

HALLMARK FINANCIAL SERVICES INC  
Form 10-Q  
August 07, 2017

**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 June 30, 2017

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.)

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777 Main Street, Suite 1000, Fort Worth, Texas 76102  
(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, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 15(a) of the Exchange Act.

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 –18,176,579 shares outstanding as of August 7, 2017.

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

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**Hallmark Financial Services, Inc. and Subsidiaries****Consolidated Balance Sheets**

(\$ in thousands, except par value)

|   | June 30, 2017<br>(unaudited) | December 31,<br>2016 |
|---|------------------------------|----------------------|
| <b>ASSETS</b>   |                              |                      |
| Investments:  |                              |                      |
| Debt securities, available-for-sale, at fair value (cost: \$605,986 in 2017 and \$597,784 in 2016)      | \$ 608,074                   | \$ 597,457           |
| Equity securities, available-for-sale, at fair value (cost: \$33,220 in 2017 and \$31,449 in 2016)      | 56,477                       | 51,711               |
| Other investments (cost, \$3,763 in 2017 and 2016)  | 4,448                        | 4,951                |
| Total investments   | 668,999                      | 654,119              |
| Cash and cash equivalents   | 77,448                       | 79,632               |
| Restricted cash   | 3,458                        | 7,327                |
| Ceded unearned premiums   | 92,638                       | 81,482               |
| Premiums receivable   | 107,806                      | 89,715               |
| Accounts receivable   | 1,756                        | 2,269                |
| Receivable for securities   | 1,620                        | 3,047                |
| Reinsurance recoverable   | 164,434                      | 147,821              |
| Deferred policy acquisition costs   | 19,335                       | 19,193               |
| Goodwill  | 44,695                       | 44,695               |
| Intangible assets, net  | 11,257                       | 12,491               |
| Deferred federal income taxes, net  | 1,621                        | 1,365                |
| Federal income tax recoverable  | 1,797                        | 3,951                |
| Prepaid expenses  | 2,256                        | 1,552                |
| Other assets  | 13,720                       | 13,801               |
| Total assets  | \$ 1,212,840                 | \$ 1,162,460         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                              |                      |
| Liabilities:  |                              |                      |
| Revolving credit facility payable   | \$ 30,000                    | \$ 30,000            |
| Subordinated debt securities (less unamortized debt issuance cost of \$975 in 2017 and \$1,001 in 2016) | 55,727                       | 55,701               |
| Reserves for unpaid losses and loss adjustment expenses   | 505,358                      | 481,567              |
| Unearned premiums   | 261,893                      | 241,254              |
| Reinsurance balances payable  | 54,178                       | 46,488               |
| Pension liability   | 2,100                        | 2,203                |
| Payable for securities  | 13,257                       | 14,215               |
| Accounts payable and other accrued expenses   | 24,627                       | 25,296               |
| Total liabilities   | \$ 947,140                   | \$ 896,724           |

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Commitments and Contingencies (Note 16)

Stockholders' equity:

|   |              |              |
|---|--------------|--------------|
| Common stock, \$.18 par value, authorized 33,333,333; issued 20,872,831 shares in 2017 and 2016 | 3,757        | 3,757        |
| Additional paid-in capital  | 123,110      | 123,166      |
| Retained earnings   | 148,663      | 148,027      |
| Accumulated other comprehensive income  | 13,933       | 10,371       |
| Treasury stock (2,637,434 shares in 2017 and 2,260,849 in 2016), at cost                        | (23,763 )    | (19,585 )    |
| Total stockholders' equity  | \$ 265,700   | \$ 265,736   |
| Total liabilities and stockholders' equity  | \$ 1,212,840 | \$ 1,162,460 |

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 June 30, |            | Six Months Ended June 30, |            |
|-------------------------------------|-----------------------------|------------|---------------------------|------------|
|                                     | 2017                        | 2016       | 2017                      | 2016       |
| Gross premiums written              | \$ 162,056                  | \$ 144,037 | \$ 297,168                | \$ 272,484 |
| Ceded premiums written              | (61,162 )                   | (48,794 )  | (107,755 )                | (89,615 )  |
| Net premiums written                | 100,894                     | 95,243     | 189,413                   | 182,869    |
| Change in unearned premiums         | (10,187 )                   | (7,545 )   | (9,483 )                  | (10,844 )  |
| Net premiums earned                 | 90,707                      | 87,698     | 179,930                   | 172,025    |
| Investment income, net of expenses  | 4,587                       | 3,994      | 9,066                     | 7,873      |
| Net realized losses                 | (3,479 )                    | (2,177 )   | (1,419 )                  | (2,404 )   |
| Finance charges                     | 936                         | 1,348      | 1,989                     | 2,789      |
| Commission and fees                 | 653                         | 155        | 725                       | 732        |
| Other income                        | 71                          | 34         | 132                       | 65         |
| Total revenues                      | 93,475                      | 91,052     | 190,423                   | 181,080    |
| Losses and loss adjustment expenses | 70,704                      | 58,502     | 132,546                   | 113,897    |
| Other operating expenses            | 25,879                      | 29,323     | 53,374                    | 56,219     |
| Interest expense                    | 1,193                       | 1,123      | 2,349                     | 2,254      |
| Amortization of intangible assets   | 617                         | 617        | 1,234                     | 1,234      |
| Total expenses                      | 98,393                      | 89,565     | 189,503                   | 173,604    |
| (Loss) income before tax            | (4,918 )                    | 1,487      | 920                       | 7,476      |
| Income tax (benefit) expense        | (1,568 )                    | 421        | 284                       | 2,336      |
| Net (loss) income                   | (3,350 )                    | 1,066      | 636                       | 5,140      |
| Net (loss) income per share:        |                             |            |                           |            |
| Basic                               | \$ (0.18 )                  | \$ 0.06    | \$ 0.03                   | \$ 0.27    |
| Diluted                             | \$ (0.18 )                  | \$ 0.06    | \$ 0.03                   | \$ 0.27    |

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<br>June 30, |          | Six Months Ended<br>June 30, |          |
|---|--------------------------------|----------|------------------------------|----------|
|   | 2017                           | 2016     | 2017                         | 2016     |
| Net (loss) income   | \$ (3,350 )                    | \$ 1,066 | \$ 636                       | \$ 5,140 |
| Other comprehensive income:   |                                |          |                              |          |
| Change in net actuarial gain  | 35                             | 29       | 70                           | 57       |
| Tax effect on change in net actuarial gain  | (12 )                          | (10 )    | (24 )                        | (20 )    |
| Unrealized holding gains arising during the period                                  | 2,654                          | 4,358    | 7,900                        | 5,729    |
| Tax effect on unrealized holding gains arising during the period                    | (929 )                         | (1,525 ) | (2,765 )                     | (2,005 ) |
| Reclassification adjustment for losses (gains) included in net income               | 10                             | (410 )   | (2,491 )                     | (484 )   |
| Tax effect on reclassification adjustment for losses (gains) included in net income | (3 )                           | 143      | 872                          | 169      |
| Other comprehensive income, net of tax  | 1,755                          | 2,585    | 3,562                        | 3,446    |
| Comprehensive (loss) income   | \$ (1,595 )                    | \$ 3,651 | \$ 4,198                     | \$ 8,586 |

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<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|---|--------------------------------|------------------|------------------------------|------------------|
|   | 2017                           | 2016             | 2017                         | 2016             |
| <b>Common Stock</b>   |                                |                  |                              |                  |
| Balance, beginning of period  | \$3,757                        | \$3,757          | \$3,757                      | \$3,757          |
| Balance, end of period  | 3,757                          | 3,757            | 3,757                        | 3,757            |
| <b>Additional Paid-In Capital</b>   |                                |                  |                              |                  |
| Balance, beginning of period  | 123,183                        | 123,619          | 123,166                      | 123,480          |
| Equity based compensation   | 19                             | 89               | 46                           | 228              |
| Shares issued under employee benefit plans  | (92 )                          | (58 )            | (102 )                       | (58 )            |
| Balance, end of period  | 123,110                        | 123,650          | 123,110                      | 123,650          |
| <b>Retained Earnings</b>  |                                |                  |                              |                  |
| Balance, beginning of period  | 152,013                        | 145,575          | 148,027                      | 141,501          |
| Net (loss) income   | (3,350 )                       | 1,066            | 636                          | 5,140            |
| Balance, end of period  | 148,663                        | 146,641          | 148,663                      | 146,641          |
| <b>Accumulated Other Comprehensive Income</b>                                     |                                |                  |                              |                  |
| Balance, beginning of period  | 12,178                         | 8,279            | 10,371                       | 7,418            |
| Additional minimum pension liability, net of tax                                  | 23                             | 19               | 46                           | 37               |
| Unrealized holding gains arising during period, net of tax                        | 1,725                          | 2,833            | 5,135                        | 3,724            |
| Reclassification adjustment for losses (gains) included in net income, net of tax | 7                              | (267 )           | (1,619 )                     | (315 )           |
| Balance, end of period  | 13,933                         | 10,864           | 13,933                       | 10,864           |
| <b>Treasury Stock</b>   |                                |                  |                              |                  |
| Balance, beginning of period  | (20,105 )                      | (15,423 )        | (19,585 )                    | (14,130 )        |
| Acquisition of treasury stock   | (3,862 )                       | (3,452 )         | (4,425 )                     | (4,745 )         |
| Shares issued under employee benefit plans  | 204                            | 58               | 247                          | 58               |
| Balance, end of period  | (23,763 )                      | (18,817 )        | (23,763 )                    | (18,817 )        |
| <b>Total Stockholders' Equity</b>   | <b>\$265,700</b>               | <b>\$266,095</b> | <b>\$265,700</b>             | <b>\$266,095</b> |

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)

|   | Six Months Ended June 30, |           |
|---|---------------------------|-----------|
|   | 2017                      | 2016      |
| Cash flows from operating activities:   |                           |           |
| Net income  | \$ 636                    | \$ 5,140  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |           |
| Depreciation and amortization expense   | 2,256                     | 1,923     |
| Deferred federal income taxes   | (2,174 )                  | (669 )    |
| Net realized losses   | 1,419                     | 2,404     |
| Share-based payments expense  | 46                        | 228       |
| Change in ceded unearned premiums   | (11,156 )                 | (9,516 )  |
| Change in premiums receivable   | (18,091 )                 | (13,683 ) |
| Change in accounts receivable   | 513                       | (11 )     |
| Change in deferred policy acquisition costs                                       | (142 )                    | (258 )    |
| Change in unpaid losses and loss adjustment expenses                              | 23,791                    | (7,266 )  |
| Change in unearned premiums   | 20,639                    | 20,360    |
| Change in reinsurance recoverable   | (16,613 )                 | (10,578 ) |
| Change in reinsurance balances payable  | 7,690                     | 11,314    |
| Change in current federal income tax recoverable                                  | 2,154                     | 1,519     |
| Change in all other liabilities   | (745 )                    | 1,167     |
| Change in all other assets  | 2,161                     | 260       |
| Net cash provided by operating activities   | 12,384                    | 2,334     |
| Cash flows from investing activities:   |                           |           |
| Purchases of property and equipment   | (1,231 )                  | (690 )    |
| Net transfers from (into) restricted cash   | 3,869                     | (720 )    |
| Purchases of investment securities  | (124,366 )                | (92,561 ) |
| Maturities, sales and redemptions of investment securities                        | 111,440                   | 73,876    |
| Net cash used in investing activities   | (10,288 )                 | (20,095 ) |
| Cash flows from financing activities:   |                           |           |
| Proceeds from exercise of employee stock options                                  | 145                       | -         |
| Purchase of treasury shares   | (4,425 )                  | (4,745 )  |
| Net cash used in financing activities   | (4,280 )                  | (4,745 )  |

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|   |           |   |           |   |
|---|-----------|---|-----------|---|
| Decrease in cash and cash equivalents   | (2,184    | ) | (22,506   | ) |
| Cash and cash equivalents at beginning of period  | 79,632    |   | 114,446   |   |
| Cash and cash equivalents at end of period  | \$ 77,448 |   | \$ 91,940 |   |
| Supplemental cash flow information:   |           |   |           |   |
| Interest paid   | \$ 2,324  |   | \$ 2,254  |   |
| Income taxes paid   | \$ 304    |   | \$ 1,486  |   |
| Supplemental schedule of non-cash investing activities:   |           |   |           |   |
| Change in receivable for securities related to investment disposals that settled after the balance sheet date | \$ 1,427  |   | \$ 9,030  |   |
| Change in payable for securities related to investment purchases that settled after the balance sheet date    | \$ (958   | ) | \$ 11,529 |   |

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 primarily through subsidiaries whose operations are organized into product-specific operating units that are supported by our insurance company subsidiaries. Our MGA Commercial Products operating unit offers commercial insurance products and services in the excess and surplus lines market. Our Specialty Commercial operating unit offers general aviation and satellite launch insurance products and services, low and middle market commercial umbrella and primary/excess liability insurance, medical and financial professional liability insurance products and services, and primary/excess commercial property coverages for both catastrophe and non-catastrophe exposures. Our Standard Commercial P&C operating unit offers industry-specific commercial insurance products and services in the standard market. Our Workers Compensation operating unit specializes in small and middle market workers compensation business. Effective July 1, 2015, this operating unit no longer markets or retains any risk on new or renewal policies. Our Specialty Personal Lines operating unit offers non-standard personal automobile and renters 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, Hallmark National Insurance Company and Texas Builders Insurance Company.

These operating units are segregated into three reportable industry segments for financial accounting purposes. The Specialty Commercial Segment includes our MGA Commercial Products operating unit and our Specialty Commercial operating unit. The Standard Commercial Segment includes our Standard Commercial P&C operating unit and our Workers Compensation operating unit. The Personal Segment consists solely of our Specialty Personal Lines operating 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, 2016 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of June 30, 2017 and 2016 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 June 30, 2017 are not necessarily indicative of the operating results to be expected for the full year.

### **Income Taxes**

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax basis 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, 2016 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: A revolving credit facility with Frost Bank had a carried value of \$30.0 million and a fair value of \$30.2 million as of June 30, 2017. The fair value is based on discounted cash flows using a discount rate derived from LIBOR spot rates plus a market spread resulting in discount rates ranging between 3.4% to 4.2% for each future payment date. This revolving credit facility would be included in Level 3 of the fair value hierarchy if it was reported at fair value.

Subordinated Debt Securities: Our trust preferred securities have a carried value of \$55.7 million and a fair value of \$43.5 million as of June 30, 2017. 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 balances, premiums receivable, federal income tax payable, 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 Trust II (collectively the “Trusts”) and have determined that 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.

**Recently Issued Accounting Pronouncements**

In March 2017, the FASB issued ASU 2017-08, “Premium Amortization on Purchased Callable Securities” (Subtopic 310-20). ASU 2017-08 is intended to enhance the accounting for amortization of premiums for purchased callable debt securities. The guidance amends the amortization period for certain purchased callable debt securities held at a premium. Securities that contain explicit, noncontingent call features that are callable at fixed prices and on preset dates should shorten the amortization period for the premium to the earliest call date (and if the call option is not exercised, the effective yield is reset using the payment terms of the debt security). The standard is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, and is to be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings. We are currently evaluating the impact that the adoption of ASU 2017-08 will have on our financial results and disclosures.



In January 2017, the FASB issued ASU 2017-01, “Clarifying the Definition of a Business” (Topic 715). ASU 2017-01 is intended to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The ASU is effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. We do not expect the adoption of this standard to have a material impact on our financial condition or results of operations.

In January 2017, the FASB issued ASU 2017-04, “Simplifying the Test for Goodwill Impairment” (Topic 350). ASU 2017-04 requires only a one-step quantitative impairment test, whereby a goodwill impairment loss will be measured as the excess of a reporting unit’s carrying amount over its fair value (not to exceed the total goodwill allocated to that reporting unit). It eliminates Step 2 of the current two-step goodwill impairment test, under which a goodwill impairment loss is measured by comparing the implied fair value of a reporting unit’s goodwill. The ASU is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. We are currently evaluating the impact that the adoption of ASU 2017-04 will have on our financial results and disclosures.

In August 2016, the FASB issued ASU 2016-15, "Classification of Certain Cash Receipts and Cash Payments" (Topic 230). ASU 2016-15 will reduce diversity in practice on how eight specific cash receipts and payments are classified on the statement of cash flows. The ASU will be effective for fiscal years beginning after December 15, 2017, including interim periods within those years. We are currently evaluating the impact that the adoption of ASU 2016-15 will have on our financial results and disclosures.

In June 2016, the FASB issued ASU 2016-13, "Measurement of Credit Losses on Financial Instruments" (Topic 326). ASU 2016-13 requires organizations to estimate credit losses on certain types of financial instruments, including receivables and available-for-sale debt securities, by introducing an approach based on expected losses. The expected loss approach will require entities to incorporate considerations of historical information, current information and reasonable and supportable forecasts. The ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The ASU requires a modified retrospective transition method and early adoption is permitted. We are currently evaluating the impact that the adoption of the ASU will have on our financial results and disclosures, but do not anticipate that any such potential impact would be material.

In February 2016, the FASB issued ASU 2016-02, "Leases" (Topic 842). ASU 2016-02 requires organizations that lease assets to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. Additionally, the ASU modifies current guidance for lessors' accounting. The ASU is effective for interim and annual reporting periods beginning on or after January 1, 2019, with early adoption permitted. We do not anticipate that this ASU will have a material impact on our results of operations, but we anticipate an increase to the value of our assets and liabilities related to leases, with no material impact to equity.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities" (Subtopic 825-10). ASU 2016-01 will require equity investments that are not consolidated or accounted for under the equity method of accounting to be measured at fair value with changes in fair value recognized in net income. This ASU will also require us to assess the ability to realize our deferred tax assets ("DTAs") related to an available-for-sale debt security in combination with our other DTAs. The ASU will be effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. While we continue to evaluate the impact of this ASU, we anticipate the standard will increase the volatility of our consolidated statements of income, resulting from the remeasurement of our equity investments.

In May 2014, the FASB issued guidance which revises the criteria for revenue recognition. Under the guidance, the transaction price is attributed to underlying performance obligations in the contract and revenue is recognized as the entity satisfies the performance obligations and transfers control of a good or service to the customer. Incremental costs of obtaining a contract may be capitalized to the extent the entity expects to recover those costs. The guidance is effective for reporting periods beginning after December 15, 2017 and is to be applied retrospectively. Revenue from insurance contracts is excluded from the scope of this new guidance and, as a result, adoption of this guidance is not expected to have a material impact on our results of operations or financial position.



**Adoption of New Accounting Pronouncements**

In March 2016, the FASB issued ASU 2016-09, “Improvements to Employee Share-Based Payment Accounting” (Topic 718). ASU 2016-09 simplifies the accounting for share-based payment award transactions including income tax consequences, classification of awards as either equity or liabilities, classification on the statement of cash flows, and accounting for forfeitures. The guidance is effective for annual periods beginning after December 15, 2016, and interim periods within those fiscal years. Effective January 2017, we prospectively adopted this new guidance on stock compensation which requires recognition of the excess tax benefits or deficiencies of share-based compensation awards to employees through net income rather than through additional paid in capital. The impact of this adoption did not have a material impact on our financial results or disclosures.

**3. 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 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 June 30, 2017 and December 31, 2016 (in thousands):

|   | As of June 30, 2017   |  |                                     | Total     |
|---|---|--|-------------------------------------|-----------|
|   | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) |           |
| U.S. Treasury securities and obligations of U.S. Government | \$-   | \$ 42,011                                  | \$ -                                | \$42,011  |
| Corporate bonds   | -   | 252,844                                    | 823                                 | 253,667   |
| Collateralized corporate bank loans                         | -   | 123,806                                    | -                                   | 123,806   |
| Municipal bonds   | -   | 148,158                                    | 5,659                               | 153,817   |
| Mortgage-backed   | -   | 34,773                                     | -                                   | 34,773    |
| Total debt securities                                       | -   | 601,592                                    | 6,482                               | 608,074   |
| Total equity securities                                     | 55,856  | -  | 621                                 | 56,477    |
| Total other investments                                     | 4,448   | -  | -                                   | 4,448     |
| Total investments   | \$60,304  | \$ 601,592                                 | \$ 7,103                            | \$668,999 |

|   | As of December 31, 2016   |  |                                     | Total     |
|---|---|--|-------------------------------------|-----------|
|   | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Other<br>Observable<br>Inputs<br>(Level 2) | Unobservable<br>Inputs<br>(Level 3) |           |
| U.S. Treasury securities and obligations of U.S. Government | \$-   | \$ 42,022                                  | \$ -                                | \$42,022  |
| Corporate bonds   | -   | 226,062                                    | -                                   | 226,062   |
| Collateralized corporate bank loans                         | -   | 106,009                                    | -                                   | 106,009   |
| Municipal bonds   | -   | 158,216                                    | 5,679                               | 163,895   |
| Mortgage-backed   | -   | 59,469                                     | -                                   | 59,469    |
| Total debt securities                                       | -   | 591,778                                    | 5,679                               | 597,457   |
| Total equity securities                                     | 51,445  | -  | 266                                 | 51,711    |
| Total other investments                                     | 4,951   | -  | -                                   | 4,951     |
| Total investments   | \$56,396  | \$ 591,778                                 | \$ 5,945                            | \$654,119 |

Due to significant unobservable inputs into the valuation model for certain municipal bonds, one corporate bond and one equity security, as of June 30, 2017 and December 31, 2016, 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 corporate bond is a convertible senior note and its fair value was estimated by the sum of the bond value using an income approach discounting the scheduled interest and principal payments and the conversion feature utilizing a binomial lattice model. We also estimated the fair value of the corporate bond utilizing an as-if converted basis into the underlying securities. The equity security classified as Level 3 in the fair value hierarchy is an investment in a non-public entity. Given the size of this investment and since there was not an observable market for the security, we estimated its fair value as the fair value on the date we acquired the investment. Changes in the unobservable inputs in the fair value measurement of these investments 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 six months ended June 30, 2017 and 2016 (in thousands):

|  |          |
|--|----------|
| Beginning balance as of January 1, 2017                | \$5,945  |
| Sales  | -        |
| Settlements  | (150 )   |
| Purchases  | 775      |
| Issuances  | -        |
| Total realized/unrealized gains included in net income | -        |
| Net gains included in other comprehensive income       | 533      |
| Transfers into Level 3                                 | -        |
| Transfers out of Level 3                               | -        |
| Ending balance as of June 30, 2017                     | \$7,103  |
| <br>   |          |
| Beginning balance as of January 1, 2016                | \$14,087 |
| Sales  | -        |
| Settlements  | (6,025 ) |
| Purchases  | -        |
| Issuances  | -        |
| Total realized/unrealized gains included in net income | -        |
| Net gains included in other comprehensive income       | 208      |
| Transfers into Level 3                                 | 265      |
| Transfers out of Level 3                               | -        |
| Ending balance as of June 30, 2016                     | \$8,535  |

#### 4. Investments

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

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| As of June 30, 2017   |                   |                              |                               |               |
| U.S. Treasury securities and obligations of U.S. Government | \$42,014          | \$ 11                        | \$ (14 )                      | \$42,011      |
| Corporate bonds   | 252,093           | 1,735                        | (161 )                        | 253,667       |
| Collateralized corporate bank loans                         | 123,523           | 575                          | (292 )                        | 123,806       |
| Municipal bonds   | 153,475           | 1,043                        | (701 )                        | 153,817       |
| Mortgage-backed   | 34,881            | 144                          | (252 )                        | 34,773        |
| Total debt securities                                       | 605,986           | 3,508                        | (1,420 )                      | 608,074       |
| Total equity securities                                     | 33,220            | 23,898                       | (641 )                        | 56,477        |
| Total other investments                                     | 3,763             | 685                          | -                             | 4,448         |
| Total investments   | \$ 642,969        | \$ 28,091                    | \$ (2,061 )                   | \$ 668,999    |
| As of December 31, 2016                                     |                   |                              |                               |               |
| U.S. Treasury securities and obligations of U.S. Government | \$41,976          | \$66                         | \$(20 )                       | \$42,022      |
| Corporate bonds   | 224,915           | 1,722                        | (575 )                        | 226,062       |
| Collateralized corporate bank loans                         | 105,220           | 959                          | (170 )                        | 106,009       |
| Municipal bonds   | 165,900           | 956                          | (2,961)                       | 163,895       |
| Mortgage-backed   | 59,773            | 49                           | (353 )                        | 59,469        |
| Total debt securities                                       | 597,784           | 3,752                        | (4,079)                       | 597,457       |
| Total equity securities                                     | 31,449            | 21,052                       | (790 )                        | 51,711        |
| Total other investments                                     | 3,763             | 1,188                        | -                             | 4,951         |
| Total investments   | \$632,996         | \$25,992                     | \$(4,869)                     | \$654,119     |

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

|   | Three Months Ended June |             | Six Months Ended June |             |
|---|-------------------------|-------------|-----------------------|-------------|
|   | 30,<br>2017             | 2016        | 30,<br>2017           | 2016        |
| U.S. Treasury securities and obligations of U.S. Government | \$ -                    | \$ -        | \$ -                  | \$ -        |
| Corporate bonds   | (148 )                  | -           | (18 )                 | 80          |
| Collateralized corporate bank loans                         | 20                      | (36 )       | 48                    | (18 )       |
| Municipal bonds   | 101                     | (44 )       | 84                    | (68 )       |
| Mortgage-backed   | -                       | -           | -                     | -           |
| Equity securities   | 17                      | 490         | 2,377                 | 490         |
| (Loss) gain on investments                                  | (10 )                   | 410         | 2,491                 | 484         |
| Change in unrealized losses on other investments            | (62 )                   | -           | (503 )                | -           |
| Other-than-temporary impairments                            | (3,407 )                | (2,587 )    | (3,407 )              | (2,888 )    |
| Net realized losses   | \$ (3,479 )             | \$ (2,177 ) | \$ (1,419 )           | \$ (2,404 ) |

We realized gross gains on investments of \$0.4 million and \$0.6 million during the three months ended June 30, 2017 and 2016, respectively, and \$3.0 million and \$0.7 million for the six months ended June 30, 2017 and 2016, respectively. We realized gross losses on investments of \$0.4 million and \$0.2 million for the three months ended June 30, 2017 and 2016, respectively, and \$0.5 million and \$0.2 million for the six months ended June 30, 2017 and 2016, respectively. We recorded proceeds from the sale of investment securities of \$0.1 million and \$11.0 million during the three months ended June 30, 2017 and 2016, respectively, and \$8.0 million and \$15.9 million for the six months ended June 30, 2017 and 2016, 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 June 30, 2017 and December 31, 2016 (in thousands):

|   | As of June 30, 2017 |                   |                       |                   |            |                   |
|---|---------------------|-------------------|-----------------------|-------------------|------------|-------------------|
|   | 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 | \$36,947            | \$ (14 )          | \$ -                  | \$ -              | \$36,947   | \$ (14 )          |
| Corporate bonds   | 72,355              | (161 )            | -                     | -                 | 72,355     | (161 )            |
| Collateralized corporate bank loans                         | 36,049              | (150 )            | 2,408                 | (142 )            | 38,457     | (292 )            |
| Municipal bonds   | 42,718              | (524 )            | 6,859                 | (177 )            | 49,577     | (701 )            |
| Mortgage-backed   | 12,781              | (249 )            | 1,628                 | (3 )              | 14,409     | (252 )            |
| Total debt securities                                       | 200,850             | (1,098 )          | 10,895                | (322 )            | 211,745    | (1,420 )          |
| Total equity securities                                     | 5,653               | (598 )            | 2,106                 | (43 )             | 7,759      | (641 )            |
| Total other investments                                     | 614                 | -                 | -                     | -                 | 614        | -                 |
| Total investments   | \$207,117           | \$ (1,696 )       | \$ 13,001             | \$ (365 )         | \$220,118  | \$ (2,061 )       |

|   | As of December 31, 2016 |                   |                       |                   |            |                   |
|---|-------------------------|-------------------|-----------------------|-------------------|------------|-------------------|
|   | 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 | \$7,037                 | \$ (20 )          | \$ -                  | \$ -              | \$7,037    | \$ (20 )          |
| Corporate bonds   | 86,592                  | (575 )            | -                     | -                 | 86,592     | (575 )            |
| Collateralized corporate bank loans                         | 2,637                   | (7 )              | 8,314                 | (163 )            | 10,951     | (170 )            |
| Municipal bonds   | 70,633                  | (1,327 )          | 13,574                | (1,634 )          | 84,207     | (2,961 )          |
| Mortgage-backed   | 29,475                  | (348 )            | 2,430                 | (5 )              | 31,905     | (353 )            |
| Total debt securities                                       | 196,374                 | (2,277 )          | 24,318                | (1,802 )          | 220,692    | (4,079 )          |
| Total equity securities                                     | 4,109                   | (483 )            | 2,037                 | (307 )            | 6,146      | (790 )            |
| Total other investments                                     | -                       | -                 | -                     | -                 | -          | -                 |
| Total investments   | \$200,483               | \$ (2,760 )       | \$ 26,355             | \$ (2,109 )       | \$226,838  | \$ (4,869 )       |

At June 30, 2017, the gross unrealized losses more than twelve months old were attributable to 15 debt security positions and one equity position. At December 31, 2016, the gross unrealized losses more than twelve months old were attributable to 28 debt security positions and one equity position. 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 other indications that the decline in values of these securities is other-than-temporary. We recognized \$3.4 million of other-than-temporary impairments for the six months ended June 30, 2017 related to six municipal bond 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.

Details regarding the carrying value of the other investments portfolio as of June 30, 2017 and December 31, 2016 were as follows (in thousands):

|                         | June 30,<br>2017 | December 31,<br>2016 |
|-------------------------|------------------|----------------------|
| Investment Type         |                  |                      |
| Equity warrant          | \$ 4,448         | \$ 4,951             |
| Total other investments | \$ 4,448         | \$ 4,951             |

We acquired this warrant in an active market. The warrant entitles us to buy the underlying common stock of a publicly traded company at a fixed price until the expiration date of January 19, 2021.

The amortized cost and estimated fair value of debt securities at June 30, 2017 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                | \$153,323      | \$153,486 |
| Due after one year through five years  | 231,340        | 232,487   |
| Due after five years through ten years | 143,558        | 144,413   |
| Due after ten years                    | 42,884         | 42,915    |
| Mortgage-backed                        | 34,881         | 34,773    |
|  | \$605,986      | \$608,074 |

## 5. 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 \$25.6 million and \$21.1 million at June 30, 2017 and December 31, 2016, respectively.

## 6. Reserves for Unpaid Losses and Loss Adjustment Expenses

Activity in the consolidated reserves for unpaid losses and LAE is summarized as follows (in thousands):

|                              | June 30,<br>2017 | June 30,<br>2016 |
|------------------------------|------------------|------------------|
| Balance at January 1         | \$481,567        | \$450,878        |
| Less reinsurance recoverable | 123,237          | 102,791          |
| Net balance at January 1     | 358,330          | 348,087          |
| Incurred related to:         |                  |                  |
| Current year                 | 122,862          | 116,654          |
| Prior years                  | 9,684            | (2,757 )         |
| Total incurred               | 132,546          | 113,897          |
| Paid related to:             |                  |                  |
| Current year                 | 33,687           | 35,217           |
| Prior years                  | 90,042           | 88,377           |
| Total paid                   | 123,729          | 123,594          |
| Net balance at June 30       | 367,147          | 338,390          |
| Plus reinsurance recoverable | 138,211          | 105,222          |
| Balance at June 30           | \$505,358        | \$443,612        |

The impact from the (favorable) unfavorable net prior years' loss development on each reporting segment is presented below:

|                              | Six Months Ended June 30, |             |
|------------------------------|---------------------------|-------------|
|                              | 2017                      | 2016        |
| Specialty Commercial Segment | \$ 8,332                  | \$ (1,594 ) |
| Standard Commercial Segment  | 264                       | (3,674 )    |
| Personal Segment             | 1,088                     | 2,511       |



|  |          |             |
|--|----------|-------------|
| Corporate  | -        | -           |
| Total (favorable) unfavorable net prior year development | \$ 9,684 | \$ (2,757 ) |

The following describes the primary factors behind each segment's prior accident year reserve development for the six months ended June 30, 2017 and 2016:

Six months ended June 30, 2017:

**Specialty Commercial Segment.** Our MGA Commercial products operating unit experienced net unfavorable development primarily in the commercial auto liability line of business in the 2015 and prior accident years, partially offset by favorable development in the 2016 accident year. Our Specialty Commercial operating unit experienced net unfavorable development in general aviation primarily in the 2010 accident year, commercial excess liability primarily in the 2013 accident year and specialty risk programs primarily in the 2015, 2013 and 2012 accident years, partially offset by net favorable development in the medical professional liability lines of business primarily in the 2016 accident years.

**Standard Commercial Segment.** Our Standard Commercial P&C operating unit experienced net unfavorable development in the 2016 and prior accident years in the occupational accident line of business, partially offset by net favorable development primarily in the general liability line of business in the 2016 and prior accident years.

**Personal Segment.** Net unfavorable development in our Specialty Personal Lines operating unit was mostly attributable to the 2016, 2014 and 2013 accident years, partially offset by favorable development in the 2015 accident year.

Six months ended June 30, 2016:

**Specialty Commercial Segment.** Our MGA Commercial products operating unit experienced net favorable development primarily in the commercial auto liability and general liability lines of business in the 2015 and 2011 accident years, partially offset by net unfavorable development in the 2014, 2013 and 2012 accident years. Our Specialty Commercial operating unit experienced net favorable development primarily in the general aviation, commercial excess liability and medical professional liability lines of business.

**Standard Commercial Segment.** Our Standard Commercial P&C operating unit experienced net favorable development primarily in the general liability line of business in the 2015 and prior accident years. Our Workers Compensation operating unit experienced net favorable development in the 2015 and prior accident years, partially offset by net unfavorable development in the occupational accident line of business in the 2015 and prior accident years.

**Personal Segment.** Our Specialty Personal Lines operating unit experienced net unfavorable development mostly attributable to the 2015 and 2013 accident years.

## 7. 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 initially approved by the shareholders on May 26, 2005 and expired by its terms on May 27, 2015. As of June 30, 2017, there were outstanding incentive stock options to purchase 168,187 shares of our common stock, non-qualified stock options to purchase 259,157 shares of our common stock and restricted stock units representing the right to receive up to 77,640 shares of our common stock. 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.

Our 2015 Long Term Incentive Plan (“2015 LTIP”) was approved by shareholders on May 29, 2015. There are 2,000,000 shares authorized for issuance under the 2015 LTIP. As of June 30, 2017, restricted stock units representing the right to receive up to 292,961 shares of our common stock were outstanding under the 2015 LTIP. There were no stock option awards granted under the 2015 LTIP as of June 30, 2017.

### **Stock Options:**

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 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 vests in equal annual increments on each of the first three anniversary dates and terminates 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 June 30, 2017 and changes during the six months then ended is presented below:

|                                | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Average<br>Remaining<br>Contractual<br>Term<br>(Years) | Aggregate<br>Intrinsic<br>Value<br>(\$000) |
|--------------------------------|---------------------|--|--|--|
| Outstanding at January 1, 2017 | 624,231             | \$ 9.14                                  |  |  |
| Granted                        | -                   |  |  |  |
| Exercised                      | (21,887 )           | \$ 6.61                                  |  |  |
| Forfeited or expired           | (175,000 )          | \$ 12.49                                 |  |  |
| Outstanding at June 30, 2017   | 427,344             | \$ 7.89                                  | 1.7  | \$ 1,469                                   |
| Exercisable at June 30, 2017   | 427,344             | \$ 7.89                                  | 1.7  | \$ 1,469                                   |

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 |      | Six Months Ended |       |
|---|--------------------|------|------------------|-------|
|   | June 30,           |      | June 30,         |       |
|   | 2017               | 2016 | 2017             | 2016  |
| Intrinsic value of options exercised                            | \$ 80              | \$ - | \$ 101           | \$ -  |
| Cost of share-based payments (non-cash)                         | \$ -               | \$ - | \$ -             | \$ 38 |
| Income tax benefit of share-based payments recognized in income | \$ -               | \$ - | \$ -             | \$ 8  |

As of June 30, 2017, there was no unrecognized compensation cost related to non-vested stock options granted under our plans which is expected to be recognized in the future.

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 option's 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 stock options granted during the first six months of 2017 or 2016.

### **Restricted Stock Units:**

The 2005 LTIP was amended by the stockholders on May 30, 2013 to authorize the grant of restricted stock units, in addition to the other types of awards available thereunder. Restricted stock units awarded under the 2005 LTIP and 2015 LTIP represent the right to receive shares of common stock upon the satisfaction of vesting requirements, performance criteria and other terms and conditions. On July 27, 2012 and April 10, 2013, an aggregate of 129,463 and 122,823 restricted stock units, respectively, were conditionally granted to certain of our employees subject to shareholder approval of the amendments to the 2005 LTIP at the May 30, 2013 shareholder meeting. One conditional grant of 9,280 restricted stock units was forfeited prior to approval at the shareholder meeting. Subsequently on September 8, 2014, an aggregate of 175,983 restricted stock units were granted to certain employees under the 2005 LTIP. On May 29, 2015, an aggregate of 103,351 restricted stock units were granted to certain employees under the 2015 LTIP. Subsequently on July 22, 2016, an aggregate of 122,770 restricted stock units were granted to certain employees under the 2015 LTIP.

The performance criteria for all restricted stock units require that we achieve certain compound average annual growth rates in book value per share over the vesting period in order to receive shares of common stock in amounts ranging from 50% to 150% of the number of restricted stock units granted. In addition, certain restricted stock unit grants contain an additional performance criteria related to the attainment of an average combined ratio percentage over the vesting period. Grantees of restricted stock units do not have any rights of a stockholder, and do not participate in any distributions to our common stockholders, until the award fully vests upon satisfaction of the vesting schedule, performance criteria and other conditions set forth in their award agreement. Therefore, unvested restricted stock units are not considered participating securities under ASC 260, "Earnings Per Share," and are not included in the calculation of basic or diluted earnings per share.

On April 1, 2017, 5,998 shares of common stock were issued with respect to 5,998 restricted stock units which were granted on September 8, 2014 and vested on March 31, 2017. On April 1, 2016, 7,144 shares of common stock were issued with respect to 7,144 restricted stock units which were granted on April 10, 2013 and vested on March 31, 2016. If and to the extent specified performance criteria have been achieved, one grant of restricted stock units granted on September 8, 2014 will vest on March 31, 2018, the restricted stock units granted on May 29, 2015 will vest on March 31, 2018 and the restricted stock units granted on July 22, 2016 will vest on March 31, 2019.

Compensation cost is measured as an amount equal to the fair value of the restricted stock units on the date of grant and is expensed over the vesting period if achievement of the performance criteria is deemed probable, with the amount of the expense recognized based on our best estimate of the ultimate achievement level. The grant date fair value of the restricted stock units granted in 2014 is \$9.66 per unit. The grant date fair value of the restricted stock units granted in 2015 is \$11.10 per unit. The grant date fair value of the restricted stock units granted in 2016 is \$11.41 per unit. We incurred compensation expense of \$19 thousand and \$46 thousand related to restricted stock units during the three months and six months ended June 30, 2017, respectively. We incurred compensation expense of \$89 thousand and \$190 thousand during the three months and six months ended June 30, 2016, respectively. We recorded income tax benefit of \$7 thousand and \$16 thousand related to restricted stock units during the three months and six months ended June 30, 2017, respectively. We recorded income tax benefit of \$32 thousand and \$67 thousand related to restricted stock units during the three months and six months ended June 30, 2016.

A summary of the status of our restricted stock units as of June 30, 2017 and 2016 and changes during the six months then ended is presented below:

|                         | Number of<br>Restricted<br>Stock Units |           |
|-------------------------|--|-----------|
|                         | 2017                                   | 2016      |
| Non-vested at January 1 | 296,574                                | 296,571   |
| Granted                 | -                                      | -         |
| Vested                  | (5,998 )                               | (7,144 )  |
| Forfeited               | (43,509 )                              | (71,460 ) |
| Non-vested at June 30   | 247,067                                | 217,967   |

As of June 30, 2017, there was \$98 thousand of total unrecognized compensation cost related to unvested restricted stock units granted under our 2015 LTIP, of which \$37 thousand is expected to be recognized during the remainder of 2017, \$50 thousand is expected to be recognized in 2018 and \$11 thousand is expected to be recognized in 2019.

## 8. Segment Information

The following is business segment information for the three and six months ended June 30, 2017 and 2016 (in thousands):

|                              | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |            |
|------------------------------|--------------------------------|-----------|------------------------------|------------|
|                              | 2017                           | 2016      | 2017                         | 2016       |
| Revenues:                    |                                |           |                              |            |
| Specialty Commercial Segment | \$ 69,501                      | \$ 63,040 | \$ 135,336                   | \$ 123,623 |
| Standard Commercial Segment  | 17,322                         | 18,219    | 35,048                       | 36,211     |
| Personal Segment             | 10,684                         | 12,147    | 22,547                       | 24,237     |
| Corporate                    | (4,032 )                       | (2,354 )  | (2,508 )                     | (2,991 )   |
| Consolidated                 | \$ 93,475                      | \$ 91,052 | \$ 190,423                   | \$ 181,080 |
| Pre-tax income (loss):       |                                |           |                              |            |
| Specialty Commercial Segment | \$ 3,632                       | \$ 7,287  | \$ 11,730                    | \$ 17,599  |
| Standard Commercial Segment  | (199 )                         | 3,011     | 652                          | 4,427      |
| Personal Segment             | (892 )                         | (1,014 )  | (1,650 )                     | (2,097 )   |
| Corporate                    | (7,459 )                       | (7,797 )  | (9,812 )                     | (12,453 )  |
| Consolidated                 | \$ (4,918 )                    | \$ 1,487  | \$ 920                       | \$ 7,476   |

The following is additional business segment information as of the dates indicated (in thousands):

|                              | June 30,<br>2017 | December 31,<br>2016 |
|------------------------------|------------------|----------------------|
| Assets                       |                  |                      |
| Specialty Commercial Segment | \$ 782,301       | \$ 734,763           |
| Standard Commercial Segment  | 164,915          | 164,295              |
| Personal Segment             | 239,882          | 241,686              |
| Corporate                    | 25,742           | 21,716               |
|                              | \$ 1,212,840     | \$ 1,162,460         |

## 9. Reinsurance

We reinsure a portion of the risk we underwrite in order to control the exposure to losses and to protect capital resources. We cede to reinsurers a portion of these risks and pay premiums based upon the risk and exposure of the policies subject to such reinsurance. Ceded reinsurance involves credit risk and is generally subject to aggregate loss



limits. Although the reinsurer is liable to us to the extent of the reinsurance ceded, we are ultimately liable as the direct insurer on all risks reinsured. Reinsurance recoverables are reported after allowances for uncollectible amounts. We monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Reinsurers are selected based on their financial condition, business practices and the price of their product offerings. In order to mitigate credit risk to reinsurance companies, most of our reinsurance recoverable balance as of June 30, 2017 was with reinsurers that had an A.M. Best rating of “A-” or better.

The following table shows earned premiums ceded and reinsurance loss recoveries by period (in thousands):

|                        | Three Months Ended |           | Six Months Ended |          |
|------------------------|--------------------|-----------|------------------|----------|
|                        | June 30,           |           | June 30,         |          |
|                        | 2017               | 2016      | 2017             | 2016     |
| Ceded earned premiums  | \$ 50,884          | \$ 41,118 | \$96,601         | \$80,098 |
| Reinsurance recoveries | \$ 31,729          | \$ 24,420 | \$58,430         | \$48,369 |

## 10. Revolving Credit Facility

Our Second Restated Credit Agreement with Frost Bank (“Frost”) dated June 30, 2015, reinstated the credit facility with Frost which expired by its terms on April 30, 2015. The Second Restated Credit Agreement also amended certain provisions of the credit facility and restated the agreement with Frost in its entirety. The Second Restated Credit Agreement provides a \$15.0 million revolving credit facility (“Facility A”), with a \$5.0 million letter of credit sub-facility. The outstanding balance of the Facility A bears interest at a rate equal to the prime rate or LIBOR plus 2.5%, at our election. We pay an annual fee of 0.25% of the average daily unused balance of Facility A and letter of credit fees at the rate of 1.00% per annum. As of June 30, 2017, we had no outstanding borrowings under Facility A.

On December 17, 2015, we entered into a First Amendment to Second Restated Credit Agreement and a Revolving Facility B Agreement (the “Facility B Agreement”) with Frost to provide a new \$30.0 million revolving credit facility (“Facility B”), in addition to Facility A. On November 1, 2016, we amended the Facility B Agreement with Frost to extend by one year the termination date for draws under Facility B and the maturity date for amounts outstanding thereunder. We paid Frost a commitment fee of \$75,000 when Facility B was established and an additional \$30,000 fee when Facility B was extended.

We may use Facility B loan proceeds solely for the purpose of making capital contributions to AHIC and HIC. As amended, we may borrow, repay and reborrow under Facility B until December 17, 2018, at which time all amounts outstanding under Facility B are converted to a term loan. Through December 17, 2018, we pay Frost a quarterly fee of 0.25% per annum of the average daily unused balance of Facility B. Facility B bears interest at a rate equal to the prime rate or LIBOR plus 3.00%, at our election. Until December 17, 2018, interest only on amounts from time to time outstanding under Facility B are payable quarterly. Any amounts outstanding on Facility B as of December 17, 2018 are converted to a term loan payable in quarterly installments over five years based on a seven year amortization of principal plus accrued interest. All remaining principal and accrued interest on Facility B become due and payable on December 17, 2023. As of June 30, 2017, we had \$30.0 million outstanding under Facility B.

The obligations under both Facility A and Facility B are secured by a security interest in the capital stock of AHIC and HIC. Both Facility A and Facility B contain covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of June 30, 2017, we were in compliance with all of these covenants.

## 11. Subordinated Debt Securities

On June 21, 2005, we entered into a trust preferred securities transaction pursuant to which we issued \$30.9 million aggregate principal amount of subordinated debt securities due in 2035. To effect the transaction, we formed Trust I as a Delaware statutory trust. Trust I issued \$30.0 million of preferred securities to investors and \$0.9 million of common securities to us. Trust I used the proceeds from these issuances to purchase the subordinated debt securities. The initial interest rate on our Trust I subordinated debt securities was 7.725% until June 15, 2015, after which interest adjusts quarterly to the three-month LIBOR rate plus 3.25 percentage points. Trust I pays dividends on its preferred securities at the same rate. Under the terms of our Trust I subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of June 30, 2017, the principal balance of our Trust I subordinated debt was \$30.9 million and the interest rate was 4.50% per annum.

On August 23, 2007, we entered into a trust preferred securities transaction pursuant to which we issued \$25.8 million aggregate principal amount of subordinated debt securities due in 2037. To effect the transaction, we formed Trust II as a Delaware statutory trust. Trust II issued \$25.0 million of preferred securities to investors and \$0.8 million of common securities to us. Trust II used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust II subordinated debt securities bear an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Trust II pays dividends on its preferred securities at the same rate. Under the terms of our Trust II subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of June 30, 2017, the principal balance of our Trust II subordinated debt was \$25.8 million.

## 12. Deferred Policy Acquisition Costs

The following table shows total deferred and amortized policy acquisition cost activity by period (in thousands):

|           | Three Months Ended |             | Six Months Ended |              |
|-----------|--------------------|-------------|------------------|--------------|
|           | June 30,           |             | June 30,         |              |
|           | 2017               | 2016        | 2017             | 2016         |
| Deferred  | \$ (10,616 )       | \$ (6,978 ) | \$ (21,713 )     | \$ (20,716 ) |
| Amortized | 10,375             | 7,091       | 21,571           | 20,458       |
| Net       | \$ (241 )          | \$ 113      | \$ (142 )        | \$ (258 )    |

**13. Earnings per Share**

The following table sets forth basic and diluted weighted average shares outstanding for the periods indicated (in thousands):

|   | Three Months Ended |        | Six Months Ended |        |
|---|--------------------|--------|------------------|--------|
|   | June 30,           |        | June 30,         |        |
|   | 2017               | 2016   | 2017             | 2016   |
| Weighted average shares - basic             | 18,424             | 18,878 | 18,518           | 18,945 |
| Effect of dilutive securities               | -                  | 174    | 145              | 170    |
| Weighted average shares - assuming dilution | 18,424             | 19,052 | 18,663           | 19,115 |

For each of the three and six months ended June 30, 2017, 97,500 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive. For each of the three and six months ended June 30, 2016, 385,000 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive.

**14. Net Periodic Pension Cost**

The following table details the net periodic pension cost incurred by period (in thousands):

|                                | Three Months Ended |         | Six Months Ended |          |
|--------------------------------|--------------------|---------|------------------|----------|
|                                | June 30,           |         | June 30,         |          |
|                                | 2017               | 2016    | 2017             | 2016     |
| Interest cost                  | \$ 111             | \$ 128  | \$ 222           | \$ 256   |
| Amortization of net loss       | 35                 | 29      | 70               | 57       |
| Expected return on plan assets | (161 )             | (162 )  | (323 )           | (323 )   |
| Net periodic pension cost      | \$ (15 )           | \$ (5 ) | \$ (31 )         | \$ (10 ) |
| Contributed amount             | \$ -               | \$ -    | \$ -             | \$ -     |

Refer to Note 14 to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2016 for more discussion of our retirement plans.

## 15. Income Taxes

Our effective income tax rate for the six months ended June 30, 2017 and 2016 was 30.9% and 31.2%, respectively. The rates varied from the statutory tax rate primarily due to the amount of tax exempt income in relation to total pre-tax income.

## 16. Commitments and Contingencies

We are engaged in various legal proceedings in the ordinary course of business, none of which, either individually or in the aggregate, are believed likely to have a material adverse effect on our consolidated financial position or results of operations, in the opinion of management. The various legal proceedings to which we are a party are routine in nature and incidental to our business.

In November 2015, one of the subsidiaries in our MGA Commercial operating unit, Hallmark Specialty Underwriters, Inc. ("HSU"), was informed by the Texas Comptroller of Public Accounts that a surplus lines tax audit covering the period January 1, 2010 through December 31, 2013 was complete. HSU frequently acts as a managing general underwriter ("MGU") authorized to underwrite policies on behalf of Republic Vanguard Insurance Company and HSIC, both Texas eligible surplus lines insurance carriers. In its role as the MGU, HSU underwrites policies on behalf of these carriers while other agencies located in Texas (generally referred to as "producing agents") deliver the policies to the insureds and collect all premiums due from the insureds. During the period under audit, the producing agents also collected the surplus lines premium taxes due on the policies from the insureds, held them in trust, and timely remitted those taxes to the Comptroller. We believe this system for collecting and paying the required surplus lines premium taxes complies in all respects with the Texas Insurance Code and other regulations, which clearly require that the same party who delivers the policies and collects the premiums will also collect premium taxes, hold premium taxes in trust, and pay premium taxes to the Comptroller. It also complies with long standing industry practice. In addition, effective January 1, 2012 the Texas legislature enacted House Bill 3410 (HB3410) which allows an MGU to contractually pass the collection, payment and administration of surplus lines taxes down to another Texas licensed surplus line agent.

The Comptroller has asserted that HSU is liable for the surplus lines premium taxes related to policy transactions and premiums collected from surplus lines insureds during January 1, 2010 through December 31, 2011, the period prior to the passage of HB3410, and that HSU therefore owes \$2.5 million in premium taxes, as well as \$0.7 million in penalties and interest for the audit period. During the second quarter of 2017, we reached an agreement with the Comptroller to settle the matter for \$0.2 million, which was accrued as of June 30, 2017.

**17. Changes in Accumulated Other Comprehensive Income Balances**

The changes in accumulated other comprehensive income balances as of June 30, 2017 and 2016 were as follows (in thousands):

|  | Minimum<br>Pension<br>Liability | Unrealized<br>Gains<br>(Loss) | Accumulated<br>Other<br>Comprehensive<br>Income |
|--|---------------------------------|-------------------------------|---|
| Balance at December 31, 2015   | \$ (2,572 )                     | \$ 9,990                      | \$ 7,418  |
| Other comprehensive income:  |                                 |                               |   |
| Change in net actuarial gain   | 57                              | -                             | 57  |
| Tax effect on change in net actuarial gain   | (20 )                           | -                             | (20 )   |
| Net unrealized holding gains arising during the period                             | -                               | 5,729                         | 5,729   |
| Tax effect on unrealized gains arising during the period                           | -                               | (2,005 )                      | (2,005 )  |
| Reclassification adjustment for gains included in net realized gains               | -                               | (484 )                        | (484 )  |
| Tax effect on reclassification adjustment for gains included in income tax expense | -                               | 169                           | 169   |
| Other comprehensive income, net of tax   | 37                              | 3,409                         | 3,446   |
| Balance at June 30, 2016   | \$ (2,535 )                     | \$ 13,399                     | \$ 10,864                                       |
| Balance at December 31, 2016   | \$ (2,666 )                     | \$ 13,037                     | \$ 10,371                                       |
| Other comprehensive income:  |                                 |                               |   |
| Change in net actuarial gain   | 70                              | -                             | 70  |
| Tax effect on change in net actuarial gain   | (24 )                           | -                             | (24 )   |
| Net unrealized holding gains arising during the period                             | -                               | 7,900                         | 7,900   |
| Tax effect on unrealized gains arising during the period                           | -                               | (2,765 )                      | (2,765 )  |
| Reclassification adjustment for gains included in net realized gains               | -                               | (2,491 )                      | (2,491 )  |
| Tax effect on reclassification adjustment for gains included in income tax expense | -                               | 872                           | 872   |
| Other comprehensive income, net of tax   | 46                              | 3,516                         | 3,562   |
| Balance at June 30, 2017   | \$ (2,620 )                     | \$ 16,553                     | \$ 13,933                                       |



## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

*The following discussion should be read together with our consolidated financial statements and the notes thereto. This discussion contains forward-looking statements. Please see "Risks Associated with Forward-Looking Statements in this Form 10-Q" for a discussion of some of the uncertainties, risks and assumptions associated with these statements.*

### Introduction

Hallmark Financial Services, Inc. ("Hallmark" and, together with subsidiaries, "we," "us" or "our") is an insurance holding company that, through its subsidiaries, engages 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. Our business is geographically concentrated in the south central and northwest regions of the United States, except for our Specialty Commercial business which is written on a national basis. We pursue our business activities through subsidiaries whose operations are organized into product-specific operating units, which are supported by our insurance company subsidiaries.

Our non-carrier insurance activities are segregated by operating units into the following reportable segments:

***Specialty Commercial Segment.*** Our Specialty Commercial Segment includes the excess and surplus lines commercial property/casualty insurance products and services handled by our MGA Commercial Products operating unit and the general aviation, satellite launch, commercial umbrella and primary/excess liability, medical and financial professional liability and primary/excess commercial property insurance products and services handled by our Specialty Commercial operating unit, as well as certain specialty risk programs which are managed at the parent level.

***Standard Commercial Segment.*** Our Standard Commercial Segment includes the standard lines commercial property/casualty and occupational accident insurance products and services handled by our Standard Commercial P&C operating unit and the workers compensation insurance products handled by our Workers Compensation operating unit. We discontinued marketing new and renewal occupational accident policies effective June 1, 2016. During 2015, we discontinued our workers' compensation line of business by transferring all renewal rights and ceding substantially all unearned premiums to a third party. As a result, effective July 1, 2015, the Workers Compensation operating unit no longer retains any risk on new or renewal policies.

**Personal Segment.** Our Personal Segment includes the non-standard personal automobile and renters insurance products and services handled by our Specialty Personal Lines operating unit.

The retained premium produced by these reportable segments is supported by our American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Specialty Insurance Company (“HSIC”), Hallmark Insurance Company (“HIC”), Hallmark National Insurance Company (“HNIC”) and Texas Builders Insurance Company (“TBIC”) insurance subsidiaries. In addition, control and management of Hallmark County Mutual (“HCM”) is maintained through our wholly owned subsidiary, CYR Insurance Management Company (“CYR”). CYR has as its primary asset a management agreement with HCM which provides for CYR to have management and control of HCM. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas. HCM does not retain any business.

AHIC, HIC, HSIC and HNIC have entered into a pooling arrangement pursuant to which AHIC retains 34% of the total net premiums written by any of them, HIC retains 32% of our total net premiums written by any of them, HSIC retains 24% of our total net premiums written by any of them and HNIC retains 10% of our total net premiums written by any of them. Neither HCM nor TBIC is a party to the intercompany pooling arrangement.

## Results of Operations

**Management overview.** During the three and six months ended June 30, 2017, our total revenues were \$93.5 million and \$190.4 million, representing an increase of 3% and 5%, respectively, from the \$91.1 million and \$181.1 million in total revenues for the same periods of 2016. This increase in revenue was primarily attributable to higher net earned premiums in our Specialty Commercial Segment during the three and six months ended June 30, 2017 as compared to the same periods during 2016. Further contributing to this increase in revenues was higher net investment income during the three and six months ended June 30, 2017 as compared to the same periods during 2016. These increases in revenue during the second quarter of 2017 were partially offset by higher realized losses recognized during the three months ended June 30, 2017 as compared to the same period during 2016, as well as lower finance charges during the three and six months ended June 30, 2017.

The increase in revenue for the three and six months ended June 30, 2017 was offset by higher losses and loss adjustment expenses (“LAE”) of \$12.2 million and \$18.6 million, respectively, as compared to the same periods in 2016. The increase in losses and LAE was primarily the result of unfavorable net prior year loss reserve development of \$10.2 million and \$9.7 million for the three and six months ended June 30, 2017 as compared to favorable net prior year loss reserve development of \$1.0 million and \$2.8 million for the same periods of 2016, as well as higher current accident year loss trends in our MGA Commercial Products operating unit. Other operating expenses decreased due mostly as a result of a \$1.8 million accrual to the earn-out related to the previous acquisition of TBIC during the second quarter of 2016 and lower production related expenses due primarily to increased ceding commissions in our Specialty Commercial Segment, partially offset by increased salary and related expenses and professional service fees for the three and six months ended June 30, 2017 as compared to the same periods during 2016.

We reported a net loss of \$3.4 million for the three months ended June 30, 2017 as compared to net income of \$1.1 million for the same period of 2016. We reported net income of \$0.6 million for the six months ended June 30, 2017 as compared to net income of \$5.1 million for the same period of 2016. On a diluted basis per share, we reported a net loss of \$0.18 per share for the three months ended June 30, 2017, as compared to net income of \$0.06 per share for the same period in 2016. On a diluted basis per share, we reported net income of \$0.03 per share for the six months ended June 30, 2017, as compared to net income of \$0.27 per share for the same period in 2016.

**Second Quarter 2017 as Compared to Second Quarter 2016**

The following is additional business segment information for the three months ended June 30, 2017 and 2016 (in thousands):

|  | Three Months Ended June 30 |           |                             |          |                  |          |           |         |              |           |
|--|----------------------------|-----------|-----------------------------|----------|------------------|----------|-----------|---------|--------------|-----------|
|  | Specialty                  |           | Standard Commercial Segment |          | Personal Segment |          | Corporate |         | Consolidated |           |
|  | 2017                       | 2016      | 2017                        | 2016     | 2017             | 2016     | 2017      | 2016    | 2017         | 2016      |
| Gross premiums written                         | \$127,805                  | \$103,717 | \$19,769                    | \$21,024 | \$14,482         | \$19,296 | \$-       | \$-     | \$162,056    | \$144,000 |
| Ceded premiums written                         | (52,386)                   | (37,538)  | (2,086)                     | (2,210)  | (6,690)          | (9,046)  | -         | -       | (61,162)     | (48,000)  |
| Net premiums written                           | 75,419                     | 66,179    | 17,683                      | 18,814   | 7,792            | 10,250   | -         | -       | 100,894      | 95,000    |
| Change in unearned premiums                    | (10,635)                   | (6,410)   | (1,301)                     | (1,473)  | 1,749            | 338      | -         | -       | (10,187)     | (7,500)   |
| Net premiums earned                            | 64,784                     | 59,769    | 16,382                      | 17,341   | 9,541            | 10,588   | -         | -       | 90,707       | 87,500    |
| Total revenues                                 | 69,501                     | 63,040    | 17,322                      | 18,219   | 10,684           | 12,147   | (4,032)   | (2,354) | 93,475       | 91,000    |
| Losses and loss adjustment expenses            | 50,529                     | 39,518    | 11,863                      | 9,369    | 8,312            | 9,615    | -         | -       | 70,704       | 58,500    |
| Pre-tax income (loss)                          | 3,632                      | 7,287     | (199)                       | 3,011    | (892)            | (1,014)  | (7,459)   | (7,797) | (4,918)      | 1,400     |
| Net loss ratio (1)                             | 78.0 %                     | 66.1 %    | 72.4 %                      | 54.0 %   | 87.1 %           | 90.8 %   |           |         | 77.9 %       | 66.7 %    |
| Net expense ratio (1)                          | 23.2 %                     | 26.2 %    | 34.9 %                      | 34.0 %   | 26.6 %           | 23.7 %   |           |         | 27.2 %       | 29.2 %    |
| Net combined ratio (1)                         | 101.2 %                    | 92.3 %    | 107.3 %                     | 88.0 %   | 113.7 %          | 114.5 %  |           |         | 105.1 %      | 95.9 %    |
| Favorable (Unfavorable) Prior Year Development | (8,032)                    | (753)     | (1,722)                     | 3,316    | (419)            | (1,523)  |           |         | (10,173)     | 1,000     |

(1)

The net loss ratio is calculated as incurred losses and LAE divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is calculated as total underwriting expenses offset by agency fee income divided by net premiums earned, each determined in accordance with GAAP. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

***Specialty Commercial Segment***

Gross premiums written for the Specialty Commercial Segment were \$127.8 million for the three months ended June 30, 2017, which was \$24.1 million, or 23%, more than the \$103.7 million reported for the same period of 2016. Net premiums written were \$75.4 million for the three months ended June 30, 2017 as compared to \$66.2 million for the same period of 2016. The increase in gross and net premiums written were primarily the result of increased premium production in both our Specialty Commercial operating unit and MGA Commercial Products operating unit.

The \$69.5 million of total revenue for the three months ended June 30, 2017 was \$6.5 million more than the \$63.0 million reported by the Specialty Commercial Segment for the same period in 2016. This increase in revenue was primarily due to higher net premiums earned of \$5.0 million due mostly to increased premium production in both our MGA Commercial Products operating unit and our Specialty Commercial operating unit. Further contributing to the increased revenue was higher net investment income of \$1.0 million and higher commission and fees of \$0.5 million for the three months ended June 30, 2017 as compared to the same period of 2016.

Pre-tax income for the Specialty Commercial Segment of \$3.6 million for the second quarter of 2017 was \$3.7 million lower than the \$7.3 million reported for the same period in 2016. The decrease in pre-tax income was primarily the result of higher losses and LAE of \$11.0 million, partially offset by lower operating expenses of \$0.8 million and the increased revenue discussed above.

Our MGA Commercial Products operating unit reported a \$9.0 million increase in losses and LAE due largely to \$6.8 million unfavorable prior year net loss reserve development recognized during the three months ended June 30, 2017 as compared to \$1.3 million unfavorable prior year net loss reserve development during the same period of 2016, as well as higher current accident year loss trends. Our Specialty Commercial operating unit reported a \$2.0 million increase in losses and LAE which consisted of (a) a \$1.5 million increase in losses and LAE in our commercial umbrella and primary/excess liability line of business, (b) a \$0.6 million increase in losses and LAE in our satellite launch insurance line of business, (c) a \$0.4 million increase in losses and LAE attributable to our primary/excess property insurance products due to increase premium production (d) a \$0.4 million increase in our general aviation line of business, partially offset by (e) a \$0.6 million decrease in losses and LAE attributable to our professional liability insurance products and (f) a \$0.3 million decrease in losses and LAE in our specialty programs. The \$0.8 million decrease in operating expense was primarily the result of lower production related expenses of \$1.5 million due primarily to increased ceding commissions in our Specialty Commercial operating unit, partially offset by increased salary and related expenses of \$0.4 million, higher travel related expenses of \$0.1 million and higher occupancy and other operating expenses of \$0.2 million.

The Specialty Commercial Segment reported a net loss ratio of 78.0% for the three months ended June 30, 2017 as compared to 66.1% for the same period during 2016. The gross loss ratio before reinsurance was 73.0% for the three months ended June 30, 2017 as compared to 62.1% for the same period in 2016. The higher gross and net loss ratios were largely the result of \$8.0 million of unfavorable prior year net loss reserve development for the three months ended June 30, 2017 as compared to unfavorable prior year net loss reserve development of \$0.8 million for the same period of 2016 as well as higher current accident year loss trends driven by commercial auto lines of business. The Specialty Commercial Segment reported a net expense ratio of 23.2% for the second quarter of 2017 as compared to 26.2% for the same period of 2016. The decrease in the expense ratio was due predominately to the impact of higher net premiums earned.

### *Standard Commercial Segment*

Gross premiums written for the Standard Commercial Segment were \$19.8 million for the three months ended June 30, 2017, which was \$1.2 million, or 6%, less than the \$21.0 million reported for the same period in 2016. The decrease in gross premiums was primarily due to a \$1.8 million reduction from the impact of the discontinued marketing of new and renewal occupational accident policies effective June 1, 2016, partially offset by higher premium production in our Standard Commercial P&C Operating unit of \$0.6 million. Net premiums written were \$17.7 million for the three months ended June 30, 2017 as compared to \$18.8 million for the same period in 2016. The decrease in net premiums written was primarily attributable to a \$1.6 million reduction from the impact of the discontinued marketing of new and renewal occupational accident policies, partially offset by higher net premiums written in our Standard Commercial P&C Operating unit of \$0.5 million.

Total revenue for the Standard Commercial Segment of \$17.3 million for the three months ended June 30, 2017, was \$0.9 million, or 5%, less than the \$18.2 million reported for the same period in 2016. This decrease in total revenue was due to lower net premiums earned of \$1.0 million resulting primarily from a \$1.7 million impact to net premiums earned due to the discontinued marketing of new and renewal occupational accident policies, partially offset by higher net premiums earned of \$0.7 million in our Standard Commercial P&C Operating unit. This decrease in net premiums earned was partially offset by higher net investment income of \$0.1 million for the three months ended June 30, 2017 as compared to the same period during 2016.

Our Standard Commercial Segment reported a pre-tax loss of \$0.2 million for the three months ended June 30, 2017 as compared to pre-tax income of \$3.0 million reported for the same period of 2016. The pre-tax loss was the result of higher losses and LAE of \$2.5 million and the decreased revenue discussed above, partially offset by a \$0.2 million decrease in operating expense. The \$0.2 million decrease in operating expense was the combined result of lower production related expenses of \$0.6 million due primarily to the discontinued marketing of new and renewal occupational accident policies, partially offset by increased salary and related expenses of \$0.2 million and a \$0.2 million increase in other expenses due predominately to an investment in technology.

The Standard Commercial Segment reported a net loss ratio of 72.4% for the three months ended June 30, 2017 as compared to 54.0% for the same period of 2016. The gross loss ratio before reinsurance for the three months ended June 30, 2017 was 64.1% as compared to the 47.7% reported for the same period of 2016. Our Standard Commercial Segment's net loss ratio included 7.3 additional loss ratio points attributable to the discontinued workers compensation and occupational accident business for the three months ended June 30, 2017 as compared to 12.0 fewer loss ratio points for the same period the prior year. During the three months ended June 30, 2017, the Standard Commercial Segment reported unfavorable net loss reserve development of \$1.7 million as compared to favorable net loss reserve development of \$3.3 million during the same period of 2016. The Standard Commercial Segment reported a net expense ratio of 34.9% for the second quarter of 2017 as compared to 34.0% for the same period of 2016. The increase in the expense ratio was primarily due to the decreased earned premium, partially offset by lower operating expenses.

### ***Personal Segment***

Gross premiums written for the Personal Segment were \$14.5 million for the three months ended June 30, 2017 as compared to \$19.3 million for the same period in the prior year. Net premiums written for our Personal Segment were \$7.8 million in the second quarter of 2017, which was a decrease of \$2.5 million, or 24%, from the \$10.3 million reported for the second quarter of 2016.

Total revenue for the Personal Segment was \$10.7 million for the second quarter of 2017 as compared to \$12.1 million for the same period in 2016. The \$1.4 million decrease in revenue was primarily the result of lower net



premiums earned of \$1.0 million and lower finance charges of \$0.4 million reported during the second quarter of 2017 as compared to the same period during 2016.

Pre-tax loss for the Personal Segment was \$0.9 million for the three months ended June 30, 2017 as compared to pre-tax loss of \$1.0 million for the same period of 2016. The decrease in the pre-tax loss was primarily the result of decreased losses and LAE of \$1.3 million for the three months ended June 30, 2017 as compared to the same period during 2016 and lower operating expenses of \$0.2 million, partially offset by the decreased revenue discussed.

The Personal Segment reported a net loss ratio of 87.1% for the three months ended June 30, 2017 as compared to 90.8% for the same period of 2016. The gross loss ratio before reinsurance was 79.0% for the three months ended June 30, 2017 as compared to 89.2% for the same period in 2016. The lower gross and net loss ratios were primarily the result of lower unfavorable prior year net loss reserve development as well as lower gross current accident year loss trends. The Personal Segment reported \$0.4 million of unfavorable prior year net loss reserve development for the three months ended June 30, 2017 as compared to \$1.5 million of net unfavorable development for the same period in the prior year. Operating expenses decreased \$0.2 million primarily as a result of a decrease in production related expenses. The Personal Segment reported a net expense ratio of 26.6% for the second quarter of 2017 as compared to 23.7% for the same period of 2016. The increase in the expense ratio was due predominately to the lower finance charges and lower net premiums earned.

### *Corporate*

Total revenue for Corporate decreased by \$1.7 million for the three months ended June 30, 2017 as compared to the same period the prior year. This decrease in total revenue was due predominately to net realized losses recognized on our investment portfolio of \$3.5 million for the three months ended June 30, 2017 as compared to net realized losses of \$2.2 million for the same period of 2016 and lower net investment income of \$0.4 million.

Corporate pre-tax loss was \$7.5 million for the three months ended June 30, 2017 as compared to pre-tax loss of \$7.8 million for the same period of 2016. The decrease in pre-tax loss was primarily due to lower operating expenses of \$2.1 million, partially offset by higher interest expense of \$0.1 million and the decreased revenue discussed above. The lower operating expenses of \$2.1 million were a combined result of an additional \$1.8 million earn-out accrued during the second quarter of 2016 in conjunction with the previous acquisition of TBIC (which was subsequently paid in July 2016) and lower salary and related expenses of \$0.4 million during the second quarter of 2017 as compared to the second quarter of 2016, partially offset by higher professional service fees and other expenses of \$0.1 million.

**Six Months Ended June 30, 2017 as Compared to Six Months Ended June 30, 2016**

The following is additional business segment information for the six months ended June 30, 2017 and 2016 (in thousands):

|  | Six Months Ended June 30 |           |                             |          |                  |          |           |          |              |      |
|--|--------------------------|-----------|-----------------------------|----------|------------------|----------|-----------|----------|--------------|------|
|  | Specialty                |           | Standard Commercial Segment |          | Personal Segment |          | Corporate |          | Consolidated |      |
|  | 2017                     | 2016      | 2017                        | 2016     | 2017             | 2016     | 2017      | 2016     | 2017         | 2016 |
| Gross premiums written                         | \$223,312                | \$191,117 | \$40,462                    | \$41,122 | \$33,394         | \$40,245 | \$-       | \$-      | \$297,168    | \$   |
| Ceded premiums written                         | (88,310)                 | (66,201)  | (3,927)                     | (4,562)  | (15,518)         | (18,852) | -         | -        | (107,755)    |      |
| Net premiums written                           | 135,002                  | 124,916   | 36,535                      | 36,560   | 17,876           | 21,393   | -         | -        | 189,413      |      |
| Change in unearned premiums                    | (8,289)                  | (7,894)   | (3,439)                     | (2,569)  | 2,245            | (381)    | -         | -        | (9,483)      |      |
| Net premiums earned                            | 126,713                  | 117,022   | 33,096                      | 33,991   | 20,121           | 21,012   | -         | -        | 179,930      |      |
| Total revenues                                 | 135,336                  | 123,623   | 35,048                      | 36,211   | 22,547           | 24,237   | (2,508)   | (2,991)  | 190,423      |      |
| Losses and adjustment expenses                 | 92,119                   | 73,931    | 22,909                      | 20,438   | 17,518           | 19,528   | -         | -        | 132,546      |      |
| Pre-tax income (loss)                          | 11,730                   | 17,599    | 652                         | 4,427    | (1,650)          | (2,097)  | (9,812)   | (12,453) | 920          |      |
| Net loss ratio (1)                             | 72.7 %                   | 63.2 %    | 69.2 %                      | 60.1 %   | 87.1 %           | 92.9 %   |           |          | 73.7 %       |      |
| Net expense ratio (1)                          | 24.4 %                   | 27.0 %    | 35.2 %                      | 34.1 %   | 26.3 %           | 21.4 %   |           |          | 28.2 %       |      |
| Net combined ratio (1)                         | 97.1 %                   | 90.2 %    | 104.4 %                     | 94.2 %   | 113.4 %          | 114.3 %  |           |          | 101.9 %      |      |
| Favorable (Unfavorable) Prior Year Development | (8,332)                  | 1,594     | (264)                       | 3,674    | (1,088)          | (2,511)  |           |          | (9,684)      |      |

(1) The net loss ratio is calculated as incurred losses and LAE divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is calculated as total underwriting expenses offset by agency fee income divided by net premiums earned, each determined in accordance with GAAP. Net combined ratio is calculated as the sum of the net loss ratio and the net expense ratio.

***Specialty Commercial Segment***

Gross premiums written for the Specialty Commercial Segment were \$223.3 million for the six months ended June 30, 2017, which was \$32.2 million, or 17%, more than the \$191.1 million reported for the same period in 2016. The increase in gross premiums written was due to increased premium production in both our MGA Commercial Products and our Specialty Commercial operating units. Net premiums written were \$135.0 million for the six months ended June 30, 2017 as compared to \$124.9 million reported for the same period in 2016. The higher net premiums written were due primarily to increased production in both our MGA Commercial and Specialty Commercial operating units.

The \$135.3 million of total revenue for the Specialty Commercial Segment for the six months ended June 30, 2017 was \$11.7 million higher than the \$123.6 million reported for the same period in 2016. This increase in revenue was due to higher net premiums earned of \$9.7 million due mostly to increased premium production in both our MGA Commercial Products operating unit and our Specialty Commercial operating unit. Further contributing to the increased revenue was higher net investment income of \$1.6 million and higher commission and fees of \$0.4 million for the six months ended June 30, 2017 as compared to the same period of 2016.

Pre-tax income for the Specialty Commercial Segment of \$11.7 million for the six months ended June 30, 2017 was \$5.9 million lower than the \$17.6 million reported for the same period in 2016. The decrease in pre-tax income was primarily the result of higher losses and LAE of \$18.2 million, partially offset by lower operating expenses of \$0.6 million and the increased revenue discussed above.

Our MGA Commercial Products operating unit reported a \$15.7 million increase in losses and LAE due primarily to \$7.5 million of unfavorable prior year net loss reserve development recognized for the six months ended June 30, 2017 as compared to \$1.1 million favorable prior year net loss reserve development recognized for the same period of 2016, as well as higher current accident year loss trends. Our Specialty Commercial operating unit reported a \$2.5 million increase in losses and LAE which consisted of (a) a \$2.6 million increase in losses and LAE in our commercial umbrella and primary/excess liability line of business, (b) a \$0.6 million increase in losses and LAE in our satellite launch insurance line of business, (c) a \$0.6 million increase in losses and LAE attributable to our primary/excess property insurance products due to increased premium production (d) a \$0.4 million increase in our general aviation line of business, partially offset by (e) a \$1.4 million decrease in losses and LAE attributable to our professional liability insurance products and (f) a \$0.3 million decrease in losses and LAE in our specialty programs. The \$0.6 million decrease in operating expense was primarily the result of lower production related expenses of \$2.2 million due primarily to increased ceding commissions in our Specialty Commercial operating unit, partially offset by increased salary and related expenses of \$0.9 million, higher occupancy and other operating expenses of \$0.4 million, higher travel related expenses of \$0.2 million and higher professional service fee expense of \$0.1 million.

The Specialty Commercial Segment reported a net loss ratio of 72.7% for the six months ended June 30, 2017 as compared to 63.2% for the same period during 2016. The gross loss ratio before reinsurance was 68.3% for the six months ended June 30, 2017 as compared to 60.2% for the same period in 2016. The higher gross and net loss ratios for the six months ended June 30, 2017 were primarily the result of \$8.3 million unfavorable prior year net loss reserve development recognized for the six months ended June 30, 2017 as compared to \$1.6 million favorable prior year net loss reserve development for the same period of 2016 as well as higher current accident year loss trends driven by our commercial auto line of business.

### ***Standard Commercial Segment***

Gross premiums written for the Standard Commercial Segment were \$40.5 million for the six months ended June 30, 2017, which was \$0.6 million, or 2%, less than the \$41.1 million reported for the same period in 2016. Net premiums written of \$36.5 million for the six months ended June 30, 2017 were relatively unchanged from the same period of 2016. The gross and net premiums written include a \$2.9 million increase in our Standard Commercial P&C operating unit for the six months ended June 30, 2107 as compared to the same period during 2016, offset by a decrease in premium volume of \$3.0 million due to the discontinued marketing of new and renewal occupational accident policies and a \$0.5 million decrease in gross premiums written due to the discontinued marketing of workers compensation policies.

Total revenue for the Standard Commercial Segment of \$35.0 million for the six months ended June 30, 2017 was \$1.2 million less than the \$36.2 million reported during the same period in 2016. This 3% decrease in total revenue was mostly due to a \$0.9 million decrease in net premiums earned primarily as a result of a \$2.7 million decrease in net premiums earned due to the discontinued marketing of new and renewal occupational accident policies, partially offset by \$1.8 million higher net premiums earned in our Standard Commercial P&C operating unit due to increased premium production. Further contributing to the decrease in revenue was lower commission and fees of \$0.4 million, partially offset by higher net investment income of \$0.1 million for the six months ended June 30, 2017 as compared to the same period in 2016.

Our Standard Commercial Segment reported pre-tax income of \$0.7 million for the six months ended June 30, 2017 as compared to \$4.4 million for the same period during 2016. The lower pre-tax income was the result of higher losses and LAE expenses of \$2.5 million and the decreased revenue discussed above.

The Standard Commercial Segment reported a net loss ratio of 69.2% for the six months ended June 30, 2017 as compared to 60.1% for the same period in 2016. The gross loss ratio before reinsurance for the six months ended June 30, 2017 was 60.9% as compared to the 56.6% reported for the same period of 2016. Our Standard Commercial Segment's net loss ratio included 6.8 additional loss ratio points attributable to the discontinued workers compensation and occupational accident business for the six months ended June 30, 2017 as compared to 4.9 fewer loss ratio points for the same period the prior year. During the six months ended June 30, 2017 the Standard Commercial Segment reported unfavorable prior year net loss reserve development of \$0.3 million as compared to favorable prior year net loss reserve development of \$3.7 million for the same period of 2016. The Standard Commercial Segment reported a net expense ratio of 35.2% for the six months ended June 30, 2017 as compared to 34.1% for the same period of 2016. The increase in the expense ratio is primarily due to the decreased earned premium.

### *Personal Segment*

Gross premiums written for the Personal Segment were \$33.4 million for the six months ended June 30, 2017, which was \$6.8 million, or 17%, less than the \$40.2 million reported for the same period in 2016. Net premiums written for our Personal Segment were \$17.9 million for the six months ended June 30, 2017, which was a decrease of \$3.5 million, or 16%, from the \$21.4 million reported for the same period of 2016.

Total revenue for the Personal Segment decreased 7% to \$22.5 million for the six months ended June 30, 2017 from \$24.2 million for the same period during 2016. The decrease in revenue was primarily due to lower net premiums earned of \$0.9 million as a result of lower premiums written and lower finance charges of \$0.8 million.

Pre-tax loss for the Personal Segment was \$1.7 million for the six months ended June 30, 2017 as compared to pre-tax loss of \$2.1 million for the same period of 2016. The lower pre-tax loss was the result of decreased losses and LAE of \$2.0 million and lower operating expenses of \$0.1 million for the six months ended June 30, 2017 as compared to the same period during 2016, partially offset by the decreased revenue discussed above.

The Personal Segment reported a net loss ratio of 87.1% for the six months ended June 30, 2017 as compared to 92.9% for the same period of 2016. The gross loss ratio before reinsurance was 83.0% for the six months ended June 30, 2017 as compared to 89.7% for the same period in 2016. The lower gross and net loss ratios were primarily the result of lower unfavorable prior year net loss reserve development of \$1.1 million for the six months ended June 30, 2017 as compared to unfavorable development of \$2.5 million for the same period in the prior year, as well as lower gross current accident year loss trends. The decrease in operating expenses of \$0.1 million was the combined result of a \$0.1 million decrease in salary and related expenses and a \$0.1 million decrease in professional service fees, partially offset by \$0.1 million increase in other operating expenses driven by our investment in technology. The Personal Segment reported a net expense ratio of 26.3% for the six months ended June 30, 2017 as compared to 21.4% for the same period of 2016. The increase in the expense ratio was due predominately to the lower finance charges and lower net premiums earned.



### *Corporate*

Total revenue for Corporate increased by \$0.5 million for the six months ended June 30, 2017 as compared to the same period the prior year. This increase in total revenue was due to net realized losses recognized on our investment portfolio of \$1.4 million for the six months ended June 30, 2017 as compared to the net realized losses of \$2.4 million for the same period of 2016, partially offset by lower net investment income of \$0.5 million.

Corporate pre-tax loss was \$9.8 million for the six months ended June 30, 2017 as compared to pre-tax loss of \$12.5 million for the same period of 2016. The decrease in pre-tax loss was primarily due to the increased revenue discussed above, lower operating expenses of \$2.3 million partially offset by higher interest expense of \$0.1 million. The lower operating expenses of \$2.3 million were primarily a result of an additional \$1.8 million earn-out accrued during the second quarter of 2016 in conjunction with the previous acquisition of TBIC (which was subsequently paid in July 2016) and lower salary and related expenses of \$0.8 million for the six months ended June 30, 2017 as compared to the same period during 2016, partially offset by higher professional service fees of \$0.2 million and other operating expenses of \$0.1 million.

### **Financial Condition and Liquidity**

#### *Sources and Uses of Funds*

Our sources of funds are from insurance-related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions, and processing and service fees. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of June 30, 2017, we had \$10.4 million in unrestricted cash and cash equivalents, as well as \$1.1 million in debt securities, at the holding company and our non-insurance subsidiaries. As of that date, our insurance subsidiaries held \$67.0 million of unrestricted cash and cash equivalents, as well as \$607.0 million in debt securities with an average modified duration of 1.7 years. Accordingly, we do not anticipate selling long-term debt instruments to meet any liquidity needs.

AHIC and TBIC, domiciled in Texas, are limited in the payment of dividends to their stockholders in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders' surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. HIC and HNIC, both domiciled in Arizona, are limited in the payment of dividends to the lesser of 10% of prior year policyholders' surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. HSIC, domiciled in Oklahoma, is limited in the payment

of dividends to the greater of 10% of prior year policyholders' surplus or prior year's statutory net income, not including realized capital gains, without prior written approval from the Oklahoma Insurance Department. During 2017, the aggregate ordinary dividend capacity of these subsidiaries is \$28.0 million, of which \$19.4 million is available to Hallmark. As a county mutual, dividends from HCM are payable to policyholders. During the first six months of 2017 and 2016, our insurance company subsidiaries paid \$6.5 million and \$4.6 million in dividends to Hallmark, respectively.

*Comparison of June 30, 2017 to December 31, 2016*

On a consolidated basis, our cash (excluding restricted cash) and investments at June 30, 2017 were \$746.4 million compared to \$733.8 million at December 31, 2016. The primary reasons for this increase in unrestricted cash and investments were cash flow from operations, the collection of an unsettled investment disposal and an increase in investment fair values, partially offset by capital expenditures and repurchases of our common stock.

*Comparison of Six Months Ended June 30, 2017 and June 30, 2016*

Net cash provided by our consolidated operating activities was \$12.4 million for the first six months of 2017 as compared to \$2.3 million for the first six months of 2016. The increase in operating cash flow was primarily due to decreased paid losses (including timing of reinsurance claim settlements), higher collected net investment income, lower net paid operating expenses, lower income taxes paid and higher collected ceding commission, partially offset by lower collected net premiums and lower finance charges collected.

Net cash used in investing activities during the first six months of 2017 was \$10.3 million as compared to \$20.1 million during the first six months of 2016. The decrease in cash used by investing activities during the first six months of 2017 was comprised of an increase of \$37.5 million in maturities, sales and redemptions of investment securities and an increase in transfers from restricted cash of \$4.6 million, partially offset by an increase in purchases of debt and equity securities of \$31.8 million and an increase in purchases of property and equipment of \$0.5 million.

Cash used in financing activities during the first six months of 2017 was \$4.3 million primarily as a result of repurchases of our common stock. Cash used in financing activities during the first six months of 2016 was \$4.7 million as a result of the repurchase of our common stock.

*Credit Facilities*

Our Second Restated Credit Agreement with Frost Bank (“Frost”) dated June 30, 2015, reinstated the credit facility with Frost which expired by its terms on April 30, 2015. The Second Restated Credit Agreement also amended certain provisions of the credit facility and restated the agreement with Frost in its entirety. The Second Restated Credit Agreement provides a \$15.0 million revolving credit facility (“Facility A”), with a \$5.0 million letter of credit sub-facility. The outstanding balance of the Facility A bears interest at a rate equal to the prime rate or LIBOR plus 2.5%, at our election. We pay an annual fee of 0.25% of the average daily unused balance of Facility A and letter of

credit fees at the rate of 1.00% per annum. As of June 30, 2017, we had no outstanding borrowings under Facility A.

On December 17, 2015, we entered into a First Amendment to Second Restated Credit Agreement and a Revolving Facility B Agreement (the "Facility B Agreement") with Frost to provide a new \$30.0 million revolving credit facility ("Facility B"), in addition to Facility A. On November 1, 2016, we amended the Facility B Agreement with Frost to extend by one year the termination date for draws under Facility B and the maturity date for amounts outstanding thereunder. We paid Frost a commitment fee of \$75,000 when Facility B was established and an additional \$30,000 fee when Facility B was extended.

We may use Facility B loan proceeds solely for the purpose of making capital contributions to AHIC and HIC. As amended, we may borrow, repay and reborrow under Facility B until December 17, 2018, at which time all amounts outstanding under Facility B are converted to a term loan. Through December 17, 2018, we pay Frost a quarterly fee of 0.25% per annum of the average daily unused balance of Facility B. Facility B bears interest at a rate equal to the prime rate or LIBOR plus 3.00%, at our election. Until December 17, 2018, interest only on amounts from time to time outstanding under Facility B are payable quarterly. Any amounts outstanding on Facility B as of December 17, 2018 are converted to a term loan payable in quarterly installments over five years based on a seven year amortization of principal plus accrued interest. All remaining principal and accrued interest on Facility B become due and payable on December 17, 2023. As of June 30, 2017, we had \$30.0 million outstanding under Facility B.

The obligations under both Facility A and Facility B are secured by a security interest in the capital stock of AHIC and HIC. Both Facility A and Facility B contain covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of June 30, 2017, we were in compliance with all of these covenants.

### ***Subordinated Debt Securities***

On June 21, 2005, we entered into a trust preferred securities transaction pursuant to which we issued \$30.9 million aggregate principal amount of subordinated debt securities due in 2035. To effect the transaction, we formed a Delaware statutory trust, Hallmark Statutory Trust I (“Trust I”). Trust I issued \$30.0 million of preferred securities to investors and \$0.9 million of common securities to us. Trust I used the proceeds from these issuances to purchase the subordinated debt securities. The initial interest rate on our Trust I subordinated debt securities was 7.725% until June 15, 2015, after which interest adjusts quarterly to the three-month LIBOR rate plus 3.25 percentage points. Trust I pays dividends on its preferred securities at the same rate. Under the terms of our Trust I subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of June 30, 2017, the principal balance of our Trust I subordinated debt was \$30.9 million and the interest rate was 4.50% per annum.

On August 23, 2007, we entered into a trust preferred securities transaction pursuant to which we issued \$25.8 million aggregate principal amount of subordinated debt securities due in 2037. To effect the transaction, we formed a Delaware statutory trust, Hallmark Statutory Trust II (“Trust II”). Trust II issued \$25.0 million of preferred securities to investors and \$0.8 million of common securities to us. Trust II used the proceeds from these issuances to purchase the subordinated debt securities. Our Trust II subordinated debt securities bear an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Trust II pays dividends on its preferred securities at the same rate. Under the terms of our Trust II subordinated debt securities, we pay interest only each quarter and the principal of the note at maturity. The subordinated debt securities are uncollateralized and do not require maintenance of minimum financial covenants. As of June 30, 2017, the principal balance of our Trust II subordinated debt was \$25.8 million.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

There have been no material changes to the market risks discussed in Item 7A to Part II of our Form 10-K for the fiscal year ended December 31, 2016.

#### **Item 4. Controls and Procedures.**

The principal executive officer and principal financial officer of Hallmark have evaluated our disclosure controls and procedures and have concluded that, as of the end of the period covered by this report, such disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is timely recorded, processed, summarized and reported. The principal executive officer and principal financial officer also concluded that such disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under such Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. During the most recent fiscal quarter, there have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### **Risks Associated with Forward-Looking Statements Included in this Form 10-Q**

This Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties.

Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.

## **PART II**

### **OTHER INFORMATION**

#### **Item 1. Legal Proceedings.**

During the third quarter of 2015, we paid \$1.2 million to the sellers of the subsidiaries comprising our Workers Compensation operating unit pursuant to the terms of the acquisition agreement. The sellers disputed the calculation of the amount paid and, pursuant to the terms of the acquisition agreement, an independent actuary was engaged to resolve this matter. In accordance with the report of the independent actuary, we accrued during the second quarter of 2016 and paid during the third quarter of 2016 an additional \$1.8 million to the sellers.

In November 2015, one of the subsidiaries in our MGA Commercial operating unit, Hallmark Specialty Underwriters, Inc. ("HSU"), was informed by the Texas Comptroller of Public Accounts that a surplus lines tax audit covering the period January 1, 2010 through December 31, 2013 was complete. HSU frequently acts as a managing general underwriter ("MGU") authorized to underwrite policies on behalf of Republic Vanguard Insurance Company and HSIC, both Texas eligible surplus lines insurance carriers. In its role as the MGU, HSU underwrites policies on behalf of these carriers while other agencies located in Texas (generally referred to as "producing agents") deliver the policies to the insureds and collect all premiums due from the insureds. During the period under audit, the producing agents also collected the surplus lines premium taxes due on the policies from the insureds, held them in trust, and timely remitted those taxes to the Comptroller. We believe this system for collecting and paying the required surplus lines premium taxes complies in all respects with the Texas Insurance Code and other regulations, which clearly require that the same party who delivers the policies and collects the premiums will also collect premium taxes, hold premium taxes in trust, and pay premium taxes to the Comptroller. It also complies with long standing industry practice. In addition, effective January 1, 2012 the Texas legislature enacted House Bill 3410 (HB3410) which allows an MGU to contractually pass the collection, payment and administration of surplus lines taxes down to another Texas licensed surplus line agent.



The Comptroller has asserted that HSU is liable for the surplus lines premium taxes related to policy transactions and premiums collected from surplus lines insureds during January 1, 2010 through December 31, 2011, the period prior to the passage of HB3410, and that HSU therefore owes \$2.5 million in premium taxes, as well as \$0.7 million in penalties and interest for the audit period. During the second quarter of 2017, we reached an agreement with the Comptroller to settle the matter for \$0.2 million, which was accrued as of June 30, 2017.

We are engaged in various legal proceedings that are routine in nature and incidental to our business. None of these proceedings, either individually or in the aggregate, are believed, in our opinion, to have a material adverse effect on our consolidated financial position or our results of operations.

### Item 1A. Risk Factors.

There have been no material changes to the risk factors discussed in Item 1A to Part I of our Form 10-K for the fiscal year ended December 31, 2016.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Our stock buyback program initially announced on April 18, 2008, authorized the repurchase of up to 1,000,000 shares of our common stock in the open market or in privately negotiated transactions (the “Stock Repurchase Plan”). On January 24, 2011, we announced an increased authorization to repurchase up to an additional 3,000,000 shares. The Stock Repurchase Plan does not have an expiration date.

The following table furnishes information for purchases made pursuant to the Stock Repurchase Plan during the quarter ended June 30, 2017:

| Period               | Total Number of Shares Purchased | Average Price Paid Per Share | Cumulative Number of Shares Purchased as Part of Publicly Announced Plan | Maximum Number of Shares that May Yet Be Purchased Under the Plan |
|----------------------|----------------------------------|------------------------------|--|---|
| April 1st-April 30th | 115,015                          | \$ 10.75                     | 2,756,034  | 1,243,966   |
| May 1st- May 31st    | 64,389                           | \$ 10.33                     | 2,820,423  | 1,179,577   |
| June 1st- June 30th  | 174,180                          | \$ 11.25                     | 2,994,603  | 1,005,397   |

**Item 3. Defaults Upon Senior Securities.**

None.

**Item 4. Mine Safety Disclosures.**

None.

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**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

The following exhibits are filed herewith or incorporated herein by reference:

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 3(a)                  | Restated Articles of Incorporation of the registrant, as amended (incorporated by reference to Exhibit 3.1 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006). |
| 3(b)                  | Amended and Restated By-Laws of the registrant (incorporated by reference to Exhibit 3.1 to the registrant's Current Report on Form 8-K filed March 28, 2017).  |
| 31(a)                 | Certification of principal executive officer required by Rule 13a-14(a) or Rule 15d-14(a).  |
| 31(b)                 | Certification of principal financial officer required by Rule 13a-14(a) or Rule 15d-14(a).  |
| 32(a)                 | Certification of principal executive officer Pursuant to 18 U.S.C. § 1350.  |
| 32(b)                 | Certification of principal financial officer Pursuant to 18 U.S.C. § 1350.  |
| 101 INS+              | XBRL Instance Document.   |
| 101 SCH+              | XBRL Taxonomy Extension Schema Document.  |
| 101 CAL+              | XBRL Taxonomy Extension Calculation Linkbase Document.  |
| 101 LAB+              | XBRL Taxonomy Extension Label Linkbase Document.  |
| 101 PRE+              | XBRL Taxonomy Extension Presentation Linkbase Document.   |

101  
DEF+ XBRL Taxonomy Extension Definition Linkbase Document.

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Filed with this Quarterly Report on Form 10-Q and included in Exhibit 101 to this report are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheets as of June 30, 2017 and December 31, 2016, (ii) Consolidated Statements of Operations for the three and six months ended June 30, 2017 and 2016, (iii) Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2017 and 2016, (iv) Consolidated Statements of Stockholder's Equity for the three and six months ended June 30, 2017 and 2016, (v) Consolidated Statements of Cash Flows for the six months ended June 30, 2017 and 2016 and (vi) related notes.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HALLMARK FINANCIAL SERVICES, INC.

(Registrant)

Date: August 7, 2017      /s/ Naveen Anand  
Naveen Anand, Chief Executive Officer and President

Date: August 7, 2017      /s/ Jeffrey R. Passmore  
Jeffrey R. Passmore, Chief Accounting Officer and Senior Vice  
President