Q2 2014 Earnings Call

Company Participants

- Jeffrey D. Kelly
- Kevin J. O'Donnell
- Peter Hill

Other Participants

- Brian R. Meredith
- Ian J. Gutterman
- Jay A. Cohen
- Josh Clayton Stirling
- Josh D. Shanker
- Kai Pan
- Michael S. Nannizzi
- Ryan Byrnes
- Vinay Misquith

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. My name is Jodie, and I will be your conference operator today. At this time, I would like to welcome everyone to the RenaissanceRe Second Quarter 2014 Financial Results Conference Call. After the speakers' remarks, there will be a question-and-answer session. Thank you.

I would now like to turn today's conference over to Mr. Peter Hill. Please go ahead, sir.

Peter Hill {BIO 1828241 <GO>}

Thank you. Good morning, and thank you, everyone, for joining our second quarter financial results conference call. Yesterday, after the market closed, we issued our quarterly release. If you didn't receive a copy, please call me at 212-521-4800 and we'll make sure to provide you with one.

There will be an audio replay of the call available from about noon Eastern Time today through midnight on August 21. The replay can be accessed by dialing 855-859-2056 or 404-537-3406. The passcode you will need for both numbers is 63559814. Today's call is also available through the Investor Information section of www.renre.com and will be archived on RenaissanceRe's website through midnight on October 8, 2014.

Before we begin, I'm obliged to caution that today's discussion may contain forward-looking statements and actual results may differ materially from those discussed. Additional information regarding the factors shaping these outcomes can be found in RenaissanceRe's SEC filings, to which we direct you.

With us to discuss today's results are Kevin O'Donnell, President and Chief Executive Officer; and Jeff Kelly, Executive Vice President and Chief Financial Officer. I'd now like to turn the call over to Kevin. Kevin?

Kevin J. O'Donnell

Thanks, Peter, and good morning, everyone. For this morning's call, I'll start with some broad themes for the quarter and I'll turn it over to Jeff to talk about financial results and then I'll come back on for some more detailed comments on the renewal.

Last night, we reported an annualized operating return on equity of 11% for the second quarter. Growth in tangible book value per share plus accumulated dividends was 3.5%. On a year-to-date basis, we have generated net income of $272 million and an annualized operating return on equity of 13.4% and have grown tangible book value per share plus accumulated dividends by 6.4%. This was a tough renewal for the industry and we saw the same trends continuing, namely intense competition and ongoing pressure on rates.

Against this backdrop, the team executed well, putting into practice the playbook we have consistently operated in soft market conditions like these. We cut back on business that did not meet our return hurdles. We positioned our portfolio and bought ceded retro to reduce risk, in line with our consistent strategy to optimize our book of business.

Our strategy is based on a long-term view. We have invested in understanding risk, underwriting it and matching it against capital for over 20 years, focused always on managing our portfolio efficiently. Our customers value our experience and trust us to help them with the unexpected.

It's been all too easy for the industry to have a short-term memory, given the eight-year hiatus without a major landfalling and hurricane in Florida and five years without a meaningful event in the Southeast. As we advance through storm season, we are more conscious than ever that good preparation, not good luck, should be the basis of sound risk management. The ability to properly assess the risk that one takes on and to differentiate between attractive and unattractive business remains more important than ever.

At this point, I'll turn it over to Jeff for his comments on results.

Jeffrey D. Kelly {BIO 1390834 <GO>}

Thanks, Kevin, and good morning, everyone. I'll cover our results for the second quarter and the year-to-date. We had a profitable second quarter again benefiting from solid underwriting, relatively low catastrophe losses and a favorable investment environment.

Our managed cat top-line decline in the second quarter to a large extent reflected the competitive market dynamics that we have been highlighting on our recent calls and our decision to pull back on business that did not meet our return criteria. As competition intensified, we elected instead to reduce the risk in our Florida book through opportunistic ceded retro purchases, which I'll discuss later on in my remarks.

We reported net income of $121 million or $2.95 per diluted share and operating income of $94 million or $2.28 per diluted share for the second quarter. The annualized operating ROE was 11% for the second quarter, and our tangible book value per share, including change in accumulated dividends increased by 3.5% during the period. For the first six months of the year, we reported an annualized operating ROE of 13.4% and growth in tangible book value per share plus dividends of 6.4%.

Let me shift to the segment results beginning with our Cat segment and followed by Specialty Reinsurance and Lloyd's. Managed cat gross premiums written declined $180 million or 29% compared with a year ago during the second quarter. Adjusting for prior-year reinstatement premiums of $10 million, a $27 million multi-year contract written and booked in the year-ago period and $28 million less on a single quota share contract this year relative to the prior-year period, Managed cat premiums declined approximately 21% in the second quarter and 15% for the first six months of 2014.

The top-line decline for cat premiums so far this year was driven largely by increased pricing competition, exposure reduction and repositioning of our portfolio as we moved higher up in layers relative to a year ago. The year-to-date decline in managed cat premiums is slightly greater than our full-year guidance for a decline of 15%.

Net premiums written in our Cat segment declined 47% in the second quarter and are down 34% for the first six months of the year, reflecting the reduction in gross premiums written as well as increased ceded retro purchases. During the quarter, we entered into a retro transaction in which we purchased $180 million of limit on a UNL basis to reduce the frequency or lower layer risk for a peak Florida exposure. Ceded premiums directly related to this deal totaled $23 million. This was an attractive transaction for us and allowed us to enhance expected returns on our portfolio while also reducing expected volatility and freeing up some capital.

The second quarter combined ratio for the Cat unit of 48.2% benefited from overall benign catastrophe loss experience. The main contributor to losses in the quarter was a series of smaller wind and thunderstorm events in the US, and net favorable reserve development totaled $1.7 million for the unit during the quarter. The main moving parts were a reduction to our ultimate loss estimates for 2011 April and May tornadoes, offset partially by some adverse development for the 2010 New Zealand earthquake and 2012 wind, hail and flooding event in Texas.

In the Specialty Reinsurance segment, gross premiums written declined by 12% in the second quarter compared with the year-ago, reflecting a generally competitive environment for specialty casualty. For the first six months of the year, Specialty gross premiums written are up 46%, driven primarily by the inception of a small number of large financial lines in mortgage insurance quota share transactions in the first quarter.

As we have often stated in the past, percentage growth rates for this segment can be uneven on a quarterly basis, given the size and nature of the transactions. The growth rate in the quarter compares with our full-year 2014 guidance of up over 20%. The Specialty Reinsurance combined ratio for the second quarter came in at 78.9%, as loss activity was again generally benign. Favorable reserve development here totaled $5 million in the quarter.

In our Lloyd's segment, we generated $72 million of premiums in the second quarter, an increase of 5% compared with the year-ago period. For the first six months of the year, gross premiums written are up 9%. This compares with our full-year guidance for premiums to be up over 20%, with the shortfall reflecting challenging market conditions.

The Lloyd's unit came in at a combined ratio of 101.3% for the second quarter, also benefiting from generally low loss activity. The favorable reserve development of $9 million was principally driven by the application of the company's formulate reserving methodologies for establishing IBNR reserves and did not relate to any particular events. We believe the financial results for the first six months of the year are more indicative of the run rate results for this segment.

The expense ratio remained high at 48.6% but has generally been trending down as the unit grows its premium base. Offsetting the improvement in the operating expense ratio has been an increase in the acquisition expense ratio due to higher seating commissions on quota share contracts.

Turning to investments, we reported net investment income of $35 million in the second quarter. Our private equity portfolio generated a gain of $8 million in the second quarter, driven by continued favorable equity market conditions. Recurring investment income from fixed maturity investments included approximately $3 million in gains on the bank loan portfolio, which we began reporting late last year as a part of fixed income securities. Adjusting for that gain, fixed maturity investment income remained under pressure from low interest rates but was reasonably consistent with prior-year periods.

The total return on the overall investment portfolio was 0.9% for the second quarter, benefiting from strong alternative investment returns and sizable realized and unrealized gains and the values of fixed income securities due to a decline in interest rates and credit spreads. Our investment portfolio remains conservatively positioned, primarily in fixed maturity investments, with a high degree of liquidity and modest credit exposure. The duration of our investment portfolio remained short at 2.2 years and has remained roughly flat over the course of the year. The yield to maturity on fixed income and short-term investments declined slightly to 1.5%.

Turning to capital, as we've stated in recent calls, we continue to believe we have capital in excess of our requirements given our portfolio and our outlook for the business. We endeavor to optimize the size of our capital base to business opportunities and seek to return excess capital to our investors when it is the most suitable option. Our preferred method of returning capital has historically been through share repurchases and we expect that will remain the same.

As we've often said, the timing of share repurchases on a quarterly basis will depend on a number of factors, including the capital needs of our underwriting portfolio, our projected liquidity requirements and the valuation of our stock. For the second quarter, we've repurchased 385,000 shares for a total of $37 million. Year-to-date, we've repurchased 3.4 million shares for an aggregate cost of $314 million.

Effective July 1, we also sold a part of our existing shares in DaVinci to a third party investor, which further reduced our stake to 23.4% from 26.5% prior to the transaction. While we are not seeking to increase the size of DaVinci given the current competitive market environment, we have gradually reduced our ownership stake in order to bring in high-quality investors who we believe will be excellent long-term partners.

Finally, let me turn to update our top-line forecast for 2014. We have already written the bulk of our cat premiums for the year, and year-to-date, managed cat premiums are down slightly more than the 15% guidance we have been giving. At this point, we expect that will probably play out through year-end.

For Specialty Reinsurance, we are maintaining our top-line guidance to be up over 20%, recognizing that premium trends can be volatile on a quarterly basis. In our Lloyd's unit, we are lowering our top-line guidance to growth of approximately 10%. This is a function of the competitive dynamics in the marketplace that have reduced the opportunities for profitable expansion.

Thanks. And with that, I'll turn the call back over to Kevin.

Kevin J. O'Donnell

Thanks, Jeff. This is the quarter where much of the focus, of course, is on the June 1 Florida renewals. While we saw both strong demand with increased purchases and new limit bought in Florida, there was ample capacity to meet this demand and the result was a very competitive renewal.

The increased demand in the Florida market and strengthening health of primary companies over the past couple of years are all long-term positives. Many companies are also electing to use cost savings from lower reinsurance rates to purchase more protection.

Larger buyers were generally loyal to their existing panels, intended to maintain core relationships. However, as we had anticipated, there was greater pricing pressure resulting from non-core participants competing hard for market share. This resulted in price reductions in excess of what we were originally expecting. Nonetheless, we were able to construct a good portfolio with lower risk. Our longstanding relationships with brokers and clients provided us with access to the business we sought to write, and we continue to draw upon our suite of options to manage inwards and outwards.

Retro pricing and capacity has followed the general market trend, giving us the opportunity to increase our ceded protections. During the quarter, we successfully executed exceeded retro transactions specifically for Florida, decreasing our exposure to more frequent return periods. So in our vernacular, we are less hot down low than we were last year.

Interestingly, as market participants have had greater access to models and tools to understand risk, one might have expected a more efficient market. However, instead of greater efficiency, the clock seems to have turned back to the 1990s and there has instead been a return to a single view of risk and a resulting decline in risk-assessment quality. We believe that the right way to price risk is to consider multiple views, understanding the full distribution of outcomes.

We have seen an increasing focus on the single point answer and expected loss reached by finding the mean of all outcomes, which we believe is flawed. This over-reliance on a single view of risk not only encourages poor pricing behavior, it can also lead to poor portfolio construction. We believe that good underwriting will continue to be the key differentiator among reinsurers and capital providers, and it's the best path for long-term success.

There has been a lot of discussion about whether the current softening is permanent or cyclical. One permanent factor is the many sources of capital available to accept cat risk. We have believed this for a long time, which is why we structured RenaissanceRe to include third-party capital many years ago. But I believe that not all this capital will be permanent. It's important to point out that different types of capital are attractive to this business at different times. The forms we're managing now are very different to post-Katrina capital, and understanding how to manage all forms of capital in all pricing environments is required for long-term success.

As for cycles, I believe all markets have cycles. The key is knowing what the characteristics of the cycle are and how to recognize them. More interesting than whether the market change is cyclical or permanent is the question about how to compete in any given market environment. We believe you need great risk assessment, great access to business, and you need to rigorously manage our cost of capital.

Our track record across all cycles has been market-leading in that regard, and our business model has the flexibility to manage a variety of forms of capital, no matter what the market dynamics. I'm very confident that we are well positioned to continue to find good risk and to match it with the most efficient capital going forward.

Turning to our international book now, our mid-year renewals were Japan and Australia, and in both markets, we saw general pricing pressure dynamics. Our established relationships served us well and we maintained our participations in those regions as well as finding attractive opportunities. Collaboration across our different business units and platforms allowed us to expand our product offering and served the needs of our multi-regional clients.

In Specialty, we have continued to establish our franchise across all lines despite a general competitive market. I'm pleased with the book we have constructed. We have achieved this by leveraging opportunities provided by our new platforms and working with customers we have known for a long time who recognize the value of the RenRe franchise.

Our Lloyd's operation continues to make good progress. Much of the expansion has resulted from capitalizing on relationships in Bermuda, especially on the property side. Five years on, we continue to be measured and deliberate in our growth. We now have the infrastructure fully in place to scale this business when we see attractive opportunities.

As we look to the future, our rated and unrated balance sheets provide us with unique flexibility to match well-structured risk efficiently with appropriate capital. At the same time, we continue to offer value beyond capital for our clients and partners by blending market insight and experience with financial strength. I believe the combination makes RenaissanceRe one of the best-placed companies, not in just today's market but over the years to come.

And with that, we're ready to take questions. Thank you.

Q&A

Operator

Your first question comes from the line of Josh Stirling from Sanford Bernstein.

Q - Josh Clayton Stirling {BIO 17463087 <GO>}

Hi. Good morning, and thanks for taking the questions. So I recognize this is a challenging renewal and it's easy for us all to be difficult because we don't actually work in the business, but we're trying to frame this. And I wonder, Kevin, a really big picture question. if you take probably the view of your career at RenRe, when you started the business and broadly was probably a 20% plus ROE kind of business, and then after Hurricane Katrina, higher capital standards came in from the rating agencies and maybe it came down to 15%. You'll have a better sense of all these numbers, but I'd guess over the past two years, pricing must be down something like 20% or 30% on some sort of risk adjusted basis. And I'm wondering if I can simplify this to say that property cat is now really just a 10% ROE business. And if that's sort of not the right high-level math, I'm wondering if maybe you could walk me through the way you think about it.

A - Kevin J. O'Donnell

Sure. I have been here for a long time, and I've seen a lot of different markets going back to when I started in 1996. Each market I've seen has been different, and when I look at the portfolios that we've built in those markets, we've built them in a way which matched the right amount of risk to the right amount of capital. In the late 1990s, our portfolio was very much constructed to be a net portfolio with little third-party capital, and then over the years, we've built in more third-party capital.

I think thinking about the returns in this business, it is one in which rates are certainly down and one is being paid less for the risk they are taking today than they were last year for sure. But it's a business where I believe the portfolios we're constructing still afford attractive returns. The other piece that had fed (22:36) into the returns is really what's going on with investments and that's really kind of more universally affecting people. But from the risk portfolio, we have seen a decline in the overall returns of the risk portfolio, but it's one in which we're not at levels – we're not at the lowest levels that I've seen since I've been here, for sure.

Q - Josh Clayton Stirling {BIO 17463087 <GO>}

Okay. So that's helpful. I – sort of a different question but similar topic, on pricing, and all of us trying to sort of second guess how much more longer the pricing pressure might last. You guys both play in the traditional reinsurance market as well as a lot of the collateralized – you do a lot of different things all throughout the sort of the market. One of the markets that I'd look to guidance for in some ways is the cat bond market. And I'm wondering when you guys think about cat bond spreads, what investors are paying for risk and you compare it to things like similarly rated junk bonds, which are at all-time lows. How much more margin is there for new money to be allocated into this space? And how much pricing pressure in the future would – if you believe that there was ultimately true conversions and the sort of similar ratings for similar margins or similar spreads, how much more pressure would that put on this business? Is this – do we still have 10% or 20% pricing declines to come?

A - Kevin J. O'Donnell

I think cat bonds still trade largely at the more remote return periods. So let's kind of just focus on that for a second. We did see some pushback on cat bond pricing earlier this year when spreads were continuing to contract. And the way that market has been trading is really just a multiple of expected loss rather than considering the full uncertainty of the bond being offered. I think if you take our perspective on the cat bond market, we have managed a small portfolio of cat bonds and we are no longer actively looking for cat bonds with where the current pricing is.

Q - Josh Clayton Stirling {BIO 17463087 <GO>}

Okay. Well, thank you, guys, for the time, and good luck this summer.

A - Kevin J. O'Donnell

Thank you. Appreciate it.

Operator

Your next question comes from the line of Vinay Misquith from Evercore.

Q - Vinay Misquith {BIO 6989856 <GO>}

Hi, good morning. Just wanted to follow up on Josh's question. So it seems that the property cat business now is barely a double-digit ROE. Would you say that given the retro purchases that you've done that, yes, while it is a double-digit ROE, the risk profile is now lower because of higher retro purchases?

A - Kevin J. O'Donnell

Yeah. I think that's a great question, and I think one of the things we're constantly looking at is getting the right risk mix into the book to match it against the return. We highlighted one retro purchase, which we made, which was the Florida-specific. That materially reduced our exposure to more frequent – the lower – the more frequent type events, particularly in Florida.

I think the other thing to focus on is we share a lot more risk today than we have in the past across all the different mechanisms that we have from third-party capital to tradition ceded to other vehicles that we have in place. So I think, thinking about our book from gross to net perspective, there's certainly a big spread between the two and it's one in which there's significantly less risk in the net than there is in the gross, particularly comparing to last year, highlighting the biggest change is that one Florida purchase which materially changes the exposure to more frequent events.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay, that's helpful. The second thing is on pricing. We've heard that some deals have been returned because the prices were too low. So, just trying to see if we're heading towards the bottom, close to the bottom. I think you tried to say something about a couple quarters ago and then last quarter, things got worse. At the risk of being wrong again, just curious from your perspective as to where do we think we are in terms of pricing and property cat?

A - Kevin J. O'Donnell

The 6/1 renewal is a very different composition than other renewals around over the course of the year. So I think it's difficult to extrapolate what we saw in the Florida renewal to what's going to happen to a much more diversified renewal at 1/1. I will say that absent some surprise or some catalyst, I think it's difficult to see the direction of pricing change. I think it's more to think about what is the magnitude of the price change. And at this point, we're kind of going into wind season. A lot will change between now and then, but that's the way we would position ourselves. We'll build our pro forma for the 2015 year in the October-November timeframe, which is when we'll really get down to making estimates as to what's going to happen with pricing going forward.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. So it seems that you're not really optimistic that pricing reached the bottom yet.

A - Kevin J. O'Donnell

I think there – if you look at – there was resistance particularly as we got closer to the June 1 renewals, but I think whenever there's – I think markets often don't change without some catalyst. So, whether the market flattens out or continues to decline, it's something that remains to be seen.

Q - Vinay Misquith {BIO 6989856 <GO>}

That's helpful. And the one last point, on the retro, I mean, you bought a lot of retrocessional reinsurance. You've not bought back any stock. Just curious about the capital, the excess capital position right now, and does the purchase of retro give you additional room to manage capital? And also you have views on given where the stock price was trading. It seems that you sort of held back on share repurchases. Would you be open to a special dividend too?

A - Kevin J. O'Donnell

So let me start, then I'll turn it over to Jeff. One of the things that I think is unique about RenaissanceRe is the way we integrate our thinking about risk in capital. So, every time we make a decision to write a piece of business, every time we make a decision to purchase ceded, we understand how much capital that's using and how much capital it's releasing. So, to think that – when we purchased the retro, we do recognize we're taking risk off and then we fully understand how that flows through into the excess capital position that we have. Jeff?

A - Jeffrey D. Kelly {BIO 1390834 <GO>}

Yeah. I think just adding to Kevin's point on the Florida ceded purchase and what it did to the capital position, I think you have to look at the overall book itself. So, with premium being down as well as the Florida ceded purchase, while the Florida ceded purchase and the reduction and exposure had the effect of increasing excess capital, if you will, the reduced expected profit in the book has the opposite effect to some degree. But on balance, we do see the excess capital in the portfolio having gone up in the quarter largely as a result of the ceded purchase but offset a bit by the reduction in the expected profit of the book.

I'd say just on the amount of excess capital, we – as I mentioned in my prepared remarks, we think we have a fair amount of excess capital and we stand ready to buy shares at what we think are attractive prices. As it relates to a special dividend, I think whenever we get asked this question, we – I think our response is always, Vinay, that we look at every option available to us to manage excess capital and that would certainly include that. And historically, while we've repurchased – done most of our share – our capital management via share repurchases, we have altered the capital structure as well by paying down debt and calling preferred stock. So we do look at every available option to us and that would include a special dividend.

Q - Vinay Misquith {BIO 6989856 <GO>}

That's helpful. In the past, you mentioned the $300 million of excess capital number. Would you care to update that number?

A - Jeffrey D. Kelly {BIO 1390834 <GO>}

No. I don't recall having mentioned $300 million. It's a – it would be denominated in several hundred million dollars and actually somewhat more than that amount.

Q - Vinay Misquith {BIO 6989856 <GO>}

Okay. Thank you.

Operator

Your next question comes from the line of Kai Pan from Morgan Stanley.

Q - Kai Pan {BIO 18669701 <GO>}

Good morning. Thank you for taking my call. And the first question is just – if you just look at the – have you quantified what exactly were the cat losses for the quarter?

A - Jeffrey D. Kelly {BIO 1390834 <GO>}

Cat losses for the quarter – well, yes, we have – I don't think we disclosed it. I would say at a very high level, Kai, we had about – there weren't any major cats during the quarter. It was really a series of small PCS (32:36) events that I think there were a total of six. On a gross basis, it was probably around $50 million and losses on a net basis about $38 million for the cat unit.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. Great. That's great. So if you look back for the quarter, it's relatively low-cash quarter and you've got 11% or you're certainly below your long-term average. I just wonder, is that because the businesses you write inherently have a lower ROE than your hurdle rates or you just simply couldn't find enough good businesses to write that you have an abundance of excess capital out there.

A - Kevin J. O'Donnell

So, firstly, let me just be clear. The portfolio we built was based on decisions that we've made. It wasn't due to access to business. It was based on what we saw from a pricing environment and how we want to construct the portfolio. The first piece of the pricing environment is gross rates are down. That's been part of the conversation throughout 2014. So with that, risk has less premium associated with it. The portfolio that we're building is really one in which how much capital are we putting against the risk that we're taking. And it's something that when we design that, it is based on providing an optimal return. One of the return on equity components, which Jeff touched on, is that we're carrying a lot of excess capital. The other piece is that we've increased the cessions we have, both to third-party capital and to secured relationships. So it's a matter of the portfolio construction rather than just what the price is and how that's flowing through to return on equity.

Q - Kai Pan {BIO 18669701 <GO>}

Okay. Then just following up on that, if you - like with all the pricing and surging out there and - so I just wonder how long do you think you need to hold on to these so-called excess capital and just sitting there and waiting for the pricing to return or being probably more proactive in terms of the capital management, because if you think the pricing going to stay where it is now, you - apparently you have less available high return business to write. Then you don't need this much of capital that you probably should think more about buying back the stocks or somehow return - reduce your capital raise.

A - Kevin J. O'Donnell

So if you look back over our historical record, we've been good stewards of managing capital, and it's one of the primary levers in which we believe we need to manage to achieve our long-term return objectives. And it's something that, as Jeff had mentioned, we will continue to work on through the course of 2014. Measuring capital returns or share buybacks in any one quarter is not the way we think about it. We think about it over the long-term. And there'll be periods in which we are carrying more excess capital. Having gone through the renewal and adjusting the way in which we built the portfolio added excess capital to our portfolio, and we will continue to manage that in the quarters to come.

Q - Kai Pan {BIO 18669701 <GO>}

Thank you so much.

Operator

Your next question comes from the line of Michael Nannizzi from Goldman Sachs.

Q - Michael S. Nannizzi {BIO 15198493 <GO>}

Thanks. I just had a couple questions. One on the expense side I guess, are you able to scale down notional operating expenses on the cat reinsurance side as earned premiums decline at least for the next six months or so? Just trying to get an understanding of the sensitivity there. Thanks.

A - Kevin J. O'Donnell

Sure. Well, one of the big expenses we have is acquisition costs. So that's a variable expense that comes in. So, obviously, that will scale with the amount of premium that we're writing. Additionally, I think we run an organization that is - that maintains the ability to scale up when opportunity is there, and I think that's important, and - but it is something that when you look at the primary levers that you have to control return, it's investment income, underwriting income, expenses, and then moving to equity. So it's something that we're constantly looking at and trying to optimize against the environment that we see both in the short-term and the long-term.

Q - Michael S. Nannizzi {BIO 15198493 <GO>}

Right. But specifically, the operating expense piece, so the non-variable, I would imagine that's mostly fixed cost. I'm just curious - I mean, are - if you scale back to, like, if this is kind of a run rate of premiums just for the near-term, should we expect the notional number of operating expenses to stay the same, or should we expect the ratio of operating expenses to sort of stay the same?

A - Kevin J. O'Donnell

So I think the way we would look at it is more on the notional basis rather than on the – to make sure that we're maintaining the capabilities within the organization. I think the other thing to look at is how much risk we're retaining and how much we're ceding. So we're not only looking at it on a gross premium, but on net premium.

Q - Michael S. Nannizzi {BIO 15198493 <GO>}

Got it. Okay. And then I guess on the top line, is it possible the Specialty or Lloyd's businesses to sort of recapture the decline in premiums that we're seeing on the cat side, sort of one-for-one? I mean, is – or other potential growth initiatives? I mean, is that something that's plausible in the near-term or is that more of a headwind? Is that more a headwind?

A - Kevin J. O'Donnell

Sure. I think – let me start with Specialty. A lot of what we're writing in Specialty is quota share business, and we saw increased – we did see increased opportunity, but we saw pressure on particularly ceding commissions within that business. And the return profile for writing that business is different than the return profile of (38:40) cat business due to the volatility embedded in it. So I think we can – from a top-line perspective, we still have room to continue to grow the Specialty, but it does have a different risk profile and a return profile than cat premium.

Within Lloyd's, I think it's similar. We have more of a mix between insurance, reinsurance, and then within reinsurance, between quota share and XOL. And I think we still have opportunities there, but there is some headwind on pricing for the business coming into Lloyd's as well. That's one of the reasons we're more cautious about the growth forecast for that business unit.

A - Jeffrey D. Kelly {BIO 1390834 <GO>}

And I'd just -

Q - Michael S. Nannizzi {BIO 15198493 <GO>}

Got it.

A - Jeffrey D. Kelly {BIO 1390834 <GO>}

I think I'd add that although – so I think the answer to your question, Mike, is I think there's flexibility in both the business and even in the expense line, but those – that flexibility comes in different timeframes. In the very short-term, there is not a lot of flexibility in either of those, but over the longer term, there is.

Q - Michael S. Nannizzi {BIO 15198493 <GO>}

Great. Thanks. And I just guess thinking about where competition is coming from, is it still sort of primarily coming from alternative vehicles? Are you seeing some of that competition coming from other more traditional reinsurers that are maybe looking to redeploy capital in different placements or in different geography in the stack? Just trying to understand what are the sources of that competition at this point that you see?

A - Kevin J. O'Donnell

The competition is broad. So we're seeing it both from traditional and non-traditional players. I think one of the concerns the market has is to how much new capital is truly interested in entering the space, which is feeding a feeling among traditional reinsurers that they need to protect market share over margin. I think within the alternative space, I think there's pressure to deploy capital. So it's not – I wouldn't point specifically to one area of the market or the other, but I think they're highly connected and we're seeing competition a reasonably broad spectrum of competitors.

Q - Michael S. Nannizzi {BIO 15198493 <GO>}

Got it. Great. Thank you so much.

Operator

Your next question comes from the line of Jay Cohen from Bank of America Merrill Lynch.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Thank you. First question, I think a lot of us are struggling when it comes to reinsurance and specifically the cat market. What's potential margin or specifically the loss ratio impact is of lower prices? Obviously, you see these big declines. You are doing things to offset those declines, whether it's buy more retro, managing your capital. But can you say at all, given the changes in the pricing environment, given the changes in your portfolio, what is your loss ratio look – on an expected basis – loss ratio look like now versus, say, a year ago?

A - Kevin J. O'Donnell

So I think that's one measure to think about. Really what we're trying to think about is across the full distribution, how much capital we're using at a given point, how much – what's the likelihood (42:17) of loss associated with that capital at a given point. So, thinking about it as simply a loss ratio, it's – you can talk about it in a specific region or specific line, but we think about it much more broadly across the portfolio.

I think rates are under pressure, so loss ratios are going up. But we're doing – we're building portfolios that I think have greater diversification from some of the specialty that we're bringing in and then changing the profile of the risk we're taking both by what we're accepting on the inward spaces and then how we're thinking about it from a ceded perspective. So I don't think it's as simple as just thinking about loss ratio A versus loss ratio B.

Q - Jay A. Cohen {BIO 1498813 <GO>}

I understand that. Second question, the Lloyd's business, with the growth slowing there, presumably it would continue to slow given the direction of market conditions. I guess one of the issues with that business is the expense ratio is relatively high because you haven't scaled up yet. I mean, slowing down the growth in that business, does that push out the eventual decent returns you'd expect to earn in that business?

A - Kevin J. O'Donnell

Yeah. I think it's – I'd rather trade a higher expense ratio than taking greater risk, greater uncertainty for writing thinly or underpriced business. So it's something that, yeah, we are prepared to be patient to continue to build that franchise so that over the long-term, it's an industry-leading franchise within Lloyd's.

Q - Jay A. Cohen {BIO 1498813 <GO>}

Got it. Thanks, Kevin.

A - Kevin J. O'Donnell

Sure.

Operator

Your next question comes from the line of Ryan Byrnes from Janney Capital.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Great. Thanks for taking my questions, guys. Firstly, I just wanted to talk about your appetite for financial – or I guess mortgage insurance or reinsuring a product. I know you guys did a lot in the first quarter this year but just wanted to see your appetite going forward now that there may be some new capital requirements on the primary guys?

A - Kevin J. O'Donnell

Let me start. One of the things that when we look at lines that are written, more financial-based lines, we are very careful to make sure that there's some value that we're bringing from the structure that we're offering. And to the extent that that we get over that hurdle, we become interested in the line such as mortgage. I think our appetite continues to be strong for that business assuming that we can determine that we're bringing a unique solution compared to a straight capital market solution for the products that we're offering.

Q - Ryan Byrnes {BIO 16902592 <GO>}

And would your expected returns from that business be similar to the cat business for you guys right now?

A - Kevin J. O'Donnell

I think there's kind of two questions in there; one is on a standalone basis and one is on a marginal basis. Marginally, we look at that risk in conjunction of the overall risk of the organization, including our investment portfolio. And on a marginal or on a diversified basis, the returns on that business are very attractive.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Okay. Great. And then just my last one, it looks like you guys are potentially an investor with Trupanion, which had an IPO a couple of weeks ago. Just wanted to think about how we should think about that mark running through earnings going forward. Will that be running through operating in the third quarter or would that be run through realized gains going forward?

A - Jeffrey D. Kelly {BIO 1390834 <GO>}

We – thanks. We – the way we handle that is when we – when an investment prior to going to IPO, we generally mark that through operating earnings. Once it gets to IPO and becomes an equity security in our portfolio, it's in what we classify as equity trading, it gets mark-to-market.

Q - Ryan Byrnes {BIO 16902592 <GO>}

Okay. Great. Thanks, guys.

A - Kevin J. O'Donnell

Thanks.

Operator

Your next question comes from the line of Josh Shanker from Deutsche Bank.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Thank you. Mr. Cohen asked my question more eloquently than I possibly could, but I just wanted to go one step further. With your concern, Kevin, that we might not have seen a bottom or directionally or whatnot, to what extent do you have an appetite for taking on the same portfolio of risk you have right now with a lower expected return?

A - Kevin J. O'Donnell

The way we would think about it is – I think it's difficult to say this portfolio cheaper. Is that still acceptable? Because we'd need to think about what is the cost of the capital we're putting against it. Is it likewise experiencing a reduction in cost? I think going forward, a different way to ask the question is, do we feel like we're going to be positioned at 1/1 to write a portfolio in which we'll provide adequate returns for the capital we're putting to work. The answer to that is absolutely yes. I think the flexibility that we have is to how much we're retaining and then all the different vehicles in which we're sharing risk is extremely important to focus on and how we're thinking about constructing not only this portfolio but portfolios that we'll renew at 1/1 and beyond.

Q - Josh D. Shanker {BIO 5292022 <GO>}

Fair answer, and good luck in the turbulence.

A - Kevin J. O'Donnell

Appreciate it. Thanks.

Operator

Your next question comes from the line of Ian Gutterman from Balyasny.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Hi, thank you. I want to clarify some numbers first and then I had a question on competition. The $38 million of sort of small PCS events in cat, can you just give us a sense – there's always some, right? It's pretty rare there is zero, and I mean, you obviously don't show attritional loss ratio to zero at any time. So, is $38 million sort of normal, is it a little high, is it a lot high? Just sort of a sense of how that fares versus expectations.

A - Jeffrey D. Kelly {BIO 1390834 <GO>}

I characterized it as I think relatively low, and I would say it's relatively low to kind of – it's relatively low I think compared with other quarters. I think compared with second quarters in the past, we've certainly had second quarters where it's been higher than that, but it's actually marginally above average.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Got it. Got it. And then the – on the retro, you said it would probably be $180 million of cover. You didn't say where it attached. Can you give us that?

A - Kevin J. O'Donnell

Yeah. I think rather than get into specifics of a single transaction, I think what we're – the guidance we're giving on that is it's at the more frequent return periods for Florida-specific events.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Got it, got it. Okay. And then just on the market, I guess I'm curious on your perceptions of the following I guess. A lot of competitive talk about how they've bought sort of quote-unquote "cheap retro" to make up for the softening market, and yet I think you're one of the only ones who have actually not just done that but also shrunk your top-line and gotten off accounts. It seems a lot of others have been either flat or even grown their top-line and said, oh, boy, we bought this cheap retro, so it's okay.

I'm just wondering how you view – A, is that sort of making the market softer? Do we need people to actually get off gross accounts to find a bottom? And B, sort of what is the risk in – and you guys obviously could have done that too, maybe bought more retro to keep relationships. What's sort of the risks you're just seeing will keep the account for distribution and retro it out?

A - Kevin J. O'Donnell

Firstly, if everyone is trying to renew what they have or more, obviously that's going to add to the supply side and pricing pressure. With regard to retro and purchasing retro, if rates are down, in order to hold your top-line, the same, you need to write more and then match that up against the retro. So they're growing and then buying retro against it. I think it is potentially a strategy to think about doing that, but there's never a perfect match between a retro and an inwards book. So one needs to think about what's the risk that's resonant around the purchase that you're making.

I think from - thinking about different capital levers that one can pull, we have more access to (50:58 - 50:03) just retro. So I feel comfortable with the decisions that we're making on how we're (51:07 - 51:14) renewal or others will be something that we'll either (51:17) provide an opportunity.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Got it. And then just lastly, this one might be a little more cynical, but there's been a lot of commentary about companies rebalancing their portfolio to - this goes back to Jay's question about the impact of lower price on margins. And again, for the strategy you guys have been taking, I can understand it, but it seems there's a little bit of Lake Wobegon where everyone seems to suggest that they've rebalanced their portfolio so that they're not taking that much of a margin hit versus the headline rate cuts. Does that make sense? I mean, is it that the traditional market's been able to do that and sort of the worst businesses have gone to alternative markets? Or should I be more skeptical that most of the traditional markets have been able to rebound favorably in what seems like a hard market to do that?

A - Kevin J. O'Donnell

I think from our perspective, the thinking about how to build a portfolio is you need to recognize and be honest with what's going on with the market around you. And if rates are down, there's less premium associated with risk. I haven't seen a tremendous - I haven't seen areas in which we've seen increasing pricing in Specialty or in Cat. So I think thinking about adding more risk and rebalancing the portfolio without taking more net risk is a difficult proposition to today's market.

I think if you're going to use ceded to make up the difference, you kind of have two options. One is you need scale, because if the arb is not big, so you need to write a lot more and then cede a lot more, hoping the spread between the two makes - captures the lost income, or you need a very large spread in pricing between primary reinsurance and retro. And at this point, that - we haven't see a complete dislocation between retro and primary.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Got it. On the gross side specifically, I mean, should I assume that there's better business to change your gross mix too that everyone kind of would realize that and most people would gravitate there and that's probably the more competitive business? Or are there really pockets? I mean, obviously there's going to be mortgage insurance, but within cat, are there pockets where maybe you think there's sort of unrecognized value that not everyone can get access to?

A - Kevin J. O'Donnell

I think if you take what we did - we at 1/1, we put our guidance out and then we wrote - the reduction that we had was less than the guidance that we've put forth because we had an expectation that 6/1 was going to be more competitive than 1/1. It was frankly a little bit more than we thought, but directionally, it was pretty close. So, being thoughtful as to how you're going to position your book before the renewal is important, and I think we did that well going into this year. So our guidance of down 15% is not far off where we ultimately were, but we wrote it very differently, declining less at 1/1 and more at 6/1.

Q - Ian J. Gutterman {BIO 18249218 <GO>}

Got it, got it. Okay. Thank you.

Operator

Your next question comes from the line of Brian Meredith from UBS.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Hey, Kevin. I'm just curious - so it looks like the industry was pretty good at holding off changes in terms and conditions. I'm curious - and the new renewals. I'm curious, is that your view? And then looking forward, do you think there will be continued pressure on terms and conditions in Cat Reinsurance contracts?

A - Kevin J. O'Donnell

Yeah. I think if you look at what was going on in 6/1, there was - even over the course of all of 2014, there's been different attempts to substantially increase the amount of additional exposure put into cat contracts. Our view is additional exposure into a contract. It's just a different way to achieve a price reduction. I think the - in general, we're reasonably pleased with how the market held up from a terms and conditions standpoint, but I think the pressure will continue going into the 1/1 renewal.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Do you think there's a possibility that maybe the actual level of rate decreases, pricing actually subsides, but there's more push or more loosening of terms and conditions?

A - Kevin J. O'Donnell

I think that's always a risk. The way we think about it, we will price in any change in exposure. I think it is an easy way, if someone is looking to have a different headline number, is to expand coverage and keep price the same. I don't know whether that will be a strategy. It certainly will not our strategy. We'll reflect the risk we're taking for the price we're getting.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Got you. And the last question is, I'm just curious – you reduced your investment in DaVinci as a new investor coming on board. What are your conversations like with third-party capital that wants to invest with RenRe right now? I mean, are you saying, yeah, go ahead, let's get into the business right now, or are you telling them to be cautious? And what's demand look like from that perspective?

A - Kevin J. O'Donnell

So we have a lot of capital that has expressed interest in coming into our vehicles. And one of the reasons they're particularly interested in our vehicles is the alignment that we offer between the capital – our capital and their capital. So we're constantly making an assessment as to whether we are giving them good risk or not, and that's extremely valuable to third-party investors.

We, at this point, have not actively been looking for new investors to come in, but when we see long-term partners that we want, we will in many instances make room for them. From a return perspective, they look at the alignment and then the ability for us to provide a home for their capital and risk-adjusted rewards that are acceptable to them over the long-term, and we continue to have good interest in the vehicles that we offer.

Q - Brian R. Meredith {BIO 3108204 <GO>}

Great. Thank you.

A - Kevin J. O'Donnell

Yep.

Operator

At this time, there are no further questions. I will now turn it back over to management for closing remarks.

A - Kevin J. O'Donnell

Well, thank you, everybody, for your attention and your questions. There's a lot changing in the market, and I believe the results that you're seeing are based on conscious decisions that we've made, which were soundly based on providing the best risk-adjusted returns that the market can afford. So we're comfortable with the portfolios that were built and we look forward to continuing to work for you and communicate with you at the next earnings call. Thanks again.

Operator

Thank you. That concludes today's conference call. You may now disconnect.