Third Quarter 2021 Earnings Call Transcript
November 4, 2021

CORPORATE PARTICIPANTS

Chris Uchida, *Chief Financial Officer*

Mac Armstrong, *Chairman, Chief Executive Officer, and Founder*

CONFERENCE CALL PARTICIPANTS

Paul Newsome, *Piper Sandler*

Jeff Schmitt, *William Blair*

Matt Carletti, *JMP*

Mark Hughes, *Truist*

David Motemaden, *Evercore ISI*

Tracy Benguigui, *Barclays*

Meyer Shields, *KBW*

Pablo Singzon, *J.P. Morgan*

Adam Klauber, *William Blair*

PRESENTATION

Operator

Good morning and welcome to the Palomar Holdings Inc. Third Quarter 2021 Earnings Conference Call.

During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference line will be open for questions with instructions to follow at that time.

As a reminder, this conference call is being recorded.

I would now like to turn the call over to Mr. Chris Uchida, Chief Financial Officer. Please go ahead, sir.

Chris Uchida

Thank you, Operator, and good morning, everyone. We appreciate your participation in our Third Quarter 2021 Earnings Call.

With me here today is Mac Armstrong, our Chairman, Chief Executive Officer and Founder.

As a reminder, a telephonic replay of this call will be available on the Investor Relations section of our website through 11:59 PM Eastern Time on November 11, 2021.

Before we begin, let me remind everyone that this call may contain certain statements that constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These include remarks about Management's future expectations, beliefs, estimates, plans and prospects. Such statements are subject to a variety of risks, uncertainties and other factors that could cause actual results to differ materially from those indicated or implied by such statements, including but not limited to the risks and uncertainties related to the COVID-19 pandemic. Such risks and other factors are set forth in our quarterly report on Form 10-Q filed with the Securities and Exchange Commission. We do not undertake any duty to update these forward-looking statements.

Additionally, during today's call we will discuss certain non-GAAP measures, which we believe are useful in evaluating our performance. The presentation of this additional information should not be considered in isolation or as a substitute for results prepared in accordance with U.S. GAAP. A reconciliation of these non-GAAP measures to their most comparable GAAP measure can be found in our earnings release.

At this point, I'll turn the call over to Mac.

Mac Armstrong

Thank you, Chris, and good morning, everyone.

Today I'll speak to our third quarter results as well as our strategic initiatives and efforts to drive profitable growth for the remainder of 2021 and beyond. From there, I'll turn the call back to Chris to review our financial results in more detail.

We are pleased with the sustained premium growth in the numerous strategic Initiatives accomplished during the third quarter. Highlights of the quarter include strong written premium growth for yet another quarter with gross written premiums increasing by 48%. Growth across the enterprise was fuelled by strong performance among our core products, continued traction of new products and partnerships and entering into new lines of business and markets. Notable premium growth occurred in our Residential and Commercial Earthquake, Flood, Inland Marine and Hawaiian Hurricane products.

We also saw continued success with our nascent E&S Company, Palomar Excess and Surplus Insurance Company, PESIC as it grew its gross written premium 362% year-over-year, and 22% sequentially from the second quarter.

Second, we further expanded our product offering. Specifically we launched an E&S Residential Flood Product in a handful of states to complement our admitted offering. In September, we announced our entrance in the fronting sector of the U.S. insurance market. Palomar Front offers many advantages to Palomar including access points into attractive lines of business, limited incremental investment, and new sources of fee income. It also enables us to quickly enter new markets as a non-risk bearing insurance entity with the flexibility to participate in the risk over time.

Third, we maintain our commitment to the long-term growth prospects of Palomar to incremental investments in technology and more importantly talent. We successfully recruited experienced professionals across the enterprise, including subject matter experts, and new in adjacent casualty markets and dynamic additions to our reinsurance technology departments. I will highlight a few of these key hires later in my remarks.

Lastly, while we experienced pre-tax cat losses of $17.5 million net of reinsurance in the quarter as a result of Hurricane Ida and Nicholas and the PG&E excess liability loss, we take solace in the fact that approximately 61% of the gross losses from these events came from our discontinued admitted all risk and Louisiana specialty homeowners lines.

The residual hurricane loss from continuing operations was modest, well inside of our retention and close to four points of incremental loss ratio on an annualized basis while the PG&E loss had a catastrophe payback of less than one year. We constantly review our underwriting portfolio to ensure we are earning the appropriate risk adjusted returns by product and geography. The actions taken over the course of 2020 and 2021 not only positively impacted the quarter's results, but moreover, put us in a very good position for 2022 and beyond.

Turning to our results in more detail. Highlights include a year-over-year gross written premium growth of 48%. When adjusting for run up discontinued operations, the growth was an even more impressive 66%. Overall, we saw continued momentum across all our lines of business. Our earthquake franchise grew 32% in the quarter with Commercial Quake growing 52% and Residential Earthquake, our largest line of business, growing 24%.

Earthquake franchise continues to benefit from numerous tailwinds, notably California homeowners market dislocation, rate increases, inbound partnerships and potential regulatory reforms. Additionally, our E&S operation delivered $41.4 million in premium growing 362% year-over-year and 22%, sequentially from the prior quarter. Other strong performers included inland Marine, which grew at a staggering 343% year-over-year and is approaching an $80 million run rate in flood which grew 49%. We're very excited by the prospects for our flood products as not only are we expanding our geographic footprint, appointing new producers and ending—entering into carrier partnerships, but there's also potential regulatory tailwinds driven by the NFIP's Risk Rating 2.0 program, a risk pricing exercise undertaken by FEMA.

Shifting to market conditions, our strong growth not only speaks to the efficacy of our products, but also the continued dislocation in the specialty insurance market. The average rate increase on renewals for commercial earthquake policies was 9% and for our E&S all-risk business, the average rate increase is 20%. Builders risk and cost of construction risks are seeing high teen rate increases in base rates that are more than double where they were in 2018. We remain confident that we'll be able to maintain material rate increases throughout the remainder of the year and frankly into 2022.

Separately, our premium retention, excluding discontinued operations, was 87% of the total portfolio in the quarter, again showcasing the unique value our products offer insurers and distribution partners.

We continue to execute and make significant progress on extending our reach and product portfolio, striving to improve our underwriting results and visibility into our earnings. Newer products such as real estate E&O and high value residential builders risk are tracking ahead of plan and demonstrate our ability to rapidly address opportunities in the market.

Our nimble operating model enables us to quickly respond to changing market conditions and add new products and distribution partners to fuel our growth. Prime example is our Palomar Front initiative. Our team has already created a robust pipeline in a short period of time and subsequent to quarter end, we executed two fronting deals with proven partners. Ultimately, we believe this business represents another opportunity to capitalize on changing market dynamics and dislocations, while adhering to our focus on predictable and profitable growth.

Turning to our team. We're proud to share several notable additions including Ty Robben and Gerrit VandeKemp who will be spearheading our expansion into the casualty market, and Chris Cebula, our new SVP of Reinsurance. These seasoned professionals bring tremendous industry experience and expertise to Palomar's underwriting and reinsurance teams. Ty, Gerrit and Chris bring a wealth of knowledge and understanding to our already strong team and are prime examples of Palomar's continued focus on investing in the long-term growth of the business. Expanding our team is critical to our success and I'm thrilled that we can attract such experienced and talented professionals to the Palomar team.

On a related note, I'd like to take a moment to thank my good friend and partner Heath Fisher, who recently made the decision to resign from his role as President of Palomar to spend more time with his family. Since day one to Palomar, Heath was instrumental in developing our strategy, building our team and architecting our distinctive reinsurance program. Thanks in major part to Heath's efforts, we have a very strong and capable reinsurance team led by Jon Knutzen and Jon Christianson, who both continue to spearhead our efforts, but we will greatly miss Heath and plan to fully utilize his expertise prior to his departure in April.

I am pleased to report that Jon Christianson, our current Chief Underwriting Officer, will step into Heath's role as President in the second quarter. Jon was the third employee at Palomar and similar to Heath, he has been instrumental in our success. He will ably fill Heath's big shoes.

I'm also pleased to report that Robert Beyerle, our SVP of Inland Marine, will become our CUO. Robert has an incredible underwriting background and is the architect of our highly successful Inland Marine department. Chris and I are thrilled to work side by side with Jon and Robert

Sustainability and responsible governance remain a key component of Palomar strategy and operations. To that end, we recently launched our ESG portal on our corporate website, which details our ESG efforts and will act as a central repository for all Palomar's ESG materials. As we move forward, this will continue to be an area of focus for us, and I look forward to updating you on future initiatives.

Our strong top line results and all the initiatives discussed on the call offer considerable optimism for the future prospects of Palomar. That said, we also recognize the quarter generated losses that push net income and ROE below target levels. I mentioned earlier that close to 61% of the gross cat losses in the quarter were from discontinued lines of business. I will add, those same lines contributed 34% of the gross attritional loss in the quarter. When looking at the losses from a steady state basis, the attritional loss ratio is closer to 15%. The hurricane losses from the continuing lines of business, namely E&S property, were well below our retention and close to four points of loss ratio based on an annualized earned premium.

As for the excess liability policy with PG&E, we had a $735 million attachment point and a 75% rate online. This price point results in a full limit loss payback of less than one year. This is evidenced by the cumulative profitability incurred in the two treaty periods we have been on risk. When factoring in the acceleration of the earning of premium, the loss reduces net income by $2.3 million in the quarter. While we don't enjoy the noise caused by losses in the quarter, I'll continue to reiterate the impact of similar types of events will have a far lesser impact on a go-forward basis. I believe it is important to point out that the run off of the discontinued operations will be complete by the end of the fourth quarter. This effort, along with Palomar Front and the aggregate reinsurance cover, are prime examples of the actions we have taken and continue to take to reduce volatility in our book of business and our new space.

At this point, I'd like to touch on our guidance before turning the call back to Chris. We are revising our 2021 expectations and believe our adjusted net income in the fourth quarter will be between $17 million and $18.5 million and $51.2 million and $52.7 million for the full year. The full year estimates equates to an adjusted ROE of 13.7% at the midpoint of the range. The range factors in additional investments and talent, systems, infrastructure and reinsurance we have made or expect to make for the remainder of the year. As a reminder, with our aggregate cover in place, we have established a floor of approximately 11% for adjusted return on equity.

With that, I will turn the call over to Chris to discuss our results in more detail.

Chris Uchida

Thank you, Mac.

Please note that during my portion, when referring to any per share figure, I am referring to per diluted common share as calculated using the treasury stock method. This methodology requires us to include common share equivalents, such as outstanding stock options during profitable periods, and exclude them in periods where we incur a net loss. We have adjusted the calculations accordingly.

For the third quarter of 2021, our net income was $246,000 or $0.01 per share compared to a net loss of $15.7 million or $0.62 per share for the same quarter of 2020. Our adjusted net income was $1.7 million or $0.07 per share compared to an adjusted net loss of $15.2 million or $0.60 per share for the same quarter of 2020.

Gross written premiums for the third quarter were $152.3 million, representing an increase of 47.9% compared to the prior year's third quarter. As Mac indicated, this growth was driven by a combination of strong performance by our core products entering into new markets and by the execution of new partnerships across multiple lines of business.

Ceded written premiums for the third quarter were $58.1 million, representing an increase of 39.7% compared to the prior year's third quarter. The increase was primarily due to increased catastrophe excess of loss reinsurance expenses related to the exposure growth and increased quota sharing sessions due to the growth in volume of written premiums subject to quota shares. Ceded written premiums as a percentage of gross written premiums decreased to 38.1% for the three months ended September 30, 2021 from 40.4% for the three months ended September 30, 2020. This decrease is primarily due to lower excess of loss expense as a percentage of gross written premiums.

Net earned premiums for the third quarter were $64.7 million, an increase of 54% compared to the prior year's third quarter due to the growth and earning of higher gross written premiums, offset by the growth and earning of higher ceded written premiums under reinsurance agreements.

For the third quarter of 2021, net earned premiums as a percentage of gross earned premiums were 55.2% compared to 52.9% in the third quarter of 2020. The ratio was approximately one point higher this quarter due to the acceleration of earned premium from the PG&E policy. We believe the ratio of net earned premiums to gross earned premiums is a better metric for assessing our business versus the ratio of net written premiums to growth written premiums.

As part of the June 1 reinsurance renewal, we adjusted our participation in our attritional quota share arrangements. With these changes, we expect the ratio to be around 53% to 55% on an annual basis, lower at the beginning of a new reinsurance placement and higher at the end with our expected growth earned premium. While we are ahead of this range for the quarter, we expect pressure on this ratio with the launch of our fronting business, though we'll add fee income that will enhance the ROE and bottom line. We will continue to monitor this ratio and update the market based on our new business.

Losses and loss adjustment expense or LAE incurred for the third quarter were $28.5 million due to attritional losses of $11 million and catastrophe losses of $17.5 million. The loss ratio for the quarter was 44%, comprised of a catastrophe loss ratio of 27% and an attritional loss ratio of 17% compared to a loss ratio of 97.7% during the same period last year, comprised of a catastrophe loss ratio of 86.9% and an attritional loss ratio of 10.8%.

The third quarter catastrophe losses results include Ida and Nicholas of $14.8 million, the PG&E excess liability loss of $5 million and favourable prior period development, including favorable current year development of $2.3 million. Non-catastrophe losses increased due to a growth of lines of business subjected to attritional losses and higher attritional loss activity on line such as Specially Homeowners, Flood, Inland Marine and our newer lines of business with conservative loss estimates as we continue to grow the premium base. Additionally, about 14% of the attritional loss ratio for the quarter was from lines of business we are exiting. The attritional loss ratio would have been below 15% if we exclude those losses.

Our expense ratio for the third quarter of 2021 was 58.8% compared to 59.4% in the third quarter of 2020. On an adjusted basis, our expense ratio was 56.3% for the quarter compared to 58.1% in the third quarter of 2021 and compared to 60.5% sequentially in the second quarter of 2021, an improvement compared to both metrics.

Similar to our net earned premium ratio, we feel is a better representation of our business to look at our expense ratios as a percentage of gross earned premium. Our acquisition expense as a percentage of gross earned premium for the third quarter of 2021 was 22.5%, a slight improvement from 22.6% in the third quarter of 2020. The ratio of other underwriting expenses, excluding adjustments to gross earned premium for the third quarter of 2021 was 9.4%, a sequential improvement compared to 11.1% in the second quarter of 2021.

While we continue to invest in talent, systems and other infrastructure, we expect our business to scale over the long-term. Our combined ratio for the third quarter was 102.8% compared to 157.1% in the third quarter of 2020. Excluding the catastrophe losses in the quarter, our adjusted combined ratio was 73.2% for the third quarter compared to 68.9% in the third quarter of 2020. We believe that given the catastrophe activity in the third quarter of both years, this is a better measure of our results for comparison purposes and offers a better sense of our business on a steady state basis.

Net investment income for the third quarter was $2.2 million, an increase of 4.6% compared with the prior year's third quarter. The year-over-year increase was primarily due to a higher average balance of investments held during the three months ended September 30, 2021, offset by slightly lower yields on invested assets.

Our fixed income investments portfolio book yield during the third quarter was 2.19% compared to 2.33% for the third quarter of 2020. The weighted average duration of our fixed maturity investment portfolio, including cash equivalents, was 4.04 years at quarter end. Cash and invested assets totaled $467 million as compared to $450 million on September 30, 2020.

For the third quarter, we recognize losses on investments in the consolidated statement of income of $300,000 compared to a $24,000 gain in the prior year's third quarter. As our capital position has solidified and our lines of business continue to evolve, we have started to move a modest portion of our portfolio into traditional dividend yielding equity index funds. Equity funds, like the rest of our portfolio, will continue to be conservatively invested, but may impact our recognized gains and losses from quarter-to-quarter.

Our effective tax rate for the third quarter was negative 101.6% compared to 28.2% for the third quarter of 2020. For both quarters our income tax differed from the statutory rate due to the tax impact of permanent component of employee stock exercises. The rate for the current quarter is also skewed with pre-tax net income so close to breakeven. Our tax rate for the nine months ended September 30, 2021 was 18.3%.

Our stockholders' equity was $377.8 million at September 30, 2021 compared to $363.7 million at December 31, 2020. For the third quarter of 2021, annualized return on equity was 0.3% compared to negative 17% for the same period last year. Our annualized adjusted return on equity was 1.8% compared to negative 16.5% for the same period last year. Our adjusted annualized return on equity for the first nine months of 2021 was 12.3% compared to 4.7% last year. We did not repurchase any of our shares during the current quarter relating to the previously announced $40 million share repurchase authorization. For the current authorization we have repurchased approximately $15.8 million or 239,000 shares of common stock.

As Mac indicated, looking ahead to the remainder of 2021, we are providing fourth quarter adjusted net income guidance between $17 million and $18.5 million. This equates to an annual adjusted return on equity of 13.5% to 14%. As of September 30, 2021, we had 26,049,566 diluted shares outstanding, as calculated using the treasury stock method. We do not anticipate a material increase to this number during the year ahead.

With that, I'd like to ask the Operator to open up the line for any questions. Operator?

Operator

Our first question comes from the line of Paul Newsome with Piper Sandler. Please proceed with your question.

Paul Newsome

Good morning. Thanks for the call.

I was hoping you could talk a little bit more about the new fronting business and maybe a little bit about what the extent and limits of what you'd be interested in fronting are and maybe some of the risk management that's going to go behind it to make sure that what's fronting is—what's being fronted is what you want it to be fronting?

Mac Armstrong

Yes. Hi, Paul, it's Mac. Good morning. Thanks for the question.

We are excited about our entrance into the fronting market. I think it's worth pointing out that we actually historically have served as a front. We did so in our specialty homeowners segments as well as in flood but ultimately what we—by going into the market, it really affords us the opportunity to generate fee income in a non-risk bearing fashion, leverage existing infrastructure, enter new markets where we can potentially study the markets, learn more about them and determine if we want to take a participation in the future and then ultimately develop an expertise.

Where we stand right now, we have two deals that have been announced. One is we are fronting on behalf of an unrated insurance company and another is we are fronting on behalf of a cyber MGA. Both have been announced earlier this month, or—excuse me, in October. In both those instances we are 100%--or we are 100% reinsured and fully collateralized with the unearned premiums, we're collateralizing the unearned premium.

Now we want to take a conservative entry into this market. We potentially would be willing to take some risk on an occasional basis, especially where alignment may be more property focused, where we can leverage our reinsurance tower as well as our underwriting acumen and do the appropriate counterparty credit analysis. But I think as we go into the market, the majority of what you'll see from us will be pure fronts where we are not taking a risk participation and where we are collateralizing the UEP and that's what we've done for these first two deals. But we're excited about it and think there's great promise here.

Paul Newsome

That's great. Is there any limits on the kinds of products that you would front or it's just whatever to get more deals?

Mac Armstrong

Yes, I think we want to be domestic focused. I think there are certain lines of business that we are less inclined to front right now. We've come out and said that workers compensation is something, because of the longer tail and the collateral requirements, that's something that we'll probably be a little less interested in. I think heavy cat business is something that we're probably, unless it's something that's really up our alley, is something that we're going to shy away from. But, if we can get comfortable with the collateral, underwrite the partner, get the appropriate reinsurance, I think it does broaden up our market, some.

Paul Newsome

Then, separately, my question on the attritional loss ratio, you mentioned what it was if you excluded the runoff businesses. Do you think that's a fair run rate for the future? Or is there some adjustments we should think about prospectively from that base?

Chris Uchida

Hey, Paul, it is Chris. Great speaking with you again, I can handle the loss ratio question. Yes, as you outlined it well, when we think about the attritional loss ratio for Q3, was about 17%. We think about 2.4 points of that came from lines of business that we have exited. We do think that, that is a better marker for how the quarter performed. What you did see this quarter is we did have a lot of growth, and a lot of lines of business that do have attritional losses associated with them. We have taken conservative positions with some of those newer lines, we continue to use reinsurance and underwriting techniques to make sure that those losses are lower. But because those lines are growing at a healthy clip, we do expect them to contribute to the loss ratio. We have said it would move up based on the current book of business. Right now, we'd probably expect that loss ratio to come in between 14% and 16%.

Over time, we do expect that to still continue to pick up because we are expecting growth from those lines of business. But it's also nice to remember that we do have a strong anchor to our book of business or to our loss ratio with our earthquake and Hawaii wind lines that are very binary, and will—we're never going to be completely, let's call it, combined ratio or loss ratio focused.

We want to make sure that we are investing in very profitable lines of business, what we do think we have with our lines that do have additional losses, so we will continue to invest in those but these are profitable lines that do add to our overall ROE and bottom line profitability. These are lines that we like and like to get into. But we do think, obviously, this does enforce our decision to get out of the attritional or the all risk book of business and this shows why we weren't getting the requisite return on it. We want to make sure that we show that with and without, so to speak.

Paul Newsome

Thank you for your insights. Appreciate it.

Mac Armstrong

Thanks, Paul.

Operator

Our next question comes from the line of Jeff Schmitt with William Blair. Please proceed with your question.

Jeff Schmitt

Hi, good morning, everyone. The residential quake book continues to grow really nicely, over 20%. Where's that growth in, just from a geographic perspective? Has it been inside of California or outside of? Then maybe, could you discuss how much of a benefit you may be seeing? I know AIG reserve may be pulling back in quake, the large players pulling back in the California homeowners market. I'm just trying to gauge how sustainable you think this 20% growth is?

Mac Armstrong

Yes, Jeff. This is Mac, great question. We obviously are pleased with the continued success and sustained growth we are seeing in residential earthquake. It grew nearly 24% and we are optimistic that it can sustain close to a 20% growth rate for an indefinite period of time.

We obviously are growing nicely in California. We are also growing in the Pacific Northwest, and in other states. It's not just limited to California, it's Washington. It's actually states like Utah, Missouri, and as well, where we can leverage partnerships, like ones with Travelers, for instance, that are really focusing on outside of California quake opportunities. But California is the predominance of what we do. The dislocation in the homeowners market is a major contributor. I think it's one that has allowed to us to not only grow the premium and the policy count, but it's allowed us to grow our distribution footprint. Residential quake, our total production plan is up, I think 19%—no, it's up 23% year-over-year. That portends for future growth.

You mentioned AIG pulling out that has—we have benefited from that. I think it's actually where we've benefited there probably more in our E&S residential quake business, because it's high value and high value is more tailored for the E&S market.

Short story is we think there's great growth ahead of us in the residential quake market driven by those factors. We also are going to continue to monetize our partnerships and we've made concerted efforts to do so through what we're calling an inside sales team that's really focusing on driving new producers, new production activity, as well as appointing producers that are associated with some of our carrier partners.

Then there are potentially some regulatory catalysts that we could benefit from as well, something that we are watching really more on a prospective basis and is something that really wouldn't impact us until '22 or beyond.

Jeff Schmitt

Okay, great. Then, the commercial all-risk premium, the drop in the quarter, and I may have missed it if you address that, but I guess I thought you were transitioning that book to being more on an E&S basis. But could you maybe address that drop there and what you expect over the next two quarters?

Chris Uchida

Yes. We are running off the admitted all risks, and that basically, there was no premium written there in the quarter. The admitted business, we will be off all of that, basically, at the end of December. All of the all-risk business that we wrote in the quarter was E&S. In the third quarter, we wrote roughly $7 million, I think it was roughly $7 million a premium and that was tied to just all E&S business.

Mac Armstrong

Just for a comparative purposes, if you think about where we were last year, if you look at the number of about $12.5 million, almost all of it was made up of an immediate all-risk. I'd say there's about $1 million of the—$1.1 million of the E&S company, so that if you do the growth rate on $1.1 million to the $6.8 million, you're looking at a north of 500% growth. That's the bogey that's out there and obviously that affects the overall growth as well. We would have been in the 60%, 66% range of growth, if you take that book out of the equation.

Chris Uchida

I think one thing I'd add, Jeff, you may have heard it, but on the renewals, what we were seeing in the E&S all-risk was 20% rate increase on average. Frankly, it's something that we expect will accelerate into the fourth quarter as the market absorbs losses from Ida.

Jeff Schmitt

Got it. Okay. Very helpful. Thank you.

Operator

Our next question comes from the line of David Motemaden with Evercore ISI. Please proceed with your question.

David Motemaden

Hi. Thanks. Just a question on the catastrophe losses this quarter and I just wanted to clarify, would you have had a full retention loss if we take out the impact from the runoff of the discontinued lines?

Mac Armstrong

Dave, this is Mac. We would not have. As I pointed out, if you annualize the recurring cat loss for the quarter, it was about four points on the annualized earned premium, and that would have been losses from Nicholas and Ida and that does not obviously include the PG&E loss, the shock loss there, but so no, it would have been retained. Ida, on a standalone basis, would have been about halfway of our retention, a little bit more than halfway of our retention.

David Motemaden

Okay, that's great. Thank you for that color. That's good to hear.

Then maybe, and Chris, I just wanted to confirm I understood this right, just on the attritional loss ratio. Should we be thinking about a 14% to 15% baseline for this year off of which you would expect to increase a point or two a year just as the mix shifts to lines with more attritional losses?

Chris Uchida

Yes, I think that's a good way to describe it. Right. I think we're talking about this year, as our mix has changed and our book has grown, that it has been ticking up. I would have expected it to be, let's call it, on the lower side of the teens at the beginning of the year. I think that the growth we're seeing from lines like inland Marine, from lines like flood, and the builder's risk, and all those lines, and some of the newer lines, we are pushing that up a little bit.

I think the 14% to 16% range is what I would expect based on the current book on an annual basis. That could be a point higher, it could be a point lower, but I would say, my expectation is it's going to be in that range. Then like you described, I would expect that if we do continue to see this growth, especially in the newer lines, that it will start to keep ticking up. I would expect one to potentially two points a quarter, but again, we are continuing to use underwriting techniques and reinsurance to make sure that this doesn't swing volatilely and it's not going to just jump, it's not going to go from 15% to 30%. This is going to go up incrementally, slowly on a quarterly basis.

Mac Armstrong

Yes. Dave, if I'd just add a couple things. I'll reiterate a point that Chris made at the end of the call, I think we talked about it last quarter, 57% of our book right now has 0% attritional loss ratio as the Hawaiian hurricane, and obviously, most prominently the earthquake. Secondly, I'll just give an example. Our builders risk book grew 350% year-over-year, and—excuse me, Inland Marine, forgive me. Inland marine was 350% and that as a target loss ratio in the 30s in the quarter, it was around 15%. It performed very well at 15% loss ratio and a 35% loss ratio, it has a very good margin and a very good return. To Chris's point, it's accretive to the ROE. It's accretive to the line.

We feel good about how we are managing that. Then the last thing that I would add is, as we enter into new segments, especially in the casualty business, we are very conservative in our risk participation. Our average net line is going to be around $1 million for casualty business, with a max line potentially of $5 million. We are going to be ceding off close to 80%, in the—on the high end, and in certain cases is closer to 50%. You can manage the volatility, so to speak. As we go enter in these new lines of business, especially with people like Gerrit and Ty joining us, we want to give them the tools they need to execute on their business plans. But we're also going to do what we've done historically and use attritional reinsurance strategies, most notably quota share, to prevent major disruption or a book getting over cedes out of the gates.

David Motemaden

Got it. That's helpful. The cat load, theoretically, would be coming down as well as you have more of the casualty lines so that also something to consider.

Just lastly, on the other line of business, when you break out by line of business, the gross premiums written, that had another very strong quarter of growth. I'm wondering how much of that was driven by the excess liability line? Just given what happened with PG&E this quarter, definitely feels like a one off. But are there any actions that you're thinking about taking in terms of reducing the limit you guys are putting out there or using more reinsurance to prevent that from happening again in the future?

Mac Armstrong

Yes. Very good question. A fair question. In that other line is going to be mostly of what—all of our casualty business at this point. When, as I just mentioned, our net line on casualty business is going to be on the high end, $1 million. That, in its own right, shot loss there will not be as impactful as the loss from the PG&E account.

I think, also, when you look at the type of risk the PG&E account was, which was a high attaching, high rate online, I think I pointed out 75% rate online. There's really only one other risk that we have that's somewhat like that. It's a $2.5 million limit. It also has a high rate online, but it's in a different part of the country. It's a different exposure.

Long story short, yes, I think what you'll see is our net exposure will come down even though the PG&E or the true net exposure was around $2.2 million. We would probably, if we were to renew account like that, the line will probably be about half what it was

David Motemaden

Got it. That's helpful. Thank you.

Operator

Our next question comes from the line of Tracy Benguigui with Barclays. Please proceed with your question.

Tracy Benguigui

Thank you. I want to just get a better frame of reference, when you previously came out with your full year guidance of $64 million to $69 million, that did include at the time, I think, the Texas winter storm. Then now you just had results and you came out with a fourth quarter guidance. It would imply that you would be below that range. I'm just wondering if the original guidance did not include catastrophe losses? Or how should I be thinking about bridging that gap?

Chris Uchida

Hey, Tracy, it's Chris. I can try and bridge that gap for you. When you look at what the guidance we gave in the second quarter, we kept it, as you called, the $64 million to $69 million range. That did include the activity, the cat activity in the first part of the year. That was included in there. When you bridge it, compared to where we are now, we did have $17.5 million of additional cat losses this quarter. That is called the lion's share of it. The losses were slightly elevated, not where I'd say materially elevated. But I think that is—the cats are the biggest contributor this quarter, when you take that $17.5 million, tax effective that gets down to $14 million, $15 million, that's kind of the big bridge between where we are now and if you added the $17 million to $18.5 million on top of our year-to-date number, that's the bridge between taking that $64 million down to the $51 million, $52 million range.

Does that answer the question? Or is that …?

Tracy Benguigui

It does. I'm just wondering why maybe we shouldn't be thinking about a cat load?

Mac Armstrong

Yes, that's a fair question. Tracy, I think what I would tell you is, we don't—have not factored in a cat load. What I would direct you to is just with the experience that we just came out of it on a steady state basis, the losses from Ida and Nicholas equated to four points on an annualized earned premium basis. That might be something directionally you could look at. But our approach has been not to try to randomly spread a cat losses across the year.

Tracy Benguigui

Okay. My next question, and this may be super basic, but I was a little bit surprised how long your exit from admitted all-risk and your specialty home and Louisiana would take to make its way, as we saw, elevated catastrophe experienced this quarter? Mac, I think you said at our conference that you've reduced your exposure on your commercial all-risk segment by 80%, at least at that point in time. I'm just wondering why the lag, once you decided to exit a market, why would we still be a little bit longer?

Mac Armstrong

All right. Yes, Tracy. I wish it was as fast as you and I both hope or could see it. Unfortunately, you have to basically run off every policy. If you make the decision to exit on, let's just pick a 1031 2020, all those policies enforced wind down over the course of the year. When we spoke at your conference, we were down to less than 180 policies in force. It just so happened that the storm came when we had 17% of the books still left. It's not as simple as saying we're out of a market. It is as simple as saying we're out of the market, we're not going to write new business, but you do have to honour the policies in force and provide coverage for them until they lapse.

Tracy Benguigui

Okay. This is my last question. Where are we right now, in terms of any of those markets that you've exited?

Mac Armstrong

We will be out by 12/31. I think we are in Louisiana, we're probably the furthest through because that was the first state. I think Texas, we are—that will be the last one. By December, I think—September 1, our total insured value there will be a couple hundred million dollars and the policies would be in the, call it, 60 to 70 in that state, but they should all come off by the end of that month.

Tracy Benguigui

Very helpful. Thank you.

Operator

Our next question comes from the line of Mark Hughes with Truist. Please proceed with your question.

Mark Hughes

Yes, thank you, Mac. I don't know whether you touched on this earlier on the call, but the pricing dynamic you're seeing in the excess risk. Yes, you made it pretty clear that PG&E was an unusual situation. But what are you seeing more broadly in terms of pricing and competition for those excess risk?

Mac Armstrong

Yes, I think, Mark, it remains a pretty hard market in that excess liability space. We were actually talking to our professional liability team yesterday that recently joined. They are building out their filings and appointing producers and starting to get their first submissions in and the rates are materially up. For us, it's hard to say where they were compared to last year because we weren't on the business last year. But what we're hearing is that in the excess space the rates are up 40%, prior year-over-year; there are certain classes that you can't get coverage for, especially in some of the professional lines. We feel like our timing there is good, but it's also a circumstance where we want to be pretty judicious in how we go into that market. That's why we're solving for a net line of $1 million on an account.

But overarchingly I think we believe in, whether it's excess property or excess liability, there is a—almost in some ways a reinvigoration of the hard market. That gives us confidence that we're going to maintain a pretty good rate integrity through 2022.

Mark Hughes

When you say reinvigoration, are you talking now versus last quarter, six months ago?

Mac Armstrong

Yes, now versus last quarter. I'll give you an example. I think in E&S all-risk, we were 20% up in Q3. I think now you're looking at 25% up, if not more.

Mark Hughes

Understood. Thank you very much.

Mac Armstrong

Thanks, Mark.

Operator

Our next question comes from the line of Meyer Shields with KBW. Please proceed with your question.

Meyer Shields

Thanks. If I can take a step back, big picture. We've always defined the cat retention, cat net retention in the context of shareholders equity. Does the diversification of line of business change that at all?

Mac Armstrong

Meyer, I don't think it does. I hope that the diversification in the other lines of business allows us to bring down the cat load across the totality of the operation and drive some scale. We expect those diversifying lines, especially like Palomar Front, to provide a less risky or not a risk free margin that will help, but I still feel like we feel we want to maintain that retention inside of 3% of surplus and well inside of a quarter of earnings.

Meyer Shields

Okay, perfect. That's helpful. On the fronting business, I don't know if this is an answerable question. But what does it look like in an inevitable soft market?

Mac Armstrong

In a soft market it depends on who you're fronting for. I think we are fronting right now for MGAs. I think we're fronting for unrated insurance companies. I think in a soft market you're still going to need access to a licensed vehicle. I don't know. It may mean that margins get tighter for reinsurers, it may mean that margins get tighter for the MGAs. But there is a sunk cost or carrying cost associated with us taking tail risk, us taking regulatory and licensing risks. I think our margins will hold.

Meyer Shields

Okay, perfect. I was just hoping for an update in terms of California because I know that they're relatively recently were basically restricting the homeowners company's ability to non-renew policies, and I just wanted to get basically the current stats.

Mac Armstrong

Yes, so I think California put in place, it's probably the third geographic moratorium where certain homeowners companies are not able to—excuse me, admitted homeowners companies are prohibited from non-renewing in those markets. That is driven purely by wildfire exposure, wildfire, lack of appetite from the homeowners markets. But that doesn't mean that they're not going to be renewing at prices that might be higher, or there's still other areas that they're going to come out of because they're trying to reduce their exposure. It still creates dislocation. I think in many ways it actually heightens dislocation because it leads to a circumstance where homeowners' cares just grow further and further concerned about doing business in the state when they are precluded from non-renewing businesses that they deem is unprofitable.

Meyer Shields

Okay, perfect. Thank you very much.

Operator

Our next question comes from the line of Pablo Singzon with JPMorgan. Please proceed with your question.

Pablo Singzon

Hi, thanks. There was news about a month ago about the California Earthquake Authority setting up an in-house insurer to essentially mitigate the rise in prices and to avoid having to raise premium rates on customers. Is Palomar exposed to a similar dynamic of having to raise prices to absorb higher reinsurance costs? Bottom line from your perspective is what's happening with an opportunity or a threat?

Mac Armstrong

Yes, Pablo, I'm glad you asked that question. I think what is happening to CA is undoubtedly an opportunity for us. The CA has gone on record specifying that they potentially, based on sustainable strain on claims paying capacity because of increasing reinsurance costs. We are not in that circumstance. We buy about $1 billion—sorry for the background noise—$1.7 billion of excessive loss limit for earthquakes. We have clearly ample capacity to support our growth there. But I think most importantly, the CA again has said that they're worried about its claim paying capacity. Furthermore, they have said that their rates may double over the next five years unless they can solve for how much limit they have on their books. There's also been talk of them potentially shutting business.

We think it's an opportunity. The CEA governing body has been getting together on a bi-monthly basis or quarterly basis to review a proposed plan that's been put forth by the management of the CA. All in all, it lends itself well to dislocation, not only in the California homeowners market, but specifically in the earthquake market. We are primed to capitalize on that. We're watching it closely. We are doing what we can from a marketing standpoint to hopefully position us well when there is some inevitable change that comes out of the CEA. But I think that's more of a 2022 dynamic that comes to play.

Pablo Singzon

All right. Then my second question is, I was wondering if you could talk about your private flood exposure in California, and whether by geography or maybe property type. I'm just trying to get—and I think California is your biggest private flood state. I'm just trying to get a sense of your potential exposure to the floods in the northern part of the state and if it's such type of events that you price for and contemplate in your models? Thanks.

Mac Armstrong

Sure, Pablo. Yes, California is our largest state for our flood products. The model that we put in place in California was very similar to what we do on earthquake in that we created a pricing grid that basically price every location uniquely in the state of California. Therefore, we are able to price competitively against the NFIP. There were heavy rains. We have seen claims but nothing out of the ordinary. In fact, even in our attritional losses in the third quarter we had some measure of flood cat claims. We had losses from Ida in the state of Pennsylvania, for instance.

The flood program performs very well for us. The inception to-date loss ratio is less than 20%. We feel very good about its prospects in light of the work that we're doing from building out—extending our production footprint, building out partnerships, but also the potential regulatory reform that's tied to NFIPs risk rating 2.0, which is basically going to be repricing 5 million accounts.

Pablo Singzon

Yes. Then the last question for me is could you talk about to what extent earthquake pricing is correlated or not with just the higher P&C pricing environment? Thank you.

Mac Armstrong

Yes, Pablo, that's a very good question. I would say earthquake pricing certainly is impacted by catastrophe losses on a global and national basis. If reinsurance cost goes up, ultimately earthquake pricing will go up. In the third quarter our rates were up 9% That is slightly below where it was the prior two quarters, but it's still steady increases and allows us to potentially improve our margins some. It is correlated to cat losses on a global basis. It's probably a little bit more of an indirect corollary than wins. I think, again, a prime example of that is our E&S win was up 20% in the third quarter, quake was up 9%.

Pablo Singzon

Got it. Thank you.

Operator

Our next question comes from the line of Adam Klauber with William Blair. Please proceed with your question.

Adam Klauber

Hi. Thanks. Hi, guys. Just one or two quick questions. On expenses, underwriting expense for the year running up almost 50%, which I'd say, underwriting expense, which makes sense because you've been building a platform, hiring teams, getting new products up and running. As we think about '22, do you think that the rate of growth in underwriting expenses will come down compared to '21?

Chris Uchida

Yes, it's Chris. I'll try and address that question. Yes, I think you outlined it well. I would expect it to flatten a little bit as well this quarter. I think we did talk about some new hires that we had on, so those are going to add to the expense. We are going to continue to invest but we have seen the rate of other underwriting expenses compared to gross written premium continue to decrease, as we talked about. Earlier this year, we did expect the first half of this year to be up to a little bit flat; that has started to come down. It was 9.4% this quarter, Q2 was 11.1%. It is moving in the right direction.

With some of the investments we continue to make in the casualty space, the E&S business, I would expect it to be a little bit flatter in Q4 and maybe in Q1. But overall, it's going to scale over the long-term. The dollars are probably always going to increase in the near future, just because we are continuing to invest. I do not expect it to be at the same rate that we're growing the top line or earned premium. When you're looking at those things, it would be at a lower rate. But it's still going to be something we invest in, because we want to make sure we're building our organization and our business to continue to sustain that growth, and make sure that we have all the right pieces in place.

Adam Klauber

Right. If we look at your gross expense ratio this year with—obviously there's some moving pieces, but looks like it's coming in around 31.5%. As the other underwriting expenses slowed down, is it possible that we'll see some improvement in that gross expense ratio more in '22?

Chris Uchida

Yes, I think you can definitely expect to see more of it. That's where I would expect the most to come in. I think the other place is the acquisition expenses, a lot steadier, right, harder to maneuver as we go into the fronting. That can actually have influence on the acquisition expense side of it. There is the potential for some reduction on that side as well. But if I was to pick it, I would expect more of it to come from the other underwriting expenses. We do have still strong growth in other lines of business that you have higher acquisition expense, but I do expect the fronting over the next year or two to help the acquisition expense ratio as that business grows.

Adam Klauber

Thanks. That leads to my next question. On the fronting that the two programs run to date, are those more like in a tons of millions range potentially, or that could even be bigger as we think about whether '22, '23?

Mac Armstrong

Yes, Adam, this is Mac. Fair question. If I had to say what we're targeting for—we'd like to see in '22 $100 million a premium from that. I think if we do that, then it'll be a nice income stream, a nice risk free income stream. Those two are good anchors, so to speak, for that goal. We don't want fronting to become, in 2022, a $1 billion line that is driven by one large account that we could lose the next year. We're going to be deliberate in how we go into it. I think we've got two very good initial partners and a healthy pipeline.

Adam Klauber

If I remember correctly, I could be off here, but I always thought front fees were a little more single digit range, is that around?

Mac Armstrong

Yes, I think 5%, 6% is a good rule of thumb.

Adam Klauber

Yes. Okay. One last question, on the $12.5 million retention. When did that come up? Is that mid-year or is that year-end?

Mac Armstrong

June 1.

Adam Klauber

June 1, okay. Okay. Great. Thank you, guys.

Mac Armstrong

Thanks, Adam.

Operator

We have reached the end of the question-and-answer session. I'll now turn the call over to Mr. Armstrong for closing remarks.

Mac Armstrong

Well, thanks, Operator, and thanks for everyone on the call this morning. As always, we appreciate your participation, your thoughtful questions, and most importantly, your support.

As I mentioned in my prepared remarks, we are pleased with all that we accomplished in the third quarter. I think especially pleased when we look at it from the lens of 2022 and beyond. We exited the quarter in a better position than when it commenced. We continue to have a very positive outlook across the breadth of our business. We feel that we're in good shape for the rest of this year, and again, 2022 and beyond. We look forward to sharing our results with you at the end of Q4 as well as updates that may avail themselves over the days between then and now.

Enjoy the rest of your day and we'll speak to you soon. Take care.

Operator

This will conclude today's conference and you may disconnect your lines at this time. Thank you for your participation.