

HALLMARK FINANCIAL SERVICES INC
Form 10-Q
May 09, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the

Securities Exchange Act of 1934

For the quarterly period ended March 31, 2013

Commission file number 001-11252

Hallmark Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
Incorporation or organization)

87-0447375
(I.R.S. Employer
Identification No.)

777 Main Street, Suite 1000, Fort Worth, Texas 76102

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(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (817) 348-1600

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value \$.18 per share – 19,263,457 shares outstanding as of May 8, 2013.

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

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Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Balance Sheets

(\$ in thousands, except share amounts)

	March 31 2013 (unaudited)	December 31 2012
<u>ASSETS</u>		
Investments:		
Debt securities, available-for-sale, at fair value (cost: \$403,554 in 2013 and \$397,800 in 2012)	\$ 407,741	\$ 401,435
Equity securities, available-for-sale, at fair value (cost: \$33,187 in 2013 and \$31,502 in 2012)	52,789	43,925
Total investments	460,530	445,360
Cash and cash equivalents	91,450	85,145
Restricted cash	9,354	8,707
Ceded unearned premiums	22,930	22,411
Premiums receivable	72,334	66,683
Accounts receivable	2,830	3,110
Receivable for securities	5,653	3
Reinsurance recoverable	57,607	51,970
Deferred policy acquisition costs	26,317	24,911
Goodwill	44,695	44,695
Intangible assets, net	22,171	23,068
Deferred federal income taxes, net	-	1,940
Prepaid expenses	2,388	1,480
Other assets	10,722	10,985
Total assets	\$ 828,981	\$ 790,468
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Revolving credit facility payable	\$ 1,473	\$ 1,473
Subordinated debt securities	56,702	56,702
Reserves for unpaid losses and loss adjustment expenses	328,731	313,416
Unearned premiums	170,429	162,502
Reinsurance balances payable	7,210	7,330
Pension liability	3,646	3,685
Payable for securities	14,928	-
Federal income tax payable	620	1,518
Deferred federal income taxes, net	754	-
Accounts payable and other accrued expenses	17,095	23,305

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Total liabilities	601,588	569,931
Commitments and contingencies (Note 17)		
Stockholders' equity:		
Common stock, \$.18 par value, authorized 33,333,333; issued 20,872,831 shares in 2013 and 2012	3,757	3,757
Additional paid-in capital	122,538	122,475
Retained earnings	99,658	97,964
Accumulated other comprehensive income	12,998	7,899
Treasury stock (1,609,374 shares in 2013 and 2012), at cost	(11,558)	(11,558)
Total stockholders' equity	227,393	220,537
	\$ 828,981	\$ 790,468

The accompanying notes are an integral part of the consolidated financial statements

Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

(\$ in thousands, except per share amounts)

	Three Months Ended March 31,	
	2013	2012
Gross premiums written	\$ 108,147	\$ 97,395
Ceded premiums written	(14,251)	(12,433)
Net premiums written	93,896	84,962
Change in unearned premiums	(7,408)	(7,754)
Net premiums earned	86,488	77,208
Investment income, net of expenses	3,628	3,846
Net realized gains (losses)	1,176	(119)
Finance charges	1,425	1,640
Commission and fees	341	180
Other income	83	231
Total revenues	93,141	82,986
Losses and loss adjustment expenses	61,738	54,791
Other operating expenses	27,194	25,932
Interest expense	1,149	1,149
Amortization of intangible assets	897	897
Total expenses	90,978	82,769
Income before tax	2,163	217
Income tax expense	469	23
Net income	1,694	194
Less: Net income attributable to non-controlling interest	-	23
Net income attributable to Hallmark Financial Services, Inc.	\$ 1,694	\$ 171
Net income per share attributable to Hallmark Financial Services, Inc. common stockholders:		
Basic	\$0.09	\$0.01
Diluted	\$0.09	\$0.01

The accompanying notes are an integral part
of the consolidated financial statements

Hallmark Financial Services, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(\$ in thousands)

	Three Months Ended March 31,	
	2013	2012
Net income	\$1,694	\$194
Other comprehensive income:		
Change in net actuarial gain	123	120
Tax effect on change in net actuarial gain	(43)	(42)
Unrealized holding gains arising during the period	9,531	2,024
Tax effect on unrealized holding gains arising during the period	(3,336)	(709)
Reclassification adjustment for (gains) losses included in net income	(1,809)	101
Tax effect on reclassification adjustment for (gains) losses included in net income	633	(35)
Other comprehensive income, net of tax	5,099	1,459
Comprehensive income	\$6,793	\$1,653
Less: comprehensive income attributable to non-controlling interest	-	23
Comprehensive income attributable to Hallmark Financial Services, Inc.	\$6,793	\$1,630

The accompanying notes are an integral part of the consolidated financial statements

Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Stockholders' Equity

(Unaudited)

(\$ in thousands)

	Three Months Ended March 31,	
	2013	2012
Common Stock		
Balance, beginning of period	\$3,757	\$3,757
Balance, end of period	3,757	3,757
Additional Paid-In Capital		
Balance, beginning of period	122,475	122,487
Accretion of redeemable noncontrolling interest	-	19
Equity based compensation	63	138
Balance, end of period	122,538	122,644
Retained Earnings		
Balance, beginning of period	97,964	94,440
Net income attributable to Hallmark Financial Services, Inc.	1,694	171
Balance, end of period	99,658	94,611
Accumulated Other Comprehensive Income		
Balance, beginning of period	7,899	6,446
Additional minimum pension liability, net of tax	80	78
Net unrealized holding gains arising during period, net of tax	6,195	1,315
Reclassification adjustment for (gains) losses included in net income, net of tax	(1,176)	66
Balance, end of period	12,998	7,905
Treasury Stock		
Balance, beginning of period	(11,558)	(11,558)
Balance, end of period	(11,558)	(11,558)
Total Stockholders' Equity	\$227,393	\$217,359

The accompanying notes are an integral
part of the consolidated financial statements

Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(\$ in thousands)

	Three Months Ended March 31,	
	2013	2012
Cash flows from operating activities:		
Net income	\$1,694	\$194
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization expense	1,189	1,110
Deferred federal income taxes	(60)	(305)
Net realized (gains) losses	(1,176)	119
Share-based payments expense	63	138
Change in ceded unearned premiums	(519)	(48)
Change in premiums receivable	(5,651)	(11,026)
Change in accounts receivable	280	329
Change in deferred policy acquisition costs	(1,406)	(1,989)
Change in unpaid losses and loss adjustment expenses	15,315	8,771
Change in unearned premiums	7,927	7,801
Change in reinsurance recoverable	(5,637)	(1,420)
Change in reinsurance balances payable	(120)	1,022
Change in federal income tax payable	(898)	238
Change in all other liabilities	(6,249)	(216)
Change in all other assets	1,073	95
Net cash provided by operating activities	5,825	4,813
Cash flows from investing activities:		
Purchases of property and equipment	(154)	(34)
Net transfers (into) from restricted cash	(647)	1,675
Purchases of investment securities	(44,190)	(37,108)
Maturities, sales and redemptions of investment securities	45,471	29,045
Net cash provided by (used) in investing activities	480	(6,422)
Cash flows from financing activities:		
Activity under revolving credit facility, net	-	(2,500)
Distribution to non-controlling interest	-	(147)

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Net cash used in financing activities	-	(2,647)
Increase (decrease) in cash and cash equivalents	6,305	(4,256)
Cash and cash equivalents at beginning of period	85,145	74,471
Cash and cash equivalents at end of period	\$91,450	\$70,215

Supplemental cash flow information:

Interest paid	\$1,149	\$1,118
Income taxes paid	\$1,427	\$91

Supplemental schedule of non-cash investing activities:

Change in receivable for securities related to investment disposals that settled after the balance sheet date	\$(5,650)	\$2,169
Change in payable for securities related to investment purchases that settled after the balance sheet date	\$14,928	\$10,142

The accompanying notes are an integral part of the consolidated financial statements

Hallmark Financial Services, Inc. and Subsidiaries
Notes to Consolidated Financial Statements (Unaudited)

1. General

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company engaged in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing our insurance products, as well as providing other insurance related services.

We pursue our business activities through subsidiaries whose operations are organized into five business units that are supported by our insurance company subsidiaries. Our Standard Commercial P&C business unit handles commercial insurance products and services in the standard market. Our Workers Compensation business unit specializes in small and middle market workers compensation business. Our E&S Commercial business unit handles primarily commercial insurance products and services in the excess and surplus lines market. Our newly formed Hallmark Select business unit offers (i) general aviation insurance products and services, (ii) low and middle market commercial umbrella and excess liability insurance on both an admitted and non-admitted basis focusing primarily on trucking, specialty automobile and non-fleet automobile coverage, and (iii) medical professional liability insurance products and services. Our Hallmark Select business unit is the combination of our operations previously known as our General Aviation business unit, our Excess & Umbrella business unit and the medical professional liability business handled by our E&S Commercial business unit. Our Personal Lines business unit handles personal insurance products and services. Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Insurance Company (“HIC”), Hallmark Specialty Insurance Company (“HSIC”), Hallmark County Mutual Insurance Company (“HCM”), Hallmark National Insurance Company (“HNIC”) and Texas Builders Insurance Company (“TBIC”).

These five business units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment includes the Standard Commercial P&C business unit and the Workers Compensation business unit. The Specialty Commercial Segment includes the E&S Commercial business unit and the Hallmark Select business unit, as well as certain specialty risk programs (“Specialty Programs”) which are managed by Hallmark. The Personal Segment consists solely of the Personal Lines business unit.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and include our accounts and the accounts of our subsidiaries. All significant

intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2012 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of March 31, 2013 and 2012 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended March 31, 2013 are not necessarily indicative of the operating results to be expected for the full year.

Business Combinations

We account for business combinations using the acquisition method of accounting pursuant to Accounting Standards Codification (“ASC”) 805, “Business Combinations.” The base cash purchase price plus the estimated fair value of any non-cash or contingent consideration given for an acquired business is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on the estimated fair values of such assets and liabilities. The excess of the fair value of the total consideration given for an acquired business over the aggregate net fair values assigned to the assets acquired and liabilities assumed is recorded as goodwill. Contingent consideration is recognized as a liability at fair value as of the acquisition date with subsequent fair value adjustments recorded in the consolidated statements of operations. The valuation of contingent consideration requires assumptions regarding anticipated cash flows, probabilities of cash flows, discount rates and other factors. Significant judgment is employed in determining the propriety of these assumptions as of the acquisition date and for each subsequent period. Accordingly, future business and economic conditions, as well as changes in any of the assumptions, can materially impact the amount of contingent consideration expense we record in any given period. Indirect and general expenses related to business combinations are expensed as incurred.

Income Taxes

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end. Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes in effect for the year in which these temporary differences are expected to be recovered or settled.

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Refer to “Critical Accounting Estimates and Judgments” under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2012 for information on accounting policies that we consider critical in preparing our consolidated financial statements. Actual results could differ materially from those estimates.

Fair Value of Financial Instruments

Fair value estimates are made at a point in time, based on relevant market data as well as the best information available about the financial instruments. Fair value estimates for financial instruments for which no or limited observable market data is available are based on judgments regarding current economic conditions, credit and interest rate risk. These estimates involve significant uncertainties and judgments and cannot be determined with precision. As a result, such calculated fair value estimates may not be realizable in a current sale or immediate settlement of the instrument. In addition, changes in the underlying assumptions used in the fair value measurement technique, including discount rate and estimates of future cash flows, could significantly affect these fair value estimates.

Cash and Cash Equivalents: The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Restricted Cash: The carrying amount for restricted cash reported in the balance sheet approximates the fair value.

Revolving Credit Facility Payable: The carrying value of our bank revolving credit facility of \$1.5 million approximates the fair value based on the current interest rate.

Subordinated Debt Securities: Our trust preferred securities have a carried value of \$56.7 million and a fair value of \$49.0 million as of March 31, 2013. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.0%, which is based on similar issues to discount future cash flows. Our trust preferred securities would be included in Level 3 of the fair value hierarchy if they were reported at fair value.

For reinsurance recoverable, federal income tax payable and receivable, other assets and other liabilities, the carrying amounts approximate fair value because of the short maturity of such financial instruments.

Variable Interest Entities

On June 21, 2005, we formed Hallmark Statutory Trust I (“Trust I”), an unconsolidated trust subsidiary, for the sole purpose of issuing \$30.0 million in trust preferred securities. Trust I used the proceeds from the sale of these securities and our initial capital contribution to purchase \$30.9 million of subordinated debt securities from Hallmark. The debt securities are the sole assets of Trust I, and the payments under the debt securities are the sole revenues of Trust I.

On August 23, 2007, we formed Hallmark Statutory Trust II (“Trust II”), an unconsolidated trust subsidiary, for the sole purpose of issuing \$25.0 million in trust preferred securities. Trust II used the proceeds from the sale of these securities and our initial capital contribution to purchase \$25.8 million of subordinated debt securities from Hallmark. The debt securities are the sole assets of Trust II, and the payments under the debt securities are the sole revenues of Trust II.

We evaluate on an ongoing basis our investments in Trust I and II (collectively the “Trusts”) and we do not have a variable interest in the Trusts. Therefore, the Trusts are not included in our consolidated financial statements.

We are also involved in the normal course of business with variable interest entities (“VIE’s”) primarily as a passive investor in mortgage-backed securities and certain collateralized corporate bank loans issued by third party VIE’s. The maximum exposure to loss with respect to these investments is the investment carrying values included in the consolidated balance sheets.

Adoption of New Accounting Pronouncements

In January 2013, we adopted new guidance issued by the Financial Accounting Standards Board (“FASB”) related to reporting and disclosure requirements about changes in accumulated other comprehensive income balances and reclassifications out of accumulated other comprehensive income. The new guidance is effective prospectively for fiscal and interim periods beginning after December 15, 2012. The adoption of this guidance did not have a material impact on our financial position or results of operations but did require additional disclosures.

3. Business Combinations

Effective August 29, 2008, we acquired 80% of the issued and outstanding membership interests in Heath XS, LLC and Hardscrabble Data Solutions, LLC for consideration of \$15.0 million. In connection with the acquisition, we executed an operating agreement for each company. The operating agreements granted us the right to purchase the remaining 20% membership interests in the companies and granted an affiliate of the seller the right to require us to purchase such remaining membership interests. We exercised our call option effective September 30, 2012 and acquired the remaining 20% membership interests in the companies for \$1.7 million.

Effective December 31, 2010, we acquired all of the issued and outstanding capital stock of HNIC for initial consideration of \$14.0 million paid in cash on January 3, 2011 to State Auto Financial Corporation, Inc. In addition, an earnout of up to \$2.0 million is payable to the seller quarterly in an amount equal to 2% of gross collected premiums on new or renewal personal lines insurance policies written by HNIC agents during the three years following closing. HNIC is an Ohio domiciled insurance company that writes non-standard personal automobile policies through independent agents in 21 states.

Effective July 1, 2011, we acquired all of the issued and outstanding capital stock of TBIC Holding Corporation (“TBIC Holding”) for initial consideration of \$1.6 million paid in cash on July 1, 2011. In addition, a holdback purchase price of \$350 thousand was paid during the third quarter of 2012. A contingent purchase price of up to \$3.0 million may become payable following 16 full calendar quarters after closing based upon a formula contained in the acquisition agreement.

4. Fair Value

ASC 820 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. ASC 820, among other things, requires us to maximize the use of

observable inputs and minimize the use of unobservable inputs when measuring fair value. In addition, ASC 820 precludes the use of block discounts when measuring the fair value of instruments traded in an active market, which were previously applied to large holdings of publicly traded equity securities.

We determine the fair value of our financial instruments based on the fair value hierarchy established in ASC 820. In accordance with ASC 820, we utilize the following fair value hierarchy:

Level 1: quoted prices in active markets for identical assets;

Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, inputs of identical assets for less active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument; and

· Level 3: inputs to the valuation methodology that are unobservable for the asset or liability.

This hierarchy requires the use of observable market data when available.

Under ASC 820, we determine fair value based on the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. It is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy described above. Fair value measurements for assets and liabilities where there exists limited or no observable market data are calculated based upon our pricing policy, the economic and competitive environment, the characteristics of the asset or liability and other factors as appropriate. These estimated fair values may not be realized upon actual sale or immediate settlement of the asset or liability.

Where quoted prices are available on active exchanges for identical instruments, investment securities are classified within Level 1 of the valuation hierarchy. Level 1 investment securities include common and preferred stock.

Level 2 investment securities include corporate bonds, collateralized corporate bank loans, municipal bonds, and U.S. Treasury securities for which quoted prices are not available on active exchanges for identical instruments. We use third party pricing services to determine fair values for each Level 2 investment security in all asset classes. Since quoted prices in active markets for identical assets are not available, these prices are determined using observable market information such as quotes from less active markets and/or quoted prices of securities with similar characteristics, among other things. We have reviewed the processes used by the pricing services and have determined that they result in fair values consistent with the requirements of ASC 820 for Level 2 investment securities. In addition, using the prices received for the securities from the third party pricing services, we compare a sample of the prices against additional sources. We have not adjusted any prices received from the third party pricing services.

In cases where there is limited activity or less transparency around inputs to the valuation, investment securities are classified within Level 3 of the valuation hierarchy. Level 3 investments are valued based on the best available data in order to approximate fair value. This data may be internally developed and consider risk premiums that a market participant would require. Investment securities classified within Level 3 include other less liquid investment securities.

There were no transfers between Level 1 and Level 2 securities during the periods presented.

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at March 31, 2013 and December 31, 2012 (in thousands):

	As of March 31, 2013			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	\$-	\$ 37,655	\$ -	\$37,655
Corporate bonds	-	72,061	-	72,061
Collateralized corporate bank loans	-	100,527	832	101,359
Municipal bonds	-	143,473	19,248	162,721
Mortgage-backed	-	33,945	-	33,945
Total debt securities	-	387,661	20,080	407,741
Financial services	18,397	-	-	18,397
All other	34,392	-	-	34,392
Total equity securities	52,789	-	-	52,789
Total debt and equity securities	\$52,789	\$ 387,661	\$ 20,080	\$460,530

	As of December 31, 2012			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	\$-	\$ 40,061	\$ -	\$40,061
Corporate bonds	-	81,547	-	81,547
Collateralized corporate bank loans	-	105,463	908	106,371
Municipal bonds	-	144,972	18,760	163,732

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Mortgage-backed	-	9,724	-	9,724
Total debt securities	-	381,767	19,668	401,435
Financial services	14,887	-	-	14,887
All other	29,038	-	-	29,038
Total equity securities	43,925	-	-	43,925
Total debt and equity securities	\$43,925	\$ 381,767	\$ 19,668	\$445,360

Due to significant unobservable inputs into the valuation model for certain municipal bonds and a collateralized corporate bank loan in illiquid markets, we classified these investments as Level 3 in the fair value hierarchy. We used an income approach in order to derive an estimated fair value of the municipal bonds classified as Level 3, which included inputs such as expected holding period, benchmark swap rate, benchmark discount rate and a discount rate premium for illiquidity. The fair value of the collateralized corporate bank loan classified as Level 3 is based on discounted cash flows using current yield to maturity of 9.2%, which is based on the relevant spread over LIBOR for this particular loan to discount future cash flows. Significant changes in the unobservable inputs in the fair value measurement of our municipal bonds and collateralized corporate bank loan could result in a significant change in the fair value measurement.

The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the three months ended March 31, 2013 and 2012 (in thousands):

Beginning balance as of January 1, 2013	\$19,668
Sales	-
Settlements	(74)
Purchases	-
Issuances	-
Total realized/unrealized gains included in net income	-
Net gains included in other comprehensive income	486
Transfers into Level 3	-
Transfers out of Level 3	-
Ending balance as of March 31, 2013	\$20,080
Beginning balance as of January 1, 2012	\$20,608
Sales	-
Settlements	(67)
Purchases	-
Issuances	-
Total realized/unrealized gains included in net income	-
Net losses included in other comprehensive income	(730)
Transfers into Level 3	-
Transfers out of Level 3	-
Ending balance as of March 31, 2012	\$19,811

5. Investments

The amortized cost and estimated fair value of investments in debt and equity securities by category is as follows (in thousands):

As of March 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government	\$ 37,638	\$ 17	\$ -	\$ 37,655
Corporate bonds	70,366	2,604	(909)	72,061
Collateralized corporate bank loans	100,511	1,163	(315)	101,359
Municipal bonds	161,183	3,860	(2,322)	162,721
Mortgage-backed	33,856	228	(139)	33,945
Total debt securities	403,554	7,872	(3,685)	407,741
Financial services	10,778	7,619	-	18,397
All other	22,409	12,871	(888)	34,392
Total equity securities	33,187	20,490	(888)	52,789
Total debt and equity securities	\$ 436,741	\$ 28,362	\$ (4,573)	\$ 460,530
As of December 31, 2012				
U.S. Treasury securities and obligations of U.S. Government	\$ 40,050	\$ 14	\$ (3)	\$ 40,061
Corporate bonds	79,516	2,794	(763)	81,547
Collateralized corporate bank loans	106,093	1,021	(743)	106,371
Municipal bonds	162,479	4,023	(2,770)	163,732
Mortgage-backed	9,662	97	(35)	9,724
Total debt securities	397,800	7,949	(4,314)	401,435
Financial services	11,008	3,880	(1)	14,887
All other	20,494	9,058	(514)	29,038
Total equity securities	31,502	12,938	(515)	43,925
Total debt and equity securities	\$ 429,302	\$ 20,887	\$ (4,829)	\$ 445,360

Major categories of net realized (losses) gains on investments are summarized as follows (in thousands):

	Three Months Ended March 31, 2013 2012	
U.S. Treasury securities and obligations of U.S. Government	\$-	\$-
Corporate bonds	358	(114)
Collateralized corporate bank loans	173	1
Municipal bonds	(8)	(80)
Equity securities-financial services	188	92
Equity securities-all other	465	-
Gain (loss) on investments	1,176	(101)
Other-than-temporary impairments	-	(18)
Net realized gains (losses)	\$1,176	\$(119)

We realized gross gains on investments of \$1.2 million and \$0.1 million during the three months ended March 31, 2013 and 2012, respectively. We realized gross losses on investments of \$8 thousand and \$0.2 million during the three months ended March 31, 2013 and 2012, respectively. We recorded proceeds from the sale of investment securities of \$8.2 million and \$0.2 million during the three months ended March 31, 2013 and 2012, respectively. Realized investment gains and losses are recognized in operations on the specific identification method.

The following schedules summarize the gross unrealized losses showing the length of time that investments have been continuously in an unrealized loss position as of March 31, 2013 and December 31, 2012 (in thousands):

As of March 31, 2013

	12 months or less		Longer than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government	\$-	\$ -	\$-	\$ -	\$-	\$ -
Corporate bonds	5,072	(55)	6,301	(854)	11,373	(909)
Collateralized corporate bank loans	6,844	(90)	10,354	(225)	17,198	(315)
Municipal bonds	24,459	(273)	34,894	(2,049)	59,353	(2,322)
Mortgage-backed	18,013	(136)	103	(3)	18,116	(139)
Total debt securities	54,388	(554)	51,652	(3,131)	106,040	(3,685)
Financial services	-	-	-	-	-	-
All other	2,368	(888)	-	-	2,368	(888)
Total equity securities	2,368	(888)	-	-	2,368	(888)
Total debt and equity securities	\$56,756	\$ (1,442)	\$51,652	\$ (3,131)	\$108,408	\$ (4,573)

As of December 31, 2012

	12 months or less		Longer than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. Government	\$23,998	\$ (3)	\$-	\$ -	\$23,998	\$ (3)
Corporate bonds	10,802	(38)	6,910	(725)	17,712	(763)
Collateralized corporate bank loans	6,273	(97)	14,236	(646)	20,509	(743)
Municipal bonds	30,073	(362)	28,809	(2,408)	58,882	(2,770)
Mortgage-backed	7,367	(32)	84	(3)	7,451	(35)
Total debt securities	78,513	(532)	50,039	(3,782)	128,552	(4,314)

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Financial services	92	(1)	-	-	92	(1)	
All other	3,271	(514)	-	-	3,271	(514)	
Total equity securities	3,363	(515)	-	-	3,363	(515)	
Total debt and equity securities	\$81,876	\$ (1,047)	\$50,039	\$ (3,782)	\$131,915	\$ (4,829)

At March 31, 2013, the gross unrealized losses more than twelve months old were attributable to 59 debt security positions. At December 31, 2012, the gross unrealized losses more than twelve months old were attributable to 56 debt security positions. We consider these losses as a temporary decline in value as they are predominately on bonds that we do not intend to sell and do not believe we will be required to sell prior to recovery of our amortized cost basis. We see no indications that the decline in values of these securities is other-than-temporary.

Based on evidence gathered through our normal credit evaluation process, we presently expect that all debt securities held in our investment portfolio will be paid in accordance with their contractual terms. Nonetheless, it is at least reasonably possible that the performance of certain issuers of these debt securities will be worse than currently expected resulting in additional future write-downs within our portfolio of debt securities.

Also, as a result of the challenging market conditions, we expect the volatility in the valuation of our equity securities to continue in the foreseeable future. This volatility may lead to impairments on our equity securities portfolio or changes regarding retention strategies for certain equity securities.

We complete a detailed analysis each quarter to assess whether any decline in the fair value of any investment below cost is deemed other-than-temporary. All securities with an unrealized loss are reviewed. We recognize an impairment loss when an investment's value declines below cost, adjusted for accretion, amortization and previous other-than-temporary impairments and it is determined that the decline is other-than-temporary.

Debt Investments: We assess whether we intend to sell, or it is more likely than not that we will be required to sell, a fixed maturity investment before recovery of its amortized cost basis less any current period credit losses. For fixed maturity investments that are considered other-than-temporarily impaired and that we do not intend to sell and will not be required to sell, we separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the investment's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the investment's fair value and the present value of future expected cash flows is recognized in other comprehensive income.

Equity Investments: Some of the factors considered in evaluating whether a decline in fair value for an equity investment is other-than-temporary include: (1) our ability and intent to retain the investment for a period of time sufficient to allow for an anticipated recovery in value; (2) the recoverability of cost; (3) the length of time and extent to which the fair value has been less than cost; and (4) the financial condition and near-term and long-term prospects for the issuer, including the relevant industry conditions and trends, and implications of rating agency actions and offering prices. When it is determined that an equity investment is other-than-temporarily impaired, the security is written down to fair value, and the amount of the impairment is included in earnings as a realized investment loss. The fair value then becomes the new cost basis of the investment, and any subsequent recoveries in fair value are recognized at disposition. We recognize a realized loss when impairment is deemed to be other-than-temporary even if a decision to sell an equity investment has not been made. When we decide to sell a temporarily impaired available-for-sale equity investment and we do not expect the fair value of the equity investment to fully recover prior to the expected time of sale, the investment is deemed to be other-than-temporarily impaired in the period in which the decision to sell is made.

The amortized cost and estimated fair value of debt securities at March 31, 2013 by contractual maturity are as follows. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties.

	Amortized Fair	
	Cost	Value
	(in thousands)	
Due in one year or less	\$67,805	\$68,784
Due after one year through five years	161,830	163,838
Due after five years through ten years	88,205	89,711
Due after ten years	51,858	51,463
Mortgage-backed	33,856	33,945
	\$403,554	\$407,741

6. Pledged Investments

We have pledged certain of our securities for the benefit of various state insurance departments and reinsurers. These securities are included with our available-for-sale debt securities because we have the ability to trade these securities. We retain the interest earned on these securities. These securities had a carrying value of \$22.1 million and \$24.3 million at March 31, 2013 and December 31, 2012, respectively.

7. Reserves for Unpaid Losses and Loss Adjustment Expenses

Unpaid losses and loss adjustment expense (“LAE”) represent the estimated ultimate net cost of all reported and unreported losses incurred through each balance sheet date. The reserves for unpaid losses and LAE are estimated using individual case-basis valuations and statistical analyses. These reserves are revised periodically and are subject to the effects of trends in loss severity and frequency. Due to the inherent uncertainty in estimating unpaid losses and LAE, the actual ultimate amounts may differ from the recorded amounts. The estimates are periodically reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations. The aggregate loss reserves are increased or decreased to reflect unfavorable or favorable loss development when the available information indicates a reasonable likelihood that the ultimate loss would be more or less than the previous estimates.

We recorded \$2.0 million of unfavorable development in reserve estimates during the three months ended March 31, 2013. The \$2.0 million unfavorable development recognized in the first quarter of 2013 was attributable to \$0.7 million unfavorable development on claims incurred in the 2012 accident year, \$1.6 million unfavorable development

on claims incurred in the 2011 accident year, \$0.1 million unfavorable development on claims incurred in the 2010 accident year partially offset by \$0.4 million favorable development on claims incurred in the 2009 and prior accident years. Our E&S Commercial business unit accounted for \$3.5 million of the unfavorable development recognized during the first quarter of 2013. These unfavorable developments were partially offset by favorable development of \$0.5 million in our Hallmark Select business unit, \$0.3 million in our Personal Lines business unit and \$0.7 million in our Standard Commercial P&C business unit. The unfavorable development for our E&S Commercial business unit of \$3.5 million was primarily driven by unfavorable claims development in the 2011 and 2010 accident years as a result of unfavorable loss development in commercial auto liability. The favorable development for our Hallmark Select business unit of \$0.5 million was driven by favorable claims development in the 2011 and prior accident years related to our aircraft liability lines of business, partially offset by unfavorable claims development in the 2012 accident year related to our aircraft hull coverage. The favorable loss development for our Personal Lines business unit of \$0.3 million was attributable to the 2012 and 2011 accident years, partially offset by unfavorable development in the 2010 and prior accident years. The favorable loss development for our Standard Commercial P&C business unit of \$0.7 million was primarily related to commercial auto liability in the 2010 and prior accident years, partially offset by unfavorable loss development related to commercial property in the 2012 accident year.

We recorded \$3.0 million of favorable development in reserve estimates during the three months ended March 31, 2012. The \$3.0 million favorable development recognized in the first quarter of 2012 was attributable to \$0.3 million favorable development on claims incurred in the 2011 accident year, \$0.5 million favorable development on claims incurred in the 2010 accident year, \$0.9 million favorable development on claims incurred in the 2009 accident year and \$1.3 million favorable development on claims incurred in the 2008 and prior accident years. Our Standard Commercial P&C business unit and E&S Commercial business unit accounted for \$2.9 million and \$0.9 million, respectively, of the favorable development recognized during the first quarter of 2012. These favorable developments were partially offset by \$0.8 million of unfavorable development in our Personal Lines business unit. The favorable development for our Standard Commercial P&C business unit of \$2.9 million was driven by favorable claims development in the 2011 accident year as a result of favorable loss development in commercial property and commercial auto liability. Further contributing to the favorable development for our Standard Commercial P&C business unit was favorable claims development in the 2009 and prior accident years driven primarily by general liability and commercial auto liability. The favorable development for our E&S Commercial business unit of \$0.9 million was driven by favorable claims development in the 2010 and prior accident years as a result of favorable loss development in general liability, commercial auto liability and commercial property, partially offset by unfavorable claims development in the 2011 accident year as a result of unfavorable loss development in commercial auto physical damage. The unfavorable loss development for our Personal Lines business unit of \$0.8 million was attributable to 2010 and prior accident years.

8. Share-Based Payment Arrangements

Our 2005 Long Term Incentive Plan (“2005 LTIP”) is a stock compensation plan for key employees and non-employee directors that was approved by the shareholders on May 26, 2005. There are 2,000,000 shares authorized for issuance under the 2005 LTIP. As of March 31, 2013, there were incentive stock options to purchase 1,100,832 shares of our common stock outstanding and non-qualified stock options to purchase 304,157 shares of our common stock outstanding and there were 579,178 shares reserved for future issuance under the 2005 LTIP. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

Incentive stock options granted under the 2005 LTIP prior to 2009 vest 10%, 20%, 30% and 40% on the first, second, third and fourth anniversary dates of the grant, respectively, and terminate five to ten years from the date of grant. Incentive stock options granted in 2009 and one grant of 5,000 incentive stock options in 2011 vest in equal annual increments on each of the first seven anniversary dates and terminate ten years from the date of grant. One grant of 25,000 incentive stock options in 2010 and one grant of 10,000 incentive stock options in 2011 vest in equal annual increments on each of the first three anniversary dates and terminate ten years from the date of grant. Non-qualified stock options granted under the 2005 LTIP generally vest 100% six months after the date of grant and terminate ten years from the date of grant. One grant of 200,000 non-qualified stock options in 2009 vests in equal annual increments on each of the first seven anniversary dates and terminates ten years from the date of grant.

A summary of the status of our stock options as of March 31, 2013 and changes during the three months then ended is presented below:

	Number of Shares	Weighted Average Exercise Price	Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (\$000)
Outstanding at January 1, 2013	1,404,989	\$ 9.63		
Granted	-			
Exercised	-			
Forfeited or expired	-			
Outstanding at March 31, 2013	1,404,989	\$ 9.63	5.0	\$ 1,421
Exercisable at March 31, 2013	1,111,418	\$ 10.40	4.7	\$ 758

The following table details the intrinsic value of options exercised, total cost of share-based payments charged against income before income tax benefit and the amount of related income tax benefit recognized in income for the periods indicated (in thousands):

	Three Months Ended March 31, 2013	2012
Intrinsic value of options exercised	\$-	\$-
Cost of share-based payments (non-cash)	\$63	\$138
Income tax benefit of share-based payments recognized in income	\$8	\$11

As of March 31, 2013, there was \$0.6 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which \$0.1 million is expected to be recognized for the remainder of 2013 and \$0.2 million is expected to be recognized each year in 2014 and 2015 and \$0.1 million is expected to be recognized in 2016.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of Hallmark's and similar companies' common stock

for a period equal to the expected term. The risk-free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options' expected lives on the dates of grant. Expected term is determined based on the simplified method as we do not have sufficient historical exercise data to provide a basis for estimating the expected term. There were no options granted during the first quarter of 2012 or 2013.

9. Segment Information

The following is business segment information for the three months ended March 31, 2013 and 2012 (in thousands):

	Three Months Ended March 31,	
	2013	2012
<u>Revenues:</u>		
Standard Commercial Segment	\$20,288	\$18,106
Specialty Commercial Segment	51,680	40,393
Personal Segment	20,978	24,431
Corporate	195	56
Consolidated		