remain redundant for the current rating level, and we do not expect any major reserve strengthening in either 2011 or 2012 (as defined by two percentage points of prior year's ending net loss reserves). As a privately held company, ORH is not expected to issue additional debt, and financial leverage should remain in the range of 10%-15% and fixed charge coverage in the 3x-5x range.

Competitive Position: A Diversified Reinsurance And Insurance Platform With Global Reach

Odyssey Re has a strong competitive position in the global reinsurance and specialty insurance arenas. The company has a diversified franchise by product, geography, and sector and operates through four divisions (Americas, EuroAsia, London Market, and U.S. Insurance) and under three brands (Odyssey Re in global reinsurance, Newline in global specialty insurance, and Hudson in U.S. specialty insurance). Odyssey Re Group, domiciled and regulated in the U.S., wrote $2.2 billion in gross premiums in 2010 supported by an equity base of about $3.3 billion.

The group is diversified by sector. As of year-end 2010, specialty insurance constituted 35% of Odyssey Re Group's gross premiums written and reinsurance accounted for the remaining 65% vs. a 17%/83% split in 2002. The improved diversification by sector has resulted mainly from growth in specialty insurance writings. The customer base of the reinsurance segment is very well diversified--reducing the company's dependence on any particular customer--with the biggest client accounting for 5% of total GWP, the top 10 clients accounting for 20% of total GWP, and the remainder of the clients accounting for less than 1% of total GPW each. The specialty insurance segment focuses on much smaller accounts compared to the reinsurance segment and there is no dependence on individual clients.

Geographically, gross written premiums are well diversified with about 50% coming from the U.S. and the remainder from the rest of the world. Growth in Europe, Asia, and Latin America, and the company's decision to

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decrease U.S. casualty reinsurance treaty writings has helped international diversification, somewhat offset by growth in U.S. specialty insurance. The reinsurance business is more global, with the U.S. accounting for 48% of total reinsurance premiums, followed by Europe at 25%, Asia-Pacific at 10%, Latin America at 10%, Canada at 4%, Middle East at 4%, and other countries and regions accounting for the remaining 1%. In contrast, the insurance business is still focused on the U.S., which accounted for 71% of total insurance writings in 2010.

Even though the breakdown between short- and long-tail classes has been gradually changing (54%/46% in 2010 vs. 43%/57% in 2002), the mix within these classes has changed substantially. For example, U.S. casualty reinsurance accounted for 13% of GPW in 2010, substantially down from 32% in 2002, but has been somewhat compensated by increases in casualty insurance.

The shift by sector, geography, and class has been a strategic move. Odyssey Re Group reacted to substantial pricing and margin deterioration in the U.S. casualty reinsurance market by shifting its product offerings to more specialty and less commoditized products where margins are higher, underwriting expertise is more recognized, and client relationships are stronger. The shifts in the portfolio are also reflected in the breakdown of gross written premiums by operating division: In 2010, Americas accounted for 34% of gross written premiums, U.S. Insurance for 25%, EuroAsia for 25%, and London Market for the remaining 16%. This compares with 63%, 7%, 14%, and 17%, respectively, in 2002, a shift that resulted from a significant reduction in the Americas division writings (mostly U.S. casualty reinsurance writings) and increases in EuroAsia and U.S. Insurance divisions' writings.

The broker channel is the main distribution channel of Odyssey Re Group. The company's reinsurance business is produced through brokers (87%) and direct relationships (13%). The direct reinsurance business is mainly written through the EuroAsia division with a 70%/30% split between brokers and direct channels. Newline's writings are mainly sourced through brokers, with AON, Marsh and Willis Re accounting for about 50% of the business. However, these brokers account for less than 10% of the U.S. Insurance division writings. In 2010, about 31%, 22%, and 14% of Odyssey Re Group's gross reinsurance premiums written were generated from, or placed by, AON, Marsh and Willis Re.

Americas

Americas is the largest division within Odyssey Re Group, though its contribution has steadily declined due to the decision of the group to decrease casualty treaty writings during softening casualty market conditions. Not only has the company reduced casualty writings by almost 65% since 2003 (about $260 million in 2010, down from $762 million in 2003) but also the hit ratios (i.e. ratio of programs bound to programs submitted) on new casualty programs submissions have been reduced dramatically since 2009 to low single-percentage points. In 2010, the Americas division produced $747 million of GPW, or 34% of the total group, substantially down from $1.4 billion in writings (or 56% of the total group) at the peak of the insurance industry cycle in 2003. Geographically, business is sourced from the U.S. (75%), Latin America (17%), and Canada (8%). The division focuses solely on reinsurance and underwrites casualty lines (35% of total premiums in 2010, down from 53% in 2009), property (45% in 2010, up from 37% in 2009), and specialty (10% in 2010 and 2009). About 90% of business is treaty business and the remainder facultative. Odyssey Re does not write property facultative in the U.S. The company participates in about 75% of the top traditional surety reinsurance programs in the U.S. and is a recognized casualty facultative underwriter with about 9,000 annual submissions from about 300 cedents. Business from Latin America and Canada will increase with expanded capacity in those markets and new offices recently opened in Montreal and Sao Paulo.

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EuroAsia

The EuroAsia division, with writings from about 60 different countries, accounted for approximately $538 million, or 25% of total GPW, in 2010. This division is more property oriented than the Americas with two thirds of the premiums coming from property catastrophe and property excluding property catastrophe (about 68%) and the remaining premiums distributed as follows: motor 12%, credit 8%, marine 5%, liability 4%, aerospace 2%, and accident and health (A&H) 1%. Geographically, Odyssey Re maintains a strong market position in the region, particularly in France and Japan, which account for about 25% and 10% of the division's volume. Business is further complemented by premium production in the rest of Europe, the Middle East, and a growing presence in Asia. We expect Odyssey Re to remain well positioned in Europe and Asia even though the division's premium is expected to remain flat because of severe competition and the company's decision to write higher excess layers.

London Market

The London Market division produced $339 million, or 16%, of total GPW in 2010 and gives the group access to the insurance and reinsurance distribution channels available in the London market. It operates through three platforms: the London branch of ORC, Newline Insurance Co. Ltd. (NICL), and Lloyd's Syndicate 1218. This division generates insurance and reinsurance business through brokers.

NICL and Lloyd's Syndicate 1218 comprise the insurance operations of the division and are branded as "Newline Group," focused primarily on non-U.S. liability insurance. In 2010, insurance writings amounted to 64% of the division's written premiums (47% through Lloyd's Syndicate 1218 and 17% through NICL) while the 36% balance came from reinsurance through ORC's London branch. Newline focuses on international specialty casualty insurance (64% of total division writings) such as professional indemnity, medical malpractice, directors and officers (D&O), crime, products liability, and employers' liability. Even though Newline operates in a coinsurance market, it leads the vast majority of the business that it writes--i.e. leads underwriting, pricing, and claims management of the majority of this portfolio.

ORC's London branch underwrites worldwide treaty reinsurance, consisting of property (23% of total division writings), marine and aerospace (11% of total division writings), and international casualty (2% of total division writings). The London branch of ORC has refocused its business since 2006 away from U.S. catastrophe treaties to focus on the attractive property catastrophe retrocession market--mostly U.S. exposures retroceded by non-U.S. insurers. The London Market division is highly opportunistic, and the absolute premium volume and relative business mix between Newline and the ORC branch is expected to fluctuate according to market conditions.

U.S. Insurance

The U.S. Insurance division generated $542 million, or 25% of total GPW, in 2010. The division writes specialty lines on an admitted (77%) and nonadmitted (23%) basis through its primary operating companies: Hudson Insurance Co. and Hudson Specialty Insurance Co. About two thirds of the admitted business has significant rate and form flexibility. This division writes mainly casualty lines of specialty insurance with property and package representing 27%, professional liability 22%, specialty liability 23%, medical malpractice 16%, commercial auto 10%, and other 2%, of GWP in 2010. Within this division, Odyssey Re Group has been migrating to in-house underwriting from program administrator underwriting in order to have greater control over the business written, and currently 55% of the portfolio is underwritten in-house compared with 31% in 2006 and none in 2002. The focus of this division is on market niches that require highly specialized underwriting capabilities (either product-based niches or geographic niches) such as:

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- Tribal insurance, focusing on medium to small tribes and covering about 70% of the federally recognized tribes in the U.S.;
- Specialty commercial automobile insurance, such as off-duty liability for truckers as well as liability coverage for West Coast regional waste haulers;
- Health care liability with a focus on tort reform states;
- Crop insurance.

Prospective

We expect Odyssey Re Group to remain a core member of Fairfax Group, because Odyssey Re Group is the largest contributor to consolidated profits and premiums. Standard & Poor's expects the company to maintain its strong competitive position, to remain very selective in its new business acquisition, and not to write business that does not meet it profitability thresholds. We expect premium growth of about 5%-10% in 2011 and 2012, mostly as a result of increases in crop insurance writings, property reinsurance writings, and also reinsurance premiums writings from Canada and Latin America.

Management And Corporate Strategy: A Total Return Philosophy

We view Odyssey Re Group's management and corporate strategy as marginally positive and a strength to the ratings. The management team has been successful in converting several reinsurance companies acquired by FFH in the 1990s into a consistent global provider of reinsurance and specialty insurance based on a well-thought-out total return philosophy combining disciplined underwriting with value investing. We view the management team as experienced and stable, and its strategy is in-line with that of the FFH group of companies. As soft market conditions continue to erode potential underwriting profitability, the company remains selective in new business acquisition, which we view favorably.

Effective April 1, 2011, Brian D. Young became President and CEO of Odyssey Re Holdings Corp., and has replaced Andrew A. Barnard, who had led Odyssey Re since its formation. Mr. Young has worked for Odyssey Re for the past 15 years in different underwriting and management positions, and most recently as Chief Operating officer overseeing the company's four operating divisions before his promotion to CEO. Standard & Poor's sees the change in senior management as a neutral rating factor and as a continuation of the existent corporate strategy.

Operational management

Odyssey Re Group operates through four strategic operating divisions (Americas, EuroAsia, London Market, and U.S. Insurance) and 30 underwriting units. The underwriting operations of each division are managed on a decentralized basis, while reserving, catastrophe exposure management, investments, and enterprise risk management activities are managed centrally at the corporate level.

Financial management

Odyssey Re Group targets book value growth of 15% on average and a combined ratio in the mid-90s throughout the underwriting cycle. Standard & Poor's views Odyssey Re Group's underlying insurance risk tolerance as relatively low, though its catastrophe loss tolerance is relatively more aggressive, as measured by an after-tax loss of about 25% of statutory surplus. The company has a high allocation to common stocks, though hedging techniques are employed periodically to mitigate this risk.

Enterprise Risk Management: Adequate

Standard & Poor's views Odyssey Re as a core entity within FFH, so we do not assess Odyssey Re's enterprise risk management (ERM) processes on a standalone basis. Rather, we assess the ERM process of the entire FFH group.

We consider FFH's ERM to be adequate. The importance of ERM to the overall appraisal of the financial strength ratings of FFH's operating insurance and reinsurance companies is high, given the group's size, complexity, and exposure to a variety of risks. The primary factor supporting the overall risk assessment is adequate risk controls for the majority of the group's risks. Notwithstanding the substantial advancement the group has made in this area, the relative newness of the ERM structure and limited centralized control currently limit a stronger assessment.

The group's ERM structure continues to evolve. FFH appointed a chief risk officer in 2008 who reports to the FFH's executive management team and the Board of Directors. Risk monitoring and control for three of Fairfax's key risks--reserves, investments, and catastrophe risk--are centralized and reviewed regularly. Although a more extensive risk identification and control framework is lacking on a centralized basis to address insurance cycle management or emerging insurance risks, we view the recent appointment of Andrew A. Barnard to Chief Operating Officer of Fairfax Insurance Group and the formation of the Executive Leadership Council as movements in the right direction to increase coordination and oversight. FFH's primary operating subsidiaries have appointed risk management staff who set and monitor subsidiary-specific risks including underwriting.

In our overall assessment, we note adequate risk controls to include investments, underwriting, loss reserves, counterparty/credit, and risk modeling. In our view, insurance emerging risk management is still weak on a consolidated basis. While we view Fairfax's operational risk control as adequate, further advances on this risk control would limit the potential for unexpected losses under the highly decentralized operating model of FFH.

Accounting

As a private company since 2009, Odyssey Re's U.S. GAAP consolidated financial statements are Standard & Poor's primary source on its accounting, as well as the individual statutory regulatory filings of its operating subsidiaries.

On Jan. 1, 2011, Odyssey Re transferred the ownership of CIC to TIG Insurance Group, which holds other Fairfax run-off operations. Approximately $460 million of net loss reserves, including about $280 million of A&E net loss reserves, were moved from Odyssey Re Group to FFH's runoff segment. The transaction ultimately has transferred potential adverse reserve development risk from loss reserves related to A&E claims--which are highly correlated with uncertain legal outcomes. Notwithstanding the benefits to Odyssey Re Group, the economics of the transaction have resulted in lower investment income as well as a reduction in its capital base.

Operating Performance: Strong, Disciplined Underwriting Combined With Value Investing

Standard & Poor's views Odyssey Re Group's underwriting and operating performance as strong. Given the demonstrated and consistent strategy of Hamblin Watsa to harvest capital gains, we analyze the operating performance of FFH and its subsidiaries including a share of its realized capital gains and losses in our analysis.

From 2006 to 2010, the average combined ratio was 97%, and the ROR including realized investments gains and losses but excluding gains on credit default swaps (CDS) was 22% (and 15% excluding all realized gains and

losses). It is also remarkable that during this period the company's ROE averaged 19%, which places its performance as measured by ROE among that of the top global insurers/reinsurers performers. The exceptional investment performance during 2006 to 2010 (i.e. annual average net investment income of $345 million and annual average realized investment gains of $240 million excluding gains on CDS) has been an important factor in operating performance in the period. Although Hamblin Watsa has historically produced exceptional realized investment gains over the long-term, results on an annual basis will be volatile.

The average combined ratio from 2006 through 2010 was strong at 97% and closer to management's target combined ratio in the mid-90s. However, this combined ratio included on average 3.5 percentage points per year stemming from CIC's results (2.5% stemming from A&E losses and 1.0% stemming from all other lines). We believe that a combined ratio of 95% (the average excluding A&E incurred losses) is more reflective of the underwriting discipline at Odyssey Re Group in the period 2006-2010, which is in line with management's target combined ratio.

In 2010, Odyssey Re Group generated a combined ratio of 98.6% (96.7% in 2009)--including 0.2% net favorable reserve development of prior years' reserves--and an underwriting gain of $27.2 million ($64.3 million in 2009). Approximately 12 percentage points of the combined ratio (or about $218 million) were related to catastrophes losses, mainly stemming from the Chilean earthquake (5 combined ratio percentage points or $87 million) and the remainder from the New Zealand earthquake, Windstorm Xynthia, the Eastern European floods, and the Haitian earthquake. The Deepwater Horizon loss added 2 percentage points to the combined ratio in 2010. The ROR including realized capital gains and losses on investments--excluding CDS gain and losses--was 19% in 2010, down from 23% in 2009 (compared to 13% and 15%, respectively, if all realized gains and losses on investments are excluded).

In the first six months of 2011, Odyssey Re Group generated a combined ratio of 121.2%--including 0.7% net favorable reserve development of prior years' reserves--and an underwriting loss of $196.4 million. Approximately 38 percentage points of the combined ratio (or about $345 million) were related to catastrophes losses, mainly stemming from the Japanese earthquake and tsunami (27 combined ratio percentage points or $251 million), the New Zealand earthquake (3 combined ratio points or $24 million), and the severe weather conditions in the U.S. (2 combined ratio percentage points or $20 million). Excluding the major catastrophes in Japan and New Zealand, the combined ratio would have been 91% with an underwriting profit of about $80 million. Expense ratio for the first half of 2011 was 29.1% in line with the same period in prior year. In the first six months of 2011, the combination of increased underwriting losses, decreased net gains on investments, the loss on repurchase of long-term debt, and decreased interest income and dividends produced a pretax loss (before interest and other) of $169.4 million, compared to a pretax income (before interest and other) of $268.2 million in the same period in the prior year. The catastrophe losses in the first half of 2011 reflect the potential volatility of Odyssey Re Group's earnings. However, we expect the company to perform better than other property catastrophe writers in 2011--as was the case in 2005, 2008, and 2010.

Prospective

For the full year 2011 and in the absence of major catastrophes for the remainder of 2011 (quarterly catastrophe losses below $65 million), we expect Odyssey Re Group to generate a combined ratio of about 110%. In the absence of major catastrophe losses in 2012 (annual catastrophe losses below $250 million), we expect the combined ratio to be in the range of 94%-98%. Although we expect the company to earn strong total return on its investments in a multi-year period, the company is not immune to investment losses or depressed investment returns

in a single year. As a result, we do expect that ROR in 2012 including realized gains and losses will be at least 15% on average on a three-year rolling basis.

Investments And Liquidity: A Key Strength To The Ratings

As a core company of FFH, Odyssey Re Group's investments are very strong. Odyssey Re, through FFH, follows a long-term value-oriented investment philosophy that emphasizes total return while preserving capital and providing sufficient liquidity for the payment of policyholders' claims.

The investment portfolio of Odyssey Re Group is fully managed by Hamblin Watsa, a company that has a long track record of successful investing with long-term average performance above equity and fixed income indexes for the past 25 years. Hamblin Watsa is an active investment manager, and the asset allocation is subject to a greater amount of change than the asset portfolios of most other insurers. For example, Hamblin Watsa increased substantially its holdings of U.S. states and municipal bonds, because of their relative attractiveness and because those bonds were insured by Berkshire Hathaway Assurance Corp. (a subsidiary of Berkshire Hathaway), for the payment of interest and principal in the event of underlying issuer default. Another example is the decision of Hamblin Watsa to increase allocation to long-term U.S. Treasuries in 2010 due to the company's expectation of decreased interest rates and its cautious view of the world economy. We analyze the investment performance of FFH's subsidiaries, including that of Odyssey Re Group, on a total return basis (i.e. investment income plus a share of realized capital gains and losses on investments). During the period 2006 to 2010, net investment income at Odyssey Re Group accounted for $1.7 billion and realized investment gains excluding CDS gains $1.2 billion (and $1.8 billion including CDS gains).

Odyssey Re's investment portfolio was well diversified as of June 30, 2011, and included municipal bonds (31%), cash and short-term investments (13%), equities (18%), preferred stock (3%), government securities (22%), corporate bonds (6%), and other (7%). Securities rated 'A' or higher comprise approximately 84% of the fixed income portfolio. The equity allocation, which is higher than the industry average, is largely hedged by total return swaps, which have been purchased over the past two years to protect the company's capital from a major downturn in equity markets. The hedge carries basis risk as the indexes underlying the derivatives instruments may not move exactly in line with the equity portfolio of the company. However, the basis risk is constantly tracked by Hamblin Watsa. During 2010 and the first half of 2011, the equity hedge has basically neutralized the uptick in the equity markets and hence hurt the investment return of the company; however, in the third quarter of 2011 this trend reversed as a result of the decline in equity markets and the company recognized a substantial gain from the hedge.

Because of Hamblin Watsa's concerns of the risk of a persistent and prolonged deflation in the global economy, the group has acquired CPI-linked derivatives contracts. These are 10-year contracts--with major banks as counterparties--that are linked to the consumer price indexes in North America and Europe. At maturity, these contracts are in the money if cumulative inflation during the 10-year term is negative (or cumulative deflation is positive), and the payoff is the cumulative deflation times the $50 billion notional amount of the contracts; however, they will have nil value at maturity if cumulative inflation is positive. To buy this protection for 10 years FFH has invested about $430 million to protect itself and its subsidiaries from a deflation scenario that can last 10 years--similar to the experience in Japan or the U.S. experience in the 1930s. These contracts are marked to market (as they do not qualify for hedge accounting) and hence they introduce volatility to earnings at FFH and its subsidiaries. The downside of these contracts is limited as the maximum the group can lose is the original

investment.

In the past two years, based on the group's view of the economy and the company's expectation of a reduction in interest rates, Hamblin Watsa has moved a substantial part of the fixed income portfolio to long-term duration bonds (mostly U.S. Government and U.S. municipal bonds). This movement has caused a substantial mismatch in the average duration of assets and insurance liabilities, though Hamblin Watsa is willing to assume interest rate risk based on its view that interest rates will remain low or even decrease in the immediate term.

Liquidity

Odyssey Re's liquidity remains strong, with 13% of its investments in cash, cash equivalents, or short-term investments as of June 30, 2011 (about $1.1 billion). This is enough to cover the company's pretax gross property catastrophe exposure (at a return period of 250 years). Operating cash flows for the first six months of 2011 were $131 million and $264 million for the full year 2010. The company has no immediate debt maturities ($180 million in 2013 and $124 million in 2015) that will affect its usual liquidity needs.

Prospective

Standard & Poor's expects investment performance to remain very strong and liquidity to remain strong. Because of the total return approach, we expect the company to produce strong total investment returns on a multi-year period, but low returns or losses in single years are possible. We expect the investment allocation at FFH and its subsidiaries to be subject to a greater amount of change than the asset portfolios of most other insurers/reinsurers.

Capitalization: Strong

We view Odyssey Re's capitalization as strong, based on our capital model and our views of the company's reserves and reinsurance. Even though the company had about $450 million of property catastrophe related losses in the first nine months of 2011, shareholders' equity totaled $3.6 billion as of Sept. 30, 2011, up by about $250 million from $3.3 billion as of year-end 2010 (pro forma excluding CIC).

Our stand-alone pro forma capital model of Odyssey Re Group as of year-end 2010: a) reflects the transfer of ownership of CIC to TIG Insurance Group, b) includes a 1-in-250 after-tax net PML catastrophe charge, and c) excludes any affiliated investments/loans on which we apply a 100% capital charge. We have not included any quantitative adjustment in the capital model for the equity hedge currently in place, but we do take it into consideration qualitatively when we analyze capital adequacy as it provides an extra layer of protection to the company's capital base in case of a major downturn in the equity markets. The group's exposure to natural-peril and man-made catastrophes are factors that somewhat offset its very strong capital adequacy.

Reserves

We view Odyssey Re's loss reserves as adequate. By transferring the ownership of CIC to TIG, Odyssey Re has removed virtually all of its A&E reserves from its balance sheet, and hence we do not expect any major A&E reserve strengthening in the future. However, we still consider that Odyssey Re faces potential reserve risk because a significant proportion of its booked loss reserves are casualty related. As of June 30, 2011, net loss reserves were $4.7 billion and about half of it was incurred but not reported (IBNR) reserves. Overall, reserve development has been fairly favorable since 2008 (based on GAAP financials). About 80% of total reserves are long-tail and the remainder short-tail with the following breakdown: liability 60%, property and short-tail lines 20%, medical malpractice 8%, workers' compensation 6%, commercial auto 3%, and other lines 3%. The uncertainty related to

the company's substantial casualty reserves is a factor that partially offsets its strong capital base.

Reinsurance

Reinsurance utilization remained relatively moderate at 13% as of June 30, 2011. Odyssey Re is largely a gross writer in property and casualty treaty reinsurance, but substantially protects its insurance operations and facultative business by using third-party reinsurance. The company's objective is to limit its peak zone net, after-tax one in 250 year per occurrence probable-maximum-loss, including reinstatement premiums, to a maximum of 25% of its statutory surplus.

As of June 30, 2011, reinsurance recoverables totaled about $792 million, an increase of $74 million since year-end 2010, mainly stemming from the catastrophe losses in the first half of 2011. As of June 30, 2011, recoverables constituted about 25% of shareholders' equity compared with 21% at year-end 2010. Excluding unrated reinsurers (which are fully collaterized), almost 100% of recoverables have ratings of 'A-' or above.

Prospective

In the absence of any major catastrophe, we expect Odyssey Re's capital adequacy in 2011 and 2012 to remain strong, reflecting strong operating performance supporting the capital base. We do not expect any major reserve strengthening in 2011 and 2012 (which we define as two percentage points of prior year's ending net loss reserves).

Financial Flexibility: Strong, Aligned With FFH

Odyssey Re Group's financial flexibility is strong. As the largest group (approximately 40% of GWP) within the FFH group, Odyssey Re Group's financial flexibility is linked with that of its parent. On a consolidated stand-alone basis (including intermediary holding company ORH), financial leverage was a modest 11.0% and fixed coverage was 6.5x as of year-end 2010. The company has no immediate debt maturities ($180 million in 2013 and $124 million in 2015). Odyssey Re's financial flexibility also benefits from a $100 million credit facility for issuance of letters of credit, and its low level of reinsurance utilization.

Related Criteria And Research

- Analysis Of Nonlife Insurance Operating Performance, April 22, 2009
- Interactive Ratings Methodology, April 22, 2009

Odyssey Re Holdings Corp.--Business Statistics

Table 1

	--Year ended Dec. 31--						
	2010	**2009**	**2008**	**2007**	**2006**	**2005**	**Five-year average**
Gross premiums written ($ mil.)	2,167	2,195	2,295	2,283	2,336	2,627	2,255
Change in gross premiums written (%)	-1.3%	-4.3%	0.5%	-2.3%	-11.1%	N/A	-3.7%
Net premiums written ($ mil.)	1,854	1,894	2,031	2,089	2,161	2,302	2,006
Change in net premiums written (%)	-2.1%	-6.7%	-2.8%	-3.3%	-6.1%	N/A	-4.2%
Net premiums earned ($ mil.)	1,886	1,927	2,076	2,121	2,226	2,277	2,047
Change in net premiums earned (%)	-2.2%	-7.2%	-2.1%	-4.7%	-2.2%	N/A	-3.7%
Total assets under management ($ mil.)	8,931	8,760	8,033	7,779	7,066	5,970	8,114
Growth in assets under management (%)	2.0%	9.0%	3.3%	10.1%	18.4%	N/A	8.5%

Odyssey Re Holdings Corp.--Business Statistics (cont.)

Reinsurance utilization (%)	14.5%	13.7%	11.5%	8.5%	7.5%	12.4%	11.1%

Table 2

Odyssey Re Holdings Corp.--Operating Statistics

	--Year ended Dec. 31--						
	2010	**2009**	**2008**	**2007**	**2006**	**2005**	Five-year average
Total revenue ($ mil.)	2,214	2,245	2,332	2,450	2,713	2,497	2,391
EBIT ($ mil.)	462	524	862	951	777	(152)	715
EBIT adjusted ($ mil.)	291	338	169	412	588	(212)	360
EBITDA ($ mil.)	462	524	862	951	777	(152)	715
EBITDA adjusted ($ mil.)	291	338	169	412	588	(212)	360
EBIT adjusted to total equity adjusted (%)	8.1%	10.4%	6.0%	16.7%	30.8%	-25.8%	14.4%
EBITDA adjusted to capital (%)	6.0%	7.7%	4.3%	10.7%	20.3%	-9.8%	9.8%
Net income ($ mil.)	333	372	549	596	508	(116)	472
Return on revenue (%)	13.2%	15.1%	7.3%	16.8%	21.7%	-8.5%	14.8%
Return on revenue (incl. realized capital gains/losses) (%)	19.4%	21.5%	28.5%	31.8%	26.8%	-5.9%	25.6%
Return on equity (%)	9.2%	11.7%	20.0%	25.1%	27.3%	-7.1%	18.7%
Return on assets (%)	4.7%	5.6%	9.8%	11.3%	10.1%	-2.1%	8.3%
Realized gains/EBITDA (%)	36.9%	35.5%	80.3%	56.7%	24.3%	-39.4%	46.8%
Administrative expense ratio (%)	10.3%	9.6%	8.4%	8.4%	6.9%	6.4%	8.7%
Commissions expense ratio (%)	18.4%	19.5%	20.1%	20.6%	20.9%	20.6%	19.9%
Expense ratio (%)	28.7%	29.1%	28.6%	29.0%	27.7%	27.1%	28.6%
Non-life loss ratio (%)	69.8%	67.6%	72.7%	66.4%	66.7%	90.5%	68.6%
Non-life combined ratio (%)	98.6%	96.7%	101.2%	95.5%	94.4%	117.6%	97.3%
Non-life (favorable)/unfavorable prior year loss ratio (%)	-0.2%	-0.6%	-0.5%	1.9%	6.3%	0.08	1.4%
Non-life accident year loss ratio (%)	70.0%	68.1%	73.1%	64.5%	60.4%	83.0%	67.2%
Non-life accident year combined ratio (%)	98.7%	97.2%	101.7%	93.5%	88.1%	110.0%	95.9%
Non-life loss ratio (%) ongoing operations	68.7%	62.0%	71.8%	65.4%	65.7%	89.6%	66.7%
Non-life combined ratio (%) ongoing operations	97.4%	91.1%	100.4%	94.4%	93.4%	116.7%	95.4%
Cash flows							
Net cash flow from operating activities ($ mil.)	264	(3)	112	157	752	644	256.5
Net cash flow from investing activities ($ mil.)	(20)	241	314	(1,231)	(304)	(382)	(200.1)
Net cash flow from financing activities ($ mil.)	(72)	(114)	(390)	(132)	63	(230)	(128.9)

Table 3

Odyssey Re Holdings Corp.--Investment Statistics

	--Year ended Dec. 31--						
	2010	**2009**	**2008**	**2007**	**2006**	**2005**	**Five-year average**
Total invested assets ($ mil.)	8,931	8,760	8,033	7,779	7,066	5,970	8,114
Change in invested assets (%)	2.0%	9.0%	3.3%	10.1%	18.4%	N/A	8.5%
Total invested assets adjusted ($ mil.)	9,158	8,980	8,174	7,937	7,312	5,970	8,312
General account invested assets ($ mil.)	8,931	8,760	8,033	7,779	7,066	5,970	8,114
Separate accounts/unit linked assets ($ mil.)	0	0	0	0	0	0	0

Table 3

Odyssey Re Holdings Corp.--Investment Statistics (cont.)							
Invested assets to total assets (%)	91.6%	92.0%	92.3%	91.1%	90.2%	82.8%	91.4%
Invested assets to loss and unearned premium reserve (%)	165.1%	167.0%	155.4%	151.4%	137.4%	100.3%	155.3%
Net investment income ($ mil.)	328	318	255	329	487	220	344
Realized capital gains/(losses) ($ mil.)	170	186	692	539	189	60	355
Unrealized gains/(losses) ($ mil.)	(317)	712	(21)	120	(127)	0	73
Net investment yield (%)	3.7%	3.8%	3.2%	4.4%	7.5%	3.7%	4.5%
Net investment yield including realized gains/(losses) (%)	5.6%	6.0%	12.0%	11.7%	10.4%	4.7%	9.1%
Net investment yield including realized and unrealized gains/(losses) (%)	2.1%	14.5%	11.7%	13.3%	8.4%	4.7%	10.0%
Common equity investment/capital (%)	42.2%	53.6%	51.5%	28.8%	24.6%	80.4%	40.1%
Real estate investments to capital (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Portfolio composition (% of invested assets)							
Bonds (%)	56.4%	56.0%	49.0%	59.7%	49.6%	43.5%	54.1%
Equity investments (%)	18.8%	23.9%	19.4%	11.4%	9.0%	19.6%	16.5%
Cash and short term investments (%)	15.0%	15.5%	25.4%	21.6%	36.0%	33.0%	22.7%
Real estate (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Investments in affiliates (%)	2.8%	2.9%	3.5%	2.0%	3.5%	0.0%	2.9%
Investment funds(%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Mortgages and loans (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Investments in partnerships, joint ventures, and other alternatives investments (%)	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Other investments (%)	6.9%	1.7%	2.8%	5.3%	1.9%	4.0%	3.7%

Table 4

Odyssey Re Holdings Corp.--Capitalization Statistics

	--Year ended Dec. 31--						
	2010	**2009**	**2008**	**2007**	**2006**	**2005**	**Five-year average**
Total assets ($ mil.)	11,115	10,785	9,727	9,501	8,954	8,647	10,016
Adjusted total assets ($ mil.)	10,001	9,760	8,859	8,714	8,104	7,214	9,088
Common equity ($ mil.)	3,661	3,478	2,733	2,557	1,986	1,639	2,883
Change in common equity (%)	5.3%	27.2%	6.9%	28.8%	21.1%	N/A	17.9%
Total adjusted capital ($ mil.)	3,972	3,904	3,021	3,084	2,586	1,454	3,313
Change in total adjusted capital (%)	1.8%	29.2%	-2.0%	19.3%	77.8%	N/A	25.2%
Reinsurance and reserves							
Reinsurance utilization (%)	14.5%	13.7%	11.5%	8.5%	7.5%	12.4%	11.1%
Reinsurance recoverables to shareholders' equity (%)	30.3%	28.8%	30.7%	29.7%	40.8%	87.4%	32.1%
Non-life loss reserves to total shareholders' equity (%)	132.4%	131.3%	161.3%	168.6%	211.3%	312.2%	161.0%
Non-life loss reserves/net premiums written (%)	262.0%	246.4%	224.6%	214.2%	203.8%	222.3%	230.2%
Liquid assets/loss and unearned premium reserves (%)	149.0%	159.4%	145.7%	140.3%	129.9%	96.3%	144.9%

Table 5

Odyssey Re Holdings Corp.--/Financial Statistics							
	--Year ended Dec. 31--						
	2010	2009	2008	2007	2006	2005	Five-year average
EBITDA interest coverage (x)	8.3	9.4	4.3	9.5	13.7	(6.6)	9.0
EBITDA fixed-charge coverage (x)	6.5	7.0	3.0	6.5	9.4	(6.6)	6.5
Debt leverage including pension deficit as debt (%)	11.0%	11.2%	14.1%	13.6%	16.0%	26.0%	13.2%
Financial leverage including pension deficit as debt (%)	11.0%	11.2%	16.5%	16.0%	18.7%	26.0%	14.7%

Ratings Detail (As Of December 16, 2011)	
Holding Company: Odyssey Re Holdings Corp.	
Issuer Credit Rating	
Local Currency	BBB-/Positive/--
Preferred Stock (2 Issues)	BB
Senior Unsecured (2 Issues)	BBB-
Operating Companies Covered By This Report	
Hudson Specialty Insurance Co.	
Financial Strength Rating	
Local Currency	A-/Positive/--
Counterparty Credit Rating	
Local Currency	A-/Positive/--
Odyssey Reinsurance Co.	
Financial Strength Rating	
Local Currency	A-/Positive/--
Issuer Credit Rating	
Local Currency	A-/Positive/--
Domicile	New York

*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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