



1996 Annual Report

## Contents

Five Year Financial Highlights	1
Corporate Profile	2
Chairman's Letter to Shareholders	4
Auditors' Report to the Shareholders	19
Valuation Actuary's Report	19
Fairfax Consolidated Financial Statements	20
Notes to Consolidated Financial Statements	24
Management's Discussion and Analysis	35
Fairfax Insurance and Reinsurance Companies - Combined Financial Statements	54
Fairfax with Equity Accounting of Lindsey Morden - Consolidated Financial Statements	56
Lindsey Morden Group Inc. - Consolidated Financial Statements	58
Fairfax Unconsolidated Financial Statements	60
Appendix	62
Consolidated Financial Summary	66
Corporate Information	67

---

# FAIRFAX

FINANCIAL HOLDINGS LIMITED

---

## 1996 Annual Report

..

---

### Five Year Financial Highlights

*(in \$ millions except share and per share data)*

	1996	1995	1994	1993	1992
Revenue	1,475.8	1,145.5	634.9	344.0	286.8
Net earnings	150.8	87.5	38.1	33.3	10.0
Total assets	5,778.4 *	2,873.5 *	2,173.4	1,200.3	590.5
Shareholders' equity	911.1	472.6	391.9	279.5	143.8
Shares outstanding - year-end ( <i>mil.</i> )	10.5	8.9	9.0	8.0	6.1
Return on average equity	21.4%	20.1%	12.1%	20.3%	7.7%
<i>Per share</i>					
Net earnings	15.36	9.79	4.66	5.42	1.76
Shareholders' equity	87.05	53.28	43.77	35.13	23.76
<i>Market prices per share</i>					
High	310.00	100.00	76.00	61.25	30.00
Low	98.00	66.25	52.00	24.00	21.75
Close	290.00	98.00	67.00	61.25	25.00

---

\*reflects a change in accounting policy for reinsurance recoverables (note 2 to the financial statements)

## CORPORATE PROFILE

**Fairfax Financial Holdings Limited** is a financial services holding company whose corporate objective is to achieve a high rate of return on invested capital and build long term shareholder value. The company has been under present management since September 1985.

**Commonwealth Insurance**, based in Vancouver, offers commercial property and oil and gas insurance in Canada, the United States and internationally, and commercial casualty insurance in Canada. In 1996 Commonwealth's net premiums written totalled \$87.3 million. Commonwealth has been in business since 1947 and at year-end the company had capital and surplus of \$136.9 million and there were 127 employees.

**Federated Insurance** is based in Winnipeg. Its two companies market a broad range of insurance products in Canada primarily for commercial customers. In 1996 Federated's net premiums written totalled \$60.4 million, consisting of \$49.5 million of property and casualty business and \$10.9 million of life and group health and disability products. Federated has been in business since 1920 and at the end of 1996 had capital and surplus of \$51.8 million and 238 employees.

**Lombard Insurance**, based in Toronto, writes a complete range of commercial and personal insurance products in Canada. The company has been in business since 1904. In 1996 Lombard's net premiums written were \$357.6 million. At year-end the company had capital and surplus of \$196.4 million and there were 671 employees.

**Markel Insurance**, based in Toronto, is one of the largest trucking insurance companies in Canada and has provided the Canadian trucking industry with a continuous market for this class of insurance since 1951. In 1996 net premiums written were \$62.6 million and the company had 95 employees and capital and surplus of \$52.8 million at year-end.

**Ranger Insurance**, based in Houston, Texas, specializes in writing property and casualty insurance to niche markets in the United States such as propane distributors, petroleum and gas marketers and agri-products. The company has been in business since 1923. In 1996 Ranger's net premiums written were US\$156.0 million. At year-end the company had capital and surplus of US\$121.3 million and there were 293 employees.

**CRC (Bermuda) Reinsurance**, based in Bermuda, continues to be a major reinsurer of Lombard Insurance. The company received its insurance certificate early in 1995 and had net premiums written

in 1996 of \$99.0 million. At year-end the company had capital and surplus of \$65.0 million.

**Compagnie Transcontinentale de Réassurance (CTR)** is based in Paris, France and writes primarily property, casualty and some life reinsurance internationally. The company was established in 1951 and in 1996 CTR's net premiums written exceeded FF1.5 billion (approximately FF4 = C\$1). At year-end the company had capital and surplus of FF900 million and 170 employees.

**Odyssey Reinsurance** (formerly Skandia America Reinsurance) is based in New York, New York and writes property and casualty reinsurance in the United States and Canada. The company was established in 1918 and in 1996 Odyssey Re's net premiums written were US\$201 million. At year-end the company had capital and surplus of US\$364.6 million and 170 employees.

**Wentworth Insurance** was incorporated in 1990 as an insurance company domiciled in Barbados. In 1996 Wentworth's net premiums written were \$8.3 million. At year-end the company had capital and surplus of \$123.7 million and there were 7 employees.

**Lindsey Morden Group** is engaged in providing claims adjusting, appraisal and loss management services to a wide variety of insurance companies and self-insured organizations across Canada and the United States. In 1996 revenue totalled \$162.3 million. The company was established in 1923, and at year-end the group had 1,513 employees located in 299 offices.

**Hamblin Watsa Investment Counsel** provides discretionary investment management, primarily to pension funds and insurance companies, including the insurance company subsidiaries of Fairfax. Hamblin Watsa was founded in 1984 and at year-end managed approximately \$5 billion.

*Note: All companies are wholly owned except Lindsey Morden Group, a public company of which Fairfax owns 57% of the equity and 92% of the votes.*

## To Our Shareholders

What a way to begin the second decade of our corporate existence! While we have had some great years in the past, 1996 was certainly the best yet. We earned 21.4% on average shareholders' equity in 1996 (versus 9.1% for the TSE 300). Net income after tax increased by 72% to \$150.8 million. In spite of an 18% increase in shares outstanding, earnings per share increased by 57% to \$15.36. Book value per share increased by 63% to \$87.05 and our shares almost tripled to \$290 per share. I did not realize that my comment last year about my shares not being for sale at *even* \$200 per share would be tested so soon!

While we were gratified by these results, what made 1996 special was that we developed a global reinsurance business through the purchase of two reinsurance companies, and ended the year in a stronger financial position than when we began. We accessed the long end of the U.S. bond market for the first time and we ended the year with in excess of \$100 million in cash in the holding company and unused, unsecured, committed, long term bank lines of \$600 million. Also, unlike many companies that have grown through acquisition, we have negative goodwill resulting from acquisitions at discounts to book value that, with the recent purchase of CTR, will amount to \$193 million (\$18 per share). This is effectively an after-tax reserve or cushion for the proverbial "rainy day". In addition, we have about \$350 million (or \$33 per share) in reserve and reinsurance recoverable indemnifications that are not shown on our balance sheet. You can see why we think 1996 was so good.

This is perhaps the best time to give you the bad news! All of this was not based on a 'vision' statement or long term plan that we have at Fairfax. It was simply reacting to the opportunities that presented themselves to us and doing what we considered was best for shareholders in the long term. If Jim Dowd, Chief Executive Officer of Odyssey Re, hadn't phoned me in December 1995, all of this may not have taken place. This also means that there is no way the results in 1996 can be extrapolated into the future. So don't be surprised if we make no acquisitions in the next five years.

The acquisitions of Odyssey Re and CTR were so significant to Fairfax that we decided to provide additional disclosure on each purchase in our first and third quarter reports to you (as opposed to waiting for this report). These disclosures are reprinted in the Appendix for those of you who are truly long term investors and only read our Annual Report! Please read them carefully as they not only outline the reasons for our purchase but also the risks involved.

The following are highlights on the two purchases together:

- 1) Odyssey Re is a North American reinsurer while CTR operates worldwide with offices in Paris, Singapore, Tokyo and New York. CTR's North American business is small and was easily amalgamated into Odyssey Re. Essentially there is very little overlap between the two companies and together they have a global network. Jim Dowd and Andy Barnard run Odyssey Re and Jean-Philippe Casanova runs CTR in co-ordination with Andy. All three are firmly committed to underwriting profitability and not market share growth. As we have little experience outside North America, it is fair to say that we would not have purchased CTR if Andy had not joined the group.
- 2) The two companies together will write net premiums in excess of US\$500 million with capital in excess of US\$500 million, ranking the Odyssey Re/CTR group among the top reinsurers in the U.S.
- 3) Both companies were purchased in our "fair and friendly" way from Skandia, Sweden and the GAN group, France.
- 4) Both companies have significant long tail liabilities (including asbestos and environmental). We feel the indemnifications are sufficient protection, but only time will tell.
- 5) Both companies have significant reinsurance recoverables and are exposed to potential bad debts on these recoverables. We feel the bad debt reserves in place, together with the indemnifications, will prove adequate, but again only time will tell.
- 6) As mentioned in our first quarter report, reinsurance is a business that magnifies the abilities of management. We are very excited about our long term prospects in the reinsurance business under the stewardship of Jim, Andy and Jean-Philippe. We welcome them and the employees of Odyssey Re and CTR to Fairfax and look forward to participating in their companies' growth.

We financed the purchase of the two reinsurance companies by issuing 1.1 million shares at \$155 per share and 500,000 shares at \$260 per share to raise a total of approximately \$300 million. The issues were led by Dick Falconer from CIBC Wood Gundy and ably supported by ScotiaMcLeod, RBC Dominion Securities, Nesbitt Burns, TD Securities, Deutsche Morgan Grenfell Canada, First Marathon, Midland Walwyn and Newcrest Capital. We thank them for an excellent job. After not issuing shares for seven years ending in 1993, we have raised almost \$500 million from share issues in the past three years. No wonder the investment dealer industry is doing well! We welcome our new shareholders and emphasize again, as we did in 1993 and 1994, that our company is run for the long term. So don't be too concerned about short term results as we will

accept short term volatility in our earnings for better long term results. We have been fortunate not to have had any short term (read quarterly) surprises but I'm sure they will come one of these days!

We have mentioned in the past that we are very careful about issuing shares. In our 1986 Annual Report we said, "We consider our stock as good as cash. When we issue stock, we will ensure that we get as much value as we give." While we have been very clear about the "getting" part, we consider the "giving" part to be equally important. So, while we have raised money at higher and higher stock prices in 1996, we feel our new shareholders are getting excellent long term value - otherwise we would not issue shares at these prices. Remember we said long term. In the short term, we have no idea where our shares will trade.

To help finance the purchase of Odyssey Re, we did our third U.S. debt financing, led again by J. P. Morgan and strongly supported by Credit Suisse First Boston and Deutsche Morgan Grenfell. For the first time, as we said earlier, we were able to access the long end of the U.S. bond market (30 years) with the issue of US\$125 million of unsecured debentures with an effective interest cost of 8.3% per annum and a 30 year term to maturity. You may be surprised to know that in the property and casualty industry there are only nine companies in the U.S., and only Fairfax in Canada, that have 30 year bonds outstanding. We were happy with the absolute rate but the spread of 153 basis points over comparable treasuries was a little higher than we expected.

The spread over comparable treasuries of all three of our U.S. debenture issues has contracted dramatically in 1996 and at year-end was in the range of 85 basis points for our 2003 issue, 110 basis points for our 2015 issue and 120 basis points for our 2026 issue - all significantly down from where we issued the debentures. While much of this is due to the general narrowing in corporate spreads, we feel there is a wider recognition in the bond market of our very strong financial position. Unfortunately, we have yet to convince the rating agencies to upgrade Fairfax to an A from BBB+.

We welcome our new debenture investors and want to reassure them that we continue to have an A rating as our objective. Our ability to access the U.S. bond market over all maturity levels is a very significant strength of our company and one that we do not take lightly.

By way of perspective, the table below shows you how significantly we have grown in 1996.

	(\$ millions)		
As of December 31	<b>1995</b>	<b>1996 *</b>	<b>Increase</b>
Net premiums written	865	1,500	1.7x
Investment portfolio	1,669	4,100	2.5x
Shareholders' equity	473	911	1.9x
Net debt	228	417	1.8x
Shares outstanding	8.9	10.5	1.2x

*\*Includes CTR, which closed in February 1997*

As shown, net premiums written, shareholders' equity and net debt have grown by approximately 2 times and the investment portfolio has increased 2.5 times, while the number of shares outstanding has increased only 1.2 times. Obviously, reinsurance is now a very significant activity for Fairfax and our future will be very dependent on the performance of our two recent acquisitions.

Investments per share have increased from \$188 per share at year-end 1995 to \$390 per share at year-end 1996 (including CTR) - an increase of 107%. Investment income per share (only interest and dividends) from this portfolio, which ultimately drives earnings per share and book value per share, should increase significantly in 1997.

While all of this frenetic activity took place in 1996, there were no changes in the small Fairfax head office. It is quite amazing what our small group, led by Rick Salsberg and John Varnell and ably supported by Brenda Adams, Sam Chan and Ronald Schokking, did over the past year. Most other companies would need a corporate head office many, many times larger and still perhaps not be as effective. Our Fairfax head office shows what a few capable, hardworking and trusted individuals can accomplish working together as a team with no egos. Late in 1996 Francis Chou joined the company. Francis was the person who gave me the idea about Fairfax almost 12 years ago. We look forward to more ideas like that from Francis.

The table below shows the sources of our net earnings.

	<i>(\$ millions)</i>	
	<b>1996</b>	<b>1995</b>
Insurance underwriting	(50.6)	(40.9)
Interest and dividends	<u>144.1</u>	<u>86.3</u>
<i>Total</i>	93.5	45.4
Claims adjusting (Fairfax portion)	2.3	2.1
Interest expense	(35.0)	(19.1)
Goodwill and other amortization	(4.8)	(4.8)
Corporate overhead and other	(6.6)	(5.6)
Realized gains	<u>131.3</u>	<u>71.9</u>
Pre-tax income	180.7	89.9
Less: taxes	<u>29.9</u>	<u>2.4</u>
Net earnings	<u>150.8</u>	<u>87.5</u>

The table shows you the results from our insurance (underwriting and investments) and non-insurance operations. *In this report insurance operations include reinsurance operations.* Claims adjusting shows you our share of Lindsey Morden's after-tax income. Goodwill and other amortization includes Hamblin Watsa goodwill (\$1.4 million) and amortization from Ranger (\$3.4 million). The corporate overhead expense is net of Hamblin Watsa's pre-tax income. Shown separately are realized gains so that you can better understand our earnings from our operating

companies. Also please note the unaudited financial statements of our combined insurance operations and of Fairfax with Lindsey Morden equity accounted, as well as Lindsey Morden's financial statements, shown on pages **x** to **x** .

The increase in underwriting losses in 1996 was largely due to Ranger. Interest and dividend income as well as interest expense increased because of the Odyssey Re acquisition in May 1996. Lindsey Morden's contribution increased in 1996 from record 1995 levels. Corporate overhead and other increased because of one time expenses associated with the debt and share issues. Realized gains were very large and almost twice 1995 levels. These gains more than offset the increase in underwriting losses and were the main reason for the increase in earnings in 1996. Fairfax's effective tax rate was 17% in 1996 reflecting utilization of loss carryforwards, tax-free Canadian dividend income and international operations with lower tax rates.

Book value per share increased from \$53.28 to \$87.05, approximately 45% from earnings and 55% from our share issues.

### **Insurance operations**

1996 was another excellent year for our Canadian insurance companies with a combined ratio of 99.1%. Odyssey Re performed as expected but Ranger had another poor year as discussed later. In total, our insurance and reinsurance operations had a combined ratio of 104.9%, the same as in 1995. This means that we have achieved our target of a combined ratio of 100% or less in only five of the last eleven years. While we are not pleased with this record, it has been achieved in an industry environment which has been in a cyclical downturn for nine of the past eleven years - with no sign of an upturn yet!

Commonwealth, led by John Watson, continued to produce extraordinary results with a combined ratio of 87.0%, even better than the 89.5% in 1995. John and his management team have had combined ratios of less than 100% in five out of the last six years.

Because of the competitive environment discussed in last year's Annual Report, Commonwealth's gross premiums written declined 10% to \$262 million while net premiums written remained flat at \$87 million. Net income after taxes was a record \$24.4 million because of significant underwriting profits and realized gains. Since we purchased Commonwealth in 1990, it has had cumulative underwriting profits and net income after taxes of \$18 million and \$94 million respectively, paid out a total of \$45 million in dividends and ended 1996 with shareholders' equity of \$137 million - all versus our purchase price of \$57<sup>1</sup>/<sub>2</sub> million in 1990.

Of course, Commonwealth's record goes much further back than 1990. It was started in its present form in Vancouver in 1968 with a \$10,000 investment, with the only significant additional capital being a contribution of about \$20 million in the middle 1980s. Ron Schwab, Executive Vice

President, Underwriting, was one of the founding employees at the time. The company has had almost no employee turnover and has never lost money since its founding - an exceptional track record and a major contributor to Fairfax's success.

While we are exposed to catastrophes at Commonwealth, the risk is managed well. Also, the company has recently further increased its catastrophe protection. While there are no guarantees, we continue to feel a major catastrophe would impact Commonwealth's income statement but not its balance sheet.

Federated, under John Paisley's leadership, had another excellent year in 1996 with a combined ratio of 98.6% for the property and casualty company (100.2% including the life operations). Gross premiums written increased by 6% to \$58.6 million while net premiums written increased 5% to \$49.5 million. Federated's expense ratio of 34.8% in 1996 was better than the 36.6% in 1995 and significantly better than the 42% that prevailed three years ago. Net income after taxes of \$5.5 million was down 20% from \$6.9 million in 1995 mainly because of lower realized gains. Since we purchased Federated in 1989, the company has had cumulative underwriting profits and net income after taxes of \$0.1 million and \$46 million respectively, paid out total dividends of \$22 million and ended the year with shareholders' equity of \$52 million - all versus our purchase price of \$28 million in 1989. Under John's leadership Federated has done very well in the past, but we think it will do even better in the future.

Byron Messier and his management team at Lombard had an excellent year in 1996 with a normalized combined ratio of 99.5% - more than fulfilling the 100% objective Byron had set in 1993 for 1996. On a net premium base of \$443 million (including CRC (Bermuda)), this was truly outstanding! Both sides of the house, commercial lines and personal lines, achieved combined ratios below 100%.

Lombard maintained its gross and net premiums written in 1996 at 1995 levels but net income after taxes increased to a record \$59 million. In the two years since we purchased Lombard it has earned \$101 million after taxes. It won't be long before we have earned our purchase price of \$155 million!

In 1995/96, Lombard commenced a pilot program of direct marketing of automobile and home insurance to people over 50 years old, partnering with a select group of brokers in Alberta and then the Maritimes. The program, called Privilege 50, provides 24-hour service via telephone with binding quotes and three day policy delivery. The program has been well received and will be introduced in Ontario during March 1997 through Zenith Insurance, a broker joint venture with Lombard. More on the results next year!

Lombard's commercial book of business continues to be more focused on its market niches and

thus less susceptible to competitive market pressures.

Considering the highly competitive state of the market, Markel, under Mark Ram's leadership, had a very good year with a combined ratio of 102.9% in 1996. As mentioned in last year's Annual Report, Mark and his management team continue to build Markel into the premier trucking insurance company in Canada by providing the best claims, underwriting and loss prevention services available in the country, a first rate driver training school, the first truck skid school in Canada, a new A-(excellent) rating from A.M. Best, etc., etc. Pricing, though, has collapsed and we have been losing some accounts at 30-50% discounts to our prices, a level at which other insurers have historically lost money. We have experienced this kind of irrational competition before and, since we began in 1985, two of Markel's largest competitors have gone bankrupt, leaving their insureds in a bind. As Santayana said, "Those who cannot remember the past are condemned to repeat it." Markel remains committed to providing stability to its insureds. Net premiums written dropped 21% to \$62.6 million in 1996. Pre-tax income at \$8.2 million was only 6% off 1995 levels but net income after tax has dropped in half because we didn't pay any taxes in 1995.

I was wrong, again, on Ranger in 1996. The key word is / and not Pete Wallner and his management team. The problems of the past continued to haunt Pete and Ranger with a combined ratio of 123.5%. Excluding the lines in run-off and a further increase in reserves for past years, Ranger's combined ratio from continuing operations drops to 105.5% - a good indication of Pete's performance in 1996.

The table below shows you our experience at Ranger in 1995 and 1996.

	<i>(US\$ millions)</i>		
	<b>1995</b>	<b>1996</b>	<b>Total</b>
Underwriting loss	(50.2)	(35.3)	(85.5)
Combined ratio	138%	124%	131%
Indemnities - vendor	11.5	-	11.5
- Fairfax	<u>14.0</u>	<u>-</u>	<u>14.0</u>
	<u>25.5</u>	<u>-</u>	<u>25.5</u>
Underwriting loss (after indemnities)	(24.7)	(35.3)	(60.0)
Investment income	<u>38.0</u>	<u>33.1</u>	<u>71.1</u>
Pre-tax income (loss)	13.3	(2.2)	11.1
Taxes (credit) <u>-</u>	<u>(11.1)</u>	<u>(11.1)</u>	
Net income	<u>13.3</u>	<u>8.9</u>	<u>22.2</u>

Some observations:

- 1) Underwriting losses totalled US\$86 million in the two years. The combined ratio for the two years was 131%. The cost to Fairfax in the two years of these underwriting losses, excluding the vendor's indemnification but including the Fairfax indemnification and some

related reinsurance, was US\$85 million, i.e. more than \$11 per share pre-tax!

- 2) Run-off lines cost us US\$56 million in losses for the two years, increasing Ranger's combined ratio by 20 percentage points to 131%. The combined ratio for these lines was 193%.
- 3) The reserve increase for 1995 and prior years (at year-end 1996) on Ranger's core lines totalled US\$24 million, approximately 8 percentage points of Ranger's combined ratio.
- 4) In spite of these underwriting losses, Ranger had net income of US\$13.3 million in 1995 and US\$8.9 million in 1996 for a total of US\$22.2 million. Year-end GAAP capital of US\$121.3 million was the highest in Ranger's history. However, A.M. Best did drop Ranger's rating to A- from A.
- 5) Ranger had net premiums written of US\$156.0 million in 1996 - up 19% from 1995 levels. After realized gains of US\$19.6 million (including US\$8.1 million from the sale of a largely inactive subsidiary, Ranger County Mutual), Ranger had a US\$2.2 million pre-tax loss. Including tax credits, Ranger had a net income after tax of US\$8.9 million in 1996.

As you can see, Pete Wallner and his management team have worked very hard to correct the problems of the past and, dare I say, 1997 should be a much better year.

While we have increased reserves at Ranger again in 1996 (even though we felt they were adequate last year), we do not think this will be repeated in 1997. I hope I don't have to eat humble pie again!

Wentworth, our Barbados company, continued to have good results with a combined ratio of 98% on much reduced net premiums written of \$8.3 million. Net income dropped to \$2.5 million in 1996 because of lower realized gains.

Odyssey Re had a good year in 1996. It had a combined ratio of 110% as expected after US\$15.7 million in indemnification from Skandia, Sweden. Net premiums written were US\$201.1 million for the year - about the same as last year. After significant realized gains, Odyssey Re earned US\$63.5 million after taxes in 1996. Even though all the earnings in 1996 accrued to the benefit of Fairfax, only US\$56 million was included in our statements as the purchase closed during the second quarter. Jim Dowd and Andy Barnard are focused on reducing Odyssey Re's combined ratio below 100% in the next two years. CTR's net income will flow into Fairfax for the full year 1997. Kris Datt and his team (from Ranger Re) have joined the reinsurance group of Odyssey Re and CTR.

Our insurance companies are all well capitalized as shown on page x. We continue to have significant unused capacity with no signs as to when we can use it.

Our reserves continue to be certified at the individual insurance company level and on a consolidated basis as in the past. Odyssey Re and CTR will have their reserves certified by external actuaries in 1997. We mentioned last year that our goal at Fairfax is to ensure that the reserve ~~past~~ does not hurt us in the future but helps us, i.e. we expect to see reserve redundancies each year in each of our insurance companies. In 1996 our Canadian insurance companies had redundancies of \$16.7 million, while Ranger had a deficiency of US\$24.0 million (C\$32.7 million). In total then, we had a net reserve deficiency of \$16.0 million in 1996 - not very good. We think we have more than adequately provided for reserves at Ranger but only time will tell. We provide extensive disclosure on our reserves beginning on page x.

### **Claims adjusting**

Under Ken Polley's leadership, Lindsey Morden had an excellent year in 1996. While earnings hit another record, the real story was free cash flow. In 1996, after capital expenditures and working capital requirements, Lindsey Morden generated \$6.7 million which, with existing cash, was used to reduce short and long term debt by \$7.2 million. If this level of earnings and cash flow persists in 1997, Lindsey Morden will soon be free of debt. With no use for additional capital, the board of Lindsey Morden has decided to increase annual dividends from 104 per share to 504 per share and will review dividend payouts at the end of each year. Our confidence in the management of Lindsey Morden has been fully justified and we feel the company has developed excellent momentum, thanks to Ken Polley, Don Smith, Don Cain and Ferd Roibas, the new Vice President, Finance. We really appreciate the efforts of Don Cain who came out of retirement to help turn around the Canadian operations and has headed back to Fredericton after a job well done.

In 1996 Lindsey Morden's revenue increased 5% to \$162.3 million while net income after taxes increased 9% to \$4.4 million. Return on average shareholders' equity in 1996 remained at the 1995 level of approximately 11%. Lindsey Morden's financial position strengthened considerably with the debt to equity ratio dropping to 0.31:1 from 0.52:1 at year-end 1995. Lindsey Morden is on its way to providing excellent returns for its shareholders.

For further information on Lindsey Morden, please read the annual report - available by phoning Doreen Brown at (416) 362-6762.

### **Investment management**

1996 was an exceptional year on an absolute and relative basis for Canadian equities and bonds. Not surprisingly, our U.S. equity results did not keep pace with the explosive U.S. market. However, as shown below, on a long term basis the partners of Hamblin Watsa Investment Counsel have produced excellent results in all of the areas in which they provide investment management - Canadian equities, U.S. equities, Canadian bonds, U.S. bonds and balanced funds.

Please note the U.S. bond results which we have disclosed for the first time. Brian Bradstreet, who manages our Canadian and U.S. bonds, has done an exceptional job in both countries. Brian Bradstreet, Frances Burke, Tony Hamblin, Roger Lace and I have worked together for more than 20 years and are responsible for the results shown below.

*Annualized rates of return (%)*

*Cumulative periods ended December 31, 1996*

..	<b>5 years</b>	<b>10 years</b>	<b>15 years</b>
Canadian Equities	18.0	14.7	16.3
TSE 300	13.9	10.0	11.3
U.S. Equities	29.9	21.8	19.2
S&P 500	19.2	15.2	17.9
Canadian Bonds	15.5	12.1	-
SM Index	11.0	11.0	-
U.S. Bonds	9.8	11.2 *	-
ML Index	6.3	8.4 *	-
Balanced Fund	17.8	15.2	-

\* 8 years

*Source: Representative balanced fund managed by HWIC for twelve years. Equity results for an additional three years are from the organization for which the principals previously worked.*

Incentive fees were earned from some clients as HWIC met the 1996 test for all funds but not the long term test (i.e. results from incentive fee inception date) for some clients. Total fees in 1996 increased to a record \$10.1 million from \$5.3 million in 1995 mainly because of incentive fees (\$3.0 million), the addition of Odyssey Re (\$1.3 million) and the rising markets. With the addition of Odyssey Re, HWIC has reduced its average base fee (before incentive fees) paid by Fairfax insurance subsidiaries from 0.17% of assets to a flat fee of 0.15% of assets. For more details of HWIC fees, please read the 1994 Annual Report. Fairfax earned a 35% pre-tax cash return in 1996 on its \$14 million investment in HWIC. On a cumulative basis, since 1992 Fairfax has earned a pre-tax cash return of 107% on its investment while revenues have increased from \$3.7 million in 1992 to \$10.1 million in 1996.

We welcome Jean Ouellet, who joined HWIC in early 1997 to manage CTR's non-North American bond portfolios.

### **Financial position**

As in previous reports, we feel our unaudited balance sheet with Lindsey Morden equity accounted (shown on page x) is the best way to understand our financial position.

Here is what our year-end financial position looks like compared to the end of 1995.

	(\$ millions)	
	<b>1996</b>	<b>1995</b>
Cash and short term investments	101.1	70.4
Bank debt	-	-
Long term debentures	470.5	298.0
Net debt	369.4	227.7
Common shareholders' equity	911.1	472.6
Net debt/equity	41%	48%
Net debt/total capital	29%	33%

As shown, common shareholders' equity, our capital, increased by \$438.5 million - \$288.3 million net from the two stock issues and \$150.8 million from net income less \$0.6 million used to purchase 3,500 shares at \$160 per share. The long term debentures increased because of the US\$125 million debenture issue in April 1996. Our cash position in the holding company (i.e. Fairfax) increased to \$101.1 million from \$70.4 million at the end of 1995. This excludes the cash raised for the acquisition of CTR which was invested in Wentworth pending the closing (note our unconsolidated balance sheet on page **x**). Our net debt (i.e. long term debentures less cash) to equity ratio dropped to 41% from 48% last year and our net debt to total capital ratio dropped to 29% from 33% last year. Including CTR, which closed in February 1997, our net debt to equity ratio at year-end 1996 would have dropped to 46% and our net debt to total capital ratio to 31%. So in spite of two significant purchases in 1996, we improved our financial ratios (and built a \$193 million negative goodwill cushion).

Also, we have increased our unused, unsecured, committed, long term bank lines to \$600 million (from \$215 million) from eight major banks - four Canadian, three U.S. and one European. Just three years ago we had only \$75 million in bank lines. As emphasized repeatedly in the past, these are unused bank lines which, for a low standby cost, provide us flexibility on an emergency basis - we have not and will not use them to make an acquisition. We also have letter of credit (LOC) facilities in excess of \$70 million for use in the ordinary course of our insurance businesses.

Our financial position continues to be very strong for the same reasons that we discussed in our 1995 Annual Report. Briefly they are:

- 1) We have no bank debt. Our debt consists of three public debentures with a long term to maturity (7 years, 19 years and 30 years) and low interest rates (7: %, 83% and 83% respectively), and a small seven year 7: % debenture issued to a vendor. All of this debt was issued under a single trust indenture containing a covenant package that provides us with great flexibility. Late in the year we decided to swap the fixed interest rate on the 30 year debenture issue into floating rates, saving approximately 120 basis points currently. On closing CTR in February 1997, we issued a 22% ten year French franc debenture.
- 2) We have unused, unsecured, committed, long term bank lines of \$600 million with excellent

covenants. In addition, we have LOC facilities in excess of \$70 million.

- 3) Our net long term debt is less than three times our earnings base. Also, our earnings base is well diversified between many insurance and reinsurance companies, Lindsey Morden, HWIC, and Canadian, U.S. and, through CTR, non-North American streams of income.
- 4) Available cash flow at the Fairfax (holding company) level from dividends, management fees and interest covers our expenses (administrative and interest) by about two times. This is based on normal dividend payouts from our insurance companies (and effectively none from our reinsurance companies) which is much less than our maximum dividend-paying capacity. Note Fairfax's parent company-only income statement on page x.
- 5) With \$101 million in cash in the holding company, we can pay our administrative and interest expenses at Fairfax, with *no* dividends from any of our insurance or reinsurance companies, for four to five years - a management holding company survival ratio, if you will!
- 6) As discussed in the MD&A, our insurance companies are all over-capitalized with large solvency margins in excess of mandated regulatory levels.
- 7) Our foreign exchange exposure from Ranger and Odyssey Re has been fully hedged by the U.S. debenture issues and the purchase of foreign exchange contracts. We have also hedged our expected U.S. dollar income for the next five years with the purchase of additional foreign exchange contracts, as disclosed in note 12. During 1996 we were able to take advantage of collapsing Canadian/U.S. interest rate spreads in the three to five year area and realize \$6.7 million in profits by extending the term of our contracts to ten years. Our French franc exposure from CTR has also been fully hedged together with our estimated French franc net income over the next three to five years (note 12).

### Investments

1996 was an excellent year for the financial markets, particularly the Canadian and U.S. stock markets. This resulted in a record year for realized gains and a very significant increase in unrealized gains as shown below:

	(\$ millions)	
	<b>1996</b>	<b>1995</b>
Bonds	26.9	21.7
Preferred stocks	19.0	5.7
Common stocks	<u>81.2</u>	<u>(12.9)</u>
	<u>127.1</u>	<u>14.5</u>

Even though they are substantial, I would de-emphasize the unrealized gains as they can easily

disappear if the markets decline. However, our realized gains of \$131 million were almost twice the record \$72 million realized in 1995 - you probably thought we had run out of ammunition! Realized gains are totally unpredictable but we purchase stocks with the intention of making significant gains in the long term - sometimes they come a little sooner! Since we began in 1985, we have realized cumulative gains of \$286 million or \$27 per share pre-tax. The \$131 million in gains in 1996 consisted of \$43 million from bonds, \$69 million from stocks, \$11 million from the sale of Ranger County Mutual (a largely inactive subsidiary of Ranger Insurance Company), and almost all the remaining \$8 million from the sale of foreign exchange contracts.

The \$69 million realized from stocks is about a 15% return on an average common stock portfolio of approximately \$447 million - about 7% (forgetting dividends) above the 8% interest income we could have obtained if it was all invested in bonds.

The table on page x shows the returns on our investment portfolios. Investment income (interest and dividends) has increased dramatically because of the Odyssey Re portfolio. Pre-tax investment income per share has increased from \$10.00 in 1995 to \$15.42 in 1996. Since the 87¢ per share generated in 1985, pre-tax investment income per share has compounded at 30% annually. Investment income per share will increase again in 1997 because of the CTR acquisition.

In our 1994 Annual Report, we mentioned the Canadian government's intention to tax unrealized stock gains in financial institutions' investment portfolios annually. We said, "We believe this is seriously wrong in principle and unjustly harmful both to the companies affected and the operation of the capital markets. We have come across no other country in the world that taxes unrealized gains, and consider this to be a significant disincentive (if passed into law) to long term capital investment in Canada by financial institutions. We hope that sanity will prevail as our government begins to recognize the importance of encouraging investors to make substantial long term capital commitments to Canadian enterprises." Well, sanity did not prevail and we will be paying cash taxes of approximately \$24 million in 1997 on unrealized capital gains on Canadian common and preferred stocks at year-end 1996 of \$55 million.

Gross realized gains totalled \$143.7 million. After realized losses of \$4.8 million and increased provisions of \$7.6 million, net realized gains were \$131.3 million. The major contributors to realized gains were Salomon Inc. (\$8.5 million), Trizec Hahn (\$8.0 million), Sears (\$7.6 million), Royal Bank (\$6.5 million), American Express (\$5.3 million), Bank of Montreal (\$4.5 million), Mercury General (\$3.6 million), E-L Financial (\$3.5 million), AIG (\$3.4 million), Toronto-Dominion Bank (\$2.6 million), Canadian Tire (\$2.3 million), Trilon (\$2.2 million) and Canadian Gypsum (\$1.2 million).

Last year we made the point that it was getting increasingly difficult to identify good long term values in the U.S. while we could find them abundantly in Canada. With both markets up significantly in 1996, we are now finding it very difficult to identify long term values in both markets. For the first

time since Fairfax's inception in 1985, we are becoming concerned about the overall stock market environment. The S&P 500 is selling at a very high P/E of approximately 18 times, exceeded in only four years since WWII (1962, 1991, 1992, 1993). With a 2% yield and long term growth in earnings per share of only 7%, the S&P 500 can provide a return of only 9% in the next decade if the current extremely high P/E ratios are maintained. If corporate earnings were to stumble, interest rates rise or P/E ratios contract, the performance of stocks could be extremely disappointing. We don't think we are being unduly pessimistic in surmising that recent extraordinary historical rates of return in U.S. equities cannot be sustained. While Canadian equities may have a little way to go, the same logic applies.

Investors with a long term perspective may be interested in knowing that the July 1996 article in *Reader's Digest*, entitled "You Can Make A Million" and extolling the virtues of long term investing in the stock market, was almost identical to the article in the August 1929 issue of the *Ladies Home Journal* entitled "Everybody Ought to be Rich". While we do not disagree with this thesis, it appears to us to be a classic example of a sound concept rendered unsound by mindless overuse and total disregard for prices paid. The explosion in U.S. mutual funds ( from 161 in 1960 to 4,764 in 1996), the proliferation of U.S. investment clubs (4,000 in 1981 to 24,000 currently) and record IPOs are all indications of a frothy market. According to the July 19, 1996 issue of *Grant's Interest Rate Observer*, "In the 20 years immediately following publication of "Everybody Ought to be Rich", big cap stocks returned 3.1% a year." *Grant's* continues, in the same issue, "The return of one's money, the humblest investment attribute in good times, is always prized in bad times." With many warning lights flashing, we are being more cautious than usual in making any new stock investments.

At the end of 1996 we had approximately \$507 million (\$48 per share) or 15% of our \$3.5 billion investment portfolios in common stock. As a percentage of our investment portfolios or as a percentage of common shareholders' equity, our common stock holdings are currently at close to their lowest relative levels in the past eleven years. Of the \$507 million in common stock, \$377 million is invested in Canadian common stock and \$130 million in U.S. common stock. Of this amount, \$121 million is invested in industrial products companies, \$120 million in financial services companies, \$112 million in consumer product companies, \$66 million in natural resource companies and \$88 million in other miscellaneous categories.

Last year I mentioned that Paul Fink and Chandran Ratnaswami are reviewing international insurance and common stock investments for us. In 1996 we began investing outside of North America - mainly through value-oriented managers with good long term records.

Our "nuclear bomb" testing on insurance regulatory capital of a simultaneous decline of 50% in our common stock holdings, 30% in our preferred stock holdings and 20% in our bond holdings continues on a monthly basis. While all our insurance and reinsurance companies met this test, we

have decided to buy a 'put' at Odyssey Re similar to the one purchased in 1995 for Lombard. We consider the cost of this put (US\$1 million) to be cheap insurance if the nuclear bomb were to explode!

We have added to our small real estate investments with the purchase of an 80% interest in a warehouse building in Toronto for a net investment of \$5.0 million. We expect to receive an income return in excess of 10% with some possible long term appreciation. We made the investment because we liked our partner who is managing the property.

### **Miscellaneous**

In 1996 Fairfax and its subsidiaries donated approximately \$1.6 million (about 1% of pre-tax income) to over 300 charities in North America. Our individual companies make a significant percentage of these donations, and Fairfax makes the rest.

Please review page x which is an unaudited, unconsolidated balance sheet on an equity accounted basis showing you where your money is invested. The table shows our investment in Odyssey Re at \$390 million - approximately \$118 million below its underlying book value. The increased investment in Wentworth is because we are financing CTR through Wentworth even though CTR will be grouped with Odyssey Re for management purposes. Excluding Odyssey Re and Wentworth, we have \$718.0 million invested in our insurance companies, \$30.3 million in Lindsey Morden, \$8.2 million in HWIC and \$101.1 million in cash. Our insurance companies and Lindsey Morden are shown at their underlying book value, i.e. very conservatively valued. In case you missed Noro Inc., that means "No Return On Investment" (courtesy of John Varnell). This is the subsidiary that owns a plane we purchased in February 1996 for US\$1.8 million. Another indicator of irrational exuberance!

You may have again missed that dividend that we paid you in 1996. By purchasing 3,500 shares at \$160 per share for a total cost of \$0.6 million, we indirectly gave you a dividend of 64 per share. You can't live on Fairfax's dividends though! We always consider investing in our stock first (i.e. stock buybacks) before making any acquisitions.

Since we began in 1985, eleven years ago, our book value has compounded at 40.4% annually while our stock price has compounded at 50.4%. During some portions of that period, the reverse has happened: our book value compounded at a rate higher than our stock price. In the long run, these rates should converge. While we are very grateful for the past, rest assured it won't help you in the future. Our objective continues to be to achieve a 20% return on shareholders' equity in the future, retain all earnings and compound book values at 20% annually - about half of what we have achieved in the past eleven years.

Our return on average shareholders' equity over the past eleven years has averaged 20.4%, slightly

in excess of our target of 20%. In case you think this is an easy bogey, the TSE 300 averaged 7.7% over the same period. In the July 1996 issue of Report on Business Magazine, Fairfax's five year return on equity was ranked 79th out of the top 1,000 companies listed on Canadian stock exchanges, i.e. in the top 7-8% of all companies in Canada. Our own analysis indicates that our ten year ROE (ending December 1995) ranks 7th out of all the TSE 300 companies. So achieving 20% is not going to be easy but it continues to be our objective.

Two further points on our record. We have an employee share purchase plan that allows employees to contribute up to 10% of their salary and the company matches 30% automatically with a further 20% if Fairfax achieves its 20% ROE objective. You will be interested to know that if an employee, at a salary of only \$20,000, had participated fully in the plan over the nine years of its existence, he or she would have approximately 775 shares worth \$225,000 at the end of 1996. You know why many of our employees have smiles on their faces! All our companies have high employee participation rates in our plan and we continue to encourage our employees to think long term. We like our employees to be owners of our company and this plan is a great way to do it. Lest you non-employee shareholders are concerned, Fairfax shares are purchased in the market and not from the treasury.

The second point on our record leads me to corporate governance. There is much discussion in the media about corporate governance, board composition, etc., etc. Also there has been some negative press about dual voting share structures. I must say that a major reason for Fairfax's track record is its small, non-bureaucratic board and its share structure that together allow us to be entrepreneurial and react quickly to opportunities, and to take the long view and not be worried about stock market fluctuations. In the past 18 months, we have seen two excellent companies in the oil industry, Nowasco and Morrison Petroleum, be taken over because their share prices were temporarily low and vulnerable to hostile takeovers. Management at both companies have served shareholders well over the long term and probably would have benefitted from a dual voting structure. While there are many abuses of this share structure, as far as Fairfax is concerned it is a big plus! Please read the proxy circular for additional information on corporate governance at Fairfax.

Our company is run for the long term and over time has attracted shareholders with a long term horizon. During 1996, 2.5 million shares of Fairfax were traded on the TSE or approximately 25% of the float. When compared to all companies on the TSE 300, Fairfax's turnover (shares traded as a percentage of the float) continues to be ranked in the bottom 10%. Long term shareholders are reminded to note the section on Issues and Risks on page x that lists the risks that Fairfax faces. Caveat emptor!

We had an excellent annual meeting last year at the old Toronto Stock Exchange building - many of you came and your questions benefitted all shareholders. In order to provide more space this year,

the meeting will be held at 4:30 p.m. on April 16, 1997 in Room 105 at the Metro Toronto Convention Centre. We hope to see as many of you there as possible, including some of our newer shareholders.

Again, on your behalf, I would like to thank the board and the management and employees of all our companies for an outstanding year.

February 28, 1997

V. Prem Watsa

*Chairman and  
Chief Executive Officer*

February 5, 1997

### **Auditors' Report to the Shareholders**

We have audited the consolidated balance sheets of Fairfax Financial Holdings Limited as at December 31, 1996 and 1995 and the consolidated statements of earnings, retained earnings and changes in cash resources for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 1996 and 1995 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

Coopers & Lybrand  
Chartered Accountants  
Toronto, Ontario

February 5, 1997

### **Valuation Actuary's Report**

Coopers & Lybrand has valued the policy liabilities of the subsidiary insurance companies of Fairfax Financial Holdings Limited in its consolidated balance sheet at December 31, 1996 and their change as reflected in its consolidated statement of earnings for the year then ended in accordance with accepted actuarial practice except as described in the following paragraph.

Under accepted actuarial practice, the valuation of policy liabilities reflects the time value of money. Management has chosen not to reflect the time value of money in the valuation of its policy liabilities. Our valuation complies with that policy.

In our opinion the valuation is appropriate, except as noted in the previous paragraph, and the consolidated financial statements fairly present its results.

Coopers & Lybrand  
Richard Gauthier, FCIA, FCAS  
Toronto, Ontario

**Consolidated Financial Statements**  
for the years ended December 31, 1996 and 1995

**Consolidated Balance Sheets**  
as at December 31, 1996 and 1995

	1996 (\$000)	1995 (\$000)
<b>Assets</b>		
Cash and short term investments .....	101,067	70,354
Accounts receivable .....	626,245	400,153
Recoverable from reinsurers .....	1,258,899	523,783
Claims in process .....	15,029	15,390
Income taxes refundable .....	16,288	18,530
Prepaid expenses .....	<u>15,273</u>	<u>12,575</u>
	<u>2,032,801</u>	<u>1,040,785</u>
<i>Portfolio investments (note 3)</i>		
Subsidiary cash and short term investments (market value - \$513,205; 1995 - \$256,677) .....	513,205	256,677
Bonds (market value - \$2,151,569; 1995 - \$821,244) .....	2,124,620	799,507
Preferred stocks (market value - \$201,239; 1995 - \$160,298) .....	182,229	154,646
Common stocks (market value - \$588,128; 1995 - \$357,722) .....	506,939	370,639
Real estate (market value - \$26,461; 1995 - \$16,268) .....	<u>26,461</u>	<u>16,268</u>
Total (market value - \$3,480,602; 1995 - \$1,612,209) .....	<u>3,353,454</u>	<u>1,597,737</u>
Deferred premium acquisition costs .....	145,496	101,773
Deferred income taxes .....	134,824	34,163
Capital assets (note 4) .....	40,915	33,763
Goodwill .....	43,758	46,449
Other assets .....	<u>27,141</u>	<u>18,878</u>
	<u>5,778,389</u>	<u>2,873,548</u>

Signed on behalf of the Board

Director

Director

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Liabilities</b>		
Bank indebtedness (note 5).....	2,394	7,621
Accounts payable and accrued liabilities .....	220,009	154,136
Premium deposits .....	<u>43,674</u>	<u>10,929</u>
	<u>266,077</u>	<u>172,686</u>
Provision for claims (note 8) .....	3,405,173	1,327,137
Unearned premiums .....	688,009	572,016
Long term debt (note 6) .....	<u>487,038</u>	<u>310,236</u>
	<u>4,580,220</u>	<u>2,209,389</u>
Non-controlling interest.....	<u>21,000</u>	<u>18,919</u>
<b>Shareholders' Equity</b>		
Capital stock (note 7).....	513,420	225,295
Retained earnings .....	<u>397,672</u>	<u>247,259</u>
	<u>911,092</u>	<u>472,554</u>
	<u>5,778,389</u>	<u>2,873,548</u>

**Consolidated Statements of Earnings**  
for the years ended December 31, 1996 and 1995

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Revenue</b>		
Premiums earned .....	1,030,888	829,340
Claims fees .....	162,266	154,914
Interest and dividends (note 3) .....	151,387	89,354
Realized gains on investments (note 3) .....	<u>131,274</u>	<u>71,912</u>
	<u>1,475,815</u>	<u>1,145,520</u>
<b>Expenses</b>		
Losses on claims .....	753,777	614,059
Operating expenses .....	336,880	304,969
Interest expense .....	36,554	21,171
Commissions, net .....	<u>161,291</u>	<u>109,404</u>
	<u>1,288,502</u>	<u>1,049,603</u>
<b>Earnings before income taxes</b> .....	187,313	95,917
Provision for income taxes (note 10) .....	<u>34,360</u>	<u>6,455</u>
Earnings from operations .....	152,953	89,462
Non-controlling interest .....	<u>(2,133)</u>	<u>(1,965)</u>
<b>Net earnings</b> .....	<u>150,820</u>	<u>87,497</u>
<b>Net earnings per share</b> (note 14) .....	\$15.36	\$9.79

**Consolidated Statements of Retained Earnings**  
for the years ended December 31, 1996 and 1995

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Retained earnings - beginning of year</b> .....	247,259	164,146
Net earnings for the year .....	150,820	87,497
Excess over stated value of shares purchased for cancellation (note 7) .....	<u>(407)</u>	<u>(4,384)</u>
<b>Retained earnings - end of year</b> .....	<u>397,672</u>	<u>247,259</u>

**Consolidated Statements of Changes in Cash Resources**  
for the years ended December 31, 1996 and 1995

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Operating activities</b>		
Earnings from operations .....	152,953	89,462
Amortization .....	13,565	12,699
Deferred income taxes .....	5,224	(805)
Gains on investments .....	<u>(131,274)</u>	<u>(71,912)</u>
	40,468	29,444
Increase (decrease) in provision for claims .....	56,635	(9,019)
Increase in unearned premiums .....	19,926	14,215
Decrease in cash funds resulting from changes in other operating working capital items .....	<u>(38,156)</u>	<u>(36,246)</u>
Cash resources provided by (used in) operating activities	<u>78,873</u>	<u>(1,606)</u>
<b>Investing activities</b>		
Investments - sales .....	29,896	9,576
Purchase of capital assets .....	(18,317)	(13,200)
Purchase of subsidiary, net of cash acquired .....	<u>(262,452)</u>	<u>-</u>
	<u>(250,873)</u>	<u>(3,624)</u>
<b>Financing activities</b>		
Capital stock transactions (note 7) .....	287,718	(6,892)
Increase in long term debt (note 6) .....	176,802	69,742
Change in non-controlling interest .....	<u>(52)</u>	<u>(361)</u>
	<u>464,468</u>	<u>62,489</u>
<b>Increase in cash resources</b> .....	292,468	57,259
<b>Cash resources - beginning of year</b> .....	<u>319,410</u>	<u>262,151</u>
<b>Cash resources - end of year</b> .....	<u>611,878</u>	<u>319,410</u>

*Cash resources consist of cash and short term investments including subsidiary cash and short term investments less bank indebtedness.*

**Notes To Consolidated Financial Statements**

for the years ended December 31, 1996 and 1995

(in \$000s except per share amounts and as otherwise indicated)

**1. Summary of Significant Accounting Policies**

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as at the date of the financial statements.

Estimates also affect the reported amounts of income and expenses for the reporting period of the statement of earnings. Actual results could differ from those estimates.

*Business operations*

The company is a financial services holding company which through its subsidiaries and affiliates is engaged in the insurance of commercial and personal property, oil and gas, casualty and life risks, property and casualty reinsurance, investment management and the provision of claims adjusting, appraisal and loss management services in Canada and the United States.

*Principles of consolidation*

The consolidated financial statements include the accounts of the company and all of its subsidiaries: Markel Insurance Company of Canada, Federated Insurance Holdings of Canada Ltd., Commonwealth Insurance Company, Wentworth Insurance Company Ltd., Ranger Insurance Company, Lombard General Insurance Company of Canada, CRC (Bermuda) Reinsurance Limited, Odyssey Reinsurance Corporation and Hamblin Watsa Investment Counsel Ltd., all 100% owned; and Lindsey Morden Group Inc., 57% equity and 92% voting interest. Acquisitions are accounted for by the purchase method, whereby the results of acquired companies are included only from the date of acquisition. Divestitures are included up to the date of disposal.

*Premiums*

Insurance premiums and reinsurance premiums are taken into income evenly throughout the terms of the related policies. As premium deposits secure the payment of premiums and are refundable, they are not taken into income unless default in payment of premiums occurs.

*Claims in process*

The company records its inventory of claims in process at its estimated value at year-end, based on a determination of the claims in process at year-end through a complete physical count of related files.

Claims adjustment fees arising therefrom are accounted for on an estimated percentage-of-completion basis.

*Deferred premium acquisition costs*

Acquisition costs consist of brokers' commissions and premium taxes. The costs incurred in acquiring insurance premiums are deferred, to the extent that they are considered recoverable, and amortized over the same period as the related premiums are taken into income.

*Investments*

Bonds are carried at amortized cost providing for the amortization of the discount or premium on a straight line basis to maturity. Bonds are classified at the earliest of the available maturity dates. Preferred and common stocks are carried at cost. Real estate is recorded at book value. When there has been a loss in value of an investment that is other than temporary, the investment is written down to its estimated net realizable value. Such writedowns are reflected in realized gains (losses) on investments. At December 31, 1996 the aggregate provision for losses on investments was \$16.5 million (1995 - \$8.9 million).

*Investment income*

Investment income is recorded as it accrues. Dividends are recorded as income on the record date. Gains and losses realized on the disposal of investments are taken into income on the date of disposal.

*Provision for claims*

Claim provisions are established by the case method as claims are reported. For reinsurance, the provision for claims is based on reports and individual case estimates received from ceding companies. The estimates are regularly reviewed and updated as additional information on the estimated claims becomes known and any resulting adjustments are included in income. A provision is also made for management's calculation of factors affecting the future development of claims including claims incurred but not reported (IBNR) based on the volume of business currently in force and the historical experience on claims.

*Translation of foreign currencies*

Assets and liabilities in foreign currencies are translated into Canadian dollars at year-end exchange rates. Income and expenses are translated at the exchange rates in effect at the date incurred. Realized gains and losses on foreign exchange are recognized in the statements of earnings.

The operations of the company's subsidiaries in the United States are self-sustaining. As a result, the assets and liabilities of these subsidiaries are translated at the year-end rates of exchange. Revenue and expenses are translated at the average rate of exchange for the years. The unrealized gains and losses, if material, which result from translation are deferred and included in shareholders' equity under a caption "currency translation adjustment".

The company enters into foreign currency contracts from time to time to hedge the foreign currency exposure related to its net investments in self-sustaining foreign operations. Such contracts are

translated at the year-end rates of exchange and a corresponding adjustment, if material, will be included in the currency translation adjustment account in shareholders' equity.

#### *Goodwill*

The excess of purchase cost over the fair value of the net assets of acquired businesses is amortized on a straight line basis over their estimated useful life which ranges from 10 years for Hamblin Watsa Investment Counsel Ltd. and Ranger Insurance Company to 40 years for Lindsey Morden Group Inc. The company assesses the continuing value of goodwill based on the underlying cash flows and operating results of the subsidiaries.

#### *Reinsurance*

The company reflects third party reinsurance balances on the balance sheet on a gross basis to indicate the extent of credit risk related to third party reinsurance and its obligations to policyholders and on a net basis in the statement of earnings to indicate the results of its retention of premiums written.

## **2. Change in Accounting Policy**

Effective January 1, 1996, the company adopted the provisions of the new CICA presentation and disclosure standards for financial instruments. This change, with respect to the presentation of third party reinsurance, has been applied retroactively with the result that amounts recoverable from third party reinsurers of \$523,783 at December 31, 1995 are disclosed separately on the balance sheet, corresponding adjustments are made to provision for claims (\$414,482), unearned premiums (\$140,483) and deferred premium acquisition costs (\$16,914), and there is a net reduction in accounts payable related to other balances with reinsurers (\$14,268).

## **3. Investment Information**

		<b>1996</b>		<b>1995</b>	
		<b>Book</b>	<b>Estimated</b>	<b>Book</b>	<b>Estimated</b>
		<b>Value</b>	<b>Fair Value</b>	<b>Value</b>	<b>Fair Value</b>
		<b>(\$000)</b>	<b>(\$000)</b>	<b>(\$000)</b>	<b>(\$000)</b>
Subsidiary cash and short					
term investments	513,205	513,205	256,677	256,677	
Bonds					
Canadian	- government	498,843	499,707	406,649	406,206
	- corporate	154,559	166,631	104,262	111,578
Foreign	- government	450,639	447,902	76,485	77,511
	- corporate	1,020,579	1,037,329	212,111	225,949
Preferred stocks					
Canadian		177,437	195,943	154,646	160,298
Foreign		4,792	5,296	-	-
Common stocks					
Canadian		376,711	431,224	284,871	265,301
Foreign		130,228	156,904	85,768	92,421
Real estate		26,461	26,461	16,268	16,268
		<u>3,353,454</u>	<u>3,480,602</u>	<u>1,597,737</u>	<u>1,612,209</u>

The estimated fair values of preferred and common stocks and debt securities are based on quoted market values. The book value of real estate approximates fair value.

Management has reviewed currently available information regarding those investments whose estimated fair value is less than book value, amounting to an aggregate unrealized loss of \$42 million, and ascertained that the book values are expected to be recovered. Debt securities whose book value exceeds market value can be held until maturity. Preferred and common stock investments have been reviewed to ensure that corporate performance expectations have not changed significantly to adversely affect the market value of these securities other than on a temporary basis.

### Liquidity and interest rate risk

Maturity profile as at December 31, 1996

	<b>Within 1 Year (\$000)</b>	<b>1 to 5 Years (\$000)</b>	<b>6 to 10 Years (\$000)</b>	<b>Over 10 Years (\$000)</b>	<b>Book Value (\$000)</b>
Bonds	139,146	510,352	1,296,266	178,856	<u>2,124,620</u>
Effective interest rate					<u>6.2%</u>

### Investment Income

	<b>1996 (\$000)</b>	<b>1995 (\$000)</b>
Interest and dividends:		
Cash and short term investments		13,887
Bonds 111,311		12,997
Preferred stocks		60,819
Common stocks		11,401
164,852	<u>28,253</u>	<u>11,949</u>
Expenses		10,054
<u>151,387</u>	<u>(13,465)</u>	<u>(6,465)</u>
Gain on sale of investments:		
Bonds 43,101		89,354
Preferred stocks		31,603
Common stocks		110
Other 26,737		201
Provision for loss		68,936
<u>131,274</u>	<u>(7,610)</u>	<u>45,300</u>
Net investment income		161,266
	<u>282,661</u>	<u>161,266</u>

<b>4. Capital Assets</b>	<b>1996</b>	<b>1995</b>
	(\$000)	(\$000)
Land and buildings	5,363	5,302
Furniture and equipment	68,646	55,924
Leasehold improvements	19,280	9,582
Transportation	<u>3,847</u>	<u>968</u>
	97,136	71,776
Accumulated amortization	<u>56,221</u>	<u>38,013</u>
	<u>40,915</u>	<u>33,763</u>

Amortization for the year was \$11,165 (1995 - \$9,269).

#### 5. Bank Indebtedness

Bank indebtedness is \$2,394 (1995 - \$7,621) for which a general assignment of accounts receivable and claims in process of subsidiaries of Lindsey Morden Group Inc. have been pledged as security. Interest expense on bank indebtedness amounted to \$583 (1995 -\$1,200).

#### 6. Long Term Debt

The long term debt at December 31 consists of the following balances:

..	<b>1996</b>	<b>1995</b>
	(\$000)	(\$000)
Fairfax unsecured senior notes of US\$100 million at 7.75% due December 15, 2003	137,060	136,520
Fairfax unsecured senior notes of US\$100 million at 8.25% due October 1, 2015	137,060	136,520
Fairfax unsecured senior notes of US\$125 million at 8.30% due April 15, 2026 *	171,325	-
Fairfax unsecured senior note at 7.75% due December 15, 2003	25,000	25,000
Long term debt of Lindsey Morden Group Inc. at an average annual rate of 8.02% during 1996 (1995 - 8.01%)	<u>16,593</u>	<u>12,196</u>
	<u>487,038</u>	<u>310,236</u>

\* In 1996, the company entered an interest rate swap agreement on its debt due in 2026 whereby it now pays interest on this debt at LIBOR plus 148 basis points.

Interest expense on long term debt amounted to \$35,971 (1995 - \$19,971).

Principal repayments on these loans are due as follows:

	(\$000)
1997	1,275
1998	154
1999	1,355
2000	2,032
2001	2,032
Thereafter	<u>481,465</u>
	488,313
Less: current portion	<u>1,275</u>
	<u>487,038</u>

## 7. Capital Stock

### *Authorized capital*

The authorized share capital of the company consists of an unlimited number of preferred shares issuable in series, an unlimited number of multiple voting shares carrying ten votes per share and an unlimited number of subordinate voting shares carrying one vote per share.

### *Issued capital*

	1996		1995	
	<i>number</i>	(\$000)	<i>number</i>	(\$000)
Subordinate voting shares	9,717,158	527,442	8,120,658	239,317
Multiple voting shares	<u>1,548,000</u>	<u>5,000</u>	<u>1,548,000</u>	<u>5,000</u>
	11,265,158	532,442	9,668,658	244,317
Interest in shares held through ownership interest in shareholder	<u>(799,230)</u>	<u>(19,022)</u>	<u>(799,230)</u>	<u>(19,022)</u>
Net effectively outstanding	<u>10,465,928</u>	<u>513,420</u>	<u>8,869,428</u>	<u>225,295</u>

On March 26, 1996 the company issued 1,100,000 subordinate voting shares at \$155 per share, for net proceeds of \$163,596, and on October 3, 1996 issued 500,000 subordinate voting shares at \$260 per share, for net proceeds of \$124,682. In 1996, under the terms of a normal course issuer bid approved by The Toronto Stock Exchange, the company purchased and cancelled 3,500 subordinate voting shares for an aggregate cost of \$560, of which \$407 was charged to retained earnings.

In 1995, under the terms of a normal course issuer bid approved by The Toronto Stock Exchange, the company purchased and cancelled 85,100 subordinate voting shares for an aggregate cost of \$6,892, of which \$4,384 was charged to retained earnings.

## 8. Provision for Claims

The provision for unpaid claims and adjustment expenses and the third party reinsurers' share are estimates subject to variability, and the variability could be material in the near term. The variability arises because all events affecting the ultimate settlement of claims have not taken place and may not take place for some time. Variability can be caused by receipt of additional claim information, changes in judicial interpretation of contracts or significant changes in severity or frequency of claims from historical trends. The estimates are principally based on the company's historical experience. Methods of estimation have been used which the company believes produce reasonable results given current information.

Changes in claim liabilities recorded on the balance sheet for the years ended December 31, 1996 and 1995 and their impact on unpaid claims and adjustment expenses for these two years are as shown in the following table:

..

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
Unpaid claim liabilities - beginning of year - net	965,372	921,675
Increase in estimated losses and expenses for losses occurring in prior years	16,018	56,904
Provision for losses and expenses on claims occurring in the current year	641,519	599,251
Paid on claims occurring during:		
the current year	(253,507)	(253,367)
prior years	<u>(315,640)</u>	<u>(359,091)</u>
Unpaid claim liabilities before reserve indemnification	1,053,762	965,372
Reserve indemnification	<u>(46,600)</u>	<u>(52,717)</u>
Unpaid claim liabilities after reserve indemnification	1,007,162	912,655
Unpaid claim liabilities of Odyssey Re	<u>1,250,589</u>	-
Unpaid claim liabilities - end of year - net	2,257,751	912,655
Reinsurance gross-up	<u>1,147,422</u>	<u>414,482</u>
	<u><b>3,405,173</b></u>	<u><b>1,327,137</b></u>

The basic assumptions made in establishing actuarial liabilities are best estimates of possible outcomes. To recognize the uncertainty in establishing these best estimates, to allow for possible deterioration in experiences, and to provide greater comfort that the actuarial liabilities are adequate to pay future benefits, actuaries are required to include margins (referred to as provisions for adverse development) in some assumptions. A range of allowable margins is prescribed by the Canadian Institute of Actuaries relating to claim development, reinsurance recoveries and

investment income variables. The company presents its claims on an undiscounted basis.

## 9. Reinsurance

The company follows the policy of underwriting and reinsuring contracts of insurance and reinsurance which, depending on the type of contract, limits the liability of the individual insurance and reinsurance companies to a maximum amount on any one loss of \$0.3 to \$4.0 million, varying by line of business. Reinsurance is generally placed on an excess of loss basis in several layers. The company's reinsurance does not, however, relieve the company of its primary obligation to the policyholders.

The company has guidelines and a review process in place to ascertain the creditworthiness of the companies to which it cedes. No information has come to the company's attention indicating weakness or failure of any of its current reinsurers.

During the year, the company ceded earned premiums of \$402,967 (1995 - \$349,932) and \$267,568 (1995 - \$318,789) of claims incurred.

## 10. Income Taxes

The provision for income taxes differs from the statutory marginal rate as certain sources of income are exempt from tax or are taxed at other than the marginal rate.

A reconciliation of income tax calculated at the statutory marginal tax rate with the income tax provision at the effective tax rate in the financial statements is summarized in the following table:

	<b>1996</b>	<b>1995</b>
	<i>(\$000)</i>	<i>(\$000)</i>
Provision for taxes at statutory marginal income tax rate	72,057	41,583
Non-taxable investment income	(15,018)	(8,689)
Income earned outside Canada	(977)	(3,451)
Utilization of prior years' losses and other	<u>(21,702)</u>	<u>(22,988)</u>
Provision for income taxes	<u>34,360</u>	<u>6,455</u>

## 11. Statutory Requirements - Insurance Subsidiaries

The company's insurance subsidiaries are subject to certain requirements and restrictions under their respective insurance company Acts including minimum asset requirements and dividend restrictions.

## 12. Contingencies and Commitments

Subsidiaries of the company are defendants in several damage suits and have been named as third party in other suits. The uninsured exposure to the company is not considered to be material.

The company may under certain circumstances be obligated to purchase loans to officers and directors of the company and its subsidiaries from a Canadian chartered bank totalling \$11,145 (1995 - \$11,135) for which 393,570 (1995 - 399,092) subordinate voting shares of the company with a year-end market value of \$114,135 (1995 - \$39,111) have been pledged as security.

At December 31, 1996 the company had net foreign currency contracts outstanding to sell US\$350,000, primarily to hedge future earnings from U.S. subsidiaries and U.S. portfolio investments of Canadian subsidiaries, as well as FF800 million to hedge its net future investment and future earnings from Compagnie Transcontinentale de Réassurance. At December 31, 1996 the unrealized gain associated with these foreign currency contracts was \$2,652.

## 13. Operating Leases

Aggregate future commitments at December 31, 1996 under operating leases relating to premises, automobiles and equipment for various terms up to ten years are as follows:

	<i>(\$000)</i>
1997	33,600
1998	28,700
1999	22,500
2000	19,300
2001	15,000
Thereafter (in aggregate)	<u>42,900</u>
	<u>162,000</u>

## 14. Earnings per Share

Fully diluted and basic earnings per share are the same in 1996, as they were in 1995. Basic earnings per share are \$15.36 for 1996 and \$9.79 for 1995. The weighted average number of shares for 1996 was 9,817,482 (1995 - 8,933,098).

## 15. Acquisitions

Effective May 31, 1996 the company purchased Odyssey Reinsurance Corporation (then named Skandia America Reinsurance Corporation) of New York, New York. The purchase price was US\$228 million cash. On May 31, 1996 Odyssey Re had US\$1,836 million in total assets and US\$1,522 million in total liabilities, at fair value. The US\$86 million (C\$118 million) excess of the fair value of net assets acquired over the purchase price has been allocated to provision for claims, which will be amortized to income as the underlying claims are paid. The vendor provided a secured indemnification to a maximum of US\$175 million for any inadequacy in Odyssey Re's provision for claims as at December 31, 1995 and any of Odyssey Re's reinsurance relating to the period up to December 31, 1995 which subsequently becomes unrecoverable.

## 16. Segmented Information

The company is a financial services holding company which through its subsidiaries and affiliates is engaged in the insurance of commercial and personal property, oil and gas, casualty and life risks, property and casualty reinsurance, investment management and the provision of claims adjusting, appraisal and loss management services mainly in Canada and the United States.

### (a) Industry segments

	Insurance and Reinsurance		Claims Adjusting, Appraisal and Loss Management		Corporate and Consolidation Adjustments		Consolidated	
	1996 (\$000)	1995 (\$000)	1996 (\$000)	1995 (\$000)	1996 (\$000)	1995 (\$000)	1996 (\$000)	1995 (\$000)
Revenue	1,299,447	985,916	162,266	154,914	14,102	4,690	1,475,815	1,145,520
Earnings before income taxes	202,423	102,920	8,898	8,083	(24,008)	(15,086)	187,313	95,917
Identifiable assets	5,558,727	2,697,496	93,087	96,836	126,575	79,216	5,778,389	2,873,548
Amortization	8,269	7,691	3,906	3,618	1,390	1,390	13,565	12,699
Interest expense	-	-	2,347	2,875	34,207	18,296	36,554	21,171

### (b) Geographic segments

	Canada		United States		Total	
	1996 (\$000)	1995 (\$000)	1996 (\$000)	1995 (\$000)	1996 (\$000)	1995 (\$000)
Revenue	805,207	766,783	670,608	378,737	1,475,815	1,145,520
Earnings before income taxes	77,316	54,640	109,997	41,277	187,313	95,917
Identifiable assets	2,161,056	1,942,116	3,617,333	931,432	5,778,389	2,873,548
Amortization	11,216	10,552	2,349	2,147	13,565	12,699
Interest expense	35,904	20,415	650	756	36,554	21,171

CRC (Bermuda) Reinsurance is included in the Canadian segment and Wentworth Insurance is included in the United States segment.

## 17. Fair Value

Information on the fair values of financial instruments of the company where those values differ from their carrying values in the financial statements at December 31, 1996 include:

..	<b>Note Reference</b>	<b>Book Value (\$000)</b>	<b>Estimated Fair Value (\$000)</b>
Investments	3	3,353,454	3,480,602
Long term debt	6	487,038	502,378
Foreign exchange contracts	12	0	2,652

The amounts do not include the fair value of underlying lines of business. While fair value amounts are designed to represent estimates of the amounts at which instruments could be exchanged in current transactions between willing parties, certain of the company's financial instruments lack an available trading market. Therefore, these instruments have been valued on a going concern basis. Fair value information on the provision for claims is not determinable.

These fair values have not been reflected on the financial statements.

## 18. Subsequent Event

On September 6, 1996 the company announced that it had agreed to purchase Compagnie Transcontinentale de Réassurance (CTR) of Paris, France for FF700 million (approximately \$175 million), of which FF300 million was to be financed by a 10 year 2½% note. At December 31, 1996 CTR had FF4.2 billion (\$1.1 billion) in total assets and shareholders' equity of FF900 million (\$225 million). CTR is an international reinsurer writing property and casualty reinsurance internationally. CTR had gross written premiums exceeding FF2 billion (\$500 million) in 1996. Completion of the purchase is expected in February 1997.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Sources of Revenue

Revenue reflected in the consolidated financial statements includes premiums earned and investment income of the insurance companies, claims adjusting fees of Lindsey Morden and other miscellaneous income. The following table summarizes the total revenue derived from these categories from the date of acquisition of each company for the past five years:

#### Revenue by

#### Line of Business

..	<b>1996</b>	<b>1995</b>	<b>1994</b>	<b>1993</b>	<b>1992</b>
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Insurance	1,299,447	985,916	476,445	201,402	143,915
Claims adjusting	162,266	154,914	156,093	142,105	139,782
Other income	<u>14,102</u>	<u>4,690</u>	<u>2,359</u>	<u>515</u>	<u>3,133</u>
	<u>1,475,815</u>	<u>1,145,520</u>	<u>634,897</u>	<u>344,022</u>	<u>286,830</u>

The increase in insurance revenue in 1996 over 1995 was mainly the result of the May 31, 1996 acquisition of Odyssey Re which resulted in higher insurance premiums and investment income.

On a geographic basis, Canadian operations accounted for approximately 55% of Fairfax's revenue and 41% of operating profits in 1996, compared with approximately 67% of revenue and 57% of operating profits in 1995.

Canadian insurance operations accounted for approximately 56% of Fairfax's insurance premiums in 1996.

## Net Earnings

Sources of net earnings with Lindsey Morden equity accounted were as follows for the past five years:

	<b>1996</b> (\$000)	<b>1995</b> (\$000)	<b>1994</b> (\$000)	<b>1993</b> (\$000)	<b>1992</b> (\$000)
Insurance underwriting	(50,563)	(40,883)	(16,880)	2,065	(16,883)
Interest and dividends	<u>144,101</u>	<u>86,274</u>	<u>53,742</u>	<u>23,006</u>	<u>22,786</u>
Insurance earnings before realized gains	93,538	45,391	36,862	25,071	5,903
Claims adjusting (Fairfax portion)	2,298	2,098	532	395	282
Interest expense	(34,997)	(19,086)	(10,426)	(4,228)	(5,552)
Goodwill and other amortization	(4,765)	(4,765)	(1,392)	(1,392)	(232)
Corporate overhead and other	(6,656)	(5,618)	(2,147)	(2,862)	2,078
Realized gains	<u>131,274</u>	<u>71,912</u>	<u>20,026</u>	<u>27,822</u>	<u>3,400</u>
Pre-tax income	180,692	89,932	43,455	44,806	5,879
Less: taxes	<u>29,872</u>	<u>2,435</u>	<u>5,350</u>	<u>11,466</u>	<u>(4,166)</u>
Net earnings	<u>150,820</u>	<u>87,497</u>	<u>38,105</u>	<u>33,340</u>	<u>10,045</u>

Net earnings in 1996 were \$150.8 million, an increase of \$ 63.3 million or 72% from 1995 net earnings of \$87.5 million.

The major changes which affected net earnings were:

- Insurance earnings before realized gains increased by \$48.1 million from 1995 due to increased interest and dividend income, partially offset by higher underwriting losses
- Net realized gains increased in 1996 to \$131.3 million from \$71.9 million in 1995
- Interest expense increased in 1996 due to higher interest expenses from the debt related to the purchase of Odyssey Re
- Corporate overhead and other increased mainly because of one time expenses associated with the debt and share issues
- The provision for income taxes was higher in 1996 due to the higher pre-tax income partially offset by a greater amount of tax-free Canadian dividend income.

## Insurance Underwriting

Fairfax's insurance companies employ disciplined underwriting practices with the objective of rejecting underpriced risks. The combined loss and expense ratio is the traditional measure of underwriting results of property and casualty companies. In any year when the ratio exceeds 100%, it generally indicates that unprofitable business has been underwritten.

A summary follows of the net premiums written and earned, and the loss, expense and combined ratios, for the past twelve years:

	<u>NET PREMIUMS</u>			<u>RATIOS</u>	
	<b>Written</b> (\$000)	<b>Earned</b> (\$000)	<b>Loss</b> (%)	<b>Expense</b> (%)	<b>Combined</b> (%)
1985	23,415	14,049	96	30	126
1986	55,992	40,885	72	23	95
1987	71,378	62,012	73	25	98
1988	68,224	66,265	73	19	92
1989	35,477	40,444	100	40	140
1990	74,487	78,427	82	31	113
1991	93,450	90,507	60	34	94
1992	128,664	118,854	79	35	114
1993	163,508	150,844	73	26	99
1994	411,570	400,559	74	30	104
1995	864,589	829,340	74	31	105
1996	1,043,079	1,030,888	73	32	105

In 1996 the combined ratio did not improve due to poor results at Ranger. Since current management took over in September 1985 Fairfax has had combined ratios of less than 100% in five of the eleven full years and greater than 100% in the remaining six years.

Net premiums written and earned by company for the past five years are shown in the following table:

		<b>1996</b>	<b>1995</b>	<b>1994</b>	<b>1993</b>	<b>1992</b>
		<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>	<i>(\$000)</i>
Markel	Written	62,576	79,683	55,937	44,896	38,422
	Earned	60,148	56,976	52,149	43,749	33,760
Federated	Written	60,405	57,549	50,396	41,629	38,923
	Earned	59,472	54,297	47,376	40,436	38,776
Commonwealth	Written	87,297	87,875	90,403	71,181	51,319
	Earned	87,770	86,962	86,520	61,855	46,318
Ranger	Written	212,815	180,253	175,410	-	-
	Earned	209,409	173,937	179,345	-	-
Lombard	Written	357,550	351,592	30,727	-	-
	Earned	349,566	352,082	26,869	-	-
CRC (Bermuda)	Written	99,044	92,270	-	-	-
	Earned	97,805	89,252	-	-	-
Odyssey Re	Written	155,044	-	-	-	-
	Earned	158,547	-	-	-	-
Wentworth and other	Written	8,348	15,367	8,697	5,802	-
	Earned	8,171	15,834	8,300	4,804	-
Totals	Written	1,043,079	864,589	411,570	163,508	128,664
	Earned	1,030,888	829,340	400,559	150,844	118,854

Increased competition resulted in a decrease in net premiums written in 1996 at Markel and flat premiums at Commonwealth and Lombard. Federated and Ranger had higher net premiums written in 1996 due to increased market penetration in their respective segments. Wentworth had a significant decrease in net premiums written in 1996 as it benefitted from significant reinstatement premiums in 1995. Odyssey Re results have been included for only seven months.

Net premiums written increased at Markel and Federated in 1995 due to price increases and additional accounts written. Ranger and Lombard were included in Fairfax's income statements for the first time in 1994 - for a year and for one month respectively. CRC (Bermuda)'s premiums written originate mainly from a quota share treaty with Lombard.

The total underwriting profit (loss) for the individual insurance companies for the past five years is shown in the following table:

	<b>1996</b> (\$000)	<b>1995</b> (\$000)	<b>1994</b> (\$000)	<b>1993</b> (\$000)	<b>1992</b> (\$000)
Markel	(1,717)	(1,088)	(7,965)	(5,088)	(5,000)
Federated	(132)	(1,120)	257	(1,320)	(1,294)
Commonwealth	11,435	9,104	1,867	5,126	(9,959)
Ranger	(49,131)	(31,524)	(15,061)	-	-
Lombard	(17,475)	(30,915)	(143)	-	-
CRC (Bermuda)	2,813	6,635	-	-	-
Odyssey Re	(4,881)	-	-	-	-
Wentworth and other	<u>8,525</u>	<u>8,025</u>	<u>4,165</u>	<u>3,347</u>	<u>(630)</u>
Totals	<u>(50,563)</u>	<u>(40,883)</u>	<u>(16,880)</u>	<u>2,065</u>	<u>(16,883)</u>

As shown, in 1996, as well as in 1995, the most significant underwriting loss (in relationship to premiums earned) was incurred at Ranger. Lombard's underwriting loss should be considered together with CRC (Bermuda)'s underwriting profit which includes an additional \$10.9 million underwriting loss from Ranger because of related reinsurance. As discussed in the Chairman's section, management does not expect Ranger's loss to be repeated, and Lombard, including CRC (Bermuda), had a small underwriting profit on a normalized basis. The Wentworth and other underwriting profit includes a \$7.9 million consolidation adjustment related to the Odyssey Re acquisition.

### Provision for Claims

Claim provisions are established by the case method as claims are reported. The provisions are subsequently adjusted as additional information on the estimated amount of a claim becomes known during the course of its settlement. A provision is also made for management's calculation of factors affecting the future development of claims including claims incurred but not reported (IBNR) based on the volume of business currently in force and the historical experience on claims.

As time passes, more information about the claims becomes known and provision estimates are appropriately adjusted upward or downward. Because of the estimation elements encompassed in this process, and the time it takes to settle many of the more substantial claims, several years are required before a meaningful comparison of actual losses to the original provisions can be developed.

The development of the provision for claims is shown by the difference between estimates of reserves as of the initial year-end and the re-estimated liability at each subsequent year-end. This is based on actual payments in full or partial settlement of claims, plus re-estimates of the reserves

required for claims still open or claims still unreported. Favourable development means that the original reserve estimates were higher than subsequently indicated. Unfavourable development means that the original reserve estimates were lower than subsequently indicated.

The following table presents a reconciliation of the provision for claims and loss adjustment expense (LAE) by company for the past five years. As shown in the table, the sum of the provision for claims for each of Fairfax's insurance subsidiaries is \$3,405.2 million as at December 31, 1996 - the amount shown as "Provision for claims" on Fairfax's balance sheet on page X. The >other=> shown in the table below is the \$14 million Fairfax indemnification of Ranger reserves.

..

*Reconciliation of Provision for Claims and LAE as at December 31*

	<b>1996</b> (\$000)	<b>1995</b> (\$000)	<b>1994</b> (\$000)	<b>1993</b> (\$000)	<b>1992</b> (\$000)
Commonwealth, Federated and Markel	244,972	219,406	211,313	185,010	179,588
Lombard	307,877	312,331	311,546	-	-
CRC (Bermuda)	<u>193,270</u>	<u>163,592</u>	<u>150,930</u>	-	-
Total Canadian subsidiaries	<u>746,119</u>	<u>695,329</u>	<u>673,789</u>	<u>185,010</u>	<u>179,588</u>
Wentworth	13,363	12,095	7,659	1,486	6,381
Ranger	210,585	169,017	217,251	235,525	-
Odyssey Re	<u>1,250,589</u>	-	-	-	-
Total U.S. subsidiaries	<u>1,474,537</u>	<u>181,112</u>	<u>224,910</u>	<u>237,011</u>	<u>6,381</u>
Federated Life	23,095	22,214	22,975	22,825	22,794
Other	<u>14,000</u>	<u>14,000</u>	-	-	53
Total provision for claims and LAE	2,257,751	912,655	<u>921,674</u>	<u>444,846</u>	<u>208,816</u>
Reinsurance gross-up	<u>1,147,422</u>	<u>414,482</u>			
Total including gross-up	<u>3,405,173</u>	<u>1,327,137</u>			

The four tables that follow show the reconciliation and the reserve development of the insurance companies' provision for claims. In order to avoid the distortions caused by foreign exchange fluctuations, separate tables are provided for the Canadian and U.S. subsidiaries of Fairfax. CRC (Bermuda) is included with the Canadian subsidiaries while Wentworth is included with the U.S. subsidiaries.

The following table shows for Fairfax's Canadian subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated for the years 1992 through 1996. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

*Reconciliation of Provision for Claims  
Canadian Subsidiaries*

..	<b>1996</b>	<b>1995</b>	<b>1994</b>	<b>1993</b>	<b>1992</b>
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Provision for claims and LAE at January 1 for Commonwealth, Federated, Markel, and, for 1996 and 1995, Lombard and CRC (Bermuda)	<u>695,328</u>	<u>673,789</u>	<u>185,010</u>	<u>179,588</u>	<u>168,394</u>
Incurring losses on claims and LAE					
Provision for current accident year's claims	482,970	456,967	139,671	102,582	94,177
Increase (decrease) in provision for prior accident years' claims	<u>(16,692)</u>	<u>4,149</u>	<u>2,809</u>	<u>360</u>	<u>(393)</u>
Total incurred losses on claims and LAE	<u>466,278</u>	<u>461,116</u>	<u>142,480</u>	<u>102,942</u>	<u>93,784</u>
Payments for losses and LAE					
Payments on current accident year's claims	(195,604)	(205,766)	(53,222)	(40,696)	(34,540)
Payments on prior accident years' claims	<u>(219,883)</u>	<u>(233,811)</u>	<u>(62,955)</u>	<u>(56,824)</u>	<u>(48,050)</u>
Total payments for losses and LAE	<u>(415,487)</u>	<u>(439,577)</u>	<u>(116,177)</u>	<u>(97,520)</u>	<u>(82,590)</u>
Provision for claims and LAE at December 31	-	-	211,313	<u>185,010</u>	<u>179,588</u>
Reserves of Lombard and CRC (Bermuda) at December 31	-	-	<u>462,476</u>		
Provision for claims and LAE at December 31 including Lombard and CRC (Bermuda)	<u>746,119</u>	<u>695,328</u>	<u>673,789</u>		

The company strives to establish adequate provisions at the original valuation date. It is the company's objective to have favourable development from the past. The Canadian subsidiaries had favourable development in 1996 of \$16.7 million. The reserves will always be subject to upward or downward development in the future.

The following table shows for Fairfax's Canadian subsidiaries the original provision for claims reserves including LAE at each calendar year-end with the subsequent cumulative payments made from these years and the subsequent re-estimated amount of these reserves. The following insurance subsidiaries' reserves are included from the respective years in which they were originally acquired:

<b>Subsidiary</b>	<b>Year Acquired</b>
Markel Insurance Company of Canada	1985
Federated Insurance Company of Canada	1990
Commonwealth Insurance Company	1990
Lombard General Insurance Company of Canada	1994
CRC (Bermuda) Reinsurance Limited	1994

*Provision for Canadian Subsidiaries' Claims Reserve Development  
(including Commonwealth, CRC (Bermuda), Federated, Lombard and Markel)*

..	1986 and										
As at December 31	prior	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)
Provision for claims including LAE	39,522	59,400	71,964	79,357	192,372	168,394	179,588	185,010	673,789	695,328	746,119
Cumulative payments as of											
One year later	13,940	18,752	21,015	25,194	44,055	48,050	56,824	62,955	233,811	219,883	
Two years later	22,613	27,154	33,196	35,440	76,947	75,402	87,878	105,537	351,600		
Three years later	27,295	32,919	42,043	44,169	98,149	94,834	110,565	127,418			
Four years later	30,156	37,784	47,901	50,119	115,417	110,838	126,123				
Five years later	33,256	41,128	52,103	55,310	127,003	120,435					
Six years later	34,928	43,991	55,675	58,687	135,020						
Seven years later	36,598	45,654	57,855	60,422							
Eight years later	37,261	46,352	59,152								
Nine years later	37,795	47,052									
Ten years later	38,280										
Reserves re-estimated as of:											
One year later	42,907	56,920	71,673	80,602	175,138	168,001	179,948	187,819	677,938	678,636	
Two years later	43,397	54,920	69,930	73,904	173,992	157,848	174,820	191,825	676,826		
Three years later	43,148	53,004	67,676	71,810	165,752	157,671	171,833	197,833			
Four years later	41,448	52,295	64,478	67,165	166,797	156,291	177,451				
Five years later	41,730	50,235	64,394	65,414	165,625	158,366					
Six years later	40,280	50,822	62,939	65,181	167,289						
Seven years later	41,094	49,198	63,103	64,087							
Eight years later	39,752	49,815	62,250								
Nine years later	40,326	48,636									
Ten years later	39,395										
Favourable (unfavourable) development before indemnification	<u>127</u>	<u>10,764</u>	<u>9,714</u>	<u>15,270</u>	<u>25,083</u>	<u>10,028</u>	<u>2,137</u>	<u>(12,823)</u>	(3,037)	16,692	
Reserve indemnification									<u>0</u>	<u>0</u>	
Favourable (unfavourable) development after indemnification									<u>(3,037)</u>	<u>16,692</u>	

For 1995, the Canadian subsidiaries had a net redundancy of \$16.7 million, with all of the Canadian insurance companies contributing to this reserve redundancy. The indemnification required at the end of last year was not required this year - but it's still early days!

While management is pleased with the generally favourable development over the years, future development could be significantly different from the past due to many unknown factors.

The following table shows for Fairfax's U.S. subsidiaries the provision for claims liability for unpaid losses and LAE as originally and as ultimately estimated for the years 1994 through 1996. The favourable or unfavourable development from prior years is credited or charged to each year's earnings.

..

*Reconciliation of Provision for Claims**U.S. Subsidiaries*

	<b>1996</b> <i>(US\$000)</i>	<b>1995</b> <i>(US\$000)</i>	<b>1994</b> <i>(US\$000)</i>
Provision for claims and LAE at January 1 for Ranger and Wentworth	<u>166,603</u>	<u>160,331</u>	<u>179,001</u>
Incurring losses on claims and LAE			
Provision for current accident year's claims	116,238	93,235	97,899
Increase in provision for prior accident years' claims	<u>23,981</u>	<u>38,117</u>	<u>8,202</u>
Total incurred losses on claims and LAE	<u>140,219</u>	<u>131,352</u>	<u>106,101</u>
Payments for losses and LAE			
Payments on current accident year's claims	(37,832)	(34,394)	(39,277)
Payments on prior accident years' claims	<u>(71,596)</u>	<u>(90,686)</u>	<u>(85,494)</u>
Total payments for losses and LAE	<u>(109,428)</u>	<u>(125,080)</u>	<u>(124,771)</u>
Provision for claims and LAE at December 31 before indemnification	197,394	166,603	160,331
Reserve indemnification	<u>(34,000)</u>	<u>(34,000)</u>	-
Provision for claims and LAE at December 31 after indemnification	163,394	<u>132,603</u>	<u>160,331</u>
Reserves of Odyssey Re at December 31	<u>848,719</u>	-	-
Provision for claims and LAE at December 31 for Ranger, Wentworth and Odyssey Re	<u>1,012,113</u>	<u>132,603</u>	<u>160,331</u>
<i>Exchange rate</i>	1.3706	1.3652	1.4028
Converted to Canadian dollars	C\$1,387,202	C\$ 181,030	C\$ <u>224,910</u>
Purchase price and other adjustments	C\$ <u>87,335</u>	C\$ <u>82</u>	-
Provision for claims and LAE at December 31 after all adjustments	C\$ <u>1,474,537</u>	C\$ <u>181,112</u>	C\$ <u>224,910</u>

The unfavourable reserve development of US\$24.0 million in the U.S. operations in 1996 was due to additional development of reserves at Ranger in the core lines as well as worse than expected performance of the run-off lines.

The following table shows for Fairfax's U.S. subsidiaries the original provision for claims reserves including LAE at each calendar year-end with the subsequent cumulative payments made from these years and the subsequent re-estimated amount of these reserves. The following insurance subsidiaries' reserves are included from the respective years in which they were originally acquired (Wentworth from 1993 as its operations were minor prior to that):

**Subsidiary**

Wentworth Insurance Company Ltd.

Commenced business 1990

Ranger Insurance Company

Acquired 1993

*Provision for U.S. Subsidiaries' Claims Reserve Development*

(including Ranger and Wentworth)

<b>As at December 31</b>	<b>1993</b> <i>(US\$000)</i>	<b>1994</b> <i>(US\$000)</i>	<b>1995</b> <i>(US\$000)</i>	<b>1996</b> <i>(US\$000)</i>
Provision for claims including LAE	179,001	160,331	166,603	197,394
Cumulative payments as of:				
One year later	85,494	90,686	71,596	
Two years later	142,398	133,272		
Three years later	170,085			
Reserves re-estimated as of:				
One year later	187,203	198,448	190,584	
Two years later	213,295	216,610		
Three years later	225,866			
Favourable (unfavourable) development before indemnification	(46,865)	(56,279)	(23,981)	
Reserve indemnification	<u>20,000</u>	<u>34,000</u>	<u>-</u>	
Favourable (unfavourable) development after indemnification	<u>(26,865)</u>	<u>(22,279)</u>	<u>(23,981)</u>	

The unfavourable reserve development of US\$56.3 million in the U.S. operations in 1994 derived from adverse development mainly from periods prior to Fairfax's acquisition of Ranger for which indemnification of US\$20.0 million is provided under the purchase agreement. In addition, Fairfax has provided a US\$14.0 million indemnification which brings the total indemnification to US\$34.0 million. The U.S. operation had a reserve deficiency of US\$24.0 million and US\$22.3 million for 1995 and 1994 respectively.

### **Insurance Environment**

The property and casualty insurance market continued to be very competitive in 1996 with combined ratios in Canada and the U.S. expected to be approximately 103% and 107% respectively, versus 102% and 107% respectively in 1995. An absence of major catastrophes in North America continued to have a favourable influence on the industry. However, many insurance companies continue to write insurance at inadequate prices. Significant restructuring and consolidation continues to take place in the industry. We continue to believe that over time price increases must take place to compensate for the underwriting losses combined with interest rates which are insufficient to adequately offset these losses. Currently, however, the industry continues to be highly competitive.

### **Odyssey Re and CTR Acquisitions**

Effective May 31, 1996 the company acquired Odyssey Reinsurance Corporation (then named Skandia America Reinsurance Corporation). The consolidated balance sheet of Odyssey Re upon acquisition was as follows:

	<i>(US\$000)</i>
Investments, including cash	1,088,136
Deferred premium acquisition costs	7,332
Accounts receivable	662,860
Deferred income taxes	70,321
Other assets	<u>7,238</u>
	<u>1,835,887</u>
Provision for claims	1,364,128
Unearned premiums	81,006
Other liabilities	76,265
Shareholders' equity	<u>314,488</u>
	<u>1,835,887</u>

The purchase price of US\$228 million was paid in cash. The US\$86 million (C\$118 million) excess of the shareholders' equity over the purchase price has been allocated to the provision for claims.

Odyssey Re underwrites a complete range of property and casualty reinsurance products. Odyssey Re's net premiums written for 1996 were US\$201 million.

Effective January 1, 1997 the company acquired Compagnie Transcontinentale de Réassurance. The consolidated balance sheet of CTR upon acquisition was as follows:

	<i>(FF millions)</i>
Investments, including cash	3,200
Deferred premium acquisition costs	80
Accounts receivable	640
Other assets	<u>230</u>
	<u>4,150</u>
Provision for claims	2,200
Unearned premiums	500
Other liabilities	500
Deferred income taxes	50
Shareholders' equity	<u>900</u>
	<u>4,150</u>

The purchase price of FF700 million (approximately \$175 million) was paid in cash (FF400 million) and a FF300 million 10 year 22% note. The FF300 million (approximately \$75 million ) excess of the shareholders- equity over the effective purchase price will be allocated to provision for claims.

CTR writes primarily property, casualty and some life reinsurance internationally. CTR's net premiums written for 1996 exceeded FF1.5 billion.

### Interest and Dividend Income

The majority of interest and dividend income is earned by the insurance companies. The Commonwealth and Federated acquisitions added \$130 million and \$101 million respectively to the investment portfolio at the end of 1990, and interest and dividend income for Commonwealth was included for only two months in 1990. Ranger's \$400 million investment portfolio acquired effective December 31, 1993, Lombard's \$684 million portfolio acquired effective November 30, 1994 and Odyssey Re's \$1,490 million portfolio acquired effective May 31, 1996 are included in the following tables only as indicated.

.. Income	Average		Interest and Dividend				
	Investments		Pre-Tax		After Tax		
	at Book Value (\$000)	Amount (\$000)	Yield (%)	Per Share (\$)	Amount (\$000)	Yield Per Share (%)	(\$)
1985	29,060	2,455	8.45	0.87	1,271	4.37	0.45
1986	64,181	4,678	7.29	0.96	2,522	3.93	0.52
1987	109,825	8,042	7.32	1.10	5,499	5.01	0.77
1988	130,782	8,922	6.82	1.22	6,618	5.06	0.90
1989	135,703	11,628	8.57	1.51	8,537	6.29	1.11
1990	237,868	20,704	8.70	2.75	14,017	5.89	1.86
1991	338,461	26,051	7.70	4.44	17,731	5.24	3.02
1992	366,481	23,988	6.55	4.17	17,749	4.84	3.09
1993 *	418,207	23,251	5.56	3.78	17,994	4.30	2.92
1994 **	852,010	58,219	6.83	7.12	39,608	4.65	4.85
1995	1,608,054	89,354	5.56	10.00	73,664	4.58	8.25
1996 ***	2,548,076	151,387	5.94	15.42	111,458	4.37	11.35

\* *Ranger is not included in this line.*  
\*\* *Lombard is not included in this line.*  
\*\*\* *Odyssey Re is included in this line for seven months.*

Interest and dividend income increased in 1996 due mainly to the inclusion of Odyssey Re's portfolio in May 1996. As shown, the pre-tax income yield increased in 1996 to 5.94% due to higher interest yields on the Odyssey Re portfolio. The after-tax income yield dropped in 1996 because the higher interest income from the Odyssey Re portfolio is fully taxable. Pre-tax interest and dividend income per share has compounded at 30% per year since 1985.

Investments for the past twelve years are shown in the following table, the first five columns of

which show them at the average of their carrying values at the beginning and end of each year, and the final two columns of which show them at year-end.

	<b>Cash and Short Term Investments</b>				<b>Total</b>		
	<b>Investments</b>	<b>Bonds</b>	<b>Preferreds</b>	<b>Common</b>	<b>Average</b>	<b>Year-End</b>	<b>Per Share</b>
	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$000)	(\$)
1985	10,526	15,388	732	2,414	29,060	32,728	6.55
1986	16,605	24,523	7,979	15,074	64,181	95,633	13.65
1987	28,025	26,242	16,516	39,042	109,825	124,016	16.90
1988	29,843	23,575	25,191	52,173	130,782	137,548	18.79
1989	20,623	28,528	32,212	54,340	135,703	133,858	18.30
1990	33,596	99,220	45,652	59,400	237,868	335,740	61.30
1991	60,099	140,177	75,685	62,500	338,461	341,180	62.54
1992	77,929	108,818	99,821	79,913	366,481	396,240	65.44
1993 *	102,968	90,682	118,604	105,953	418,207	848,774	106.70
1994 **	226,205	303,859	132,138	189,808	852,010	1,551,343	173.25
1995	297,989	796,310	157,017	356,738	1,608,054	1,668,656	188.14
1996 ***	470,651	1,462,064	168,438	446,923	2,548,076	3,454,521	330.07

\* *Ranger is not included in the first five columns in this line.*

\*\* *Lombard is not included in the first five columns in this line.*

\*\*\* *Odyssey Re is included in this line*

Total investments per share at year-end 1996 increased significantly due to the Odyssey Re acquisition. Since 1985 investments per share have compounded at 43% per year.

The acquisition of CTR in February 1997 will increase investments per share to about \$390 per share.

### **Return on Investment Portfolio**

The following table shows the performance of the investment portfolio for the past twelve years. The total return includes all interest and dividend income, gains (losses) on the disposal of securities and the change in the unrealized gains (losses) during the year.

Year	Average Investments at Book Value (\$000)	Interest and Dividends Earned (\$000)	Realized Gains (Losses) after Provisions (\$000)	Change in Unrealized Gains (Losses) (\$000)	Total Return Average (\$000)	Total Return Average (%)
1985	29,060	2,455	878	3,792	13	
1986	64,181	4,678	(352)	5,278	8	
1987	109,825	8,042	(7,976)	9,225	8	
1988	130,782	8,922	12,131	28,855	22	
1989	135,703	11,628	(6,272)	20,814	15	
1990	237,868	20,704	(32,943)	(9,961)	(4)	
1991	338,461	26,051	27,866	49,405	15	
1992	366,481	23,988	(11,197)	16,191	4	
1993 *	418,207	23,251	27,822	28,792	79,865	19
1994 **	852,010	58,219	20,026	(42,407)	35,838	4
1995	1,608,054	89,354	45,438	206,704	13	
1996***	2,548,076	151,387	131,274	112,676	395,337	16

\* Ranger is not included in this line.  
\*\* Lombard is not included in this line.  
\*\*\* Odyssey Re is included in this line.

Investment gains (losses) have been an important component of Fairfax's net earnings since 1985. The amount has fluctuated significantly from period to period, but the amount of investment gains (losses) for any period has no predictive value and variations in amount from period to period have no practical analytical value. At December 31, 1996 the aggregate provision for losses on investments was \$16.5 million (1995 - \$8.9 million). At December 31, 1996 the Fairfax investment portfolio had an unrealized gain of \$127.1 million compared to an unrealized gain at December 31, 1995 of \$14.5 million.

The company has a long term value-oriented investment philosophy. It continues to expect fluctuations in the stock market.

### Capital Resources

At December 31, 1996 total capital, comprising shareholders' equity and non-controlling (minority) interest, was \$932.1 million, compared to \$491.5 million at December 31, 1995.

The following table shows the level of capital as at December 31 for the past five years:

	1996	1995	1994	1993	1992
	(\$ millions)				
Non-controlling interest	21.0	18.9	17.3	17.4	17.4
Shareholders' equity	<u>911.1</u>	<u>472.6</u>	<u>391.9</u>	<u>279.5</u>	<u>143.8</u>
	<u>932.1</u>	<u>491.5</u>	<u>409.2</u>	<u>296.9</u>	<u>161.2</u>

Fairfax's consolidated balance sheet as at December 31, 1996 continues to reflect significant financial strength. Fairfax's shareholders' equity has increased from \$472.6 million at December 31, 1995 to \$911.1 million at December 31, 1996.

On March 26, 1996 the company issued 1,100,000 subordinate voting shares at \$155 per share, for net proceeds of \$163.6 million, and on October 3, 1996 issued 500,000 subordinate voting shares at \$260 per share, for net proceeds of \$124.7 million. In 1996, under the terms of a normal course issuer bid approved by The Toronto Stock Exchange, the company purchased and cancelled 3,500 subordinate voting shares for an aggregate cost of \$560,000 of which \$407,000 was charged to retained earnings.

In 1995 the company purchased and cancelled 85,100 subordinate voting shares for an aggregate cost of \$6,892,000, of which \$4,384,000 was charged to retained earnings.

On October 12, 1994 the company issued 1,000,000 subordinate voting shares at \$76 per share, for net proceeds of \$74.4 million. On November 26, 1993 the company issued 2,000,000 subordinate voting shares at \$55 per share, for net proceeds of \$104.8 million.

Fairfax's indirect ownership of its own shares through The Sixty Two Investment Company Limited results in an effective reduction of shares outstanding by 799,230, and this reduction has been reflected in the earnings per share and book value per share figures.

A common measure of capital adequacy in the property and casualty industry is the premiums to surplus (or common shareholders' equity) ratio. This is shown for the insurance subsidiaries of Fairfax for the past five years in the following table:

.. <b>Written to Surplus</b>  <b>Shareholders' Equity)</b>	<b>Net Premiums</b>  <b>(Common</b>				
	<b>1996</b>	<b>1995</b>	<b>1994</b>	<b>1993</b>	<b>1992</b>
Markel	1.2:1	1.6:1	1.3:1	1.1:1	1.0:1
Federated	1.2:1	1.2:1	0.9:1	1.1:1	1.1:1
Commonwealth	0.6:1	0.7:1	0.8:1	0.7:1	0.6:1
Ranger	1.1:1	1.2:1	1.5:1	1.6:1	-
Lombard	1.7:1	2.0:1	2.3:1	-	-
Odyssey Re	0.6:1	-	-	-	-
Canadian insurance industry	1.3:1	1.3:1	1.4:1	1.4:1	1.4:1
U.S. insurance industry	1.0:1	1.1:1	1.3:1	1.3:1	1.4:1

In Canada, property and casualty companies are regulated by the Office of the Superintendent of Financial Institutions on the basis of their Section 516 surplus. At December 31, 1996 Fairfax's Canadian property and casualty insurance subsidiaries had a consolidated Section 516 surplus of approximately \$406 million (1995 - \$275 million), significantly in excess of minimum requirements.

In the U.S. the National Association of Insurance Commissioners (NAIC) developed a model law and risk-based capital (RBC) formula designed to help regulators identify property-casualty insurers that may be inadequately capitalized. Under the NAIC's requirements an insurer must maintain total capital and surplus above a calculated threshold or face varying levels of regulatory action. The threshold is based on a formula that attempts to quantify the risk of a company's insurance, investment and other business activities. Fairfax does not anticipate any adverse effects of such requirements because of the strong capitalization of Ranger and Odyssey Re. At the end of 1996 Ranger and Odyssey Re each had capital and surplus in excess of three times the authorized control level.

Fairfax and its insurance subsidiaries are rated as follows by the respective rating agencies as at December 31, 1996:

	<b>A.M. Best</b>	<b>Standard &amp; Poor's</b>	<b>Duff &amp; Phelps</b>	<b>DBRS</b>	<b>Moody's</b>
Fairfax	-	BBB+	BBB+	BBB(high)	Baa3
Commonwealth	A	A	A+	-	-
Federated	A	-	-	-	-
Markel	A-	-	-	-	-
Ranger	A-	-	A	-	-
Lombard	A-	-	-	-	-
CRC (Bermuda)	A-	-	-	-	-
Wentworth	A-	-	-	-	-
Odyssey Re	A-	BBB+	-	-	-

In 1996 Markel was upgraded by A.M. Best to an A-(excellent), while CRC (Bermuda) and Wentworth were given initial ratings by A.M. Best of A-. Odyssey Re was upgraded to BBB+ by S&P on the purchase by Fairfax, while Ranger was downgraded by A.M. Best to A-. All other ratings were maintained during the year.

### **Liquidity**

The purpose of liquidity management is to ensure that there is sufficient cash to meet all financial commitments and obligations as they fall due.

Fairfax's parent company-only income statement is disclosed on page X. As shown, Fairfax had revenue of \$58.2 million in 1996, consisting of dividends from its insurance subsidiaries (\$34.5 million), management fees (\$8.7 million), interest income (\$8.2 million) and realized gains (\$6.8 million). After interest expense (\$35.0 million), operating expenses (\$7.6 million) and non-recurring expenses (\$3.0 million), the parent company (or holding company) had income of \$12.6 million before taxes. As inter-company dividends are tax free the parent company paid no income taxes, so that net income after taxes amounted to \$12.6 million. This income statement shows that in 1996 Fairfax comfortably met all its obligations from internal sources.

In 1997 Fairfax has access to a much larger amount of dividends and management fees and should again comfortably meet all its obligations from internal sources, all the more so given the elimination of non-recurring expenses.

Fairfax has a large cash holding of \$101 million available to meet unexpected requirements. The cash in the holding company would permit Fairfax to meet its net interest and other expenses for four to five years without access to any dividends from its insurance subsidiaries.

Also, Fairfax has \$600 million of unused, unsecured, committed, five year bank lines. The principal covenant attached to these lines is a covenant to maintain a net debt to equity ratio not exceeding 1:1.

During 1996 Fairfax raised US\$125 million in unsecured debentures due 2026 through a public issue in the United States. These funds were used to complete the acquisition of Odyssey Reinsurance Corporation.

During 1995 Fairfax raised US\$100 million in unsecured 83% debentures due 2015 through a public issue in the United States. These funds were used in part to pay off the long term bank debt of \$60 million described in the next paragraph.

During 1994 Fairfax raised \$74.4 million through the share issue referred to above under "Capital Resources". A further \$60 million in five year unsecured bank loans provided the balance of the cash component of the purchase price of Lombard. Payment of the purchase price was completed by the issue of an unsecured \$25 million 7: % debenture due December 15, 2003 containing the same terms as the publicly issued debentures.

The company manages its debt levels based on the following financial measurements and ratios:

..	1996	1995	1994
Net debt (\$ millions)	369.4	227.7	218.0
Net debt to equity	41%	48%	56%
Net debt to capital	29%	33%	36%

Net debt to earnings	2.4x	2.6x	5.7x
Interest coverage	6.2x	5.7x	5.2x

The company's financial position is very strong and all of its ratios improved in 1996.

The company has not paid and does not intend to pay dividends as long as it can reinvest its funds and earn a 20% return on equity over time.

### **Issues and Risks**

The following issues and risks, among others, should also be considered in evaluating the outlook of the company.

#### *Claims Reserves*

The major risk that all property and casualty insurance and reinsurance companies face is that the provision for claims is an estimate and may be found to be deficient in the future for a variety of reasons including unpredictable jury verdicts, expansion of insurance coverage to include exposures not contemplated at the time of policy issue (e.g. asbestos, pollution, breast implants), or poor weather. The provision for claims before reinsurance gross-up amounted to \$2,257.8 million on Fairfax's balance sheet as at December 31, 1996.

#### *Reinsurance Recoverables*

Most insurance and reinsurance companies reduce their liability for any individual claim by reinsuring amounts in excess of the maximum they want to retain. This third party reinsurance does not relieve the company of its primary obligation to the insured. Reinsurance recoverables can become an issue mainly due to solvency credit concerns but also due to policy disputes. Fairfax had \$1,258.9 million recoverable from reinsurers as at December 31, 1996.

#### *Catastrophe Exposure*

Insurance and reinsurance companies are subject to losses from catastrophes like earthquakes, windstorms or hailstorms, which are unpredictable and can be very significant.

#### *Prices*

Prices in the insurance and reinsurance industry are cyclical and can fluctuate quite dramatically. With under-reserving, competitors can price below underlying costs for many years and still survive.

#### *Foreign Exchange*

The company has assets, liabilities, revenue and costs that are subject to currency fluctuations, particularly in the U.S. dollar but also other foreign currencies. These currency fluctuations have been and can be very significant.

*Cost of Revenue*

Unlike most businesses, the insurance and reinsurance business can have enormous costs that bear no relation to revenue. Similar to short selling in the stock market (selling shares not owned), there is no limit to the losses that can arise from most insurance policies.

*Regulation*

Insurance companies are regulated businesses which means that Fairfax does not have access to each insurance company's net income and shareholders' capital without the approval of the insurance regulatory authorities.

*Common Stock Holdings*

The company has a significant amount of common stocks in its portfolio. As common stocks fluctuate, the company's shareholders' equity (or surplus) is exposed to fluctuations in the stock market.

*Goodwill*

Most of the goodwill on the balance sheet comes from Lindsey Morden. Continued profitability is essential for there to be no deterioration in the carrying value of the goodwill.

*Ratings*

The company has excellent claims paying and debt ratings by the major rating agencies in North America. As financial stability is very important to its customers, the company is vulnerable to downgrades by the rating agencies.

*Holding Company*

Being a small company, Fairfax is very dependent on strong operating management, which makes it vulnerable to management turnover.

**Quarterly Data (unaudited)**

*(in \$ millions except per share data)*

<i>Years ended December 31</i>	<b>First quarter</b>	<b>Second quarter</b>	<b>Third quarter</b>	<b>Fourth quarter</b>	<b>Full year</b>
1996					
Revenue	276.4	316.1	420.0	463.3	1,475.8
Net income	15.6	20.1	40.3	74.8	150.8
Earnings per share	\$1.75	\$2.03	\$4.11	\$7.47	\$15.36
1995					
Revenue	266.0	281.0	294.8	303.7	1,145.5
Net income	13.4	13.8	18.1	42.2	87.5
Earnings per share	\$1.50	\$1.53	\$2.02	\$4.74	\$9.79

**Stock Prices**

Below are The Toronto Stock Exchange high, low and closing prices of subordinate voting shares of Fairfax for each quarter of 1996 and 1995.

	<b>First quarter (\$)</b>	<b>Second quarter (\$)</b>	<b>Third quarter (\$)</b>	<b>Fourth quarter (\$)</b>
1996				
High	190.00	190.00	266.00	310.00
Low	98.00	160.00	172.00	250.00
Close	167.00	173.00	256.00	290.00
1995				
High	79.00	82.00	86.00	100.00
Low	66.25	72.50	79.00	78.00
Close	73.00	79.00	81.00	98.00

**Fairfax Insurance and Reinsurance Companies**  
**Combined Balance Sheets**  
*as at December 31, 1996 and 1995*  
*(unaudited)*

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Assets</b>		
Accounts receivable .....	596,928	369,094
Recoverable from reinsurers .....	1,258,899	523,783
Income taxes refundable .....	14,652	18,911
Prepaid expenses .....	<u>5,797</u>	<u>7,661</u>
	<u>1,876,276</u>	<u>919,449</u>
<i>Portfolio investments (at book value)</i>		
Cash and short term investments .....	509,554	252,500
Bonds .....	2,124,620	799,507
Preferred stocks .....	184,229	155,646
Common stocks .....	504,925	371,951
Real estate .....	<u>26,461</u>	<u>16,268</u>
	<u>3,349,789</u>	<u>1,595,872</u>
Deferred premium acquisition costs .....	145,496	101,773
Deferred income taxes .....	138,860	38,046
Capital assets .....	26,906	20,987
Other assets .....	<u>21,400</u>	<u>21,369</u>
	<u>5,558,727</u>	<u>2,697,496</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities.....	190,239	125,741
Premium deposits.....	<u>43,674</u>	<u>10,929</u>
	<u>233,913</u>	<u>136,670</u>
Provision for claims .....	3,405,173	1,327,137
Unearned premiums .....	<u>688,009</u>	<u>572,016</u>
	<u>4,093,182</u>	<u>1,899,154</u>
<b>Shareholders' Equity</b>		
Capital stock .....	758,862	319,031
Contributed surplus .....	21,182	21,157
Retained earnings .....	<u>451,588</u>	<u>321,485</u>
	<u>1,231,632</u>	<u>661,673</u>
	<u>5,558,727</u>	<u>2,697,496</u>

**Fairfax Insurance and Reinsurance Companies**  
**Combined Statements of Earnings**  
*for the years ended December 31, 1996 and 1995*  
*(unaudited)*

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Revenue</b>		
Premiums earned .....	<u>1,030,888</u>	<u>829,340</u>
<b>Expenses</b>		
Losses on claims .....	753,777	614,059
Operating expenses .....	166,383	146,760
Commissions, net .....	<u>161,291</u>	<u>109,404</u>
	<u>1,081,451</u>	<u>870,223</u>
<b>Underwriting loss</b> .....	<u>(50,563)</u>	<u>(40,883)</u>
<b>Investment and other income (expense)</b>		
Interest and dividends .....	144,100	86,274
Realized gains on investments .....	<u>124,459</u>	<u>70,302</u>
	268,559	156,576
Other .....	<u>(15,573)</u>	<u>(12,773)</u>
	<u>252,986</u>	<u>143,803</u>
<b>Earnings before income taxes</b> .....	202,423	102,920
Provision for income taxes .....	<u>30,028</u>	<u>2,418</u>
<b>Net earnings</b> .....	<u>172,395</u>	<u>100,502</u>

**Fairfax Insurance and Reinsurance Companies**

Fairfax's insurance and reinsurance business is conducted by eight subsidiaries. These subsidiaries underwrite a wide range of commercial and personal property, oil and gas, casualty and life insurance, and property and casualty reinsurance, in Canada, the United States and internationally.

**Fairfax with Equity Accounting of Lindsey Morden**  
**Consolidated Balance Sheets**  
*as at December 31, 1996 and 1995*  
*(unaudited)*

..	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Assets</b>		
Cash and short term investments .....	101,067	70,354
Accounts receivable .....	597,170	369,811
Recoverable from reinsurers .....	1,258,899	523,783
Income taxes refundable .....	17,611	19,501
Prepaid expenses .....	<u>11,280</u>	<u>7,781</u>
	<u>1,986,027</u>	<u>991,230</u>
<i>Portfolio investments</i>		
Subsidiary cash and short term investments (market value - \$512,867; 1995 - \$255,684).....	512,867	255,684
Bonds (market value - \$2,151,569; 1995 - \$821,244).....	2,124,620	799,507
Preferred stocks (market value - \$201,239; 1995 - \$160,298).....	182,229	154,646
Common stocks (market value - \$588,128; 1995 - \$357,722).....	506,939	370,639
Real estate (market value - \$26,461; 1995 - \$16,268).....	<u>26,461</u>	<u>16,268</u>
Total (market value - \$3,480,264; 1995 - \$1,611,216).....	<u>3,353,116</u>	<u>1,596,744</u>
Investment in Lindsey Morden .....	30,330	28,107
Deferred premium acquisition costs .....	145,496	101,773
Deferred income taxes .....	138,860	38,046
Capital assets .....	29,006	20,987
Goodwill .....	12,656	14,675
Other assets .....	<u>25,497</u>	<u>18,112</u>
	<u>5,720,988</u>	<u>2,809,674</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities.....	202,595	128,998
Premium deposits .....	<u>43,674</u>	<u>10,929</u>
	<u>246,269</u>	<u>139,927</u>
Provision for claims.....	3,405,173	1,327,137
Unearned premiums .....	688,009	572,016
Long term debt .....	<u>470,445</u>	<u>298,040</u>
	<u>4,563,627</u>	<u>2,197,193</u>
<b>Shareholders' Equity</b>		
Capital stock.....	513,420	225,295
Retained earnings .....	<u>397,672</u>	<u>247,259</u>
	<u>911,092</u>	<u>472,554</u>
	<u>5,720,988</u>	<u>2,809,674</u>

**Fairfax with Equity Accounting of Lindsey Morden**  
**Consolidated Statements of Earnings**  
*for the years ended December 31, 1996 and 1995*  
*(unaudited)*

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Revenue</b>		
Premiums earned .....	1,030,888	829,340
Interest and dividends .....	152,177	90,144
Realized gains on investments.....	131,274	71,912
Equity earnings of Lindsey Morden, net of dividends .....	<u>2,278</u>	<u>2,098</u>
	<u>1,316,617</u>	<u>993,494</u>
<b>Expenses</b>		
Losses on claims .....	753,777	614,059
Operating expenses .....	185,860	161,013
Interest expense .....	34,997	19,086
Commissions, net .....	<u>161,291</u>	<u>109,404</u>
	<u>1,135,925</u>	<u>903,562</u>
<b>Earnings before income taxes</b> .....	180,692	89,932
Provision for income taxes .....	<u>29,872</u>	<u>2,435</u>
<b>Net earnings</b> .....	<u>150,820</u>	<u>87,497</u>
<b>Net earnings per share</b> .....	\$15.36	\$9.79

**Lindsey Morden Group Inc.**  
**Consolidated Balance Sheets**  
*as at December 31, 1996 and 1995*

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Assets</b>		
Cash .....	336	995
Accounts receivable .....	29,074	29,813
Claims in process .....	15,029	15,390
Prepaid expenses .....	<u>919</u>	<u>1,478</u>
	45,358	47,676
Capital assets .....	11,909	12,777
Other assets .....	<u>35,820</u>	<u>36,383</u>
	<u>93,087</u>	<u>96,836</u>
<b>Liabilities</b>		
Bank indebtedness .....	2,394	7,621
Accounts payable and accrued liabilities .....	17,459	17,824
Long term debt - current portion .....	1,275	1,672
Deferred income taxes .....	<u>4,036</u>	<u>3,883</u>
	<u>25,164</u>	<u>31,000</u>
Long term debt .....	10,335	11,947
Future retirement payments .....	<u>6,258</u>	<u>6,614</u>
	<u>16,593</u>	<u>18,561</u>
Subordinated convertible debenture .....	<u>7,900</u>	<u>8,149</u>
<b>Shareholders' Equity</b>		
Capital stock .....	22,986	22,618
Retained earnings .....	<u>20,444</u>	<u>16,508</u>
	<u>43,430</u>	<u>39,126</u>
	<u>93,087</u>	<u>96,836</u>

**Lindsey Morden Group Inc.**  
**Consolidated Statements of Earnings**  
*for the years ended December 31, 1996 and 1995*

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Revenue</b> .....	<u>162,266</u>	<u>154,914</u>
<b>Cost and expenses</b>		
Cost of service.....	127,102	120,631
Selling, general and administration .....	23,919	23,425
Interest .....	<u>2,347</u>	<u>2,775</u>
	<u>153,368</u>	<u>146,831</u>
<b>Earnings before income taxes</b> .....	8,898	8,083
Income taxes .....	<u>4,487</u>	<u>4,020</u>
<b>Net earnings</b> .....	<u>4,411</u>	<u>4,063</u>

**Consolidated Statements of Retained Earnings**  
*for the years ended December 31, 1996 and 1995*

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Retained earnings - beginning of year</b> .....	16,508	12,921
Net earnings for the year.....	4,411	4,063
Dividends.....	<u>(475)</u>	<u>(476)</u>
<b>Retained earnings - end of year</b> .....	<u>20,444</u>	<u>16,508</u>

*These condensed financial statements have been prepared from the Lindsey Morden Group Inc. audited consolidated financial statements as at and for the years ended December 31, 1996 and 1995, copies of which are available on request.*

**Fairfax Financial Holdings Limited**  
**Unconsolidated Balance Sheets (equity accounted)**  
*as at December 31, 1996 and 1995*  
*(unaudited)*

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Assets</b>		
Insurance companies		
Odyssey Re .. .. .	390,270	-
Ranger .. .. .	215,087	195,268
Lombard.....	196,449	172,105
Commonwealth.....	136,916	127,191
Federated .....	51,812	52,927
Markel .. .. .	52,768	52,163
CRC (Bermuda) .. .. .	65,004	40,875
Wentworth .....	<u>123,724</u>	<u>13,185</u>
	<u>1,232,030</u>	<u>653,714</u>
Lindsey Morden - common shares.....	22,430	20,207
- debentures .. .. .	<u>7,900</u>	<u>7,900</u>
	<u>30,330</u>	<u>28,107</u>
Hamblin Watsa .. .. .	8,167	9,567
Cash and short term investments.....	101,067	70,354
Investment portfolio.....	8,496	6,813
Noro Inc. (see page x) .. .. .	2,326	-
Other assets .....	<u>12,086</u>	<u>2,217</u>
	<u>1,394,502</u>	<u>770,772</u>
<b>Liabilities</b>		
Accounts payable .. .. .	12,965	178
Long term debt .. .. .	<u>470,445</u>	<u>298,040</u>
	<u>483,410</u>	<u>298,218</u>
<b>Shareholders' Equity</b>		
Capital stock .....	513,420	225,295
Retained earnings .. .. .	<u>397,672</u>	<u>247,259</u>
	<u>911,092</u>	<u>472,554</u>
	<u>1,394,502</u>	<u>770,772</u>

**Fairfax Financial Holdings Limited**  
**Unconsolidated Statements of Earnings**  
 (parent company-only income statement)  
 for the years ended December 31, 1996 and 1995  
 (unaudited)

	<b>1996</b> (\$000)	<b>1995</b> (\$000)
<b>Revenue</b>		
Dividend income .....	34,452	
Interest income .....	27,302	
Management fees .....	8,212	3,898
Realized gains .....	8,736	8,736
	<u>6,840</u>	<u>2,610</u>
	<u>58,240</u>	<u>42,546</u>
<b>Expenses</b>		
Interest expense .....	34,997	
Operating expenses .....	19,420	
Non-recurring expenses .....	7,574	5,061
	<u>3,044</u>	<u>4,131</u>
	<u>45,615</u>	<u>28,612</u>
<b>Net earnings</b> .....	<u>12,625</u>	<u>13,934</u>

## APPENDIX

1. This is the letter which accompanied Fairfax's interim report for the three months ended March 31, 1996.

**To Our Shareholders:**

May 13, 1996

This letter is being mailed to you with our first quarter report to provide you with additional details on our recently announced purchase of Skandia America Reinsurance Corporation (as opposed to waiting for the 1996 Annual Report).

On February 21, 1996, we announced that we had signed a definitive agreement, subject to our due diligence and financing, to purchase Skandia Re, an established reinsurance company located in New York, for US\$230 million. As of December 31, 1995, Skandia Re had a book value of US\$344 million and an investment portfolio of US\$1.2 billion. It expects to write net premiums of approximately US\$200 million in 1996. The vendor, Skandia Sweden, is providing a US\$175 million secured indemnification against adverse development in reserves and reinsurance unrecoverables over the next 10 years.

On April 22, 1996, we announced that we had closed the purchase of Skandia Re in escrow, with final closing being subject to regulatory approval which we expect to receive by the end of May. We financed the purchase price of US\$230 million through the issue of 1.1 million Fairfax shares at \$155 per share and a 30 year U.S. public debenture issue for US\$125 million with an interest cost of 8 3/4% per annum. By year end 1996, we expect our debt/equity and debt/total capital ratios to be similar to year end 1995 ratios. Our financial position will continue to be very strong.

So why are we buying Skandia Re? The major reasons are:

- 1) Skandia Re is among the oldest reinsurance companies in the U.S. with established management in place, led by Jim Dowd. A.M. Best Company rates it A-(excellent) and Standard & Poor's, BBB+.
- 2) Reinsurance magnifies the abilities of management. A few people can have a very significant impact on the company. Also, the business is not as regulated as a primary insurance company.
- 3) The investment portfolio of US\$1.2 billion provides significant diversification for Fairfax.
- 4) The US\$175 million secured indemnification, together with the US\$114 million discount to book value, provides very significant downside protection for Fairfax.
- 5) The low premium volume (US\$200 million) to investment portfolio (US\$1.2 billion), combined with the indemnification, should result in Fairfax comfortably achieving its 20% return objective on the purchase price of US\$230 million.
- 6) Long term equity and debt financing was available on fair terms.

As always, there are risks in any purchase and the main ones are discussed below.

- a) Skandia Re has significant long tail liabilities (including asbestos and environmental). We feel the US\$175 million indemnification is sufficient protection but only time will tell (you may be too old to care by the time we know!).
- b) Skandia Re lacked parental commitment since 1992 and has lost some management talent and some clients. It will take time to replace both.
- c) Historical results at Skandia Re have been very poor (due mainly to adverse loss development). Adverse loss development from the past should not be a problem going forward due to the reserve indemnification. We think Skandia Re can achieve a combined ratio of 110% in 1996 with a target of 100% or better going forward.
- d) Skandia Re has reinsurance recoverables of approximately US\$500 million on a net reserve base of approximately US\$1 billion. The company is exposed to potential bad debts on its reinsurance recoverables. We feel comfortable with the bad debt reserve of US\$30 million already in place and the US\$175 million indemnification but again, only time will tell.

All in all, we feel that we have significant protection against the downside at Skandia Re and we are quite excited about the company's prospects in the future.

After the purchase and the financing of Skandia Re, Fairfax's investment portfolios will increase to approximately \$3.3 billion or \$329 per share - up 75% from \$188 per share as at December 31, 1995. Investment income per share (only interest and dividends) from these portfolios, which ultimately drives earnings per share and book value per share, should double to \$20 per share from \$10 per share in 1995.

As always, who knows what the short term will bring, but we are very excited about our long term prospects with the purchase of Skandia Re.

V. Prem Watsa  
*Chairman and Chief Executive Officer*

*B. This is the letter which accompanied Fairfax's interim report for the three months ended September 30, 1996.*

**To Our Shareholders:**

November 2

This letter is being mailed to you with our third quarter report to provide you with additional details on our recently announced purchase of Compagnie Transcontinentale de Réassurance (CTR) of France. The purchase terms are very similar to the terms of our purchase of Odyssey Re (Skandia Re's new name) discussed in our first quarter report.

On September 6, 1996, we announced that we had agreed, subject to our due diligence and financing, to purchase CTR, an established reinsurance company located in Paris, France for FF700 million (currently 3.85 French Francs = CDN\$1). By December 31, 1996, CTR is expected to have a book value of approximately FF900 million, and an investment portfolio of approximately FF3.2 billion. It expects to write net premiums of approximately FF1.5 billion in 1996. The vendor, the GAN group of France, is providing a FF250 million secured indemnification against adverse development in reserves and reinsurance unrecoverables over the next 10 years.

We have now signed a definitive purchase agreement for CTR. Closing is expected to be in mid-January, subject only to approval from the Government of France. We have financed the purchase price of FF700 million through the issue in early October of 500,000 shares of Fairfax at \$260 per share and by arranging a 10 year, FF300 million credit facility bearing interest at 2.5% per annum and a possible participating interest based on CTR's combined ratio. As with the purchase of Odyssey Re, we expect our debt/equity and debt/total capital ratios to be similar to year end 1995 ratios. Our financial position will continue to be very strong.

So why are we buying CTR? The major reasons are:

- 1) CTR is among the oldest reinsurance companies in France with established management in place, led by Jean-Philippe Casanova. Established in 1951, CTR has strong relationships all over the world, particularly in Europe and Asia. As mentioned with the Odyssey Re purchase, we like the reinsurance business as it magnifies the abilities of management.
- 2) CTR provides an international reinsurance network for Odyssey Re under the capable leadership of Jim Dowd, Chairman and Chief Executive Officer, and Andy Barnard, President and Chief Operating Officer. Andy, who joined Odyssey Re in August 1996, helped build Transatlantic Re into an international reinsurance company.
- 3) CTR provides Fairfax with further business and investment diversification. For the first time, we will have sources of income from outside North America.
- 4) The FF250 million secured indemnification, together with the discount to book value, provides very meaningful downside protection for Fairfax.

- 5) With CTR's combined ratio around 100% and investment portfolio of FF3.2 billion, as well as attractive purchase financing, Fairfax should achieve its 20% return objective on the purchase price of FF700 million.
- 6) The purchase of CTR was able to be financed at fair terms and Fairfax continues to maintain its very strong financial position.

As with Odyssey Re, there are risks in any purchase and the main ones are discussed below:

- a) CTR has a run-off book of business from the London market (business that had been cancelled in 1983 and has been in run-off since). We feel the FF250 million secured indemnification is sufficient protection, but like Odyssey Re, only time will tell.
- b) CTR has reinsurance recoverables of approximately FF340 million on a net reserve base of approximately FF2 billion. The company is exposed to potential bad debts on its reinsurance recoverables. We feel comfortable with the reinsurers CTR uses, its excellent bad debt experience in the past and the FF250 million secured indemnification, but again, only time will tell.
- c) We have no insurance/reinsurance experience outside North America. Andy Barnard's experience is very key for us.
- d) We have no significant investment experience outside North America. However, we are in the process of establishing that capability.

All in all, we feel we have significant protection against the downside at CTR and we are quite excited about the company's prospects in the future.

With the purchase of CTR, the combination of Odyssey Re and CTR will have in excess of US\$500 million in both capital and net premiums - ranking Odyssey Re among the top reinsurers in the U.S.

After the purchase and financing of CTR, Fairfax's investment portfolios will increase to approximately \$4.1 billion or \$390 per share - up 20% from \$325 per share as at September 30, 1996. Investment income per share (only interest and dividends) from these portfolios, which ultimately drives earnings per share and book value per share, should increase to over \$24 per share in 1997.

As always, who knows what the short term will bring, but we are very optimistic about our long term prospects with the purchase of Odyssey Re and CTR.

V. Prem Watsa  
*Chairman and Chief Executive Officer*

**Consolidated Financial Summary** (in \$ millions except share and per share data)

	Return on average share-holders' equity	Share-holders' equity	Per Share		Earnings before income taxes	Net earnings	Total assets	Investments	Net debt *	Share-holders' equity	Shares outstanding at year-end (000)	Closing stock price
			Share-earnings - fully diluted	Net Revenue								
For the years ended December 31:												
1985	-	2.08	(1.89)	17.0	(0.9)	(0.9)	41.5	32.7	-	10.4	5,000	3.25 **
1986	25.4%	5.89	1.35	53.7	9.1	6.5	129.8	95.6	2.8	41.3	7,007	12.75
1987	31.3%	8.32	2.23	113.0	18.2	16.0	185.4	124.0	2.8	61.0	7,337	12.37
1988	21.2%	10.13	1.94	133.6	21.3	14.4	246.8	137.5	28.2	74.2	7,322	15.00
1989	20.3%	12.41	2.25	125.8	19.2	16.7	248.1	133.9	22.0	90.8	7,316	18.75
1990	23.0%	17.29	2.92	195.4	23.2	21.3	536.0	335.7	65.9	94.7	5,477	11.00
1991	21.3%	21.41	3.94	250.0	32.5	22.5	516.6	341.2	51.3	116.8	5,455	21.25
1992	7.7%	23.76	1.76	286.8	7.0	10.0	590.5	396.2	68.2	143.8	6,055	25.00
1993	20.3%	35.13	5.42	344.0	46.7	33.3	1,200.3	848.8	132.4	279.5	7,955	61.25
1994	12.1%	43.77	4.66	634.9	46.0	38.1	2,173.4	1,551.3	218.0	391.9	8,955	67.00
1995	20.1%	53.28	9.79	1,145.5	95.9	87.5	2,873.5 ***	1,668.1	227.7	472.6	8,869	98.00
1996	21.4%	87.05	15.36	1,475.8	187.3	150.8	5,778.4 ***	3,454.5	369.4	911.1	10,466	290.00

\* Total debt (beginning in 1994, net of cash in the holding company) with Lindsey Morden equity accounted

\*\* When current management took over in September 1985

\*\*\* Reflects a change in accounting policy for reinsurance recoverables (note 2 to the financial statements)

Readers of the Management's Discussion and Analysis should review the entire Annual Report for additional commentary and information.

**Directors of the Company**

- Winslow W. Bennett  
President, Winwood Holdings Ltd.
- H Robbert Hartog  
President, Robhar Investments Ltd.
- H Steven A. Markel  
Vice Chairman  
Markel Corporation
- Kenneth R. Polley  
President and Chief Executive Officer  
Lindsey Morden Group Inc.
- John C. Puddington  
President, Trilwood Investments Limited
- H V. Prem Watsa  
Chairman and  
Chief Executive Officer
- H *Audit Committee Member*

**Operating Management**

- John B. O. Watson  
President  
Commonwealth Insurance Company
- Jean-Philippe Casanova  
President  
Compagnie Transcontinentale de Réassurance
- John M. Paisley  
President  
Federated Insurance Company of Canada and  
Federated Life Insurance Company of Canada
- Anthony F. Hamblin  
President  
Hamblin Watsa Investment Counsel Ltd.
- Kenneth R. Polley  
President  
Lindsey Morden Group Inc.
- Byron G. Messier  
President  
Lombard General Insurance Company  
of Canada
- Mark J. Ram  
President  
Markel Insurance Company of Canada
- James F. Dowd, Chairman  
Andrew A. Barnard, President  
Odyssey Reinsurance Corporation
- Peter M. Wallner  
President  
Ranger Insurance Company

**Officers of the Company**

- Brenda Adams  
Vice President and Corporate Secretary
- Sam Chan  
Vice President
- J. Paul T. Fink  
Vice President
- Eric P. Salsberg  
Vice President, Corporate Affairs
- Ronald Schokking  
Vice President, Finance
- John C. Varnell  
Vice President and  
Chief Financial Officer
- V. Prem Watsa  
Chairman and Chief Executive Officer

**Head Office**

95 Wellington Street West  
Suite 800  
Toronto, Ontario M5J 2N7  
Telephone (416) 367-4941

**Transfer Agent and Registrar**

The R-M Trust Company

**Share Listing**

The Toronto Stock Exchange  
Stock Symbol FFH

**General Counsel**

Tory Tory DesLauriers & Binnington

**Auditors**

Coopers & Lybrand

**Annual Meeting**

The annual meeting of shareholders of Fairfax Financial Holdings Limited will be held on Wednesday, April 16, 1997 in Room 105 at 4.30 p.m. at the Metro Toronto Convention Centre, 255 Front Street West, Toronto.