

HALLMARK FINANCIAL SERVICES INC  
Form 10-K  
March 09, 2017

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended **DECEMBER 31, 2016**

Or

**..TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number **001-11252**

**Hallmark Financial Services, Inc.**

(Exact name of registrant as specified in its charter)

**Nevada**

(State or Other Jurisdiction of Incorporation or Organization)

**87-0447375**

(I.R.S. Employer Identification No.)

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

**76102**

(Address of Principal Executive Offices)

(Zip Code)

Registrant's Telephone Number, Including Area Code: **(817) 348-1600**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
<b>Common Stock \$.18 par value</b>	<b>Nasdaq Global Market</b>

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information

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statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of “accelerated filer”, “large accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

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

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant’s most recently completed second fiscal quarter. \$ 157.3 million

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. 18,616,982 shares of common stock, \$.18 par value per share, outstanding as of March 9, 2017.

## DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

*Unless the context requires otherwise, in this Form 10-K the term "Hallmark" refers solely to Hallmark Financial Services, Inc. and the terms "we," "our," "us" and the "Company" refer to Hallmark and its subsidiaries. The direct and indirect subsidiaries of Hallmark are referred to in this Form 10-K in the manner identified in the chart under "Item 1. Business – Operational Structure."*

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

This Form 10-K contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which are intended to be covered by the safe harbors created thereby. Forward-looking statements include statements which are predictive in nature, which depend upon or refer to future events or conditions, or which include words such as "expect," "anticipate," "intend," "plan," "believe," "estimate" or similar expressions. 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. Statements regarding the following subjects are forward-looking by their nature:

our business and growth strategies;

our performance goals;

our projected financial condition and operating results;

our understanding of our competition;

industry and market trends;

the impact of technology on our products, operations and business; and

any other statements or assumptions that are not historical facts.

The forward-looking statements included in this Form 10-K are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to these forward-looking statements involve judgments with respect to, among other things, future economic, competitive and market conditions, legislative initiatives, 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 these 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-K will prove to be accurate. In light of the significant uncertainties inherent in these forward-looking statements, the inclusion of such information should not be regarded as a representation that our objectives and plans will be achieved.

## **PART I**

### **Item 1. Business.**

#### **Who We Are**

We are a diversified property/casualty insurance group that serves businesses and individuals in specialty and niche markets.

We offer specialty commercial insurance, standard commercial insurance and personal insurance in selected market subcategories that are characteristically low-severity and predominately short-tailed risks. We focus on marketing, distributing, underwriting and servicing property/casualty insurance products that require specialized underwriting expertise or market knowledge. We believe this approach provides us the best opportunity to achieve favorable policy terms and pricing. The insurance policies we produce are written by our six insurance company subsidiaries as well as unaffiliated insurers.

We market, distribute, underwrite and service our property/casualty insurance products 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 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, the Workers Compensation 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.

Each operating unit has its own management team with significant experience in distributing products to its target markets and proven success in achieving underwriting profitability and providing efficient claims management. Each operating unit is responsible for marketing, distribution, underwriting and claims management while we provide capital management, reinsurance, actuarial, investment, financial reporting, technology and legal services and other administrative support at the parent level. We believe this approach optimizes our operating results by allowing us to effectively penetrate our selected specialty and niche markets while maintaining operational controls, managing risks, controlling overhead and efficiently allocating our capital across operating units. We expect future growth to be derived from organic growth in the premium production of our existing operating units and selected opportunistic acquisitions that meet our criteria.

## **What We Do**

We market commercial and personal lines property/casualty insurance products which are tailored to the risks and coverages required by the insured. We believe that most of our target markets are underserved by larger property/casualty insurers because of the specialized nature of the underwriting required. We are able to offer these products profitably as a result of the expertise of our experienced underwriters. We also believe our long-standing relationships with independent general agencies and retail agents and the service we provide differentiate us from larger property/casualty insurers.

Our MGA Commercial Products operating unit primarily offers commercial property/casualty insurance products in the excess and surplus lines market. Excess and surplus lines insurance provides coverage for difficult to place risks that do not fit the underwriting criteria of insurers operating in the standard market. Our MGA Commercial Products operating unit focuses on middle market commercial risks that do not meet the underwriting requirements of standard insurers due to factors such as loss history, number of years in business, minimum premium size and types of business operation. Our MGA Commercial Products operating unit primarily writes commercial automobile, general liability, commercial property and excess casualty coverages. Our MGA Commercial Products operating unit markets its products in 22 states through 12 wholesale brokers and 90 general agency offices, as well as 63 independent retail agents in Texas and Oregon.

Our Specialty Commercial operating unit offers small and middle market commercial excess liability, umbrella and general liability insurance on both an admitted and non-admitted basis; general aviation property/casualty insurance primarily for private and small commercial aircraft and airports; satellite launch property/casualty insurance products; medical professional liability insurance on an excess and surplus lines basis; and primary/excess commercial property coverages on an excess and surplus lines basis for both catastrophe and non-catastrophe exposures. The principal focus of the excess & umbrella insurance products offered is transportation (trucking for hire and specialty automobile coverage). The Specialty Commercial operating unit also provides excess liability coverage for small to midsize businesses in class categories such as contracting, manufacturing, hospitality and service (non-transportation). Typical risks range from one power unit to fleets of up to 200 power units and up to \$150 million in receipts (non-construction) or \$75 million in receipts (construction) from operations. Public entity excess coverage is also offered on an insurance and reinsurance basis for cities, counties and other public entities with populations up to 1,000,000. Our Specialty Commercial operating unit markets these excess & umbrella products through 132 wholesale brokers in all 50 states. The aircraft liability and hull insurance products underwritten by our Specialty Commercial operating unit target standard general aviation aircraft risks. Airport liability insurance is marketed to smaller, regional airports. Our Specialty Commercial operating unit markets these general aviation insurance products through 173 independent specialty brokers in 48 states. The satellite launch property/casualty policies produced by our Specialty Commercial operating unit are marketed through underwriting agencies with technical knowledge of space insurance. We can retain up to \$2.0 million per risk for satellite launches and in-orbit coverage for up to 12 months. The medical professional liability insurance underwritten on an excess and surplus lines basis by our Specialty Commercial operating unit focuses on standard risk healthcare professionals as well as those who do not meet the underwriting requirements of standard insurers due to factors such as loss history, number of years in business, minimum premium size and types of business operation. In addition to healthcare professionals, our Specialty Commercial operating unit also underwrites medical professional liability for medical facilities. These are generally outpatient facilities such as surgery centers, imaging centers, labs, home health agencies, and other non-hospital facilities providing medical services. The primary/excess commercial property coverages underwritten by our Specialty Commercial operating unit specializes in shared and layered accounts on a non-admitted basis which target regional and national property programs. Our Specialty Commercial operating unit markets these products through 36 wholesale brokers in 50 states.

Our Standard Commercial P&C operating unit primarily underwrites low-severity, short-tailed commercial property/casualty insurance products in the standard market. These products have historically produced stable loss results and include general liability, commercial automobile, commercial property and umbrella coverages. Our Standard Commercial P&C operating unit currently markets its products through a network of 330 independent agents primarily serving businesses in the non-urban areas of Texas, New Mexico, Oregon, Idaho, Montana, Washington, Utah, Wyoming, Arkansas, Hawaii and Missouri. In addition, our Standard Commercial P&C operating unit offers occupational accident coverage in Texas through an underwriting agency that specializes in the occupational accident insurance market. Effective June 1, 2016, we no longer market new or renewal occupational accident policies.

Our Specialty Personal Lines operating unit offers non-standard personal automobile policies, which generally provide the minimum limits of liability coverage mandated by state law to drivers who find it difficult to obtain insurance from standard carriers due to various factors including age, driving record, claims history or limited financial resources. Our Specialty Personal Lines operating unit also provides a renters insurance product that complements our non-standard auto offering and fits well in our distribution channel. During the fourth quarter of 2014, our Specialty Personal Lines operating unit discontinued the low value dwelling/homeowner's and manufactured



homes insurance products it previously offered. Our Specialty Personal Lines operating unit actively markets and services these policies through 3,488 independent retail agents in 14 states.

Our insurance company subsidiaries are American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Insurance Company (“HIC”), Hallmark Specialty Insurance Company (“HSIC”), Hallmark County Mutual Insurance Company (“HCM”), Hallmark National Insurance Company (“HNIC”) and Texas Builders Insurance Company (“TBIC”). AHIC, HIC, HSIC and HNIC have entered into a pooling arrangement, pursuant to which AHIC retains 34% of the net premiums written by any of them, HIC retains 32% of the net premiums written by any of them, HSIC retains 24% of the net premiums written by any of them and HNIC retains 10% of the net premiums written by any of them. A.M. Best Company (“A.M. Best”), a nationally recognized insurance industry rating service and publisher, has pooled its ratings of these four insurance company subsidiaries and assigned a financial strength rating of “A-” (Excellent) and an issuer credit rating of “a-” to each of these individual insurance company subsidiaries and to the pool formed by these four insurance company subsidiaries. Also, A.M. Best has assigned a financial strength rating of “A-” (Excellent) and an issuer credit rating of “a-” to HCM. A.M. Best does not assign a financial strength rating or an issuer credit rating to TBIC.

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 Specialty Commercial operating unit. The Standard Commercial Segment consists of the Standard Commercial P&C operating unit and the Workers Compensation operating unit. The Personal Segment consists solely of our Specialty Personal Lines operating unit. The following table displays the gross premiums written and net premiums written by these reportable segments for affiliated and unaffiliated insurers for the years ended December 31, 2016, 2015 and 2014.

	Year Ended December 31,		
	2016	2015	2014
	(dollars in thousands)		
Gross Premiums Written:			
Specialty Commercial Segment	\$388,914	\$351,050	\$324,547
Standard Commercial Segment	76,891	81,892	84,679
Personal Segment	83,272	81,281	63,992
Total	\$549,077	\$514,223	\$473,218
Net Premiums Written:			
Specialty Commercial Segment	\$249,072	\$241,775	\$230,638
Standard Commercial Segment	68,490	71,097	76,912
Personal Segment	44,267	44,072	16,802
Total	\$361,829	\$356,944	\$324,352

## Operational Structure

Our insurance company subsidiaries retain a portion of the premiums produced by our operating units. The following chart reflects the operational structure of our organization, including the subsidiaries comprising our operating units and the operating units included in each reportable segment as of December 31, 2016.

## Specialty Commercial Segment

The Specialty Commercial Segment of our business includes our MGA Commercial Products operating unit and our Specialty Commercial operating unit. During 2016, our MGA Commercial Products operating unit accounted for 56% and our Specialty Commercial operating unit accounted for 44% of the aggregate premiums produced by the Specialty Commercial Segment.

**MGA Commercial Products operating unit.** Our MGA Commercial Products operating unit markets, underwrites, finances and services commercial lines insurance in 22 states with a particular emphasis on commercial automobile, general liability and commercial property risks produced on an excess and surplus lines basis. Excess and surplus lines insurance provides coverage for difficult to place risks that do not fit the underwriting criteria of insurers operating in the standard market. The subsidiaries comprising our MGA Commercial Products operating unit include HSU, which is a regional managing general underwriter, TGASRI which is a Texas managing general agency, and PAAC, which provides premium financing for policies marketed by HSU and certain unaffiliated general and retail agents. HSU accounts for 87% of the premium volume financed by PAAC.

Our MGA Commercial Products operating unit focuses on middle market commercial risks that do not meet the underwriting requirements of traditional standard insurers due to issues such as loss history, number of years in business, minimum premium size and types of business operation. During 2016, commercial automobile, general liability and all other property & casualty accounted for 86%, 10% and 4%, respectively, of the premiums produced by our MGA Commercial Products operating unit. Target risks for commercial automobile insurance are business auto and trucking for hire fleets, excluding hazardous or flammable materials haulers. Target risks for general liability insurance are small business risk exposures including artisan contractors, sales and service organizations, and building and premises liability exposures. Target risks for commercial property insurance are low- to mid-value structures including office buildings, mercantile shops, restaurants and rental dwellings, in each case with aggregate property limits of less than \$1,000,000. The commercial insurance products offered by our MGA Commercial Products operating unit include the following:



**Commercial automobile.** Commercial automobile insurance provides third-party bodily injury and property damage coverage and first-party property damage coverage against losses resulting from the ownership, maintenance or use of automobiles and trucks in connection with an insured's business.

**General liability.** General liability insurance provides coverage for third-party bodily injury and property damage claims arising from accidents occurring on the insured's premises or from their general business operations.

**Commercial property.** Commercial property insurance provides first-party coverage for the insured's real property, business personal property, theft and business interruption losses caused by fire, wind, hail, water damage, vandalism and other insured perils. Windstorm, hurricane and hail are generally excluded in coastal areas.

**Commercial excess liability.** Commercial excess liability insurance is designed to provide an extra layer of protection for bodily injury, personal and advertising injury, or property damage losses above the primary layer of commercial automobile, general liability and employer's liability insurance. The excess insurance does not begin until the limits of liability in the primary layer have been exhausted. The excess layer provides not only higher limits, but catastrophic protection from large losses.

**Commercial umbrella.** Commercial umbrella insurance protects businesses for bodily injury, personal and advertising injury, or property damage claims in excess of the limits of their primary commercial automobile, general liability and employers liability policies, and for some claims excluded by their primary policies (subject to a deductible). Umbrella insurance provides not only higher limits, but catastrophic protection for large losses.

Our MGA Commercial Products operating unit markets its products in 22 states through 12 wholesale brokers and 90 general agency offices, as well as 63 independent retail agents in Texas and Oregon. Our MGA Commercial Products operating unit strives to simplify the placement of its excess and surplus lines policies by providing our general agents with a web rating portal which allows for instantaneous quoting and signature-ready applications which can be emailed or faxed to its independent retail agents. During 2016, general agents produced 90%, retail agents produced 3% and wholesale brokers produced 7% of total premiums produced by our MGA Commercial Products operating unit. During 2016, the top ten general agents produced 40%, the twelve wholesale brokers produced 7% and no general agent produced more than 9%, of the total premium volume of our MGA Commercial Products operating unit. During the same period, the top ten retail agents produced 3%, and no retail agent produced more than 1%, of the total premium volume of our MGA Commercial Products operating unit.

Through 2008, all business of our MGA Commercial Products operating unit was produced under a fronting agreement with member companies of the Republic Group ("Republic"), which granted our MGA Commercial Products operating unit the authority to develop underwriting programs, set rates, appoint retail and general agents, underwrite risks, issue policies and adjust and pay claims. We assumed 70% of the risk under this arrangement in 2008. In 2009, our MGA Commercial Products operating unit wrote a portion of its policies under a fronting arrangement with Republic pursuant to which we assumed 100% of the risk. Commission revenue was generated under the fronting agreement on the portion of premiums not assumed by AHIC. An additional commission may be earned if certain loss

ratio targets are met. Additional revenue was generated from fully earned policy fees and installment billing fees charged on legacy personal lines products. Since 2010, in states where we were not yet licensed to offer a non-admitted product, we utilized a fronting arrangement with a third party pursuant to which we assumed all of the risk and then retroceded a portion of the risk to third party reinsurers.

The majority of the commercial policies written by our MGA Commercial Products operating unit are for a term of 12 months. Exceptions include certain commercial automobile policies that are written for a term that coincides with the annual harvest of crops and special event general liability policies that are written for the term of the event, which is generally one to two days. Commercial lines policies are paid in full up front or financed with various premium finance companies, including PAAC.

**Specialty Commercial operating unit.** Our Specialty Commercial operating unit offers small and middle market commercial excess liability, umbrella, public entity and general liability insurance on both an admitted and non-admitted basis focusing primarily on trucking, specialty automobile and non-fleet automobile coverage, general aviation property/casualty insurance primarily for private and small commercial aircraft and airports, satellite launch insurance products, medical professional liability insurance on an excess and surplus lines basis and primary/excess commercial property coverage for both catastrophe and non-catastrophe exposures on an excess and surplus lines basis. Certain specialty programs are also managed by our Specialty Commercial operating unit.

The small and middle market commercial excess liability, umbrella and general liability insurance underwritten by our Specialty Commercial operating unit is offered on an admitted and non-admitted basis in all 50 states plus the District of Columbia. Limits of liability offered are from \$1,000,000 to \$5,000,000 (transportation) and \$1,000,000 to \$10,000,000 (non-transportation) in coverage in excess of the primary carrier's limits of liability. The majority of the excess & umbrella and general liability insurance policies written by our Specialty Commercial operating unit are on an annual basis. However, exceptions are common in an attempt to have policy effective dates coincide with those of the primary insurance policies. Policy premiums are due in full 30 days from the inception date of the policy. During 2016, the top ten wholesale brokers accounted for 43% of our primary and excess casualty premium volume, with no single wholesale broker accounting for more than 10%. During 2016, commercial transportation excess liability risks accounted for 82% of the premiums, with the remaining 18% coming from non-transportation commercial excess, public entity and general liability risks.

The commercial excess & umbrella and general liability insurance products offered by our Specialty Commercial operating unit include the following:

**Commercial excess liability.** Commercial excess liability insurance is designed to provide an extra layer of protection for bodily injury, personal and advertising injury, or property damage losses above the primary layer of commercial automobile, general liability and employer's liability insurance. The excess insurance does not begin until the limits of liability in the primary layer have been exhausted. The excess layer provides not only higher limits, but catastrophic protection from large losses.

**Commercial umbrella.** Commercial umbrella insurance protects businesses for bodily injury, personal and advertising injury, or property damage claims in excess of the limits of their primary commercial automobile, general liability and employer's liability policies, and for some claims excluded by their primary policies (subject to a deductible). Umbrella insurance provides not only higher limits, but catastrophic protection for large losses.

**Commercial general liability.** General liability insurance provides coverage for third-party bodily injury and property damage claims arising from accidents occurring on the insured's premises or from their general business operations.

We generally cede 80% of the excess & umbrella and general liability risk on policies presently written by our Specialty Commercial operating unit.

Our Specialty Commercial operating unit markets, underwrites and services general aviation property/casualty insurance in 48 states. The subsidiaries marketing our general aviation insurance products include Aerospace Insurance Managers, which markets standard aviation coverages, ASRI, which markets excess and surplus lines aviation coverages, and ACMG, which handles claims management. Aerospace Insurance Managers is one of only a few similar entities in the U.S. and has focused on developing a well-defined niche centering on transitional pilots, older aircraft and small airports and aviation-related businesses. In addition, our Specialty Commercial operating unit offers satellite launch property/casualty policies marketed through underwriting agencies with technical knowledge of space insurance. The general aviation and satellite launch products offered by our Specialty Commercial operating unit include the following:

***Aircraft.*** Aircraft insurance provides third-party bodily injury and property damage coverage and first-party hull damage coverage against losses resulting from the ownership, maintenance or use of aircraft.

***Airport liability.*** Airport liability insurance provides coverage for third-party bodily injury and property damage claims arising from accidents occurring on airport premises or from their operations.

***Satellite.*** We can retain up to \$2.0 million per risk for satellite launches and in-orbit coverage for up to 12 months.



We presently cede 80% of the general aviation risk on policies written by our Specialty Commercial operating unit.

Our Specialty Commercial operating unit distributes its general aviation insurance products through 173 aviation specialty brokers. These specialty brokers submit to Aerospace Insurance Managers requests for aviation insurance quotations received from the states in which we operate and our Specialty Commercial operating unit selectively determines the risks fitting its target niche for which it will prepare a quote. During 2016, the top ten independent specialty brokers produced 35%, and no broker produced more than 5%, of the total general aviation premium volume of our Specialty Commercial operating unit. Our Specialty Commercial operating unit independently develops, underwrites and prices each general aviation coverage written. We target standard general aviation risks for both commercial (non-airline) and non-commercial uses. We do not accept aircraft that are used for hazardous purposes such as crop dusting or heli-skiing. Liability limits are controlled, with 89% of the aircraft written in 2016 bearing per-occurrence limits of \$1,000,000 and per-passenger limits of \$100,000 or less. The average insured aircraft hull value for aircraft written in 2016 was approximately \$125,000. All general aviation policies produced by our Specialty Commercial operating unit are written through our insurance company subsidiaries.

Our Specialty Commercial operating unit markets medical professional liability insurance on an excess and surplus lines basis. Medical professional liability insurance provides coverage for third-party bodily injury claims resulting from professional services provided by physicians, surgeons, podiatrists and medical entities, as well as outpatient medical facilities. Our Specialty Commercial operating unit distributes its medical professional liability insurance products through 26 wholesale brokers in 49 states.

Our Specialty Commercial operating unit markets primary/excess commercial property coverages, on a non-admitted basis, for both catastrophe and non-catastrophe exposures. Our Specialty Commercial operating unit distributes its primary/excess commercial property insurance products through 36 wholesale brokers in 50 states. We presently cede 80% of the primary/excess commercial property risk on policies underwritten by our insurance companies and we receive a fee on the portion of the business written as a cover-holder through a Lloyds Syndicate.

The specialty programs within our Specialty Commercial operating unit consist of fronting and agency arrangements, as well as a program underwriter. The specialty programs business presently consists primarily of a fronting arrangement in Texas for a third party insurance company and a program underwriter writing primarily commercial auto liability and physical damage risk in 18 states.

## **Standard Commercial Segment**

The Standard Commercial Segment of our business includes our Standard Commercial P&C operating unit and our Workers Compensation operating unit. Effective July 1, 2015, our Workers Compensation operating unit no longer markets or retains any risk on new or renewal policies. During 2016, our Standard Commercial P&C operating unit accounted for 99% and our Workers Compensation operating unit accounted for the remaining 1% of the aggregate premiums produced by the Standard Commercial Segment.

**Standard Commercial P&C operating unit.** Our Standard Commercial P&C operating unit markets, underwrites and services standard commercial lines insurance primarily in the non-urban areas of Texas, New Mexico, Idaho, Oregon, Montana, Washington, Utah, Wyoming, Arkansas, Hawaii and Missouri. The subsidiaries comprising our Standard Commercial P&C operating unit include American Hallmark Insurance Services, a regional managing general agency, and ECM, a claims administration company. American Hallmark Insurance Services targets customers that are in low-severity classifications in the standard commercial market, which as a group have relatively stable loss results. The typical customer is a small to midsize business with a policy that covers property, general liability and automobile exposures. Our Standard Commercial P&C operating unit underwriting criteria exclude lines of business and classes of risks that are considered to be high-severity or volatile, or which involve significant latent injury potential or other long-tailed liability exposures. ECM administers the claims on the insurance policies produced by American Hallmark Insurance Services. In addition, our Standard Commercial P&C operating unit offers occupational accident coverage in Texas through an underwriting agency that is a specialist in the occupational accident insurance market. Effective June 1, 2016, we no longer market new or renewal occupational accident policies. Products offered by our Standard Commercial P&C operating unit include the following:

- **Commercial automobile.** Commercial automobile insurance provides third-party bodily injury and property damage coverage and first-party property damage coverage against losses resulting from the ownership, maintenance or use of automobiles and trucks in connection with an insured's business.

**General liability.** General liability insurance provides coverage for third-party bodily injury and property damage claims arising from accidents occurring on the insured's premises or from their general business operations.

**Umbrella.** Umbrella insurance provides coverage for third-party liability claims where the loss amount exceeds coverage limits provided by the insured's underlying general liability and commercial automobile policies.

**Commercial property.** Commercial property insurance provides first-party coverage for the insured's real property, business personal property, and business interruption losses caused by fire, wind, hail, water damage, theft, vandalism and other insured perils.

**Commercial multi-peril.** Commercial multi-peril insurance provides a combination of property and liability coverage that can include commercial automobile coverage on a single policy.

**Business owner's.** Business owner's insurance provides a package of coverage designed for small to midsize businesses with homogeneous risk profiles. Coverage includes general liability, commercial property and commercial automobile.

**Occupational accident.** Occupational accident insurance provides an alternative to statutory workers compensation insurance in Texas. Coverage includes medical, short term disability and accidental death and dismemberment. Effective June 1, 2016, we no longer market new or renewal occupational accident policies.

Our Standard Commercial P&C operating unit markets its property/casualty insurance products through 330 independent agencies operating in its target markets. Our Standard Commercial P&C operating unit applies a strict agent selection process and seeks to provide its independent agents some degree of non-contractual geographic exclusivity. Our Standard Commercial P&C operating unit also strives to provide its independent agents with convenient access to product information and personalized service. As a result, the Standard Commercial P&C operating unit has historically maintained excellent relationships with its producing agents, as evidenced by the 23 year average tenure of the 18 agency groups that each produced more than \$1.0 million in premium during the year ended December 31, 2016. During 2016, the top ten agency groups produced 39%, and no individual agency group produced more than 9%, of the total premium volume of our Standard Commercial P&C operating unit.

Our Standard Commercial P&C operating unit writes most risks on a package basis using a commercial multi-peril policy or a business owner's policy. Umbrella policies are written only when our Standard Commercial P&C operating unit also writes the insured's underlying general liability and commercial automobile coverage. Through December 31, 2005, our Standard Commercial P&C operating unit marketed policies on behalf of Clarendon National Insurance Company ("Clarendon"), a third-party insurer. Our Standard Commercial P&C operating unit earns a commission based on a percentage of the earned premium it produced for Clarendon. The commission percentage is determined by the underwriting results of the policies produced. Our Standard Commercial P&C operating unit presently markets all new and renewal policies exclusively for AHIC.

All of the commercial policies written by our Standard Commercial P&C operating unit are for a term of 12 months. If the insured is unable or unwilling to pay for the entire premium in advance, we provide an installment payment plan that requires the insured to pay 20% or 25% down and the remaining payments over eight months. We charge installment fees of up to \$7.50 per payment for the installment payment plan.

**Workers Compensation operating unit.** Effective July 1, 2015, this operating unit no longer markets or retains any risk on new or renewal policies. The subsidiaries comprising our Workers Compensation operating unit include TBIC Holding which has two wholly-owned subsidiaries, TBIC, a Texas domiciled workers compensation insurance carrier and TBICRM, which provided risk management services to customers of TBIC. The run-off of existing policies issued by TBIC is being administered by an independent third party.

### **Personal Segment / Specialty Personal Lines operating unit**

The Personal Segment of our business consists solely of our Specialty Personal Lines operating unit. Our Specialty Personal Lines operating unit markets and services non-standard personal automobile policies and renters insurance in 14 states. During the fourth quarter of 2014, the Specialty Personal Lines operating unit discontinued the low value dwelling/homeowner's and manufactured homes insurance products it previously offered. Our Specialty Personal Lines operating unit provides management, policy and claims administration services and includes the operations of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc. Our non-standard personal automobile insurance generally provides for the minimum limits of liability coverage mandated by state laws to drivers who find it difficult to purchase automobile insurance from standard carriers as a result of various factors, including driving record, vehicle, age, claims history, or limited financial resources. Products offered by our Specialty Personal Lines operating unit include the following:

**Personal automobile.** Personal automobile insurance is the primary product offered by our Specialty Personal Lines operating unit. Our policies typically provide third-party coverage to individuals for bodily injury and property damage at the minimum limits required by law, and for physical damage to an insured's own vehicle from collision and various other perils. In addition, many states require policies to provide for first party personal injury protection, frequently referred to as no-fault coverage.

**Renters.** Renters insurance provides coverage for the contents of a renter's home or apartment and for liability. Renter's policies are similar to homeowners insurance, except they do not cover the structure.

We presently cede 50% of the personal automobile risk on policies written by our Specialty Personal Lines operating unit.

Our Specialty Personal Lines operating unit markets its products through 3,488 independent retail agents operating in its target geographic markets. Non-standard automobile represented 97% of the premiums produced during 2016. Our Specialty Personal Lines operating unit qualifies new agent appointments in order to establish an efficient network of independent agents to effectively penetrate its highly competitive markets. Our Specialty Personal Lines operating unit periodically evaluates its independent agents and discontinues the appointment of agents whose production history does not satisfy certain standards. During 2016, the top ten independent agency groups produced 23%, and no individual agency group produced more than 4%, of the total premium volume of our Specialty Personal Lines operating unit.

During 2016, personal automobile liability coverage accounted for 74% and personal automobile physical damage coverage accounted for the remaining 26% of the total non-standard automobile premiums produced by our Specialty Personal Lines operating unit. Our most common policy term is a six month policy. We offer additional terms of one-

two-, three- and twelve-month policies on a limited basis. Our typical non-standard personal automobile customer is unable or unwilling to pay a full or half year premium in advance. Accordingly, we currently offer a direct bill program where the premiums are directly billed to the insured on a monthly basis. We charge installment fees for each payment under the direct bill program. Our Specialty Personal Lines operating unit markets its products in 14 states directly for HIC, AHIC, HCM and HNIC.

## **Our Competitive Strengths**

We believe that we enjoy the following competitive strengths:

***Specialized market knowledge and underwriting expertise.*** All of our operating units possess extensive knowledge of the specialty and niche markets in which they operate, which we believe allows them to effectively structure and market their property/casualty insurance products. Our Specialty Personal Lines operating unit has a thorough understanding of the unique characteristics of the non-standard personal automobile market. Our Standard Commercial P&C operating unit has significant underwriting experience in its target market for standard commercial property/casualty insurance products. In addition, our MGA Commercial Products operating unit and Specialty Commercial operating unit have developed specialized underwriting expertise which enhances their ability to profitably underwrite non-standard property/casualty insurance coverages.

***Tailored market strategies.*** Each of our operating units has developed its own customized strategy for penetrating the specialty or niche markets in which it operates. These strategies include distinctive product structuring, marketing, distribution, underwriting and servicing approaches by each operating unit. As a result, we are able to structure our property/casualty insurance products to serve the unique risk and coverage needs of our insureds. We believe these market-specific strategies enable us to provide policies tailored to the target customer that are appropriately priced and fit our risk profile.

***Superior agent and customer service.*** We believe performing the underwriting, billing, customer service and claims management functions at the operating unit level allows us to provide superior service to both our independent agents and insured customers. The easy-to-use interfaces and responsiveness of our operating units enhance their relationships with the independent agents who sell our policies. We also believe our consistency in offering our insurance products through hard and soft markets helps to build and maintain the loyalty of our independent agents. Our customized products, flexible payment plans and prompt claims processing are similarly beneficial to our insureds.

***Market diversification.*** We believe operating in various specialty and niche segments of the property/casualty insurance market diversifies both our revenues and our risks. We also believe our operating units generally operate on different market cycles, producing more earnings stability than if we focused entirely on one product. As a result of the pooling arrangement among four of our insurance company subsidiaries, we are able to efficiently allocate our capital among these various specialty and niche markets in response to market conditions and expansion opportunities. We believe this market diversification reduces our risk profile and enhances our profitability.

***Experienced management team.*** Our senior corporate management has an average of over 20 years of insurance experience. In addition, our operating units have strong management teams, with an average of more than 20 years of insurance industry experience for the heads of our operating units and an average of more than 15 years of underwriting experience for our underwriters. Our management has significant experience in all aspects of property/casualty insurance, including underwriting, claims management, actuarial analysis, reinsurance and regulatory compliance. In addition, Hallmark's senior management has a strong track record of acquiring businesses that expand our product offerings and improve our profitability profile.

## **Our Strategy**

We strive to become a “Best in Class” specialty insurance company offering products in specialty and niche markets through the following strategies:

***Focusing on underwriting discipline and operational efficiency.*** We seek to consistently generate an underwriting profit on the business we write in hard and soft markets. Our operating units have a strong track record of underwriting discipline and operational efficiency, which we seek to continue. We believe that in soft markets our competitors often offer policies at a low or negative underwriting profit in order to maintain or increase their

premium volume and market share. In contrast, we seek to write business based on its profitability rather than focusing solely on premium production. To that end, we provide financial incentives to many of our underwriters and independent agents based on underwriting profitability.

***Achieving organic growth in our existing business lines.*** We believe we can achieve organic growth in our existing business lines by consistently providing our insurance products through market cycles, expanding geographically, expanding our product offerings, expanding our agency relationships and further penetrating our existing customer base. We believe our extensive market knowledge and strong agency relationships position us to compete effectively in our various specialty and niche markets. We also believe there is a significant opportunity to expand some of our existing business lines into new geographical areas and through new agency relationships while maintaining our underwriting discipline and operational efficiency. In addition, we believe there is an opportunity for some of our operating units to further penetrate their existing customer bases with additional products offered by other operating units.



***Pursuing selected, opportunistic acquisitions.*** We seek to opportunistically acquire insurance organizations that operate in specialty or niche property/casualty insurance markets that are complementary to our existing operations. We seek to acquire companies with experienced management teams, stable loss results and strong track records of underwriting profitability and operational efficiency. Where appropriate, we intend to ultimately retain profitable business produced by the acquired companies that would otherwise be retained by unaffiliated insurers. Our management has significant experience in evaluating potential acquisition targets, structuring transactions to ensure continued success and integrating acquired companies into our operational structure.

***Maintaining a strong balance sheet.*** We seek to maintain a strong balance sheet by employing conservative investment, reinsurance and reserving practices and to measure our performance based on long-term growth in book value per share.

## Distribution

We market our property/casualty insurance products predominately through independent general agents, retail agents and specialty brokers. Therefore, our relationships with independent agents and brokers are critical to our ability to identify, attract and retain profitable business. Each of our operating units has developed its own tailored approach to establishing and maintaining its relationships with these independent distributors of our products. These strategies focus on providing excellent service to our agents and brokers, maintaining a consistent presence in our target niche and specialty markets through hard and soft market cycles and fairly compensating the agents and brokers who market our products. Our operating units also regularly evaluate independent general and retail agents based on the underwriting profitability of the business they produce and their performance in relation to our objectives.

Except for the products of our Specialty Commercial operating unit, the distribution of property/casualty insurance products by our operating units is geographically concentrated. For the twelve months ended December 31, 2016, five states accounted for 59% of the gross premiums written by our insurance company subsidiaries. The following table reflects the geographic distribution of our insured risks, as represented by direct and assumed premiums written by our business segments for the twelve months ended December 31, 2016.

State	Specialty Commercial Segment	Standard Commercial Segment	Personal Segment	Total	Percent of Total	
	(dollars in thousands)					
Texas	\$ 187,500	\$ 22,139	\$ 23,094	\$ 232,733	42.4	%
Louisiana	24,618	-	-	24,618	4.5	%
Arizona	2,140	-	22,430	24,570	4.5	%
Oklahoma	11,938	-	10,581	22,519	4.1	%
New Mexico	1,138	8,544	10,047	19,729	3.5	%
All other states	161,580	46,208	17,120	224,908	41.0	%

Total gross premiums written	\$388,914	\$ 76,891	\$ 83,272	\$549,077
Percent of total	70.8	% 14.0	% 15.2	% 100.0 %

## Underwriting

The underwriting process employed by our operating units involves securing an adequate level of underwriting information, identifying and evaluating risk exposures and then pricing the risks we choose to accept. Each of our operating units offering commercial, healthcare professional or aviation insurance products employs its own underwriters with in-depth knowledge of the specific niche and specialty markets targeted by that operating unit. We employ a disciplined underwriting approach that seeks to provide policies appropriately tailored to the specified risks and to adopt price structures that will be supported in the applicable market. Our experienced commercial, healthcare professional and aviation underwriters have developed underwriting principles and processes appropriate to the coverages offered by their respective operating units.

We believe that managing the underwriting process through our operating units capitalizes on the knowledge and expertise of their personnel in specific markets and results in better underwriting decisions. All of our underwriters have established limits of underwriting authority based on their level of experience. We also provide financial incentives to many of our underwriters based on underwriting profitability.

To better diversify our revenue sources and manage our risk, we seek to maintain an appropriate business mix among our operating units. At the beginning of each year, we establish a target net loss ratio for each operating unit. We then monitor the actual net loss ratio on a monthly basis. If any line of business fails to meet its target net loss ratio, we seek input from our underwriting, actuarial and claims management personnel to develop a corrective action plan. Depending on the particular circumstances, that plan may involve tightening underwriting guidelines, increasing rates, modifying product structure, re-evaluating independent agency relationships or discontinuing unprofitable coverages or classes of risk.

An insurance company's underwriting performance is traditionally measured by its statutory loss and loss adjustment expense ratio, its statutory expense ratio and its statutory combined ratio. The statutory loss and loss adjustment expense ratio, which is calculated as the ratio of net losses and loss adjustment expenses ("LAE") incurred to net premiums earned, helps to assess the adequacy of the insurer's rates, the propriety of its underwriting guidelines and the performance of its claims department. The statutory expense ratio, which is calculated as the ratio of underwriting and operating expenses to net premiums written, assists in measuring the insurer's cost of processing and managing the business. The statutory combined ratio, which is the sum of the statutory loss and LAE ratio and the statutory expense ratio, is indicative of the overall profitability of an insurer's underwriting activities, with a combined ratio of less than 100% indicating profitable underwriting results.

The following table shows, for the periods indicated, (i) our gross premiums written (in thousands); and (ii) our underwriting results as measured by the net statutory loss and LAE ratio, the net statutory expense ratio, and the net statutory combined ratio of our insurance company subsidiaries.

	Year Ended December 31,					
	2016		2015		2014	
Gross premiums written	\$549,077		\$514,223		\$473,218	
Net statutory loss & LAE ratio	71.2	%	65.4	%	64.8	%
Net statutory expense ratio	29.4	%	30.6	%	33.1	%
Net statutory combined ratio	100.6	%	96.0	%	97.9	%

These statutory ratios do not reflect the deferral of policy acquisition costs, investment income, premium finance revenues, or the elimination of inter-company transactions required by U.S. generally accepted accounting principles ("GAAP").

The premium-to-surplus percentage measures the relationship between net premiums written in a given period (premiums written, less returned premiums and reinsurance ceded to other carriers) to policyholders surplus (admitted assets less liabilities), determined on the basis of statutory accounting practices prescribed or permitted by insurance regulatory authorities. State insurance department regulators expect insurance companies to maintain a premium-to-surplus percentage of not more than 300%. For the years ended December 31, 2016, 2015 and 2014, our consolidated premium-to-surplus ratios were 146%, 144% and 154%, respectively.

### **Claims Management and Administration**

We believe that effective claims management is critical to our success and that our claims management process is cost-effective, delivers the appropriate level of claims service and produces superior claims results. Our claims management philosophy emphasizes the delivery of courteous, prompt and effective claims handling and embraces responsiveness to policyholders and agents. Our claims strategy focuses on thorough investigation, timely evaluation and fair settlement of covered claims while consistently maintaining appropriate case reserves. We seek to compress the cycle time of claim resolution in order to control both loss and claim handling cost. We also strive to control legal expenses by negotiating competitive rates with defense counsel and vendors, establishing litigation budgets and monitoring invoices.

Each of our operating units maintains its own dedicated staff of specialized claims personnel to manage and administer claims arising under policies produced through their respective operations. The claims process is managed through a combination of experienced claims managers, seasoned claims supervisors, trained staff adjusters and independent adjustment or appraisal services, when appropriate. All adjusters are licensed in those jurisdictions for which they handle claims that require licensing. Limits on settlement authority are established for each claims supervisor and staff adjuster based on their level of experience. Certain independent adjusters have limited authority to settle claims. Claim exposures are periodically and systematically reviewed by claim supervisors and managers as a method of quality and loss control. Large loss exposures are reviewed at least quarterly with senior management of the operating unit and monitored by Hallmark senior management.

Claims personnel receive in-house training and are required to attend various continuing education courses pertaining to topics such as best practices, fraud awareness, legal environment, legislative changes and litigation management. Depending on the criteria of each operating unit, our claims adjusters are assigned a variety of claims to enhance their knowledge and ensure their continued development in efficiently handling claims. As of December 31, 2016, our operating units had a total of 86 claims managers, supervisors and adjusters with an average experience of approximately 16 years.

### **Analysis of Losses and LAE**

Our consolidated financial statements include an estimated reserve for unpaid losses and LAE. We estimate our reserve for unpaid losses and LAE by using case-basis evaluations and statistical projections, which include inferences from both losses paid and losses incurred. We also use recent historical cost data and periodic reviews of underwriting standards and claims management practices to modify the statistical projections. We give consideration to the impact of inflation in determining our loss reserves, but do not discount reserve balances.

The amount of reserves represents our estimate of the ultimate cost of all unpaid losses and LAE incurred. These estimates are subject to the effect of trends in claim severity and frequency. We regularly review the estimates and adjust them as claims experience develops and new information becomes known. Such adjustments are included in current operations, including increases and decreases, net of reinsurance, in the estimate of ultimate liabilities for insured events of prior years.

Changes in loss development patterns and claim payments can significantly affect the ability of insurers to estimate reserves for unpaid losses and related expenses. We seek to continually improve our loss estimation process by refining our ability to analyze loss development patterns, claim payments and other information within a legal and regulatory environment that affects development of ultimate liabilities. Future changes in estimates of claim costs may adversely affect future period operating results. However, such effects cannot be reasonably estimated currently.



**Reconciliation of reserve for unpaid losses and LAE.** The following table provides a reconciliation of our beginning and ending reserve balances on a net-of-reinsurance basis for the years ended December 31, 2016, 2015 and 2014, to the gross-of-reinsurance amounts reported in our balance sheets at December 31, 2016, 2015 and 2014.

	As of and for Year Ended December 31		
	2016	2015	2014
	(dollars in thousands)		
Reserve for unpaid losses and LAE, net of reinsurance recoverables, January 1	\$ 348,087	\$ 323,192	\$ 312,468
Provision for losses and LAE for claims occurring in the current period	246,080	237,102	215,258
Increase (decrease) in reserve for unpaid losses and LAE for claims occurring in prior periods	7,608	(6,953 )	(5,203 )
Payments for losses and LAE, net of reinsurance:			
Current period	(93,067 )	(83,132 )	(76,231 )
Prior periods	(150,378 )	(122,122 )	(123,100 )
Reserve for unpaid losses and LAE at December 31, net of reinsurance recoverable	358,330	348,087	323,192
Reinsurance recoverable on unpaid losses and LAE at December 31	123,237	102,791	91,943
Reserve for unpaid losses and LAE at December 31, gross of reinsurance	\$ 481,567	\$ 450,878	\$ 415,135

The \$7.6 million unfavorable net development, \$7.0 million favorable net development and \$5.2 million favorable net development in prior accident years recognized in 2016, 2015 and 2014, respectively, represent normal changes in our loss reserve estimates. In 2016, the aggregate loss reserve estimates for prior years were increased to reflect unfavorable loss development when the available information indicated a reasonable likelihood that the ultimate losses would be more than the previous estimates. In 2015 and 2014, the aggregate loss reserve estimates for prior years were decreased to reflect favorable loss development when the available information indicated a reasonable likelihood that the ultimate losses would be less than the previous estimates. Generally, changes in reserves are caused by variations between actual experience and previous expectations and by reduced emphasis on the Bornhuetter-Ferguson method due to the aging of the accident years. (See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Estimates and Judgments - Reserves for unpaid losses and loss adjustment expenses.”)

The \$7.6 million increase in prior period reserves for unpaid losses and LAE recognized in 2016 was attributable to \$5.3 million favorable net development on claims incurred in the 2015 accident year, \$3.9 million unfavorable net development on claims incurred in the 2014 accident year and \$9.0 million unfavorable net development on claims incurred in the 2013 and prior accident years. Our MGA Commercial Products operating unit, Specialty Personal Lines operating unit and Specialty Commercial operating unit accounted for \$11.3 million, \$5.0 million, and \$1.2 million, respectively, of the increase in prior period reserves recognized during 2016. The increase in reserves for our MGA Commercial operating unit was primarily related to our commercial auto liability line of business. The increase in reserves for our Specialty Personal Lines operating unit was primarily attributable to the 2015, 2014 and 2013 and prior accident years. The increase in reserves for our Specialty Commercial operating unit was primarily related to

\$0.9 million unfavorable development in our medical professional liability products and \$0.7 million related to our commercial auto liability specialty program, partially offset by \$0.3 million favorable development in our general aviation line of business and \$0.1 million favorable development in our commercial excess liability line of business. These unfavorable developments were partially offset by favorable development of \$6.6 million in our Standard Commercial P&C operating unit and \$3.3 in our Workers Compensation operating unit. The decrease in reserves for our Standard Commercial P&C operating unit was primarily related to our general liability lines of business. The decrease in prior period reserves for our Workers Compensation operating unit was attributable to the 2015, 2014, 2013 and prior accident years.



The \$7.0 million decrease in prior period reserves for unpaid losses and LAE recognized in 2015 was attributable to \$7.4 million favorable development on claims incurred in the 2014 accident year, \$1.5 million unfavorable development on claims incurred in the 2013 accident year and \$1.1 million favorable development on claims incurred in the 2012 and prior accident years. Our Standard Commercial P&C operating unit, Workers Compensation operating unit and Specialty Commercial operating unit accounted for \$5.4 million, \$2.0 million and \$3.4 million, respectively, of the decrease in prior period reserves recognized during 2015. The decrease in reserves for our Standard Commercial P&C operating unit was primarily related to our general liability lines of business. The decrease in reserves for our Workers Compensation operating unit was attributable to the 2014, 2013 and 2012 and prior accident years. The decrease in reserves for our Specialty Commercial operating unit was primarily related to \$1.4 million in our commercial auto liability specialty program, \$0.9 million favorable development in our general aviation line of business, \$0.8 million favorable development in our medical professional liability products and \$0.3 million favorable development in our commercial excess liability line of business. These favorable developments were partially offset by unfavorable development of \$2.6 million in our Specialty Personal Lines operating unit primarily attributable to the 2014 accident year and unfavorable development of \$1.2 million in our MGA Commercial Products operating unit primarily related to our commercial auto liability line of business.

The \$5.2 million decrease in prior period reserves for unpaid losses and LAE recognized in 2014 was attributable to \$7.2 million favorable development on claims incurred in the 2013 accident year, \$4.4 million unfavorable development on claims incurred in the 2012 accident year and \$2.4 million favorable development on claims incurred in the 2011 and prior accident years. Our Standard Commercial P&C operating unit, Specialty Personal Lines operating unit, Workers Compensation operating unit and Specialty Commercial operating unit accounted for \$4.1 million, \$2.9 million, \$1.9 million and \$1.6 million, respectively, of the decrease in prior period reserves recognized during 2014. The decrease in reserves for our Standard Commercial P&C operating unit was primarily related to our commercial auto and general liability lines of business. The decrease in reserves for our Specialty Personal Lines operating unit was primarily attributable to the 2013 accident year. The decrease in reserves for our Workers Compensation operating unit was attributable to the 2013, 2012 and 2011 and prior accident years. The decrease in reserves for our Specialty Commercial operating unit was primarily related to \$0.9 million favorable development in our commercial excess liability line of business, \$0.6 million related to our commercial auto liability specialty program and \$0.4 million favorable development in our medical professional liability products, partially offset by a \$0.3 million unfavorable development in our general aviation line of business. These favorable developments were partially offset by unfavorable development of \$5.3 million in our MGA Commercial Products operating unit primarily related to our commercial auto liability and general liability lines of business.

***Analysis of loss and LAE reserve development.*** The following table shows the development of our loss reserves, net of reinsurance, for years ended December 31, 2006 through 2016. Section A of the table shows the estimated liability for unpaid losses and LAE, net of reinsurance, recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of losses and LAE for claims arising in prior years that are unpaid at the balance sheet date, including losses that have been incurred but not yet reported to us. Section B of the table shows the re-estimated amount of the previously recorded liability, based on experience as of the end of each succeeding year. The estimate is increased or decreased as more information becomes known about the frequency and severity of claims.

Cumulative Redundancy/ (Deficiency) (Section C of the table) represents the aggregate change in the estimates over all prior years. Thus, changes in ultimate development estimates are included in operations over a number of years, minimizing the significance of such changes in any one year.

**ANALYSIS OF LOSS AND LAE DEVELOPMENT****As of and for Year Ended December 31**

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
A. Reserve for unpaid loss & LAE, net of reinsurance recoverables	\$72,801	\$120,849	\$150,025	\$176,250	\$213,723	\$254,901	\$263,832	\$312,468	\$323,192	\$323,192
B. Net reserve re-estimated as of:										
One year later	66,387	119,034	151,645	185,440	230,089	251,226	273,786	307,265	316,239	316,239
Two years later	68,490	118,646	155,155	183,689	226,856	256,198	275,778	307,793	329,158	329,158
Three years later	68,809	120,444	154,738	181,268	230,145	253,814	274,704	316,766		
Four years later	69,847	119,771	155,520	185,848	227,555	251,968	272,542			
Five years later	71,879	123,949	158,842	184,995	227,357	250,349				
Six years later	78,396	128,006	159,151	185,666	239,551					
Seven years later	79,939	128,907	159,747	194,083						
Eight years later	80,439	129,724	161,843							
Nine years later	81,737	131,311								
Ten years later	87,568									
C. Net cumulative (deficiency) redundancy	(14,767)	(10,462)	(11,818)	(17,833)	(25,828)	4,552	(8,710)	(4,298)	(5,966)	(5,966)
D. Cumulative amount of claims paid, net of reserve recoveries through:										
One year later	30,061	50,458	64,810	73,647	105,848	109,538	110,812	123,100	122,122	122,122
Two years later	46,860	78,314	95,385	121,222	156,176	163,803	174,684	194,925	209,484	209,484
Three years later	58,322	93,286	120,133	146,956	188,044	200,637	209,619	261,379		
Four years later	65,084	105,251	131,912	162,704	207,484	216,349	238,192			
Five years later	71,082	112,029	140,618	172,330	220,627	229,408				
Six years later	75,225	118,171	146,581	179,880	226,459					
Seven years later	75,141	122,410	152,232	185,104						
Eight years later	83,865	126,144	156,844							
Nine years later	85,724	128,671								
Ten years later	87,292									
	72,801	120,849	150,025	176,250	213,723	254,901	263,832	312,468	323,192	323,192

Net reserve-December 31										
Reinsurance recoverables	4,763	4,489	6,338	8,412	37,954	42,044	49,584	70,172	91,943	
Gross reserve-December 31	77,564	125,338	156,363	184,662	251,677	296,945	313,416	382,640	415,135	
Net re-estimated reserve	87,568	131,311	161,843	194,083	239,551	250,349	272,542	316,766	329,158	
Re-estimated reinsurance recoverable	7,048	6,494	7,975	7,123	27,053	35,971	40,685	63,474	85,436	
Gross re-estimated reserve	94,616	137,805	169,818	201,206	266,604	286,320	313,227	380,240	414,594	
Gross cumulative redundancy (deficiency)	\$(17,052)	\$(12,467)	\$(13,455)	\$(16,544)	\$(14,927)	\$10,625	\$189	\$2,400	\$541	\$0

## 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 December 31, 2016 was with reinsurers that had an A.M. Best rating of “A-” or better. We also mitigate our credit risk for the remaining reinsurance recoverable by obtaining letters of credit.

The following table presents our gross and net premiums written and earned and reinsurance recoveries for each of the last three years (in thousands).

	Year Ended December 31		
	2016	2015	2014
Gross premiums written	\$549,077	\$514,223	\$473,218
Ceded premiums written	(187,248)	(157,279)	(148,866)
Net premiums written	\$361,829	\$356,944	\$324,352
Gross premiums earned	\$524,229	\$494,643	\$461,694
Ceded premiums earned	(170,859)	(145,562)	(140,477)
Net premiums earned	\$353,370	\$349,081	\$321,217
Reinsurance recoveries	\$116,057	\$89,892	\$99,911

## Investment Portfolio

Our investment objective is to maximize current yield while maintaining safety of capital together with sufficient liquidity for ongoing insurance operations. Our investment portfolio is composed of fixed-income, equity securities and other investments. As of December 31, 2016, we had total invested assets of \$654.1 million. If market rates were to increase by 1%, the fair value of our fixed-income securities as of December 31, 2016 would decrease by approximately \$17.8 million. The following table shows the fair values of various categories of fixed-income securities, the percentage of the total fair value of our invested assets represented by each category and the tax equivalent book yield of each category of invested assets as of December 31, 2016 and 2015.



Category:	As of December 31, 2016			As of December 31, 2015		
	Fair Value (in thousands)	Percent of Total	Yield	Fair Value (in thousands)	Percent of Total	Yield
Corporate bonds	\$226,062	37.8	% 3.0	\$121,709	22.9	% 3.0
Collateralized corporate bank loans	106,009	17.8	% 3.5	81,596	15.4	% 4.6
Municipal bonds	163,895	27.4	% 4.4	192,368	36.2	% 2.7
US Treasury securities and obligations of U.S. Government	42,022	7.0	% 1.2	76,269	14.3	% 0.8
Mortgage backed	59,469	10.0	% 2.4	59,383	11.2	% 2.0
Total	\$597,457	100.0	% 3.3	\$531,325	100.0	% 2.7

The weighted average credit rating for our fixed-income portfolio, using ratings assigned by Standard and Poor's Rating Services (a division of the McGraw-Hill Companies, Inc.), was BBB+ at December 31, 2016. The following table shows the distribution of our fixed-income portfolio by Standard and Poor's rating as a percentage of total fair value as of December 31, 2016 and 2015:

Rating:	As of December 31, 2016	As of December 31, 2015
"AAA"	9.5	10.1
"AA"	22.4	34.8
"A"	7.4	10.2
"BBB"	39.8	27.9
"BB"	12.6	9.8
"B"	0.9	0.8
"CCC"	0.1	2.0
"CC"	1.6	0.0
"NR"	5.7	4.4
Total	100.0	100.0

The following table shows the composition of our fixed-income portfolio by remaining time to maturity as of December 31, 2016 and 2015.

	As of December 31, 2016		As of December 31, 2015		
	Fair Value (in thousands)	Percentage of Total Fair Value	Fair Value (in thousands)	Percentage of Total Fair Value	
Remaining time to maturity:					
Less than one year	\$ 97,849	16.4	% \$ 76,560	14.4	%
One to five years	272,168	45.5	% 234,213	44.1	%
Five to ten years	115,248	19.3	% 101,387	19.1	%
More than ten years	52,723	8.8	% 59,782	11.2	%
Mortgage-backed	59,469	10.0	% 59,383	11.2	%
Total	\$ 597,457	100.0	% \$ 531,325	100.0	%

Our investment strategy is to conservatively manage our investment portfolio by investing primarily in readily marketable, investment-grade, fixed-income securities. As of December 31, 2016, 8% of our investment portfolio was invested in equity securities. Our investment portfolio is managed internally. We regularly review our portfolio for declines in value. 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.

The following table details the net unrealized gain balance by invested asset category as of December 31, 2016.

Category	Net Unrealized Gain Balance (in thousands)
U.S. Treasury securities and obligations of U.S. Government	\$ 46
Corporate bonds	1,147
Collateralized corporate bank loans	789
Municipal bonds	(2,005 )
Mortgage-backed	(304 )
Equity securities	20,262
Other investments	1,188
Total	\$ 21,123



As part of our overall investment strategy, we also maintain an integrated cash management system utilizing on-line banking services and daily overnight investment accounts to maximize investment earnings on all available cash.

## **Technology**

The majority of our technology systems are based on products licensed from insurance-specific technology vendors that have been substantially customized to meet the unique needs of our various operating units. Our technology systems primarily consist of integrated central processing computers, a series of server-based computer networks and various communications systems that allow our various operations to share systems solutions and communicate to the corporate office in a timely, secure and consistent manner. We maintain backup facilities and systems through a contract with a leading provider of computer disaster recovery services. Each operating unit bears the information services expenses specific to its operations as well as a portion of the corporate services expenses. Increases to vendor license and service fees are capped per annum.

We believe the implementation of our various technology systems has increased our efficiency in the processing of our business, resulting in lower operating costs. Additionally, our systems enable us to provide a high level of service to our agents and policyholders by processing our business in a timely and efficient manner, communicating and sharing data with our agents and providing a variety of methods for the payment of premiums. We believe these systems have also improved the accumulation and analysis of information for our management.

## **Ratings**

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they are considering purchasing insurance. A.M. Best has pooled its ratings of our AHIC, HIC, HSIC and HNIC subsidiaries and assigned a financial strength rating of "A-" (Excellent) and an issuer credit rating of "a-" to each of these individual insurance company subsidiaries and to the pool formed by the four insurance company subsidiaries. A.M. Best has also assigned a financial strength rating of "A-" (Excellent) and an issuer credit rating of "a-" to HCM. A.M. Best does not assign a financial strength rating or an issuer credit rating to TBIC. An "A-" rating is the fourth highest of 15 rating categories used by A.M. Best. In evaluating an insurer's financial and operating performance, A.M. Best reviews the company's profitability, indebtedness and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated fair value of its assets, the adequacy of its loss reserves, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. A.M. Best's ratings reflect its opinion of an insurer's financial strength, operating performance and ability to meet its obligations to policyholders and are not an evaluation directed at investors or recommendations to buy, sell or hold an insurer's stock.

## **Competition**

The property/casualty insurance market, our primary source of revenue, is highly competitive and, except for regulatory considerations, has very few barriers to entry. According to A.M. Best, there were 3,037 property/casualty insurance companies and 2,062 property/casualty insurance groups operating in North America as of July 12, 2016. The primary competition for our MGA Commercial Products operating unit includes such carriers as Canal Insurance Company, Global Hawk Insurance Company, National Casualty Company, National Liability & Fire Insurance Company, Northland Insurance Company, Progressive County Mutual, State National Insurance Company and Underwriters at Lloyds of London. Our Specialty Commercial operating unit considers its primary competition for our excess & umbrella and general liability insurance products to include such carriers as American International Group, Inc., First Mercury Insurance Company, Axis Insurance Company, XL Specialty Insurance, Navigators, and W.R. Berkley Corporation and, to a lesser extent, a number of national standard lines carriers such as Travelers Companies, Inc. and Liberty Mutual Group. The primary competitors for our general aviation insurance products produced by our Specialty Commercial operating unit are Phoenix Aviation Managers, Starr Aviation, Chartis, United States Specialty Insurance Company, W. Brown & Company, United States Aircraft Insurance Group, Global Aerospace and Allianz Aviation Managers. The primary competition for the medical professional liability insurance products produced by our Specialty Commercial operating unit are Admiral Insurance Company, Catlin Insurance Company, CNA Financial Corporation, Evanston Insurance Company, Kinsale Insurance Company, Lexington Insurance Company, ProAssurance Corporation, RSUI Group and TDC Companies. The primary competition for our primary/excess commercial property insurance products includes such carriers as Chubb Westchester, Aspen Insurance, Axis Insurance Company, Endurance Specialty Holdings, Ltd., Liberty Insurance Underwriters and Markel Insurance Company. Our Standard Commercial P&C operating unit competes with a variety of large national standard commercial lines carriers such as Liberty Mutual Group, Travelers Companies, Inc., Cincinnati Financial Corporation and The Hartford Financial Services Group, as well as numerous smaller regional companies. The primary competition for the occupational accident insurance product offered by our Standard Commercial P&C unit includes such carriers as Great American Insurance Group, One Beacon Insurance Company, North American Insurance Company and Service Lloyds. Although our Specialty Personal Lines operating unit competes with large national insurers such as Allstate Corporation, GEICO Corporation and Progressive Insurance Company, as a participant in the non-standard personal automobile marketplace its competition is most directly associated with numerous regional companies and managing general agencies. Our competitors include entities that have, or are affiliated with entities that have, greater financial and other resources than we have.

Generally, we compete on price, customer service, coverages offered, claims handling, financial stability, agent commission and support, customer recognition and geographic coverage. We compete with companies who use independent agents, captive agent networks, direct marketing channels or a combination thereof.

## **Insurance Regulation**

AHIC, HCM and TBIC are domiciled in Texas, HIC and HNIC are domiciled in Arizona and HSIC is domiciled in Oklahoma. Therefore, our insurance operations are regulated by the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department, as well as the applicable insurance department of each state in which we issue policies. Our insurance company subsidiaries are required to file quarterly and annual statements of their financial condition prepared in accordance with statutory accounting practices with the insurance departments of their respective states of domicile and the applicable insurance department of each state in which they write business. The financial conditions of our insurance company subsidiaries, including the adequacy of surplus, loss reserves and investments, are subject to review by the insurance department of their respective states of domicile.

***Periodic financial and market conduct examinations.*** The insurance departments of the states of domicile for our insurance company subsidiaries have broad authority to enforce insurance laws and regulations through examinations, administrative orders, civil and criminal enforcement proceedings, and suspension or revocation of an insurer's certificate of authority or an agent's license. The state insurance departments that have jurisdiction over our insurance company subsidiaries may conduct on-site visits and examinations of the insurance companies' affairs, especially as to their financial condition, ability to fulfill their obligations to policyholders, market conduct, claims practices and compliance with other laws and applicable regulations. Typically, these examinations are conducted every three to five years. In addition, if circumstances dictate, regulators are authorized to conduct special or target examinations of insurance companies to address particular concerns or issues. The results of these examinations can give rise to injunctive relief, regulatory orders requiring remedial or other corrective action on the part of the company that is the subject of the examination, assessment of fines, or other penalties against that company. In extreme cases, including actual or pending insolvency, the insurance department may take over, or appoint a receiver to take over, the management or operations of an insurer or an agent's business or assets.

***Guaranty funds.*** All insurance companies are subject to assessments for state-administered funds that cover the claims and expenses of insolvent or impaired insurers. The size of the assessment is determined each year by the total claims on the fund that year. Each insurer is assessed a pro rata share based on its direct premiums written in that state. Payments to the fund may generally be recovered by the insurer through deductions from its premium taxes over a specified period of years.

***Transactions between insurance companies and their affiliates.*** Hallmark is also regulated as an insurance holding company by the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance

Department. Financial transactions between Hallmark or any of its affiliates and our insurance company subsidiaries are subject to regulation. Transactions between our insurance company subsidiaries and their affiliates generally must be disclosed to state regulators, and prior regulatory approval generally is required before any material or extraordinary transaction may be consummated or any management agreement, services agreement, expense sharing arrangement or other contract providing for the rendering of services on a regular, systematic basis is implemented. State regulators may refuse to approve or may delay approval of such a transaction, which may impact our ability to innovate or operate efficiently.

**Dividends.** Dividends and distributions to Hallmark by our insurance company subsidiaries are restricted by the insurance regulations of the respective state in which each insurance company subsidiary is domiciled. As property/casualty insurance companies domiciled in the state of Texas, AHIC and TBIC may only pay dividends from unassigned surplus funds. In addition, AHIC and TBIC must obtain the approval of the Texas Department of Insurance before the payment of extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the greater of: (1) statutory net income as of the prior December 31 or (2) 10% of statutory policyholders' surplus as of the prior December 31. HIC and HNIC, both domiciled in Arizona, may pay dividends out of that part of their available surplus funds that is derived from realized net profits on their business. Without prior written approval from the Arizona Department of Insurance, HIC and HNIC may not pay extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the lesser of: (1) 10% of statutory policyholders' surplus as of the prior December 31 or (2) net investment income as of the prior December 31. HSIC, domiciled in Oklahoma, may only pay dividends out of that part of its available surplus funds that is derived from realized net profits on its business. Without prior written approval from the Oklahoma Insurance Department, HSIC may not pay extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the greater of: (1) 10% of statutory policyholders' surplus as of the prior December 31 or (2) statutory net income as of the prior December 31, not including realized capital gains. As a county mutual, dividends from HCM are payable to policyholders.

***Risk-based capital requirements.*** The National Association of Insurance Commissioners requires property/casualty insurers to file a risk-based capital calculation according to a specified formula. The purpose of the formula is twofold: (1) to assess the adequacy of an insurer's statutory capital and surplus based upon a variety of factors such as potential risks related to investment portfolio, ceded reinsurance and product mix; and (2) to assist state regulators under the RBC for Insurers Model Act by providing thresholds at which a state commissioner is authorized and expected to take regulatory action. As of December 31, 2016, the adjusted capital under the risk-based capital calculation of each of our insurance company subsidiaries substantially exceeded the minimum requirements.

***Required licensing.*** Our non-insurance company subsidiaries are subject to and in compliance with the licensing requirements of the department of insurance in each state in which they produce business. These licenses govern, among other things, the types of insurance coverages, agency and claims services and products that we may offer consumers in these states. Such licenses typically are issued only after we file an appropriate application and satisfy prescribed criteria. Generally, each state requires one officer to maintain an agent license. Claims adjusters employed by us are also subject to the licensing requirements of each state in which they conduct business. Each employed claim adjuster either holds or has applied for the required licenses. Our premium finance subsidiaries are subject to licensing, financial reporting and certain financial requirements imposed by the Texas Department of Insurance, as well as regulations promulgated by the Texas Office of Consumer Credit Commissioner.

***Regulation of insurance rates and approval of policy forms.*** The insurance laws of most states in which our subsidiaries operate require insurance companies to file insurance rate schedules and insurance policy forms for review and approval. State insurance regulators have broad discretion in judging whether our rates are adequate, not excessive and not unfairly discriminatory and whether our policy forms comply with law. The speed at which we can change our rates depends, in part, on the method by which the applicable state's rating laws are administered. Generally, state insurance regulators have the authority to disapprove our rates or request changes in our rates.

***Restrictions on cancellation, non-renewal or withdrawal.*** Many states have laws and regulations that limit an insurance company's ability to exit a market. For example, certain states limit an automobile insurance company's ability to cancel or not renew policies. Some states prohibit an insurance company from withdrawing from one or more lines of business in the state, except pursuant to a plan approved by the state insurance department. In some states, this applies to significant reductions in the amount of insurance written, not just to a complete withdrawal. State insurance departments may disapprove a plan that may lead to market disruption.

***Investment restrictions.*** We are subject to state laws and regulations that require diversification of our investment portfolios and that limit the amount of investments in certain categories. Failure to comply with these laws and regulations would cause non-conforming investments to be treated as non-admitted assets for purposes of measuring statutory surplus and, in some instances, would require divestiture.

***Trade practices.*** The manner in which we conduct the business of insurance is regulated by state statutes in an effort to prohibit practices that constitute unfair methods of competition or unfair or deceptive acts or practices. Prohibited practices include disseminating false information or advertising; defamation; boycotting, coercion and intimidation; false statements or entries; unfair discrimination; rebating; improper tie-ins with lenders and the extension of credit; failure to maintain proper records; failure to maintain proper complaint handling procedures; and making false statements in connection with insurance applications for the purpose of obtaining a fee, commission or other benefit.

***Unfair claims practices.*** Generally, insurance companies, adjusting companies and individual claims adjusters are prohibited by state statutes from engaging in unfair claims practices on a flagrant basis or with such frequency to indicate a general business practice. Examples of unfair claims practices include:

- misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;

· failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;

· failing to adopt and implement reasonable standards for the prompt investigation and settlement of claims arising under insurance policies;

· failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed;

· attempting to settle a claim for less than the amount to which a reasonable person would have believed such person was entitled;

· attempting to settle claims on the basis of an application that was altered without notice to, or knowledge and consent of, the insured;

· compelling insureds to institute suits to recover amounts due under policies by offering substantially less than the amounts ultimately recovered in suits brought by them;

· refusing to pay claims without conducting a reasonable investigation;

· making claim payments to an insured without indicating the coverage under which each payment is being made;

· delaying the investigation or payment of claims by requiring an insured, claimant or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information;

· failing, in the case of claim denials or offers of compromise or settlement, to promptly provide a reasonable and accurate explanation of the basis for such actions; and

· not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear.

## **Employees**



As of December 31, 2016, we employed 420 people on a full-time basis. None of our employees are represented by labor unions. We consider our employee relations to be good.

### **Available Information**

The Company's executive offices are located at 777 Main Street, Suite 1000 Fort Worth, Texas 76102. The Company's mailing address is 777 Main Street, Suite 1000 Fort Worth, Texas 76102. Its telephone number is (817) 348-1600. The Company's website address is [www.hallmarkgrp.com](http://www.hallmarkgrp.com). The Company files annual, quarterly and current reports, proxy statements and other information and documents with the U.S. Securities and Exchange Commission (the "SEC"), which are made available to read and copy at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by contacting the SEC at 1-800-SEC-0330. Reports filed with the SEC are also made available at [www.sec.gov](http://www.sec.gov). The Company makes available free of charge on its website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed with or furnished to the SEC pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practical after it electronically files them with or furnishes them to the SEC.

**Item 1A. Risk Factors.**

**Our success depends on our ability to price accurately the risks we underwrite.**

Our results of operations and financial condition depend on our ability to underwrite and set premium rates accurately for a wide variety of risks. Adequate rates are necessary to generate premiums sufficient to pay losses, loss settlement expenses and underwriting expenses and to earn a profit. To price our products accurately, we must collect and properly analyze a substantial amount of data; develop, test and apply appropriate pricing techniques; closely monitor and timely recognize changes in trends; and project both severity and frequency of losses with reasonable accuracy. Our ability to undertake these efforts successfully, and as a result price our products accurately, is subject to a number of risks and uncertainties, some of which are outside our control, including:

- the availability of sufficient reliable data and our ability to properly analyze available data;
- the uncertainties that inherently characterize estimates and assumptions;
- our selection and application of appropriate pricing techniques; and
- changes in applicable legal liability standards and in the civil litigation system generally.

Consequently, we could underprice risks, which would adversely affect our profit margins, or we could overprice risks, which could reduce our sales volume and competitiveness. In either case, our profitability could be materially and adversely affected.

**Our results may fluctuate as a result of cyclical changes in the property/casualty insurance industry.**

Our revenue is primarily attributable to property/casualty insurance, which as an industry is cyclical in nature and has historically been characterized by soft markets followed by hard markets. A soft market is a period of relatively high levels of price competition, less restrictive underwriting standards and generally low premium rates. A hard market is a period of capital shortages resulting in lack of insurance availability, relatively low levels of competition, more selective underwriting of risks and relatively high premium rates. If we find it necessary to reduce premiums or limit premium increases due to competitive pressures on pricing in a softening market, we may experience a reduction in our premiums written and in our profit margins and revenues, which could adversely affect our financial results.

**Estimating reserves is inherently uncertain. If our loss reserves are not adequate, it will have an unfavorable impact on our results.**

We maintain loss reserves to cover our estimated ultimate liability for unpaid losses and LAE for reported and unreported claims incurred as of the end of each accounting period. Reserves represent management's estimates of what the ultimate settlement and administration of claims will cost and are not reviewed by an independent actuary. These estimates, which generally involve actuarial projections, are based on management's assessment of facts and circumstances then known, as well as estimates of future trends in claim severity and frequency, judicial theories of liability, and other factors. These variables are affected by both internal and external events, such as changes in claims handling procedures, inflation, judicial trends and legislative changes. Many of these factors are not quantifiable. Additionally, there may be a significant lag between the occurrence of an event and the time it is reported to us. The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to reserves are reflected in the results of the periods in which such estimates are changed. For example, a 1% change in December 31, 2016 unpaid losses and LAE would have produced a \$4.8 million change to pretax earnings. Our gross loss and LAE reserves totaled \$481.6 million at December 31, 2016. Our loss and LAE reserves, net of reinsurance recoverable on unpaid loss and LAE, were \$358.3 million at that date. Because setting reserves is inherently uncertain, there can be no assurance that the current reserves will prove adequate.

**Our failure to maintain favorable financial strength ratings could negatively impact our ability to compete successfully.**

Third-party rating agencies assess and rate the claims-paying ability of insurers based upon criteria established by the agencies. AHIC, HIC, HSIC and HNIC have entered into a pooling arrangement, pursuant to which AHIC retains 34% of the net premiums written by any of them, HIC retains 32% of the net premiums written by any of them, HSIC retains 24% of the net premiums written by any of them and HNIC retains 10% of the net premiums written by any of them. A.M. Best has pooled its ratings of these four insurance company subsidiaries and assigned a financial strength rating of "A-" (Excellent) and an issuer credit rating of "a-" to each of these individual insurance company subsidiaries and to the pool formed by these four insurance company subsidiaries. Also, A.M. Best has assigned HCM a financial strength rating of "A-" (Excellent) and an issuer credit rating of "a-". A.M. Best does not assign a financial strength rating or an issuer credit rating to TBIC.

These financial strength ratings are used by policyholders, insurers, reinsurers and insurance and reinsurance intermediaries as an important means of assessing the financial strength and quality of insurers. These ratings are not evaluations directed to potential purchasers of our common stock and are not recommendations to buy, sell or hold our common stock. Our ratings are subject to change at any time and could be revised downward or revoked at the sole discretion of the rating agencies. We believe that the ratings assigned by A.M. Best are an important factor in marketing our products. Our ability to retain our existing business and to attract new business in our insurance operations depends largely on these ratings. Our failure to maintain our ratings, or any other adverse development with respect to our ratings, could cause our current and future independent agents and insureds to choose to transact their business with more highly rated competitors. If A.M. Best downgrades our ratings or publicly indicates that our ratings are under review, it is likely that we would not be able to compete as effectively with our competitors, and our ability to sell insurance policies could decline. If that happened, our sales and earnings would decrease. For example, many of our agencies and insureds have guidelines that require us to have an A.M. Best financial strength rating of “A-” (Excellent) or higher. A reduction of our A.M. Best rating below “A-” would prevent us from issuing policies to insureds or potential insureds with such ratings requirements.

Lenders and reinsurers also use our A.M. Best ratings as a factor in deciding whether to transact business with us. The failure of our insurance company subsidiaries to maintain their current ratings could dissuade a lender or reinsurance company from conducting business with us or might increase our interest or reinsurance costs. In addition, a ratings downgrade by A.M. Best below “A-” would require us to post collateral in support of our obligations under certain of our reinsurance agreements pursuant to which we assume business.

**The loss of key executives could disrupt our business.**

Our success will depend in part upon the continued service of certain key executives. Our success will also depend on our ability to attract and retain additional executives and personnel. The loss of key personnel, or our inability to recruit and retain additional qualified personnel, could cause disruption in our business and could prevent us from fully implementing our business strategies, which could materially and adversely affect our business, growth and profitability.

**Our industry is very competitive, which may unfavorably impact our results of operations.**

The property/casualty insurance market, our primary source of revenue, is highly competitive and, except for regulatory considerations, has very few barriers to entry. According to A.M. Best, there were 3,037 property/casualty insurance companies and 2,062 property/casualty insurance groups operating in North America as of July 12, 2016. Our competitors include entities that have, or are affiliated with entities that have, greater financial and other resources than we have. In addition, competitors may attempt to increase market share by lowering rates. In that case, we could experience reductions in our underwriting margins, or sales of our insurance policies could decline as customers

purchase lower-priced products from our competitors. Losing business to competitors offering similar products at lower prices, or having other competitive advantages, could adversely affect our results of operations.

**Our results may be unfavorably impacted if we are unable to obtain adequate reinsurance.**

As part of our overall risk and capacity management strategy, we purchase reinsurance for significant amounts of risk, especially catastrophe risks that we and our insurance company subsidiaries underwrite. Our catastrophe and non-catastrophe reinsurance facilities are generally subject to annual renewal. We may be unable to maintain our current reinsurance facilities or to obtain other reinsurance facilities in adequate amounts and at favorable rates. The amount, availability and cost of reinsurance are subject to prevailing market conditions beyond our control, and may affect our ability to write additional premiums as well as our profitability. If we are unable to obtain adequate reinsurance protection for the risks we have underwritten, we will either be exposed to greater losses from these risks or be required to reduce the level of business that we underwrite, which will reduce our revenue.

**If the companies that provide our reinsurance do not pay our claims in a timely manner, we could incur severe losses.**

We purchase reinsurance by transferring, or ceding, part of the risk we have assumed to a reinsurance company in exchange for part of the premium we receive in connection with the risk. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us of our liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. We cannot assure that our reinsurers will pay all of our reinsurance claims, or that they will pay our claims on a timely basis. At December 31, 2016, we had a total of \$229.3 million due us from reinsurers, including \$147.8 million of recoverables from losses and \$81.5 million in ceded unearned premiums. The largest amount due us from a single reinsurer as of December 31, 2016 was \$51.9 million reinsurance and premium recoverable from Swiss Reinsurance America Corporation. If any of our reinsurers are unable or unwilling to pay amounts they owe us in a timely fashion, we could suffer a significant loss or a shortage of liquidity, which would have a material adverse effect on our business and results of operations.

**Catastrophic losses are unpredictable and may adversely affect our results of operations, liquidity and financial condition.**

Property/casualty insurance companies are subject to claims arising out of catastrophes that may have a significant effect on their results of operations, liquidity and financial condition. Catastrophes can be caused by various events, including hurricanes, windstorms, earthquakes, hail storms, explosions, severe winter weather and fires, and may include man-made events, such as terrorist attacks. The incidence, frequency, and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event.

Claims from catastrophic events could reduce our net income, cause substantial volatility in our financial results for any fiscal quarter or year or otherwise adversely affect our financial condition, liquidity or results of operations. Catastrophes may also negatively affect our ability to write new business. Increases in the value and geographic concentration of insured property and the effects of inflation could increase the severity of claims from catastrophic events in the future.

**Catastrophe models may not accurately predict future losses.**

Along with other insurers in the industry, we use models developed by third-party vendors in assessing our exposure to catastrophe losses that assume various conditions and probability scenarios. However, these models do not necessarily accurately predict future losses or accurately measure losses currently incurred. Catastrophe models,

which have been evolving since the early 1990s, use historical information about various catastrophes and detailed information about our in-force business. While we use this information in connection with our pricing and risk management activities, there are limitations with respect to their usefulness in predicting losses in any reporting period. Examples of these limitations are significant variations in estimates between models and modelers and material increases and decreases in model results due to changes and refinements of the underlying data elements and assumptions. Such limitations lead to questionable predictive capability and post-event measurements that have not been well understood or proven to be sufficiently reliable. In addition, the models are not necessarily reflective of company or state-specific policy language, demand surge for labor and materials or loss settlement expenses, all of which are subject to wide variation by catastrophe. Because the occurrence and severity of catastrophes are inherently unpredictable and may vary significantly from year to year, historical results of operations may not be indicative of future results of operations.

**We are subject to comprehensive regulation, and our results may be unfavorably impacted by these regulations.**

We are subject to comprehensive governmental regulation and supervision. Most insurance regulations are designed to protect the interests of policyholders rather than of the stockholders and other investors of the insurance companies. These regulations, generally administered by the department of insurance in each state in which we do business, relate to, among other things:

- approval of policy forms and rates;

- standards of solvency, including risk-based capital measurements, which are a measure developed by the National Association of Insurance Commissioners and used by the state insurance regulators to identify insurance companies that potentially are inadequately capitalized;

- licensing of insurers and their agents;

- restrictions on the nature, quality and concentration of investments;

- restrictions on the ability of insurance company subsidiaries to pay dividends;

- restrictions on transactions between insurance company subsidiaries and their affiliates;

- requiring certain methods of accounting;
  - periodic examinations of operations and finances;
    - the use of non-public consumer information and related privacy issues;
  - the use of credit history in underwriting and rating;
  - limitations on the ability to charge policy fees;
  - the acquisition or disposition of an insurance company or of any company controlling an insurance company;
  - involuntary assignments of high-risk policies, participation in reinsurance facilities and underwriting associations, assessments and other governmental charges;
  - restrictions on the cancellation or non-renewal of policies and, in certain jurisdictions, withdrawal from writing certain lines of business;
  - prescribing the form and content of records of financial condition to be filed;
  - requiring reserves for unearned premium, losses and other purposes; and
- with respect to premium finance business, the federal Truth-in-Lending Act and similar state statutes. In states where specific statutes have not been enacted, premium finance is generally subject to state usury laws that are applicable to consumer loans.

State insurance departments also conduct periodic examinations of the affairs of insurance companies and require filing of annual and other reports relating to the financial condition of insurance companies, holding company issues and other matters. Our business depends on compliance with applicable laws and regulations and our ability to maintain valid licenses and approvals for our operations. Regulatory authorities may deny or revoke licenses for various reasons, including violations of regulations. Changes in the level of regulation of the insurance industry or changes in laws or regulations themselves or interpretations by regulatory authorities could have a material adverse effect on our operations. In addition, we could face individual, group and class-action lawsuits by our policyholders and others for alleged violations of certain state laws and regulations. Each of these regulatory risks could have an adverse effect on our profitability.



**State statutes limit the aggregate amount of dividends that our subsidiaries may pay Hallmark, thereby limiting its funds to pay expenses and dividends.**

Hallmark is a holding company and a legal entity separate and distinct from its subsidiaries. As a holding company without significant operations of its own, Hallmark's principal sources of funds are dividends and other sources of funds from its subsidiaries. State insurance laws limit the ability of Hallmark's insurance company subsidiaries to pay dividends and require our insurance company subsidiaries to maintain specified minimum levels of statutory capital and surplus. The aggregate maximum amount of dividends permitted by law to be paid by an insurance company does not necessarily define an insurance company's actual ability to pay dividends. The actual ability to pay dividends may be further constrained by business and regulatory considerations, such as the impact of dividends on surplus, by our competitive position and by the amount of premiums that we can write. Without regulatory approval, the aggregate maximum amount of dividends that could be paid to Hallmark in 2017 by our insurance company subsidiaries is \$19.4 million. State insurance regulators have broad discretion to limit the payment of dividends by insurance companies and Hallmark's right to participate in any distribution of assets of one of our insurance company subsidiaries is subject to prior claims of policyholders and creditors except to the extent that its rights, if any, as a creditor are recognized. Consequently, Hallmark's ability to pay debts, expenses and cash dividends to our stockholders may be limited.

**Our insurance company subsidiaries are subject to minimum capital and surplus requirements. Failure to meet these requirements could subject us to regulatory action.**

Our insurance company subsidiaries are subject to minimum capital and surplus requirements imposed under the laws of their respective states of domicile and each state in which they issue policies. Any failure by one of our insurance company subsidiaries to meet minimum capital and surplus requirements imposed by applicable state law will subject it to corrective action, which may include requiring adoption of a comprehensive financial plan, revocation of its license to sell insurance products or placing the subsidiary under state regulatory control. Any new minimum capital and surplus requirements adopted in the future may require us to increase the capital and surplus of our insurance company subsidiaries, which we may not be able to do.

**We are subject to assessments and other surcharges from state guaranty funds, mandatory reinsurance arrangements and state insurance facilities, which may reduce our profitability.**

Virtually all states require insurers licensed to do business therein to bear a portion of the unfunded obligations of impaired or insolvent insurance companies. These obligations are funded by assessments, which are levied by guaranty associations within the state, up to prescribed limits, on all member insurers in the state on the basis of the proportionate share of the premiums written by member insurers in the lines of business in which the impaired, insolvent or failed insurer was engaged. Accordingly, the assessments levied on us by the states in which we are licensed to write insurance may increase as we increase our premiums written. In addition, as a condition to the ability to conduct business in certain states, insurance companies are required to participate in mandatory reinsurance funds. The effect of these assessments and mandatory reinsurance arrangements, or changes in them, could reduce our profitability in any given period or limit our ability to grow our business.

We monitor developments with respect to various state facilities, such as the Texas FAIR Plan and the Texas Windstorm Insurance Association. The impact of any catastrophe experience on these facilities could result in the facilities recognizing a financial deficit or a financial deficit greater than the level currently estimated. They may, in turn, have the ability to assess participating insurers when financial deficits occur, adversely affecting our results of operations. While these facilities are generally designed so that the ultimate cost is borne by policyholders, the exposure to assessments and the availability of recoupments or premium rate increases from these facilities may not offset each other in our financial statements. Moreover, even if they do offset each other, they may not offset each other in financial statements for the same fiscal period due to the ultimate timing of the assessments and recoupments or premium rate increases, as well as the possibility of policies not being renewed in subsequent years.

**Adverse securities market conditions can have a significant and negative impact on our investment portfolio.**

Our results of operations depend in part on the performance of our invested assets. As of December 31, 2016, 91% of our investment portfolio was invested in fixed-income securities. Certain risks are inherent in connection with fixed-income securities, including loss upon default and price volatility in reaction to changes in interest rates and general market factors. In general, the fair value of a portfolio of fixed-income securities increases or decreases inversely with changes in the market interest rates, while net investment income realized from future investments in fixed-income securities increases or decreases along with interest rates. In addition, 30% of our fixed-income securities have call or prepayment options. This subjects us to reinvestment risk should interest rates fall and issuers call their securities. Furthermore, actual net investment income and/or cash flows from investments that carry prepayment risk, such as mortgage-backed and other asset-backed securities, may differ from those anticipated at the time of investment as a result of interest rate fluctuations. An investment has prepayment risk when there is a risk that cash flows from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. The fair value of our fixed-income securities as of December 31, 2016 was \$597.5 million. If market interest rates were to increase 1%, the fair value of our fixed-income securities would decrease by approximately \$17.8 million as of December 31, 2016. The calculated change in fair value was determined using duration modeling assuming no prepayments.

In addition to the general risks described above, although 79% of our portfolio is investment-grade, our fixed-income securities are nonetheless subject to credit risk. If any of the issuers of our fixed-income securities suffer financial setbacks, the ratings on the fixed-income securities could fall (with a concurrent fall in market value) and, in a worst case scenario, the issuer could default on its obligations. As of December 31, 2016, Hallmark had \$0.1 million in its investment portfolio exposed to sub-prime mortgages and \$59.5 million total exposure in mortgage-backed securities.

Future changes in the fair value of our available-for-sale securities will be reflected in other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our stockholders' equity, total comprehensive income and/or cash flows.

**We rely on independent agents and specialty brokers to market our products and their failure to do so would have a material adverse effect on our results of operations.**

We market and distribute our insurance programs exclusively through independent insurance agents and specialty insurance brokers. As a result, our business depends in large part on the marketing efforts of these agents and brokers and on our ability to offer insurance products and services that meet the requirements of the agents, the brokers and their customers. However, these agents and brokers are not obligated to sell or promote our products and many sell or promote competitors' insurance products in addition to our products. Some of our competitors have higher financial strength ratings, offer a larger variety of products, set lower prices for insurance coverage and/or offer higher commissions than we do. Therefore, we may not be able to continue to attract and retain independent agents and brokers to sell our insurance products. The failure or inability of independent agents and brokers to market our insurance products successfully could have a material adverse impact on our business, financial condition and results of operations.

**We may experience difficulty in integrating acquisitions into our operations.**

The successful integration of any newly acquired business into our operations will require, among other things, the retention and assimilation of their key management, sales and other personnel; the coordination of their lines of insurance products and services; the adaptation of their technology, information systems and other processes; and the retention and transition of their customers. Unexpected difficulties in integrating any acquisition could result in increased expenses and the diversion of management time and resources. If we do not successfully integrate any acquired business into our operations, we may not realize the anticipated benefits of the acquisition, which could have a material adverse impact on our financial condition and results of operations. Further, any potential acquisition may require significant capital outlay and, if we issue equity or convertible debt securities to pay for an acquisition, the issuance may be dilutive to our existing stockholders.

**Our internal controls are not fail-safe.**

We continually enhance our operating procedures and internal controls to effectively support our business and comply with our regulatory and financial reporting requirements. As a result of the inherent limitations in all control systems, no system of controls can provide absolute assurance that all control objectives have been or will be met, and that every instance of error or fraud has been or will be detected. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by individual acts or by collusion of two or more persons. The design of any system of controls is based in part upon assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals

under all potential future conditions. Internal controls may also become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Further, the design of a control system must reflect resource constraints, and the benefits of controls must be considered relative to their costs. As a result of the inherent limitations in a cost-effective control system, misstatement due to error or fraud may occur and not be detected. Accordingly, our internal controls and procedures are designed to provide reasonable, not absolute, assurance that the control objectives are met.

**Our geographic concentration ties our performance to the business, economic and regulatory conditions of certain states.**

The following states accounted for 59% of our gross written premiums for 2016: Texas (42%), Louisiana (5%), Arizona (4%), Oklahoma (4%) and New Mexico (4%). Our revenues and profitability are subject to the prevailing regulatory, legal, economic, political, demographic, competitive, weather and other conditions in the principal states in which we do business. Changes in any of these conditions could make it less attractive for us to do business in such states and would have a more pronounced effect on us compared to companies that are more geographically diversified. In addition, our exposure to severe losses from localized natural perils, such as windstorms or hailstorms, is increased in those areas where we have written significant numbers of property/casualty insurance policies.

**The exclusions and limitations in our policies may not be enforceable.**

Many of the policies we issue include exclusions or other conditions that define and limit coverage, which exclusions and conditions are designed to manage our exposure to certain types of risks and expanding theories of legal liability. In addition, many of our policies limit the period during which a policyholder may bring a claim under the policy, which period in many cases is shorter than the statutory period under which these claims can be brought by our policyholders. While these exclusions and limitations help us assess and control our loss exposure, it is possible that a court or regulatory authority could nullify or void an exclusion or limitation, or legislation could be enacted modifying or barring the use of these exclusions and limitations. This could result in higher than anticipated losses and LAE by extending coverage beyond our underwriting intent or increasing the number or size of claims, which could have a material adverse effect on our operating results. In some instances, these changes may not become apparent until sometime after we have issued the insurance policies that are affected by the changes. As a result, the full extent of liability under our insurance contracts may not be known for many years after a policy is issued.

**We rely on our information technology and telecommunications systems and the failure or disruption of these systems could disrupt our operations and adversely affect our results of operations.**

Our business is highly dependent upon the successful and uninterrupted functioning of our information technology and telecommunications systems. We rely on these systems to process new and renewal business, provide customer service, make claims payments and facilitate collections and cancellations, as well as to perform actuarial and other analytical functions necessary for pricing and product development. Our systems could fail of their own accord or might be disrupted by factors such as natural disasters, power disruptions or surges, computer hackers or terrorist attacks. Failure or disruption of these systems for any reason could interrupt our business and adversely affect our results of operations.

Cybersecurity risks in particular are evolving and include malicious software, unauthorized access to data and other electronic security breaches. We have not experienced cybersecurity attacks in the past and believe that we have adopted appropriate measures to mitigate potential risks to our information technology systems. However, the timing, nature and scope of cybersecurity attacks are difficult to predict and prevent. Therefore, we could be subject to operational delays, compromised confidential or proprietary information, destruction or corruption of data, manipulation or improper use of our systems and networks, financial losses from remedial actions and/or damage to our reputation from cybersecurity attacks. A cybersecurity attack on our information technology systems could disrupt our business and adversely affect our results of operations and financial position.

**Global climate change may have an adverse effect on our financial statements.**

Although uncertainty remains as to the nature and effect of greenhouse gas emissions, we could suffer losses if global climate change results in an increase in the frequency and severity of natural disasters. As with traditional natural disasters, claims arising from these incidents could increase our exposure to losses and have a material adverse impact on our business, results of operations, and/or financial condition.

**Item 1B. Unresolved Staff Comments.**

Not applicable

**Item 2. Properties.**

Our corporate headquarters, Standard Commercial P&C operating unit and Workers Compensation operating unit are located at 777 Main Street, Suite 1000, Fort Worth, Texas. The suite is located in a high-rise office building and contains 27,808 square feet of space. The rent is currently \$50,981 per month pursuant to a lease which expires June 30, 2022.

Our MGA Commercial Products operating unit is presently located at 7550 IH-10 West, San Antonio, Texas. These leased premises consist of a 16,599 square foot office suite and 800 square feet of storage space. The rent is currently \$34,073 per month pursuant to a lease that expires November 30, 2020.

Our Specialty Commercial operating unit is located at 13727 Noel Road, Dallas, Texas. These leased premises consist of 15,072 square feet of office space. The rent is currently \$28,574 per month pursuant to a lease that expires November 30, 2022. Our Specialty Commercial operating unit also maintains branch offices in the following locations:

Location	Monthly Rent	Lease Expiration
Atlanta, Georgia	\$ 12,052	November 30, 2022
Glendale, California	\$ 2,570	July 31, 2020
Chicago, Illinois	\$ 8,900	April 30, 2017

Our Specialty Personal Lines operating unit is located at 6500 Pinecrest, Suite 100, Plano, Texas. The suite is located in a one story office building and contains 23,941 square feet of space. The rent is currently \$27,931 per month pursuant to a lease that expires December 31, 2020.



### **Item 3. Legal Proceedings.**

During the third quarter of 2015 we paid \$1.2 million in fulfillment of the contingent purchase price with the sellers of TBIC Holding. 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, 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 Legislators 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 asserts 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.

We disagree with the Comptroller and intend to vigorously fight their assertion that HSU is liable for the surplus lines premium taxes. We are currently in negotiations with the Comptroller to settle the matter. However, we are presently unable to reasonably estimate the possible loss or legal costs that are likely to arise out of the surplus lines tax audit or any future proceedings relating to this matter. Therefore we have not accrued any amount as of December 31, 2016 related to this matter.

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, likely to have a material adverse effect on our consolidated financial position or our results of operations.

**Item 4. Mine Safety Disclosures.**

Not applicable.

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**PART II****Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.****Market for Common Stock**

Our common stock is currently traded on the Nasdaq Global Market under the symbol “HALL.” The following table shows the high and low sales prices of our common stock on the Nasdaq Global Market for each quarter since January 1, 2015.

Period	High Sale	Low Sale
Year Ended December 31, 2016:		
First quarter	\$ 11.98	\$ 9.79
Second quarter	12.01	9.50
Third quarter	11.93	9.71
Fourth quarter	12.09	9.77
Year Ended December 31, 2015:		
First quarter	\$ 12.67	\$ 9.50
Second quarter	12.15	10.46
Third quarter	11.87	9.33
Fourth quarter	13.29	11.19

**Holder**s

As of March 1, 2017, there were 1,679 shareholders of record of our common stock.

**Dividends**

Hallmark has never paid dividends on its common stock. Our board of directors intends to continue this policy for the foreseeable future in order to retain earnings for development of our business.

Hallmark is a holding company and a legal entity separate and distinct from its subsidiaries. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to pay dividends and make other payments. State insurance laws limit the ability of our insurance company subsidiaries to pay dividends to Hallmark. As property/casualty insurance companies domiciled in the state of Texas, AHIC and TBIC are limited in the payment of dividends to Hallmark 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. 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. As a county mutual, dividends from HCM are payable to policyholders.

## Equity Compensation Plan Information

The following table sets forth information regarding shares of our common stock authorized for issuance under our equity compensation plans as of December 31, 2016.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options and warrants	Number of securities remaining available for future issuance under equity compensation plans excluding securities reflected in column (a)](1)
	(a)	(b)	(c)
Equity compensation plans approved by security holders	624,231	\$ 9.14	1,707,039
Equity compensation plans not approved by security holders	-	-	-
Total	624,231	\$ 9.14	1,707,039

(1) Securities remaining available for future issuance are net of a maximum of 292,961 shares of common stock issuable pursuant to outstanding restricted stock units, subject to applicable vesting requirements and performance criteria. See Note 13 to the audited consolidated financial statements included in this report.

## Issuer Repurchases

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 December 31, 2016:

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	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
	(a)	(b)	(c)	(d)
October 1st - October 31st	31,408	\$ 10.34	2,590,133	1,409,867
November 1st – November 30th	-	\$ -	2,590,133	1,409,867
December 1st – December 31st	-	\$ -	2,590,133	1,409,867

## Performance Graph

The following graph compares the five year cumulative total return provided shareholders on Hallmark's common stock relative to the cumulative total returns of the NASDAQ Composite Index, the NASDAQ Insurance Index, and the S&P Property & Casualty Insurance Index. An investment of \$100 (with reinvestment of all dividends) is assumed to have been made in our common stock and in each index on December 31, 2011 and its relative performance is tracked through December 31, 2016.

**Item 6. Selected Financial Data**

	Year Ended December 31				
	2016	2015	2014	2013	2012
	(in thousands, except per share data)				
<b>Statement of Operations Data:</b>					
Gross premiums written	\$549,077	\$514,223	\$473,218	\$460,027	\$389,842
Ceded premiums written	(187,248)	(157,279)	(148,866)	(99,262)	(57,353)
Net premiums written	361,829	356,944	324,352	360,765	332,489
Change in unearned premiums	(8,459)	(7,863)	(3,135)	(224)	(13,053)
Net premiums earned	353,370	349,081	321,217	360,541	319,436
Investment income, net of expenses	16,342	13,969	12,383	12,884	15,293
Net realized (losses) gains	(369)	2,503	134	10,540	1,943
Finance charges	4,977	5,952	5,279	5,830	5,957
Commission and fees	1,427	213	(1,694)	(487)	(1,145)
Other income	205	684	47	120	316
Total revenues	375,952	372,402	337,366	389,428	341,800
Loss and loss adjustment expenses	253,688	230,149	210,055	261,345	226,414
Operating expenses	106,769	103,993	101,427	109,289	103,792
Interest expense	4,549	3,906	4,576	4,599	4,634
Amortization of intangible assets	2,468	2,468	2,526	3,115	3,586
Total expenses	367,474	340,516	318,584	378,348	338,426
Income before tax	8,478	31,886	18,782	11,080	3,374
Income tax expense (benefit)	1,952	10,023	5,353	2,835	(474)
Net income	6,526	21,863	13,429	8,245	3,848
Less: Net income attributable to non-controlling interest	-	-	-	-	324
Net income attributable to Hallmark Financial Services, Inc.	6,526	21,863	13,429	8,245	3,524
<b>Net income per share attributable to Hallmark Financial Services, Inc. common stockholders:</b>					
Basic	\$0.35	\$1.14	\$0.70	\$0.43	\$0.18
Diluted	\$0.34	\$1.13	\$0.69	\$0.43	\$0.18



Balance Sheet Items:	As of December 31				
	2016	2015	2014	2013	2012
Total investments	\$654,119	\$578,829	\$507,229	\$461,325	\$445,360
Total assets (1)	\$1,162,460	\$1,075,547	\$979,765	\$907,867	\$789,261
Reserves for unpaid loss and loss adjustment expenses	\$481,567	\$450,878	\$415,135	\$382,640	\$313,416
Unearned premiums	\$241,254	\$216,407	\$196,826	\$185,303	\$162,502
Total liabilities (1)	\$896,724	\$813,521	\$727,728	\$669,749	\$568,724
Total stockholders' equity	\$265,736	\$262,026	\$252,037	\$238,118	\$220,537
Book value per share	\$14.28	\$13.72	\$13.11	\$12.36	\$11.45

(1) Amounts have been adjusted for the adoption of ASU 2015-03 which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts, (See, "Simplifying the Presentation of Debt Issuance Costs" in Note 1 to the audited consolidated financial statements, included in this report.)

## Item 7. 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-K" for a discussion of some of the uncertainties, risks and assumptions associated with these statements.*

### Overview

Hallmark is an insurance holding company which, 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. We pursue our business activities primarily through subsidiaries whose operations are organized into operating units and are supported by our insurance carrier subsidiaries.

Our insurance activities are organized 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 professional liability and primary/excess commercial property insurance products and services handled by our Specialty Commercial operating unit. Certain specialty programs are also managed by our Specialty Commercial operating unit. Our MGA Commercial Products operating unit is comprised of our HSU, PAAC and TGASRI subsidiaries. Our Specialty Commercial operating unit is comprised of our Aerospace Insurance Managers, ASRI, ACMG, HXS and HDS subsidiaries.

**Standard Commercial Segment.** The 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. Effective June 1, 2016, we no longer market new or renewal occupational accident policies. Effective July 1, 2015, the Workers Compensation operating unit no longer retains any risk on new or renewal policies. Our Standard Commercial P&C operating unit is comprised of our American Hallmark Insurance Services and ECM subsidiaries. Our Workers Compensation operating unit is comprised of our TBIC Holdings, TBIC and TBICRM subsidiaries.

**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. During the fourth quarter of 2014, our Specialty Personal Lines operating unit discontinued the low value dwelling/homeowners and manufactured homes insurance products it previously offered. Our Specialty Personal Lines operating unit is comprised of our AHGA and HCS subsidiaries.

The retained premium produced by these reportable segments is supported by our American Hallmark Insurance Company of Texas, Hallmark Specialty Insurance Company, Hallmark Insurance Company, Hallmark National Insurance Company and Texas Builders Insurance Company insurance subsidiaries. In addition, control and management of Hallmark County Mutual 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 net premiums written by any of them, HIC retains 32% of the net premiums written by any of them, HSIC retains 24% of the net premiums written by any of them and HNIC retains 10% of the net premiums written by any of them. Neither HCM nor TBIC is a party to the intercompany pooling arrangement.

### **Critical Accounting Estimates and Judgments**

The significant accounting policies requiring our estimates and judgments are discussed below. Such estimates and judgments are based on historical experience, changes in laws and regulations, observation of industry trends and information received from third parties. While the estimates and judgments associated with the application of these accounting policies may be affected by different assumptions or conditions, we believe the estimates and judgments associated with the reported consolidated financial statement amounts are appropriate in the circumstances. For additional discussion of our accounting policies, see Note 1 to the audited consolidated financial statements included in this report.

**Impairment of investments.** 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.

***Fair values of financial instruments.*** Accounting Standards Codification (“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 stock, preferred stock and the equity warrant classified as Other Investments.

Level 2 investment securities include corporate bonds, collateralized corporate bank loans, municipal bonds, U.S. Treasury securities, other obligations of the U.S. Government and mortgage-backed securities for which quoted prices are not available on active exchanges for identical instruments. We use a third party pricing service 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 service and have determined that they result in fair values consistent with the requirements of ASC 820 for Level 2 investment securities. We have not adjusted any prices received from third-party pricing sources.

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.

***Deferred policy acquisition costs.*** Policy acquisition costs (mainly commission, underwriting and marketing expenses) that vary with and are primarily related to the successful acquisition of new and renewal insurance contracts are deferred and charged to operations over periods in which the related premiums are earned. Ceding commissions from reinsurers, which include expense allowances, are deferred and recognized over the period premiums are earned for the underlying policies reinsured.

The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. A premium deficiency exists if the sum of expected claim costs and claim adjustment expenses, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums and expected investment income on those unearned premiums, as computed on a product line basis. We routinely evaluate the realizability of deferred policy acquisition costs. At December 31, 2016 and 2015, there was no premium deficiency related to deferred policy acquisition costs.

**Goodwill.** Goodwill is tested for impairment at the reporting unit level (operating unit or one level below an operating unit) on an annual basis (October 1) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. For purposes of evaluating goodwill for impairment, we have determined that our reporting units are the same as our operating units except for the Specialty Commercial operating unit for which reporting units are at the component level (“one level below”). Our consolidated balance sheet as of December 31, 2016 includes goodwill of acquired businesses of \$44.7 million that is assigned to our operating units as follows: Standard Commercial P&C operating unit - \$2.1 million; MGA Commercial Products operating unit - \$19.8 million; Specialty Commercial operating unit - \$17.4 million (comprised of \$7.7 million for the primary/excess & umbrella component and \$9.7 million for the general aviation and satellite component); and Specialty Personal Lines operating unit - \$5.4 million. This amount has been recorded as a result of prior business acquisitions accounted for under the acquisition method of accounting. Under ASC 350, “Intangibles - Goodwill and Other,” goodwill is tested for impairment annually. We completed our last annual test for impairment on the first day of the fourth quarter of 2016 and determined that there was no impairment.

A significant amount of judgment is required in performing goodwill impairment tests. Such tests include estimating the fair value of our reporting units. As required by ASC 350, we compare the estimated fair value of each reporting unit with its carrying amount, including goodwill. Under ASC 350, fair value refers to the amount for which the entire reporting unit may be bought or sold.

The determination of fair value was based on an income approach utilizing discounted cash flows. The valuation methodology utilized is subject to key judgments and assumptions. Estimates of fair value are inherently uncertain and represent management’s reasonable expectation regarding future developments. These estimates and the judgments and assumptions upon which the estimates are based will, in all likelihood, differ in some respects from actual future results. Declines in estimated fair value could result in goodwill impairments in future periods which could materially adversely affect our results of operations or financial position.

The income approach to determining fair value computed the projections of the cash flows that the reporting unit is expected to generate converted into a present value equivalent through discounting. Significant assumptions in the income approach model include income projections, discount rates and terminal growth values. The income projections reflect an improved premium rate environment across most of our lines of business that continued throughout 2016. The income projections also include loss and LAE assumptions which reflect recent historical claim trends and the movement towards a more favorable pricing environment. The income projections also include assumptions for expense growth and investment yields which are based on business plans for each of our operating units. The discount rate was based on a risk free rate plus a beta adjusted equity risk premium and specific company risk premium. The assumptions were based on historical experience, expectations of future performance, expected market conditions and other factors requiring judgment and estimates. While we believe the assumptions used in these models were reasonable, the inherent uncertainty in predicting future performance and market conditions may change over time and influence the outcome of future testing.

The fair values of each of our operating units were in excess of their respective carrying values, including goodwill, as a result of our annual test for impairment during the fourth quarter 2016. However, a 10% decline in the fair value of our Standard Commercial P&C operating unit, a 7% decline in the fair value of our MGA Commercial Products operating unit, a 6% decline in the fair value of our Specialty Personal Lines operating unit, a 49% decline in the fair value of our excess & umbrella component or a 16% decline in the fair value of our general aviation and satellite component would have caused the carrying value of the respective reporting unit to be in excess of its fair value, resulting in the need to perform the second step of impairment testing prescribed by ASC 350, which could have resulted in an impairment to our goodwill.

The market capitalization of Hallmark's common stock has been below book value during 2016. We consider our market capitalization in assessing the reasonableness of the fair values estimated for our operating units in connection with our goodwill impairment testing. We believe the current financial market conditions, as well as the limited daily trading volume of Hallmark shares has resulted in a decrease in our market capitalization that is not representative of a long-term decrease in value. The valuation analysis discussed above supports our view that goodwill was not impaired at October 1, 2016. Through December 31, 2016, there were no indicators of impairment.



While we believe the estimates and assumptions used in determining the fair value of our operating units were reasonable, actual results could vary materially. If our actual results are not consistent with our estimates and assumptions used to calculate fair value, we may be required to perform the second step of impairment testing prescribed by ASC 350 in future periods and impairment of goodwill could result. We cannot predict future events that might impact the fair value of our operating units and goodwill impairment. Such events include, but are not limited to, increased competition in insurance markets and global economic changes.

***Deferred income tax assets and liabilities.*** 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. A valuation allowance is provided against our deferred tax assets to the extent that we do not believe it is more likely than not that future taxable income will be adequate to realize these future tax benefits.

***Reserves for unpaid losses and LAE.*** Reserves for unpaid losses and LAE are established for claims that have already been incurred by the policyholder but which we have not yet paid. Unpaid losses and LAE represent the estimated ultimate net cost of all reported and unreported losses incurred through each balance sheet date. The reserves for unpaid losses and LAE are estimated using individual case-basis valuations and statistical analyses. These reserves are revised periodically and are subject to the effects of trends in loss severity and frequency. (See “Item 1. Business – Analysis of Losses and LAE” and “-Analysis of Loss and LAE Reserve Development.”)

Although considerable variability is inherent in such estimates, we believe that our reserves for unpaid losses and LAE are adequate. Due to the inherent uncertainty in estimating unpaid losses and LAE, the actual ultimate amounts may differ from the recorded amounts. A small percentage change could result in a material effect on reported earnings. For example, a 1% change in December 31, 2016 reserves for unpaid losses and LAE would have produced a \$4.8 million change to pretax earnings. The estimates are continually reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations.

An actuarial range of ultimate unpaid losses and LAE is developed independent of management’s best estimate and is only used to assess the reasonableness of that estimate. There is no exclusive method for determining this range, and judgment enters into the process. The primary actuarial technique utilized is a loss development analysis in which ultimate losses are projected based upon historical development patterns. The primary assumption underlying this loss development analysis is that the historical development patterns will be a reasonable predictor of the future development of losses for accident years which are less mature. An alternate actuarial technique, known as the Bornhuetter-Ferguson method, combines an analysis of loss development patterns with an initial estimate of expected losses or loss ratios. This approach is most useful for recent accident years. In addition to assuming the stability of loss development patterns, this technique is heavily dependent on the accuracy of the initial estimate of expected losses or loss ratios. Consequently, the Bornhuetter-Ferguson method is primarily used to confirm the results derived

from the loss development analysis.

The range of unpaid losses and LAE estimated by our actuary as of December 31, 2016 was \$390.9 million to \$498.7 million. Our best estimate of unpaid losses and LAE as of December 31, 2016 is \$481.6 million. Our carried reserve for unpaid losses and LAE as of December 31, 2016 is comprised of \$254.8 million in case reserves and \$226.8 million in incurred but not reported reserves. In setting this estimate of unpaid losses and LAE, we have assumed, among other things, that current trends in loss frequency and severity will continue and that the actuarial analysis was empirically valid. We have established a best estimate of unpaid losses and LAE which is \$36.8 million higher than the midpoint, or 96.6% of the high end, of the actuarial range at December 31, 2016 as compared to \$30.1 million above the midpoint, or 96.9% of the high end, of the actuarial range at December 31, 2015. We expect our best estimate to move within the actuarial range from year to year due to changes in our operations and changes within the marketplace. Due to the inherent uncertainty in reserve estimates, there can be no assurance that the actual losses ultimately experienced will fall within the actuarial range. However, because of the breadth of the actuarial range, we believe that it is reasonably likely that actual losses will fall within such range.

Our reserve requirements are also interrelated with product pricing and profitability. We must price our products at a level sufficient to fund our policyholder benefits and still remain profitable. Because claim expenses represent the single largest category of our expenses, inaccuracies in the assumptions used to estimate the amount of such benefits can result in our failing to price our products appropriately and to generate sufficient premiums to fund our operations.

**Recognition of profit sharing commissions.** Profit sharing commission is calculated and recognized when the loss ratio, as determined by a qualified actuary, deviates from contractual targets. We receive a provisional commission as policies are produced as an advance against the later determination of the profit sharing commission actually earned. The profit sharing commission is an estimate that varies with the estimated loss ratio and is sensitive to changes in that estimate.

The following table details the profit sharing commission revenue sensitivity of the Standard Commercial P&C operating unit to the actual ultimate loss ratio for each effective quota share treaty at 5.0% above and below the current estimate, which we believe is a reasonably likely range of variance (\$ in thousands).

	Treaty Effective Dates				
	7/1/2001	7/1/2002	7/1/2003	7/1/2004	7/1/2005
Provisional loss ratio	60.0 %	59.0 %	59.0 %	64.2 %	64.2 %
Estimated ultimate loss ratio recorded at December 31, 2016	63.5 %	64.5 %	61.2 %	66.1 %	61.0 %
Effect of actual 5.0% above estimated loss ratio at December 31, 2016	\$-	\$-	\$(3,360 )	\$(3,790 )	\$(546 )
Effect of actual 5.0% below estimated loss ratio at December 31, 2016	\$1,850	\$3,055	\$2,734	\$3,790	\$546

The following table details the profit sharing commission revenue sensitivity of the MGA Commercial Products operating unit for each effective quota share treaty at 5.0% above and below the current estimate, which we believe is a reasonably likely range of variance (\$ in thousands).

	Treaty Effective Dates		
	1/1/2006	1/1/2007	1/1/2008
Provisional loss ratio	65.0 %	65.0 %	65.0 %
Estimated ultimate loss ratio recorded at December 31, 2016	59.1 %	65.0 %	60.6 %
Effect of actual 5.0% above estimated loss ratio at December 31, 2016	\$(3,096)	\$-	\$(1,430 )
Effect of actual 5.0% below estimated loss ratio at December 31, 2016	\$3,096	\$2,351	\$1,618

### **Results of Operations**

#### **Comparison of Years ended December 31, 2016 and December 31, 2015**

**Management overview.** During fiscal 2016, our total revenues were \$376.0 million, which was \$3.6 million more than the \$372.4 million in total revenues for fiscal 2015. During the year ended December 31, 2016, our income before tax was \$8.5 million as compared to \$31.9 million during the same period of 2015.

This increase in revenue was primarily attributable to higher net premiums earned, higher net investment income and higher commission and fee revenue, partially offset by realized losses recognized on our investment portfolio during the current period as compared to realized gains recognized during the same period the prior year and lower finance charges.

The increased net earned premiums were primarily attributable to higher net premiums written in our Specialty Commercial Segment and the favorable impact of increased retention under a quota share reinsurance agreement in our Personal Segment effective October 1, 2014, partially offset by the adverse impact on the Standard Commercial Segment of ceding substantially all unearned workers' compensation premiums effective July 1, 2015.

The decrease in income before tax for the year ended December 31, 2016 was due primarily to increased loss and LAE of \$23.5 million, higher operating expenses of \$2.8 million and higher interest expense of \$0.6 million, partially offset by the increased revenue discussed above. The increase in loss and LAE was primarily the result of unfavorable net prior year loss reserve development and higher current accident year loss trends in our Specialty Commercial Segment and Personal Segment, partially offset by higher favorable net prior year loss reserve development in our Standard Commercial Segment. During the twelve months ended December 31, 2016, we recorded unfavorable prior year net loss reserve development of \$7.6 million as compared to \$7.0 million of favorable prior year net loss reserve development for the same period of 2015. We incurred an aggregate of \$11.0 million of net catastrophe losses during the year ended December 31, 2016 as compared to \$9.3 million for the same period the prior year. Other operating expenses increased during the year ended December 31, 2016 primarily as the result of increased salary and related expenses in our Specialty Commercial Segment and a \$1.8 million payment to settle the earn-out related to the previous acquisition of TBIC accrued during the second quarter of 2016, partially offset by lower production related expenses predominately in our Specialty Commercial Segment. The increase in interest expense was due to interest on our Facility B revolving credit facility entered into during the fourth quarter of 2015.

We reported net income of \$6.5 million for the year ended December 31, 2016, as compared to net income of \$21.9 million for the year ended December 31, 2015. On a diluted per share basis, net income was \$0.34 per share for fiscal 2016 as compared to net income of \$1.13 per share for fiscal 2015.

*Segment information*

The following is additional business segment information for the years ended December 31, 2016 and 2015 (in thousands):

	Year Ended December 31		Standard Commercial		Personal Segment		Corporate		Consolidated
	Specialty Segment 2016	Commercial 2015	Segment 2016	2015	2016	2015	2016	2015	
Gross premiums written	\$388,914	\$351,050	\$76,891	\$81,892	\$83,272	\$81,281	\$-	\$-	\$549,077
Ceded premiums written	(139,842)	(109,275)	(8,401)	(10,795)	(39,005)	(37,209)	-	-	(187,248)
Net premiums written	249,072	241,775	68,490	71,097	44,267	44,072	-	-	361,829
Change in unearned premiums	(7,182 )	(4,135 )	(980 )	1,516	(297 )	(5,244 )	-	-	(8,459 )
Net premiums earned	241,890	237,640	67,510	72,613	43,970	38,828	-	-	353,370
Total revenues	255,897	249,910	71,966	76,864	49,826	45,538	(1,737 )	90	375,952
Losses and loss adjustment expenses	169,125	148,664	41,173	47,071	43,390	34,414	-	-	253,688
Pre-tax income (loss)	24,417	40,277	8,866	6,687	(6,839 )	(885 )	(17,966)	(14,193)	8,478
Net loss ratio (1)	69.9 %	62.6 %	61.0 %	64.8 %	98.7 %	88.6 %			71.8 %
Net expense ratio (1)	25.3 %	25.6 %	33.0 %	32.6 %	21.5 %	19.0 %			28.0 %
Net combined ratio (1)	95.2 %	88.2 %	94.0 %	97.4 %	120.2 %	107.6 %			99.8 %
Favorable (Unfavorable) Prior Year	(12,502 )	2,147	9,901	7,416	(5,007 )	(2,610 )			(7,608 )

Development

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 \$388.9 million for the year ended December 31, 2016, which was \$37.9 million, or 11%, more than the \$351.0 million reported for the same period in 2015. Net premiums written were \$249.1 million for the year ended December 31, 2016 as compared to \$241.8 million reported for the same period in 2015. The increase in gross and net premiums written was due to increased premium production in both our MGA Commercial Products and our Specialty Commercial operating units.

The \$255.9 million of total revenue for the year ended December 31, 2016 was \$6.0 million higher than the \$249.9 million reported for 2015. This 2% increase in revenue was due to higher net premiums earned of \$4.3 million due predominately to increased production discussed above. Further contributing to this increased revenue was higher net investment income of \$1.4 million, higher commission and fees of \$0.3 million and higher other income of \$0.1 million, partially offset by lower finance charges of \$0.1 million.

Pre-tax income for the Specialty Commercial Segment of \$24.4 million for the year ended December 31, 2016 was \$15.9 million lower than the \$40.3 million reported for the same period in 2015. This decrease in pre-tax income was primarily due to higher loss and LAE expenses of \$20.5 million and higher operating expense of \$1.4 million, partially offset by the increased revenue discussed above.

Our MGA Commercial Products operating unit reported a \$16.5 million increase in loss and LAE due primarily to \$11.3 million of unfavorable prior year net loss reserve development recognized during the year ended December 31, 2016 as compared to \$1.2 million of unfavorable prior year net loss reserve development recognized for the same period the prior year, as well as higher current accident year loss trends. Our Specialty Commercial operating unit reported a \$2.1 million increase in loss and LAE which consisted of (a) a \$1.6 million increase in loss and LAE attributable to our medical professional liability insurance products, (b) a \$0.8 million increase in loss and LAE in our commercial umbrella and primary/excess liability line of business, (c) a \$0.8 million increase in loss and LAE attributable to our primary/excess property insurance products, partially offset by (d) a \$1.1 million decrease in loss and LAE attributable to our satellite launch insurance line of business due primarily to favorable current accident year loss trend. Our specialty programs reported a \$1.9 million increase in loss and LAE due primarily to \$0.7 million of unfavorable prior year net loss reserve development recognized during the year ended December 31, 2016 as compared to \$1.4 million of favorable prior year net loss reserve development recognized for the same period the prior year. The increase of \$1.4 million in operating expense was the combined result of increased salary and related expenses of \$3.8 million, higher travel related expenses of \$0.2 million, higher occupancy and other expenses of \$0.9 million and higher professional service fee expenses of \$0.1 million, partially offset by lower production related expenses of \$3.6 million due primarily to increased ceding commissions in our Specialty Commercial operating unit.

The Specialty Commercial Segment reported a net loss ratio of 69.9% for the year ended December 31, 2016 as compared to 62.6% for the same period during 2015. The gross loss ratio before reinsurance was 67.3% for the year ended December 31, 2016 as compared to 61.6% for the same period in 2015. The higher gross and net loss ratio included \$12.5 million of unfavorable prior year net loss reserve development for the year ended December 31, 2016 as compared to \$2.1 million of favorable prior year net loss reserve development for the same period during 2015, as well as higher current accident year loss trends.

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

Gross premiums written for the Standard Commercial Segment were \$76.9 million for the year ended December 31, 2016, which was \$5.0 million, or 6%, less than the \$81.9 million reported for the same period in 2015. Net premiums written were \$68.5 million for the year ended December 31, 2016 as compared to \$71.1 million reported for the same period in 2015. The decrease in premium volume was primarily due to lower premium production in our Workers Compensation operating unit due to the renewal rights agreement entered into during the second quarter of 2015 and subsequently amended during the third quarter of 2015 to cede substantially all of the unearned premium effective July 1, 2015.



Total revenue for the Standard Commercial Segment of \$72.0 million for the year ended December 31, 2016 was \$4.9 million less than the \$76.9 million reported during the year ended December 31, 2015. This 6% decrease in total revenue was mostly due to the Workers Compensation operating unit experiencing both a \$0.6 million gain during the year ended December 31, 2015 in connection with the transfer of renewal rights and a \$5.1 million decrease in net premiums earned during 2016 primarily as a result of ceding substantially all unearned premiums as of July 1, 2015 and lower net investment income of \$0.2 million. These decreases in revenue were partially offset by a decreased adverse profit share commission revenue adjustment of \$1.0 million.

Our Standard Commercial Segment reported pre-tax income of \$8.9 million for the year ended December 31, 2016 which was \$2.2 million higher than the \$6.7 million reported for the same period of 2015. Lower loss and LAE of \$5.9 million was the primary driver for the higher pre-tax income, as well as lower operating expenses of \$1.2 million, partially offset by the decreased revenue discussed above.

The net loss ratio for the year ended December 31, 2016 was 61.0% as compared to the 64.8% reported for the year ended December 31, 2015. The gross loss ratio before reinsurance was 59.6% for the year ended December 31, 2016 as compared to 63.4% for the prior year. The lower gross and net loss ratios resulted primarily from lower premium volume, lower current accident year non-catastrophe loss trends and increased favorable net loss reserve development partially offset by higher current accident year catastrophe losses. The net loss ratios for the year ended December 31, 2016 include \$8.4 million of catastrophe related losses. The net loss ratios for the year ended December 31, 2015 include \$7.8 million of catastrophe related losses. During the year ended December 31, 2016 and 2015, the Standard Commercial Segment reported favorable prior year net loss reserve development of \$9.9 million and \$7.4 million, respectively. The Standard Commercial Segment reported a net expense ratio of 33.0% for the year ended December 31, 2016 as compared to 32.6% for the same period of 2015. The increase in the expense ratio was primarily due to the runoff of our Workers Compensation operating unit and the discontinued marketing of new and renewal occupational accident policies during 2016.

***Personal Segment.***

Gross premiums written for the Personal Segment were \$83.3 million for the year ended December 31, 2016, which was \$2.0 million more than the \$81.3 million reported for the same period in 2015. Net premiums written for our Personal Segment were \$44.3 million for the year ended December 31, 2016, which was an increase of \$0.2 million from the \$44.1 million reported for the same period of 2015.

Total revenue for the Personal Segment increased 9% to \$49.8 million for the year ended December 31, 2016 from \$45.5 million the prior year. The \$4.3 million increase in revenue was primarily due to higher net premiums earned of \$5.1 million due mostly to increased retention under a quota share reinsurance agreement effective October 1, 2014 and higher net investment income of \$0.1 million, partially offset by lower finance charges of \$0.9 million.

Our Personal Segment reported a pre-tax loss of \$6.8 million for the year ended December 31, 2016 as compared to pre-tax loss of \$0.9 million for the same period of 2015. The pre-tax loss was the result of increased losses and LAE of \$9.0 million and increased operating expenses of \$1.2 million, partially offset by the increased revenue discussed above.

The Personal Segment reported a net loss ratio of 98.7% for the year ended December 31, 2016 as compared to 88.6% for the same period in 2015. The gross loss ratio before reinsurance was 94.8% for the year ended December 31, 2016 as compared to 80.8% for the same period in 2015. The higher gross and net loss ratios were primarily the result of unfavorable prior year net loss reserve development of \$5.0 million for the year ended December 31, 2016 as compared to unfavorable prior year net loss reserve development of \$2.6 million for the same period of 2015, as well as higher current accident year loss trends. The increase in operating expenses of \$1.2 million was the combined result of \$0.4 million increase in other operating expenses driven by our investment in technology, a \$0.3 million increase in production related expenses, a \$0.4 million increase in salary and related expenses and a \$0.1 million increase in professional service fees and occupancy expenses. The Personal Segment reported a net expense ratio of 21.5% for the year ended December 31, 2016 as compared to 19.0% for the same period of 2015.

***Corporate.***

Total revenue for Corporate decreased by \$1.8 million for the year ended December 31, 2016 as compared to the same period the prior year. This decrease in total revenue was due to net realized losses recognized on our investment portfolio of \$0.4 million for the year ended December 31, 2016 as compared to the net realized gains of \$2.5 million for the same period of 2015, partially offset by higher net investment income of \$1.1 million.

Corporate pre-tax loss was \$18.0 million for the year ended December 31, 2016 as compared to pre-tax loss of \$14.2 million for the same period of 2015. The increase in pre-tax loss was primarily due to the decreased revenue discussed above, higher operating expenses of \$1.3 million and increased interest expense of \$0.6 million. The increase in operating expenses of \$1.3 million was due primarily to an additional \$1.8 million earn-out paid in conjunction with the previous acquisition of TBIC and higher other operating expenses of \$0.1 million, partially offset by lower salary and related expenses of \$0.4 million due primarily to lower incentive compensation expense in 2016, lower professional service fee expense of \$0.1 million and lower travel and related expenses of \$0.1 million. The increase in interest expense of \$0.6 million was due primarily to the interest expense under Facility B, partially offset by a reduction in interest expense due to the transition from a fixed interest rate to a lower floating interest rate as of June 15, 2015 on our Trust I subordinated debt securities.

*Comparison of Years ended December 31, 2015 and December 31, 2014*

**Management overview.** During fiscal 2015, our total revenues were \$372.4 million, representing a 10% increase over the \$337.4 million in total revenues for fiscal 2014. This increase in revenue was primarily attributable to higher net premiums earned, higher net investment income, higher realized gains recognized on our investment portfolio and lower adverse profit share commission adjustments in our Standard Commercial Segment. The increased net earned premiums were primarily attributable to increased retained premium under a renewed quota share reinsurance agreement effective October 1, 2014 in our Personal Segment and to increased premium production in our Personal Segment and our MGA Commercial Products operating unit.

The increase in revenue for the year ended December 31, 2015 was partially offset by increased loss and LAE of \$20.1 million as compared to the same period of 2014. The increase in loss and LAE was primarily the result of an increase in retained losses in our Personal Segment under the renewed quota share reinsurance agreement. During the twelve months ended December 31, 2015, we recorded favorable prior year net loss reserve development of \$7.0 million as compared to \$5.2 million of favorable prior year net loss reserve development for the same period of 2014. Also partially offsetting the increased revenue was increased other operating expenses due mostly to higher production related expenses in our Personal Segment due to the impact of the change in terms of the quota share reinsurance agreement and increased salary and related expenses in our Specialty Commercial and Corporate Segments.

We reported net income of \$21.9 million for the year ended December 31, 2015, as compared to net income of \$13.4 million for the year ended December 31, 2014. On a diluted per share basis, net income was \$1.13 per share for fiscal 2015 as compared to net income of \$0.69 per share for fiscal 2014.

***Segment information.***

The following is additional business segment information for the years ended December 31, 2015 and 2014 (in thousands):

	Year Ended December 31		Specialty Commercial Segment		Standard Commercial Segment		Personal Segment		Corporate		Consolidated 2015
	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	
	Gross premiums written	\$351,050	\$324,547	\$81,892	\$84,679	\$81,281	\$63,992	\$-	\$-		
Ceded premiums written	(109,275)	(93,909)	(10,795)	(7,767)	(37,209)	(47,190)	-	-			(157,279)
Net premiums written	241,775	230,638	71,097	76,912	44,072	16,802	-	-			356,944
Change in unearned premiums	(4,135)	(1,815)	1,516	1,399	(5,244)	(2,719)	-	-			(7,863)
Net premiums earned	237,640	228,823	72,613	78,311	38,828	14,083	-	-			349,081
Total revenues	249,910	241,920	76,864	81,464	45,538	20,404	90	(6,422)			372,402

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Losses and loss adjustment expenses	148,664	149,961	47,071	51,130	34,414	8,964	-	-	230,149
Pre-tax income (loss)	40,277	34,237	6,687	4,595	(885 )	1,226	(14,193)	(21,276)	31,886
Net loss ratio (1)	62.6 %	65.5 %	64.8 %	65.3 %	88.6 %	63.7 %			65.9 %
Net expense ratio (1)	25.6 %	25.6 %	32.6 %	33.3 %	19.0 %	43.3 %			28.0 %
Net combined ratio (1)	88.2 %	91.1 %	97.4 %	98.6 %	107.6 %	107.0 %			93.9 %
Favorable (Unfavorable) Prior Year Development	2,147	(3,721 )	7,416	6,033	(2,610 )	2,891			6,953

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 \$351.0 million for the year ended December 31, 2015, which was \$26.5 million, or 8%, more than the \$324.5 million reported for the same period in 2014. Net premiums written were \$241.8 million for the year ended December 31, 2015 as compared to \$230.6 million reported for the same period in 2014. The increase in gross and net premiums written was due to increased premium production in both our MGA Commercial Products and Specialty Commercial operating units, including our specialty programs.

The \$249.9 million of total revenue for the year ended December 31, 2015 was \$8.0 million higher than the \$241.9 million reported for 2014. This 3% increase in revenue was due to higher net premiums earned of \$8.8 million due predominately to increased production discussed above. Further contributing to this increased revenue was higher commission and fees of \$0.3 million and higher other income of \$0.1 million, partially offset by lower net investment income of \$1.1 million and lower finance charges of \$0.1 million.

Pre-tax income for the Specialty Commercial Segment of \$40.3 million for the year ended December 31, 2015 was \$6.1 million higher than the \$34.2 million reported for the same period in 2014. The increase in pre-tax income was primarily due to the increased revenue discussed above, lower loss and LAE expenses of \$1.3 million and lower amortization of intangible assets of \$0.1 million, partially offset by higher operating expenses of \$3.3 million.

Our MGA Commercial Products operating unit reported a \$2.8 million increase in loss and LAE for the year ended December 31, 2015 as compared to the same period of 2014. Our MGA Commercial Products operating unit reported \$1.2 million of unfavorable prior year loss reserve development during the year ended December 31, 2015 as compared to \$5.3 million of unfavorable prior year loss reserve development reported for the same period the prior year. Our Specialty Commercial operating unit reported a \$0.9 million decrease in loss and LAE which consisted of (a) a \$2.3 million decrease in loss and LAE in our general aviation and satellite launch insurance products due primarily to \$0.9 million of favorable prior year loss reserve development recognized during the year ended December 31, 2015 as compared to \$0.3 million of adverse prior year loss reserve development recognized for the same period the prior year, (b) a \$0.5 million increase in loss and LAE due primarily to \$0.6 million lower favorable prior year net loss reserve development recognized during the year ended December 31, 2015 as compared to the same period during 2014 in our commercial umbrella and primary/excess liability line of business, and (c) a \$0.9 million increase in loss and LAE attributable to our medical professional liability insurance products. Our specialty programs reported a \$3.2 million decrease in loss and LAE due primarily to \$1.4 million of favorable prior year net loss reserve development recognized during the year ended December 31, 2015 as compared to \$0.6 million of favorable prior year net loss reserve development recognized for the same period the prior year as well as the impact of a quota share agreement entered into during the second quarter of 2014. The increase of \$3.3 million in operating expense was primarily the combined result of the year to date expenses to start up our primary/excess property coverage business of \$1.9 million, increased salary and related expenses of \$1.2 million, higher professional service fees of \$0.3 million, increased travel related expenses of \$0.1 million and higher other operating expenses of \$0.2 million, partially offset by lower production related expense of \$0.4 million primarily in our commercial umbrella and primary/excess liability line of

business.

The Specialty Commercial Segment reported a net loss ratio of 62.6% for the year ended December 31, 2015 as compared to 65.5% for the same period during 2014. The gross loss ratio before reinsurance was 61.6% for the year ended December 31, 2015 as compared to 65.7% for the same period in 2014. The lower gross and net loss ratio included \$2.1 million of favorable prior year loss reserve development for the year ended December 31, 2015 as compared to \$3.7 million of unfavorable prior year loss reserve development for the same period during 2014.

***Standard Commercial Segment.***

Gross premiums written for the Standard Commercial Segment were \$81.9 million for the year ended December 31, 2015, which was \$2.8 million, or 3%, less than the \$84.7 million reported for the same period in 2014. The decrease in gross premium was primarily due to lower premium production in our Workers Compensation operating unit due to a renewal rights agreement which ceded 100% of the unearned premium effective July 1, 2015. Net premiums written were \$71.1 million for the year ended December 31, 2015 as compared to \$76.9 million reported for the same period in 2014. The lower net premiums written were primarily due to the workers compensation renewal rights agreement.

Total revenue for the Standard Commercial Segment of \$76.9 million for the year ended December 31, 2015 was \$4.6 million less than the \$81.5 million reported during the year ended December 31, 2014. This 6% decrease in total revenue was mostly due to a \$5.7 million decrease in net premiums earned as a result of the workers compensation renewal rights agreement and lower net premiums earned in our Standard Commercial P&C operating unit, as well as lower net investment income of \$1.0 million, partially offset by a decreased adverse profit share commission revenue adjustment of \$1.5 million and a \$0.6 million gain on the sale of our workers compensation renewal rights.

Our Standard Commercial Segment reported pre-tax income of \$6.7 million for the year ended December 31, 2015 which was \$2.1 million higher than the \$4.6 million reported for the same period of 2014. Lower loss and LAE of \$4.1 million was the primary driver for the higher pre-tax income, as well as lower operating expenses of \$2.6 million, partially offset by the decreased revenue discussed above.

The net loss ratio for the year ended December 31, 2015 was 64.8% as compared to the 65.3% reported for the year ended December 31, 2014. The gross loss ratio before reinsurance was 63.4% for the year ended December 31, 2015 as compared to 71.7% for the prior year. The improvement in the gross and net loss ratios was driven primarily by lower net catastrophe losses. The gross and net loss ratios for the year ended December 31, 2015 included \$7.8 million of net catastrophe related losses compared to \$13.4 million of net catastrophe related losses for the same period the prior year. During the year ended December 31, 2015, the Standard Commercial Segment reported \$7.4 million of favorable loss development as compared to \$6.0 million reported for the same period of 2014.

### ***Personal Segment.***

Gross premiums written for the Personal Segment were \$81.3 million for the year ended December 31, 2015, which was \$17.3 million more than the \$64.0 million reported for the same period in 2014. Net premiums written for our Personal Segment were \$44.1 million for the year ended December 31, 2015, which was an increase of \$27.3 million, or 162%, from the \$16.8 million reported for the same period of 2014. The increase in the gross premiums written was due mostly to increased production in our ongoing core states. The increase in net premium written was due mostly to increased retained premium under a renewed quota share reinsurance agreement effective October 1, 2014.

Total revenue for the Personal Segment increased 123% to \$45.5 million for the year ended December 31, 2015 from \$20.4 million the prior year. Increased net premiums earned of \$24.7 million and higher finance charges of \$0.8 million were the primary reasons for the increase in revenue for the period, partially offset by decreased net investment income of \$0.4 million.



Our Personal Segment reported a pre-tax loss of \$0.9 million for the year ended December 31, 2015 as compared to pre-tax income of \$1.2 million for the same period of 2014. The pre-tax loss was the result of increased losses and LAE of \$25.5 million and increased operating expenses of \$1.7 million, partially offset by the increased revenue discussed above.

The Personal Segment reported a net loss ratio of 88.6% for the year ended December 31, 2015 as compared to 63.7% for 2014. The gross loss ratio before reinsurance was 80.8% for the year ended December 31, 2015 as compared to 70.1% for the same period in 2014. The higher gross and net loss ratios were primarily the result of unfavorable prior year net loss reserve development of \$2.6 million for the year ended December 31, 2015 as compared to favorable prior year net loss reserve development of \$2.9 million for the same period of 2014. The Personal Segment reported a net expense ratio of 19.0% for the year ended December 31, 2015 as compared to 43.3% for the same period of 2014. The decrease in the expense ratio was due predominately to the impact of the renewed quota share reinsurance agreement.

*Corporate.*

Total revenue for Corporate increased by \$6.5 million for the year ended December 31, 2015 as compared to the same period the prior year. This increase in total revenue was due primarily to higher net investment income of \$4.1 million as compared to the same period the prior year and higher net realized gains on our investment portfolio of \$2.4 million recognized during the year ended December 31, 2015 as compared to the same period of 2014.

Corporate pre-tax loss was \$14.2 million for the year ended December 31, 2015 as compared to a \$21.3 million pre-tax loss for the same period the prior year. The improvement in pre-tax loss was primarily due to the increased revenue discussed above and lower interest expense of \$0.7 million due to the lower floating interest rate effective June 15, 2015 on our Trust I subordinated debt securities. (See, "Liquidity and Capital Resources - Subordinated Debt Securities.") This improvement in pre-tax loss was partially offset by higher operating expenses of \$0.1 million primarily as a result of higher salary and related costs of \$0.5 million due primarily to increased incentive compensation accruals compared to the prior period, partially offset by lower professional service fees of \$0.3 million and lower other operating expenses of \$0.1 million.

## **Liquidity and Capital Resources**

### *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 December 31, 2016, Hallmark had \$9.0 million in unrestricted cash and cash equivalents. Unrestricted cash and cash equivalents of our non-insurance subsidiaries were \$6.1 million as of December 31, 2016. As of that date, our insurance subsidiaries held \$64.5 million of cash and cash equivalents as well as \$597.5 million in debt securities with an average modified duration of 3.0 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. 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. For all our insurance companies, dividends may only be paid from unassigned surplus funds. 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 years ended December 31, 2016 and 2015 our insurance company subsidiaries paid \$10.5 million and \$8.0 million, respectively, in dividends to Hallmark.

The state insurance departments also regulate financial transactions between our insurance subsidiaries and their affiliated companies. Applicable regulations require approval of management fees, expense sharing contracts and similar transactions. The net amount paid in management fees by our insurance subsidiaries to Hallmark and our non-insurance company subsidiaries was \$1.1 million, \$1.3 million and \$1.1 million during each of 2016, 2015 and 2014, respectively.

Statutory capital and surplus is calculated as statutory assets less statutory liabilities. The various state insurance departments that regulate our insurance company subsidiaries require us to maintain a minimum statutory capital and surplus. As of December 31, 2016, our insurance company subsidiaries reported statutory capital and surplus of \$248.4 million, substantially greater than the minimum requirements for each state. Each of our insurance company

subsidiaries is also required to satisfy certain risk-based capital requirements. (See, “Item 1. Business – Insurance Regulation – Risk-based Capital Requirements.”) As of December 31, 2016, the adjusted capital under the risk-based capital calculation of each of our insurance company subsidiaries substantially exceeded the minimum requirements. Our total statutory premium-to-surplus percentage for the years ended December 31, 2016 and 2015 was 146% and 144%, respectively.

***Comparison of December 31, 2016 to December 31, 2015***

On a consolidated basis, our cash and investments, excluding restricted cash and investments, at December 31, 2016 were \$733.8 million compared to \$693.3 million at December 31, 2015. The primary reasons for this increase in unrestricted cash and investments were cash flow from operations, unsettled investment trades and an increase in investment fair values, partially offset by increase in capital expenditures, the repurchase of our common stock and a contingent purchase price payment to the sellers of TBIC Holding.

***Comparison of Years Ended December 31, 2016 and December 31, 2015***

Net cash provided by our consolidated operating activities was \$30.9 million for the year ended December 31, 2016 compared to \$52.9 million for the year ended December 31, 2015. The decrease in operating cash flow was primarily due to increased paid losses including timing of reinsurance claim settlements, partially offset by increased net collected premium, lower taxes paid, lower net paid operating expenses and higher collected net investment income.

Cash used in investing activities during the year ended December 31, 2016 was \$58.2 million as compared to \$96.3 million for the prior year. The decrease in cash used by investing activities during the year ended December 31, 2016 was comprised of a decrease in purchases of debt and equity securities of \$24.1 million and an increase of \$16.9 million in maturities, sales and redemptions of investment securities, partially offset by an increase in purchases of property and equipment of \$0.7 million and a decrease in transfers from restricted cash of \$2.2 million

Cash used in financing activities during the year ended December 31, 2016 was \$7.4 million as a result of \$6.1 million related to the repurchase of our common stock and \$1.8 million payment of the settlement of contingent consideration to the sellers of TBIC, partially offset by \$0.5 million related to proceeds from the exercise of employee stock options. Cash provided by financing activities during the year ended December 31, 2015 was \$26.8 million as a result of \$29.9 million proceeds, net of debt issuance costs, from our Revolving Facility B during the fourth quarter of 2015 and \$0.6 million related to proceeds from the exercise of employee stock options, partially offset by \$2.5 million related to the repurchase of our common stock and \$1.2 million related to the contingent purchase price payment to the sellers of TBIC Holding.

### *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 December 31, 2016, 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 December 31, 2016, 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 December 31, 2016, 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 December 31, 2016, the principal balance of our Trust I subordinated debt was \$30.9 million and the interest rate was 4.21% 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 Hallmark Statutory Trust II (“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 December 31, 2016, the principal balance of our Trust II subordinated debt was \$25.8 million.

### *Long-Term Contractual Obligations*

Set forth below is a summary of long-term contractual obligations as of December 31, 2016. Amounts represent estimates of gross undiscounted amounts payable over time. In addition, certain unpaid losses and LAE are ceded to others under reinsurance contracts and are, therefore, recoverable. Such potential recoverables are not reflected in the table.

	Estimated Payments by Period (in thousands)				
	Total	2017	2018-2019	2020-2021	After 2022
Revolving credit facility payable	\$30,000	\$-	\$ 3,214	\$ 8,572	\$ 18,214
Interest on revolving credit facility payable	8,201	1,554	3,025	2,276	1,346
Subordinated debt securities (1)	56,702	-	-	-	56,702
Interest on subordinated debt securities	61,577	3,795	6,874	6,159	44,749
Unpaid losses and LAE (2)	481,567	183,473	161,174	61,398	75,522
Operating leases (3)	9,279	2,281	3,822	2,835	341
Purchase obligations	7,997	3,358	3,798	750	91

(1) The subordinated debt securities excludes unamortized debt issuance costs of \$1.0 million.

(2) The payout pattern for unpaid losses and LAE is based upon historical payment patterns and does not represent actual contractual obligations. The timing and amount ultimately paid will likely vary from these estimates.

(3) Minimum payments have not been reduced by minimum sublease rentals of \$0.5 million due in the future under noncancelable subleases.

Based on 2017 budgeted and year-to-date cash flow information, we believe that we have sufficient liquidity to meet our projected insurance obligations, operational expenses and capital expenditure requirements for the next 12 months.

### **Effects of Inflation**

We do not believe that inflation has a material effect on our results of operations, except for the effect that inflation may have on interest rates and claim costs. The effects of inflation are considered in pricing and estimating reserves for unpaid losses and LAE. The actual effects of inflation on results of operations are not known until claims are ultimately settled. In addition to general price inflation, we are exposed to the upward trend in the judicial awards for damages. We attempt to mitigate the effects of inflation in the pricing of policies and establishing reserves for losses and LAE.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

We believe that interest rate risk, credit risk and equity risk are the types of market risk to which we are principally exposed.

**Interest rate risk.** Our investment portfolio consists largely of investment-grade, fixed-income securities, all of which are classified as available-for-sale. Accordingly, the primary market risk exposure to these securities is interest rate risk. In general, the fair value of a portfolio of fixed-income securities increases or decreases inversely with changes in market interest rates, while net investment income realized from future investments in fixed-income securities increases or decreases along with interest rates. The fair value of our fixed-income securities as of December 31, 2016 was \$597.5 million. The effective duration of our portfolio as of December 31, 2016 was 3.0 years. Should interest rates increase 1.0%, our fixed-income investment portfolio would be expected to decline in market value by 3.0%, or \$17.8 million, representing the effective duration multiplied by the change in market interest rates. Conversely, a 1.0% decline in interest rates would be expected to result in a 3.0%, or \$17.8 million, increase in the fair value of our fixed-income investment portfolio.

**Credit risk.** An additional exposure to our fixed-income securities portfolio is credit risk. We attempt to manage the credit risk by investing primarily in investment-grade securities and limiting our exposure to a single issuer. As of December 31, 2016, our fixed-income investments were in the following: U.S. Treasury bonds – 7.0%; municipal bonds – 27.4%; collateralized corporate bank loans – 17.8%; corporate bonds – 37.8%; and mortgage-backed – 10.0%. As of December 31, 2016, 79% of our fixed-income securities were rated investment-grade by nationally recognized statistical rating organizations.

We are also subject to credit risk with respect to reinsurers to whom we have ceded underwriting risk. Although a reinsurer is liable for losses to the extent of the coverage it assumes, we remain obligated to our policyholders in the event that the reinsurers do not meet their obligations under the reinsurance agreements. In order to mitigate credit risk to reinsurance companies, most of our reinsurance recoverable balance as of December 31, 2016 was with reinsurers having an A.M. Best rating of “A-” or better.

**Equity price risk.** Investments in equity securities and our other investments that are subject to equity price risk made up 8.7% of our portfolio as of December 31, 2016. The carrying values of equity securities and our other investments are based on quoted market prices as of the balance sheet date. Market prices are subject to fluctuation and, consequently, the amount realized in the subsequent sale of an investment may significantly differ from the reported fair value. Fluctuation in the market price of a security may result from perceived changes in the underlying economic characteristics of the issuer, the relative price of alternative investments and general market conditions. Furthermore, amounts realized in the sale of a particular security may be affected by the relative quantity of the security being sold.



The fair value of our equity securities and other investments as of December 31, 2016 was \$56.7 million. The fair value of these securities would increase or decrease by \$17.0 million assuming a hypothetical 30% increase or decrease in market prices as of the balance sheet date. This would increase or decrease stockholders' equity by 4.2%. The selected hypothetical change does not reflect what should be considered the best or worst case scenario.

**Item 8. Financial Statements and Supplementary Data.**

The following consolidated financial statements of Hallmark and its subsidiaries are filed as part of this report.

Description	Page Number
Report of Independent Registered Public Accounting Firm	F-2
Consolidated Balance Sheets at December 31, 2016 and 2015	F-3
Consolidated Statements of Operations for the Years Ended December 31, 2016, 2015 and 2014	F-4
Consolidated Statements of Comprehensive Income (Loss) for the Years Ended December 31, 2016, 2015 and 2014	F-5
Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2016, 2015 and 2014	F-6
Consolidated Statements of Cash Flows for the Years Ended December 31, 2016, 2015 and 2014	F-7
Notes to Consolidated Financial Statements	F-8
Financial Statement Schedules	F-47

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

**Evaluation of Disclosure 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 three month period ended December 31, 2016, there were no changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Management's Report on Internal Control over Financial Reporting**

Management is responsible for establishing and maintaining adequate "internal control over financial reporting," as such phrase is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of management, including our Chief Executive Officer and Chief Accounting Officer, an evaluation of the effectiveness of our internal control over financial reporting was conducted based upon the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 Framework). Based upon that evaluation, management has concluded that our internal control over financial reporting was effective as of December 31, 2016.

Ernst & Young LLP, the independent registered public accounting firm that audited our consolidated financial statements as of December 31, 2016 included in this Annual Report on Form 10-K, has issued an attestation report on our internal control over financial reporting as of December 31, 2016. The Ernst & Young LLP attestation report, which expresses an unqualified opinion on the effectiveness of our internal control over financial reporting as of December 31, 2016, is included in this Item under the heading “ Report of Independent Registered Public Accounting Firm.”

## **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders of

Hallmark Financial Services, Inc. and subsidiaries

We have audited Hallmark Financial Services, Inc. and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 Framework) (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Hallmark Financial Services, Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Hallmark Financial Services, Inc. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity and cash flows for each of the three years in the period ended December 31, 2016 of Hallmark Financial Services, Inc. and subsidiaries and our report dated March 9, 2017 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Fort Worth, Texas  
March 9, 2017

**Item 9B. Other Information.**

None.

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance.**

The information required by Item 10 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

**Item 11. Executive Compensation.**

The information required by Item 11 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information required by Item 12 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information required by Item 13 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

**Item 14. Principal Accounting Fees and Services.**

The information required by Item 14 is incorporated by reference from the Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this report.

## PART IV

### Item 15. Exhibits, Financial Statement Schedules.

#### (a)(1) Financial Statements

The following consolidated financial statements, notes thereto and related information are included in Item 8 of this report:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets at December 31, 2016 and 2015

Consolidated Statements of Operations for the Years Ended December 31, 2016, 2015 and 2014

Consolidated Statements of Comprehensive Income (Loss) for the Years Ended December 31, 2016, 2015 and 2014

Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2016, 2015 and 2014

Consolidated Statements of Cash Flows for the Years Ended December 31, 2016, 2015 and 2014

Notes to Consolidated Financial Statements

#### (a)(2) Financial Statement Schedules

The following financial statement schedules are included in this report:

Schedule II – Condensed Financial Information of Registrant (Parent Company Only)

Schedule III – Supplemental Insurance Information

Schedule IV – Reinsurance

Schedule VI – Supplemental Information Concerning Property-Casualty Insurance Operations

#### (a)(3) Exhibit Index

The following exhibits are either filed with this report or incorporated by reference:

### Exhibit

### Description

### Number

- |     |  |
|-----|--|
| 3.1 | Restated Articles of Incorporation of the registrant (incorporated by reference to Exhibit 3.1 to Amendment No. 1 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006).                       |
| 3.2 | 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 October 1, 2007).  |
| 4.1 | Specimen certificate for common stock, \$0.18 par value, of the registrant (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the registrant's Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006). |



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4.2 Indenture dated June 21, 2005, between Hallmark Financial Services, Inc. and JPMorgan Chase Bank, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).

4.3 Amended and Restated Declaration of Trust of Hallmark Statutory Trust I dated as of June 21, 2005, among Hallmark Financial Services, Inc., as sponsor, Chase Bank USA, National Association, as Delaware trustee, and JPMorgan Chase Bank, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005).

4.4 Form of Junior Subordinated Debt Security Due 2035 (included in Exhibit 4.2 above).

4.5 Form of Capital Security Certificate (included in Exhibit 4.3 above).

4.6 Indenture dated as of August 23, 2007, between Hallmark Financial Services, Inc. and The Bank of New York Trust Company, National Association (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed August 24, 2007).

4.7 Amended and Restated Declaration of Trust of Hallmark Statutory Trust II dated as of August 23, 2007, among Hallmark Financial Services, Inc., as sponsor, The Bank of New York (Delaware), as Delaware trustee, and The Bank of New York Trust Company, National Association, as institutional trustee, and Mark Schwarz and Mark Morrison, as administrators (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed August 24, 2007).

4.8 Form of Junior Subordinated Debt Security Due 2037 (included in Exhibit 4.7 above).

4.9 Form of Capital Security Certificate (included in Exhibit 4.8 above).

4.10 Second Restated Credit Agreement among Hallmark Financial Services, Inc., American Hallmark Insurance Company of Texas, Hallmark Insurance Company and Frost Bank dated June 30, 2015 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed July 2, 2015).

4.11 First Amendment to Second Restated Credit Agreement among Hallmark Financial Services, Inc., American Hallmark Insurance Company of Texas, Hallmark Insurance Company and Frost Bank dated December 17, 2015 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed December 21, 2015).

4.12 Revolving Facility B Agreement between Hallmark Financial Services, Inc. and Frost Bank dated December 17, 2015 (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed December 21, 2015).

4.13 First Amendment to Revolving Facility B Agreement between Hallmark Financial Services, Inc. and Frost Bank dated November 1, 2016 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed November 2, 2016).

10.1 Office Lease for 6500 Pinecrest, Plano, Texas, dated July 22, 2008, between Hallmark Financial Services, Inc. and Legacy Tech IV Associates, Limited Partnership (incorporated by reference to Exhibit 99.1 to the registrant's Current Report on Form 8-K filed July 29, 2008).

10.2 Lease Agreement for 777 Main Street, Fort Worth, Texas, dated June 12, 2003 between Hallmark Financial Services, Inc. and Crescent Real Estate Funding I, L.P. (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2003).

10.3 Office Lease by and between SAOP Northwest Center, L.P. and Hallmark Specialty Underwriters, Inc. dated January 29, 2010 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed February 2, 2010).

10.4 First Amendment to Office Lease between MS Crescent One SPV, LLC and Hallmark Financial Services, Inc., dated February 28, 2011 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed March 1, 2011).

10.5 Assignment and Assumption of Lease Agreement and Bill of Sale between Equitymetrix, LLC and Hallmark Financial Services, Inc. dated March 1, 2016 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed March 2, 2016).

10.6 Lease between Musref 13727 Noel, L.P. and Equitymetrix, LLC dated March 25, 2009, as amended by First Amendment to Lease between Musref 13727 Noel, L.P. and Equitymetrix, LLC dated February 3, 2010, Second Amendment to Lease between Musref 13727 Noel, L.P. and Equitymetrix, LLC dated July 2, 2013, and Third Amendment to Lease between Musref 13727 Noel, L.P. and Equitymetrix, LLC dated February 25, 2014 (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed March 2, 2016).

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- Form of Indemnification Agreement between Hallmark Financial Services, Inc. and its officers and directors,  
10.7\* adopted July 19, 2002 (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2002).
- 10.8\* Hallmark Financial Services, Inc. Amended and Restated 2005 Long Term Incentive Plan (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 3, 2013).

- 10.9\* Form of Incentive Stock Option Grant Agreement (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed June 3, 2005).
- 10.10\* Form of Non-Qualified Stock Option Agreement (incorporated by reference to Exhibit 10.3 to the registrant's Current Report on Form 8-K filed June 3, 2005).
- 10.11\* Form of Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 10.13 to the registrant's Form 10-K for the year ended December 31, 2013).
- 10.12\* Hallmark Financial Services, Inc. 2015 Long Term Incentive Plan (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 2, 2015).
- 10.13\* Form of Incentive Stock Option Grant Agreement (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed June 2, 2015).
- 10.14\* Form of Non-Qualified Stock Option Agreement (incorporated by reference to Exhibit 10.3 to the registrant's Current Report on Form 8-K filed June 2, 2015).
- 10.15\* Form of Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 10.4 to the registrant's Form 8-K filed June 2, 2015).
- 10.16 Guarantee Agreement dated as of June 21, 2005, by Hallmark Financial Services, Inc. for the benefit of the holders of trust preferred securities (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed June 27, 2005).
- 10.17 Guarantee Agreement dated as of August 23, 2007, by Hallmark Financial Services, Inc. for the benefit of the holders of trust preferred securities (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed August 24, 2007).
- 10.18 Stock Purchase Agreement dated March 25, 2011, between American Hallmark Insurance Company of Texas and Robert C. Siddons, Stephen W. Gurasich, Andrew J. Reynolds, Paul W. Keller, Kerry A. Keller and Austin Engineering Co., Inc. (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K dated March 25, 2011).
- 10.19\* Letter agreement dated August 13, 2014, between Hallmark Financial Services, Inc. and Naveen Anand (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed August 15, 2014).
- 10.20 First Amendment to Lease Agreement between BRI 1849 Legacy, LLC and Hallmark Financial Services, Inc. dated January 1, 2015 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed January 21, 2015).
- 10.21\* Form of Confidentiality and Non-Solicitation Agreement dated May 29, 2015, between Hallmark Financial Services, Inc. and certain employees of the Company (incorporated by reference to Exhibit 10.23 to the registrant's Form 10-K for the year ended December 31, 2015).
- 21+ List of subsidiaries of the registrant.

23(a)+ Consent of Independent Registered Public Accounting Firm.

31(a)+ Certification of principal executive officer required by Rule 13a-14(a) or Rule 15d-14(b).

31(b)+ Certification of principal financial officer required by Rule 13a-14(a) or Rule 15d-14(b).

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.

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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.

\* Management contract or compensatory plan or arrangement.

+Filed herewith.

**Item 16. Form 10-K Summary.**

Not Applicable.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**HALLMARK FINANCIAL SERVICES, INC.**  
(Registrant)

Date: March 9, 2017 By: /s/ Naveen Anand  
Naveen Anand, Chief Executive Officer and  
President

Date: March 9, 2017 By: /s/ Jeffrey R. Passmore  
Jeffrey R. Passmore, Chief Accounting Officer and Senior  
Vice President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: March 9, 2017 /s/ Naveen Anand  
Naveen Anand, Chief Executive Officer and  
President (Principal Executive Officer)

Date: March 9, 2017 /s/ Jeffrey R. Passmore  
Jeffrey R. Passmore, Chief Accounting Officer and Senior  
Vice President (Principal Financial Officer and Principal  
Accounting Officer)

Date: March 9, 2017 /s/ Mark E. Schwarz  
Mark E. Schwarz, Executive Chairman

Date: March 9, 2017 /s/ James H. Graves  
James H. Graves, Director

Date: March 9, 2017 /s/ Mark E. Pape  
Mark E. Pape, Director

Date: March 9, 2017 /s/ Scott T. Berlin  
Scott T. Berlin, Director





**HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES**

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## **Report Of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders of

Hallmark Financial Services, Inc. and subsidiaries

We have audited the accompanying consolidated balance sheets of Hallmark Financial Services, Inc. and subsidiaries (the Company) as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income (loss), stockholders' equity and cash flows for each of the three years in the period ended December 31, 2016. Our audits also included the financial statement schedules listed in Item 15(a)(2). These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Hallmark Financial Services, Inc. and subsidiaries at December 31, 2016 and 2015, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We also have audited in accordance with the standards of the Public Company Accounting Oversight Board (United States), Hallmark Financial Services, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 Framework) and our report dated March 9, 2017 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Fort Worth, Texas

March 9, 2017

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**HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****December 31, 2016 and 2015****(\$ in thousands)**

	2016	2015
<b>ASSETS</b>		
Investments:		
Debt securities, available-for-sale, at fair value (cost; \$597,784 in 2016 and \$538,629 in 2015)	\$597,457	\$531,325
Equity securities, available-for-sale, at fair value (cost; \$31,449 in 2016 and \$24,524 in 2015)	51,711	47,050
Other investments (cost; \$3,763 in 2016 and \$427 in 2015)	4,951	454
Total investments	654,119	578,829
Cash and cash equivalents	79,632	114,446
Restricted cash	7,327	8,522
Ceded unearned premiums	81,482	65,094
Premiums receivable	89,715	83,376
Accounts receivable	2,269	2,005
Receivable for securities	3,047	10,424
Reinsurance recoverable	147,821	114,287
Deferred policy acquisition costs	19,193	20,366
Goodwill	44,695	44,695
Intangible assets, net	12,491	14,959
Deferred federal income taxes, net	1,365	3,360
Federal income tax recoverable	3,951	1,779
Prepaid expenses	1,552	3,213
Other assets	13,801	10,192
Total assets	\$1,162,460	\$1,075,547
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities:		
Revolving credit facility payable	\$30,000	\$30,000
Subordinated debt securities (less unamortized debt issuance cost of \$1,001 in 2016 and \$1,053 in 2015)	55,701	55,649
Reserves for unpaid losses and loss adjustment expenses	481,567	450,878
Unearned premiums	241,254	216,407
Reinsurance balances payable	46,488	33,741
Pension liability	2,203	2,496
Payable for securities	14,215	1,097
Accounts payable and other accrued expenses	25,296	23,253
Total liabilities	896,724	813,521

Commitments and contingencies (Note 16)

Stockholders' equity:

Common stock, \$.18 par value, authorized 33,333,333 shares; issued 20,872,831 shares in 2016 and 2015	3,757	3,757
Additional paid-in capital	123,166	123,480
Retained earnings	148,027	141,501
Accumulated other comprehensive income	10,371	7,418
Treasury stock (2,260,849 shares in 2016 and 1,775,512 in 2015), at cost	(19,585 )	(14,130 )
Total stockholders' equity	265,736	262,026
Total liabilities and stockholders' equity	\$1,162,460	\$1,075,547

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

**HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****For the years ended December 31, 2016, 2015 and 2014****(\$ in thousands, except per share amounts)**

	2016	2015	2014
Gross premiums written	\$549,077	\$514,223	\$473,218
Ceded premiums written	(187,248)	(157,279)	(148,866)
Net premiums written	361,829	356,944	324,352
Change in unearned premiums	(8,459 )	(7,863 )	(3,135 )
Net premiums earned	353,370	349,081	321,217
Investment income, net of expenses	16,342	13,969	12,383
Net realized (losses) gains	(369 )	2,503	134
Finance charges	4,977	5,952	5,279
Commission and fees	1,427	213	(1,694 )
Other income	205	684	47
Total revenues	375,952	372,402	337,366
Losses and loss adjustment expenses	253,688	230,149	210,055
Operating expenses	106,769	103,993	101,427
Interest expense	4,549	3,906	4,576
Amortization of intangible assets	2,468	2,468	2,526
Total expenses	367,474	340,516	318,584
Income before tax	8,478	31,886	18,782
Income tax expense	1,952	10,023	5,353
Net income	\$6,526	\$21,863	\$13,429
Net income per share:			
Basic	\$0.35	\$1.14	\$0.70
Diluted	\$0.34	\$1.13	\$0.69

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

**HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)****For the years ended December 31, 2016, 2015 and 2014****(\$ In thousands)**

	<b>2016</b>	<b>2015</b>	<b>2014</b>
Net income	\$6,526	\$21,863	\$13,429
Other comprehensive income (loss):			
Change in net actuarial (loss) gain	(145 )	43	(1,723 )
Tax effect on change in net actuarial (loss) gain	51	(15 )	603
Unrealized holding gains (losses) arising during the period	6,019	(10,191)	3,543
Tax effect on unrealized holding gains (losses) arising during the period	(2,107)	3,567	(1,240 )
Reclassification adjustment for gains included in net income	(1,331)	(5,826 )	(408 )
Tax effect on reclassification adjustment for gains included in net income	466	2,039	143
Other comprehensive income (loss), net of tax	2,953	(10,383)	918
Comprehensive income	\$9,479	\$11,480	\$14,347

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

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the years ended December 31, 2016, 2015 and 2014

(\$ In thousands)

	Number of Shares	Par Value	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Number of Shares	Total Stockholders' Equity
Balance at January 1, 2014	20,873	\$ 3,757	\$ 122,827	\$ 106,209	\$ 16,883	\$(11,558)	1,609	\$ 238,118
Acquisition of treasury stock	-	-	-	-	-	(1,805)	181	(1,805)
Equity incentive plan activity	-	-	222	-	-	-	-	222
Stock options exercised	-	-	145	-	-	1,010	(135)	1,155
Net income	-	-	-	13,429	-	-	-	13,429
Other comprehensive income, net of tax	-	-	-	-	918	-	-	918
Balance at December 31, 2014	20,873	\$ 3,757	\$ 123,194	\$ 119,638	\$ 17,801	\$(12,353)	1,655	\$ 252,037
Acquisition of treasury stock	-	-	-	-	-	(2,532)	221	(2,532)
Equity incentive plan activity	-	-	383	-	-	-	-	383
Shares issued under employee benefit plans	-	-	(97)	-	-	755	(100)	658
Net income	-	-	-	21,863	-	-	-	21,863
Other comprehensive loss, net of tax	-	-	-	-	(10,383)	-	-	(10,383)
Balance at December 31, 2015	20,873	\$ 3,757	\$ 123,480	\$ 141,501	\$ 7,418	\$(14,130)	1,776	\$ 262,026
Acquisition of treasury stock	-	-	-	-	-	(6,117)	562	(6,117)
	-	-	(118)	-	-	-	-	(118)



Equity incentive plan activity								
Shares issued under employee benefit plans	-	-	(196 )	-	-	662	(77 )	466
Net income	-	-	-	6,526	-	-	-	6,526
Other comprehensive income, net of tax	-	-	-	-	2,953	-	-	2,953
Balance at December 31, 2016	20,873	\$ 3,757	\$ 123,166	\$ 148,027	\$ 10,371	\$(19,585)	2,261	\$ 265,736

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

**HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the years ended December 31, 2016, 2015 and 2014****(\$ in thousands)**

	2016	2015	2014
Cash flows from operating activities:			
Net income	\$6,526	\$21,863	\$13,429
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization expense	3,894	3,516	3,224
Deferred federal income taxes	405	(1,030 )	(393 )
Net realized losses (gains)	369	(2,503 )	(134 )
Share-based payments expense	(118 )	383	222
Change in ceded unearned premiums	(16,388 )	(11,718 )	(8,388 )
Change in premiums receivable	(6,339 )	(12,373 )	154
Change in accounts receivable	(264 )	1,136	(759 )
Change in deferred policy acquisition costs	1,173	380	1,840
Change in unpaid losses and loss adjustment expenses	30,689	35,743	32,495
Change in unearned premiums	24,847	19,581	11,523
Change in reinsurance recoverable	(33,534 )	(4,568 )	(32,901 )
Change in reinsurance balances payable	12,747	7,338	5,805
Change in current federal income tax (recoverable)/payable	(2,172 )	(2,747 )	249
Change in all other liabilities	3,586	(1,368 )	7,998
Change in all other assets	5,433	(697 )	(680 )
Net cash provided by operating activities	30,854	52,936	33,684
Cash flows from investing activities:			
Purchases of property and equipment, net	(4,340 )	(3,608 )	(546 )
Net transfers from restricted cash	1,195	3,392	276
Purchases of investment securities	(241,374)	(265,482)	(188,749)
Maturities, sales and redemptions of investment securities	186,286	169,409	146,777
Net cash used in investing activities	(58,233 )	(96,289 )	(42,242 )
Cash flows from financing activities:			
Activity under revolving credit facility, net	-	30,000	(1,473 )
Payment of debt issuance costs	-	(96 )	-
Payment of contingent consideration	(1,784 )	(1,216 )	-
Proceeds from exercise of employee stock options	466	658	1,155
Purchase of treasury shares	(6,117 )	(2,532 )	(1,805 )
Net cash (used in) provided by financing activities	(7,435 )	26,814	(2,123 )
Decrease in cash and cash equivalents	(34,814 )	(16,539 )	(10,681 )
Cash and cash equivalents at beginning of year	114,446	130,985	141,666
Cash and cash equivalents at end of year	\$79,632	\$114,446	\$130,985

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Supplemental cash flow information:

Interest paid	\$4,287	\$3,906	\$4,576
Income taxes paid	\$3,718	\$13,800	\$5,497
Supplemental schedule of non-cash activities:			
Change in receivable for securities related to investment disposals that settled after the balance sheet date	\$7,377	\$(9,492)	) \$388
Change in payable for securities related to investment purchases that settled after the balance sheet date	\$13,118	\$(224)	) \$1,115

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

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HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

**1. Accounting Policies:**

**General**

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, the “Company”, “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 market, distribute, underwrite and service our property/casualty insurance products 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 handles primarily commercial insurance products and services and is comprised of Hallmark Specialty Underwriters, Inc. (“HSU”), Pan American Acceptance Corporation (“PAAC”) and TGA Special Risk, Inc. (“TGASRI”). Our Specialty Commercial operating unit offers (i) general aviation insurance products and services, (ii) low and middle market commercial umbrella and excess liability insurance, (iii) medical professional liability insurance products and services, (iv) satellite launch insurance products, and (v) primary/excess commercial property coverages for both catastrophe and non-catastrophe exposures. Our Specialty Commercial operating unit is comprised of Aerospace Insurance Managers, Inc. (“Aerospace Insurance Managers”), Aerospace Special Risk, Inc. (“ASRI”), Aerospace Claims Management Group, Inc. (“ACMG”), Heath XS, LLC (“HXS”) and Hardscrabble Data Solutions, LLC (“HDS”). Our Standard Commercial P&C operating unit handles commercial insurance products and services and is comprised of American Hallmark Insurance Services, Inc. (“American Hallmark Insurance Services”) and Effective Claims Management, Inc. (“ECM”). Our Workers Compensation operating unit specializes in small and middle market workers compensation business and is comprised of TBIC Holding Corporation, Inc. (“TBIC Holding”), Texas Builders Insurance Company (“TBIC”) and TBIC Risk Management (“TBICRM”). 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 handles personal insurance products and services and is comprised of American Hallmark General Agency, Inc. (“AHGA”) and Hallmark Claims Services, Inc. (“HCS”). Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Insurance Company (“HIC”), Hallmark Specialty Insurance Company (“HSIC”), Hallmark County Mutual Insurance Company (“HCM”), Hallmark National Insurance Company (“HNIC”) and TBIC.

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.

#### Basis of Presentation

The accompanying consolidated financial statements include the accounts and operations of Hallmark and its subsidiaries. Intercompany accounts and transactions have been eliminated. The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) which, as to our insurance company subsidiaries, differ from statutory accounting practices prescribed or permitted for insurance companies by insurance regulatory authorities.

#### Reclassifications

Certain prior year amounts have been reclassified to conform with current year presentation.

#### Use of Estimates in the Preparation of Financial Statements

Our preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect our reported amounts of assets and liabilities at the dates of the financial statements and our reported amounts of revenues and expenses during the reporting periods. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors, including the current economic environment, which management believes to be reasonable under the circumstances. We adjust such estimates and assumptions when facts and circumstances dictate. Since future events and their effects cannot be determined with precision, actual results could differ significantly from these estimates. Changes in estimates resulting from continuing changes in the economic environment may be reflected in the financial statements in future periods.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

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:** Our revolving credit facility with Frost Bank had a carried value of \$30.0 million and a fair value of \$30.2 million as of December 31, 2016. 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 3.3% to 4.5% 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 are reported at carry value of \$55.7 million and \$55.6 million, and had a fair value of \$44.2 million and \$44.2 million, as of December 31, 2016 and 2015, respectively. The fair value of our trust preferred securities is based on discounted cash flows using current yields to maturity of 8.0% and 8.0% as of December 31, 2016 and 2015, respectively, which are based on similar issues to discount future cash flows and 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.

### Investments

Debt and equity securities available for sale are reported at fair value. Unrealized gains and losses are recorded as a component of stockholders' equity, net of related tax effects. Equity securities that are determined to have other-than-temporary impairment are recognized as a loss on investments in the consolidated statements of operations. Debt securities that are determined to have other-than-temporary impairment are recognized as a loss on investments in the consolidated statements of operations for the portion that is related to credit deterioration with the remaining portion recognized in other comprehensive income. Debt security premiums and discounts are amortized into earnings using the effective interest method. Maturities of debt securities and sales of equity securities are recorded in receivable for securities until the cash is settled. Purchases of debt and equity securities are recorded in payable for securities until the cash is settled.

Other investments consists of an equity warrant which is reported at fair value. Unrealized gains and losses are reported in the statement of operations as a component of net realized gains (losses).

Realized investment gains and losses are recognized in operations on the specific identification method.

### Cash and Cash Equivalents

We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents.

### Restricted Cash

We collect premiums from customers and, after deducting authorized commissions, remit these premiums to the Company's consolidated insurance subsidiaries. Unremitted insurance premiums are held in a fiduciary capacity until disbursed to the Company's consolidated insurance subsidiaries.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

Premiums Receivable

Premiums receivable represent amounts due from policyholders or independent agents for premiums written and uncollected. These balances are carried at net realizable value.

Reinsurance

We are routinely involved in reinsurance transactions with other companies. Reinsurance premiums, losses and loss adjustment expenses ("LAE") are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. (See Note 7.)

Deferred Policy Acquisition Costs

Policy acquisition costs (mainly commission, underwriting and marketing expenses) that are directly related to the successful acquisition of new and renewal insurance contracts are deferred and charged to operations over periods in which the related premiums are earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. In determining estimated realizable value, the computation gives effect to the premium to be earned, expected investment income, losses and LAE and certain other costs expected to be incurred as the premiums are earned. If the computation results in an estimated net realizable value less than zero, a liability will be accrued for the premium deficiency. During 2016, 2015 and 2014, we deferred \$37.9 million, \$32.3 million and \$39.1 million of policy acquisition costs and amortized \$39.1 million, \$32.7 million and \$40.9 million of deferred policy acquisition costs, respectively. Therefore, the net (amortization) deferrals of policy acquisition costs were (\$1.2) million, (\$0.4) million and (\$1.8) million for 2016, 2015 and 2014, respectively.

Business Combinations



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

#### Goodwill and Intangible Assets, net

We account for our goodwill and intangible assets according to ASC 350, “Intangibles – Goodwill and Other.” Under ASC 350, Intangible assets with a finite life are amortized over the estimated useful life of the asset. Goodwill and intangible assets with an indefinite useful life are not amortized. Goodwill and intangible assets are tested for impairment on an annual basis or more frequently if events or changes in circumstances indicate that the carrying amount may not be recoverable. For goodwill, we may perform a qualitative test to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the quantitative goodwill impairment test. The first step of the quantitative test is to identify if a potential impairment exists by comparing the fair value of a reporting unit with its carrying amount, including goodwill (“Step 1”). If the fair value of a reporting unit exceeds its carrying value amount, goodwill of the reporting unit is not considered to have a potential impairment and the second step is not necessary. However, if the carrying amount of the reporting unit exceeds its fair value, the second step (“Step 2”) is performed to determine if goodwill is impaired and to measure the amount of impairment loss to recognize, if any. Step 2 compares the implied fair value of goodwill with the carrying amount of goodwill. If the implied value of goodwill is less than the carrying amount of goodwill, it is written down to its fair value with a corresponding expense reflected in the Consolidated Statements of Income. The implied goodwill is calculated based on a hypothetical purchase price allocation, similar to the requirements in the accounting guidance for business combinations, whereby the implied fair value of the reporting unit is allocated to the fair value of the assets and liabilities of the reporting unit. We have elected to perform our goodwill impairment test on the first day of the fourth quarter, October 1, of each year.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

Leases

We have several leases, primarily for office facilities and computer equipment, which expire in various years through 2022. Some of these leases include rent escalation provisions throughout the term of the lease. We expense the average annual cost of the lease with the difference to the actual rent invoices recorded as deferred rent which is classified in accounts payable and other accrued expenses on our consolidated balance sheets.

Property and Equipment

Property and equipment (including leasehold improvements), aggregating \$22.2 million and \$17.9 million, at December 31, 2016 and 2015, respectively, which is included in other assets, is recorded at cost and is depreciated using the straight-line method over the estimated useful lives of the assets (three to ten years). Depreciation expense for 2016, 2015 and 2014 was \$1.4 million, \$1.0 million and \$0.7 million, respectively. Accumulated depreciation was \$15.1 million and \$13.7 million at December 31, 2016 and 2015, respectively.

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 we do not have variable interests in the Trusts. Therefore, the Trusts are not consolidated in our consolidated financial statements.

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

#### Losses and Loss Adjustment Expenses

Losses and LAE represent the estimated ultimate net cost of all reported and unreported losses incurred through December 31, 2016 and 2015. The reserves for unpaid losses and LAE are estimated using individual case-basis valuations and statistical analyses. These estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, we believe that the reserves for unpaid losses and LAE are adequate. The estimates are continually reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations.

#### Recognition of Premium Revenues

Insurance premiums are earned pro rata over the terms of the policies. Insurance policy fees are earned as of the effective date of the policy. Upon cancellation, any unearned premium is refunded to the insured. Insurance premiums written include gross policy fees of \$9.8 million, \$11.2 million and \$11.5 million for the years ended December 31, 2016, 2015, and 2014, respectively. Insurance premiums on monthly reporting workers’ compensation policies are earned on the conclusion of the monthly coverage period. Deposit premiums for workers’ compensation policies are earned upon the expiration of the policy.

#### Finance Charges

We receive premium installment fees for each direct bill payment from policyholders. Installment fee income is classified as finance charges on the consolidated statement of operations and is recognized as the fee is invoiced.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014Relationship with Third Party Insurers

Through December 31, 2005, our Standard Commercial P&C operating unit marketed policies on behalf of Clarendon National Insurance Company (“Clarendon”), a third-party insurer. Through December 31, 2008, all business of our MGA Commercial Products operating unit was produced under a fronting agreement with member companies of the Republic Group (“Republic”), a third-party insurer. These insurance contracts on third party paper are accounted for under agency accounting. Ceding commissions and other fees received under these arrangements were classified as unearned commission revenue until earned pro rata over the terms of the policies.

Profit sharing commission is calculated and recognized when the loss ratio, as determined by a qualified actuary, deviates from contractual targets. We received a provisional commission as policies were produced as an advance against the later determination of the profit sharing commission actually earned. The profit sharing commission is an estimate that varies with the estimated loss ratio and is sensitive to changes in that estimate. Profit share commission is classified as commissions and fees on the consolidated statement of operations.

The following table details the profit sharing commission provisional loss ratio compared to the estimated ultimate loss ratio for each effective quota share treaty between the Standard Commercial P&C operating unit and Clarendon.

	Treaty Effective Dates				
	7/1/2001	7/1/2002	7/1/2003	7/1/2004	7/1/2005
Provisional loss ratio	60.0%	59.0 %	59.0 %	64.2 %	64.2 %
Estimated ultimate loss ratio recorded at December 31, 2016	63.5%	64.5 %	61.2 %	66.1 %	61.0 %

As of December 31, 2016, we had a payable of \$0.6 million on these profit share treaties. The payable or receivable is the difference between the cash received to date and the recognized commission revenue based on the estimated ultimate loss ratio.

The following table details the profit sharing commission revenue provisional loss ratio compared to the estimated ultimate loss ratio for the effective quota share treaty between the MGA Commercial Products operating unit and Republic.

	Treaty Effective Dates			
	1/1/2006	1/1/2007	1/1/2008	
Provisional loss ratio	65.0%	65.0 %	65.0 %	
Estimated ultimate loss ratio recorded at December 31, 2016	59.1 %	65.0 %	60.6 %	

As of December 31, 2016, we had a net payable of \$1.1 million on these profit share treaties. The payable or receivable is the difference between the cash received to date and the recognized commission revenue based on the estimated ultimate loss ratio.

#### Agent Commissions

We pay monthly commissions to agents based on written premium produced, but generally recognize the expense pro rata over the term of the policy. If the policy is cancelled prior to its expiration, the unearned portion of the agent commission is refundable to us. The unearned portion of commissions paid to agents is included in deferred policy acquisition costs. We annually pay a profit sharing commission to our independent agency force based upon the results of the business produced by each agent. We estimate and accrue this liability to commission expense in the year the business is produced.

Commission expense is classified as operating expenses in the consolidated statements of operations.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

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.

Earnings Per Share

The computation of earnings per share is based upon the weighted average number of common shares outstanding during the period plus the effect of common shares potentially issuable (in periods in which they have a dilutive effect), primarily from stock options. (See Notes 11 and 13.)

Adoption of New Accounting Pronouncements

In February 2015, the FASB issued ASU 2015-02, "Amendments to the Consolidation Analysis" (Topic 810). ASU 2015-02 changes the analysis that a reporting entity must perform to determine whether entities should be consolidated if they are deemed variable interest entities. It is effective for annual reporting periods, and interim periods within those years, beginning after December 15, 2015. We have adopted this standard as of the effective date, and the adoption did not impact our financial statements.

In April 2015, the FASB issued ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs," which amends the guidance in Accounting Standards Codification Topic 835-30 "Interest-Imputation of Interest." ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. For public business entities,

the guidance was effective for annual and interim periods beginning after December 15, 2015. We adopted this guidance effective January 1, 2016 and adjusted our prior period balances to reflect the adoption of this guidance.

In May 2015, the FASB issued guidance which requires additional disclosures about short-duration contracts for products in effect for typically a year or less. The disclosures will focus on the liability for unpaid losses and loss adjustment expenses. This guidance is effective for annual periods beginning after December 15, 2015 and interim periods within annual periods beginning after December 15, 2016. We have adopted this standard as of the effective date, and the adoption had no impact on our financial statements other than to provide for additional footnote disclosures.

#### Recently Issued Accounting Pronouncements

In May 2014, the FASB issued guidance which revises the criteria for revenue recognition. Insurance contracts are excluded from the scope of the new guidance. 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.

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 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.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

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.

**2. Investments:**

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
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

As of December 31, 2015



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U.S. Treasury securities and obligations of U.S. Government	\$ 76,323	\$ 7	\$ (61 )	\$ 76,269
Corporate bonds	122,894	637	(1,822 )	121,709
Collateralized corporate bank loans	83,434	44	(1,882 )	81,596
Municipal bonds	196,446	1,888	(5,966 )	192,368
Mortgage-backed	59,532	155	(304 )	59,383
Total debt securities	538,629	2,731	(10,035 )	531,325
Total equity securities	24,524	23,364	(838 )	47,050
Total other investments	427	27	-	454
Total investments	\$ 563,580	\$ 26,122	\$ (10,873 )	\$ 578,829

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

Major categories of net investment income are summarized as follows (in thousands):

	Twelve Months Ended December 31		
	2016	2015	2014
U.S. Treasury securities and obligations of U.S. Government	\$594	\$670	\$395
Corporate bonds	5,573	1,435	1,378
Collateralized corporate bank loans	3,190	4,727	4,400
Municipal bonds	5,442	5,901	5,232
Mortgage-backed	1,320	1,288	995
Equity securities	638	673	509
Other investments	-	-	-
Cash and cash equivalents	277	148	230
	17,034	14,842	13,139
Investment expenses	(692 )	(873 )	(756 )
Investment income, net of expenses	\$16,342	\$13,969	\$12,383

No investments in any entity or its affiliates exceeded 10% of stockholders' equity at December 31, 2016 or 2015.

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

	Twelve Months Ended December 31		
	2016	2015	2014
U.S. Treasury securities and obligations of U.S. Government	\$-	\$-	\$-
Corporate bonds	(264 )	-	263
Collateralized corporate bank loans	(86 )	126	109
Municipal bonds	(189 )	(83 )	(140)
Mortgage-backed	(1 )	240	32
Equity securities	1,871	5,543	144

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Gain on investments	1,331	5,826	408
Unrealized gain on other investments	1,188	-	-
Other-than-temporary impairments	(2,888)	(3,323)	(274)
Net realized (losses) gains	\$(369 )	\$2,503	\$134

We realized gross gains on investments of \$2.1 million, \$6.7 million, and \$0.6 million during the years ended December 31, 2016, 2015 and 2014, respectively. We realized gross losses on investments of \$0.8 million, \$0.9 million and \$0.2 million during the years ended December 31, 2016, 2015 and 2014, respectively. We recorded proceeds from the sale of investment securities of \$28.5 million, \$51.7 million and \$15.3 million during the years ended December 31, 2016, 2015 and 2014, respectively. Realized investment gains and losses are recognized in operations on the specific identification method.

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

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 December 31, 2016 and December 31, 2015 (in thousands):

	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 )

	As of December 31, 2015					
	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	\$41,428	\$ (61 )	\$ -	\$ -	\$41,428	\$ (61 )
Corporate bonds	96,475	(1,822 )	-	-	96,475	(1,822 )
Collateralized corporate bank loans	65,868	(1,758 )	3,532	(124 )	69,400	(1,882 )
Municipal bonds	44,525	(488 )	25,310	(5,478 )	69,835	(5,966 )
Mortgage-backed	36,251	(302 )	48	(2 )	36,299	(304 )
Total debt securities	284,547	(4,431 )	28,890	(5,604 )	313,437	(10,035 )

Total equity securities	6,584	(838 )	-	-	6,584	(838 )
Total other investments	-	-	-	-	-	-
Total investments	\$291,131	\$ (5,269 )	\$28,890	\$ (5,604 )	\$320,021	\$ (10,873 )

At December 31, 2016, the gross unrealized losses more than twelve months old were attributable to 28 debt security positions and one equity position. At December 31, 2015, the gross unrealized losses more than twelve months old were attributable to 39 debt security positions. We consider these losses as a temporary decline in value as they are predominately on securities 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.

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

We complete a detailed analysis each quarter to assess whether any decline in the fair value of any investment below cost is deemed other-than-temporary. All securities with an unrealized loss are reviewed. We recognize an impairment loss when an investment's value declines below cost, adjusted for accretion, amortization and previous other-than-temporary impairments and it is determined that the decline is other-than-temporary. We recognized other-than-temporary losses on our debt securities portfolio of \$2.9 million during 2016. Of the \$2.9 million other-than-temporary impairments recorded for fiscal 2016, \$2.6 million relate to credit losses on certain senior and subordinated municipal bonds. We utilized the most recent restructuring offer for each of the senior and subordinated bonds to estimate the credit loss portion of the other-than-temporary impairments.

**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 invested assets portfolio as of December 31, 2016 and 2015 were as follows:

	2016	2015
Investment Type		
Equity warrant	\$4,951	\$454
Total other investments	\$4,951	\$454

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

The amortized cost and estimated fair value of debt securities at December 31, 2016 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.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

	Amortized Cost	Fair Value
	(in thousands)	
Due in one year or less	\$97,836	\$ 97,849
Due after one year through five years	272,190	272,168
Due after five years through ten years	114,461	115,248
Due after ten years	53,524	52,723
Mortgage-backed	59,773	59,469
	\$597,784	\$ 597,457

We have certain of our securities pledged 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 \$21.1 million at December 31, 2016 and a carrying value of \$17.6 million at December 31, 2015.



HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

**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 and the equity warrant classified as Other Investments.

Level 2 investment securities include corporate bonds, collateralized corporate bank loans, municipal bonds, U.S. Treasury securities, other obligations of the U.S. Government and mortgage-backed 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. We have not adjusted any prices received from third party pricing services. There were no transfers between Level 1 and Level 2 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.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

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 December 31, 2016 and December 31, 2015 (in thousands).

	As of December 31, 2016			
	Quoted Prices in			
	Active Markets for	Observable	Unobservable	Total
	Identical Assets	(Level 2)	Inputs (Level 3)	
	(Level 1)			
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
	As of December 31, 2015			
	Quoted Prices in			
	Active Markets for	Observable	Unobservable	Total
	Identical Assets	(Level 2)	Inputs (Level 3)	
	(Level 1)			
U.S. Treasury securities and obligations of U.S. Government	\$-	\$ 76,269	\$ -	\$76,269
Corporate bonds	-	121,709	-	121,709
Collateralized corporate bank loans	-	81,596	-	81,596
Municipal bonds	-	178,281	14,087	192,368
Mortgage-backed	-	59,383	-	59,383
Total debt securities	-	517,238	14,087	531,325

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Total equity securities	47,050	-	-	47,050
Total other investments	454	-	-	454
Total investments	\$47,504	\$ 517,238	\$ 14,087	\$578,829

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

Due to significant unobservable inputs into the valuation model for certain municipal bonds in illiquid markets, we classified these 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. Significant changes in the unobservable inputs in the fair value measurement of these municipal bonds 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 year ended December 31, 2016 and 2015 (in thousands).

	2016	2015
Beginning balance as of January 1	\$14,087	\$14,598
Sales	-	(370 )
Settlements	(8,825 )	-
Purchases	-	-
Issuances	-	-
Total realized/unrealized gains included in net income	417	-
Net losses included in other comprehensive income	-	(141 )
Transfers into Level 3	266	-
Transfers out of Level 3	-	-
Ending balance as of December 31	\$5,945	\$14,087

**4. Acquisitions, Goodwill and Intangible Assets:**

On June 30, 2015, Redpoint Comp Holdings LLC (“Purchaser”) acquired exclusive renewal rights to our current in-force Texas workers compensation policies, together with certain physical assets associated with the administration of such in-force policies. In consideration for such renewal rights and physical assets, Purchaser assumed certain office lease obligations and offered employment to certain of our employees associated with the Workers Compensation operating unit. Purchaser also agreed to administer the run-off of all of our current workers compensation policies and claims for a period of three years. In connection with the transaction, we made a one-time payment to the Purchaser of \$83,000. We also agreed not to compete in the workers compensation line of insurance in

the State of Texas (with certain exceptions) until after the assumed office lease obligations expire on October 31, 2017. We recorded a gain of \$0.2 million during the second quarter of 2015 in Other Income in the Consolidated Statement of Operations on the sale of the renewal rights.

On September 15, 2015, we executed Amendment No. 1 to the sale agreement with the Purchaser. Pursuant to the Amendment, the Purchaser has agreed to pay us an additional \$115,000 and administer the run-off of all of our workers compensation policies and claims in perpetuity or through final conclusion (rather than for three years as contemplated by the original agreement) in consideration of us assigning to Purchaser the commission on all unearned premiums on such policies as of July 1, 2015. We recorded an additional gain of \$0.4 million during the third quarter of 2015 in Other Income in the Consolidated Statement of Operations as a result of this Amendment No.1.

Goodwill is tested for impairment at the reporting unit level (operating unit or one level below an operating unit) on an annual basis (October 1) and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value. For purposes of evaluating goodwill for impairment, we have determined that our reporting units are the same as our operating units except for the Specialty Commercial operating unit for which reporting units are at the component level (“one level below”). Our consolidated balance sheet as of December 31, 2016 includes goodwill of acquired businesses of \$44.7 million that is assigned to our operating units as follows: Standard Commercial P&C operating unit - \$2.1 million; MGA Commercial Products operating unit - \$19.8 million; Specialty Commercial operating unit- \$17.4 million (comprised of \$7.7 million for the primary/excess & umbrella component and \$9.7 million for the general aviation and satellite component); and Specialty Personal Lines operating unit - \$5.4 million. This amount has been recorded as a result of prior business acquisitions accounted for under the acquisition method of accounting. Under ASC 350, “Intangibles-Goodwill and Other,” goodwill is tested for impairment annually. We completed our last annual test for impairment on the first day of the fourth quarter of 2016 and determined that there was no impairment.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

The income approach to determining fair value computed the projections of the cash flows that the reporting unit was expected to generate converted into a present value equivalent through discounting. Significant assumptions in the income approach model included income projections, discount rates and terminal growth values. The income projections reflected an improved premium rate environment across most of our lines of business that continued throughout 2016. The income projections also included loss and LAE assumptions which reflected recent historical claim trends and the movement towards a more favorable pricing environment. The income projections also included assumptions for expense growth and investment yields which were based on business plans for each of our operating units. The discount rate was based on a risk free rate plus a beta adjusted equity risk premium and specific company risk premium. The assumptions were based on historical experience, expectations of future performance, expected market conditions and other factors requiring judgment and estimates. While we believe the assumptions used in these models were reasonable, the inherent uncertainty in predicting future performance and market conditions may change over time and influence the outcome of future testing.

During 2016, 2015, and 2014, we completed the first step prescribed by ASC 350 for testing for impairment and determined that there was no impairment.

We have obtained various intangible assets from several acquisitions since 2002. The table below details the gross and net carrying amounts of these assets by major category (in thousands):

	December 31	
	2016	2015
Gross Carrying Amount:		
Customer/agent relationships	\$32,177	\$32,177
Tradename	3,440	3,440
Management agreement	3,232	3,232
Non-compete & employment agreements	4,235	4,235
Insurance licenses	1,300	1,300
Total gross carrying amount	44,384	44,384
Accumulated Amortization:		
Customer/agent relationships	(22,038)	(19,799)
Tradename	(2,388 )	(2,159 )
Management agreement	(3,232 )	(3,232 )

Non-compete & employment agreements	(4,235 )	(4,235 )
Total accumulated amortization	(31,893)	(29,425)
Total net carrying amount	\$12,491	\$14,959

Insurance licenses are not amortized because they have an indefinite life. We amortize definite-lived intangible assets straight line over their respective lives. The estimated aggregate amortization expense for definite-lived intangible assets for the next five years is as follows (in thousands):

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HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

2017 \$2,468  
2018 \$2,468  
2019 \$2,468  
2020 \$2,468  
2021 \$503

The weighted average amortization period for definite-lived intangible assets by major class is as follows:

	Years
Tradename	15
Customer/ agent relationships	15
Management agreement	4
Non-compete agreements	5

The aggregate weighted average period to amortize these assets is approximately 13 years.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014**5. Other Assets:**

The following table details our other assets as of December 31, 2016 and 2015 (in thousands):

	2016	2015
Profit sharing commission receivable	\$251	\$228
Credit Facility B issuance costs	109	92
Accrued investment income	4,599	3,876
Investment in unconsolidated trust subsidiaries	1,702	1,702
Fixed assets	6,947	4,120
Other assets	193	174
	\$13,801	\$10,192

**6. Reserves for Losses and Loss Adjustment Expenses:**

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

	2016	2015	2014
Balance at January 1	\$450,878	\$415,135	\$382,640
Less reinsurance recoverable	102,791	91,943	70,172
Net balance at January 1	348,087	323,192	312,468
Incurred related to:			
Current year	246,080	237,102	215,258
Prior years	7,608	(6,953 )	(5,203 )
Total incurred	253,688	230,149	210,055
Paid related to:			
Current year	93,067	83,132	76,231
Prior years	150,378	122,122	123,100
Total paid	243,445	205,254	199,331

Net balance at December 31	358,330	348,087	323,192
Plus reinsurance recoverable	123,237	102,791	91,943
Balance at December 31	\$481,567	\$450,878	\$415,135

The \$7.6 million unfavorable net development, \$7.0 million favorable net development and \$5.2 million favorable net development in prior accident years recognized in 2016, 2015 and 2014, respectively, represent normal changes in our loss reserve estimates. In 2016, the aggregate loss reserve estimates for prior years were increased to reflect unfavorable loss development when the available information indicated a reasonable likelihood that the ultimate losses would be more than the previous estimates. In 2015 and 2014, the aggregate loss reserve estimates for prior years were decreased to reflect favorable loss development when the available information indicated a reasonable likelihood that the ultimate losses would be less than the previous estimates. Generally, changes in reserves are caused by variations between actual experience and previous expectations and by reduced emphasis on the Bornhuetter-Ferguson method due to the aging of the accident years.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

The \$7.6 million increase in prior period reserves for unpaid losses and LAE recognized in 2016 was attributable to \$5.3 million favorable net development on claims incurred in the 2015 accident year, \$3.9 million unfavorable net development on claims incurred in the 2014 accident year and \$9.0 million unfavorable net development on claims incurred in the 2013 and prior accident years. Our MGA Commercial Products operating unit, Specialty Personal Lines operating unit and Specialty Commercial operating unit accounted for \$11.3 million, \$5.0 million, and \$1.2 million, respectively, of the increase in prior period reserves recognized during 2016. The increase in reserves for our MGA Commercial operating unit was primarily related to our commercial auto liability line of business. The increase in reserves for our Specialty Personal Lines operating unit was primarily attributable to the 2015, 2014 and 2013 and prior accident years. The increase in reserves for our Specialty Commercial operating unit was primarily related to \$0.9 million unfavorable development in our medical professional liability products and \$0.7 million related to our commercial auto liability specialty program, partially offset by \$0.3 million favorable development in our general aviation line of business and \$0.1 million favorable development in our commercial excess liability line of business. These unfavorable developments were partially offset by favorable development of \$6.6 million in our Standard Commercial P&C operating unit and \$3.3 in our Workers Compensation operating unit. The decrease in reserves for our Standard Commercial P&C operating unit was primarily related to our general liability lines of business. The decrease in prior period reserves for our Workers Compensation operating unit was attributable to the 2015, 2014, 2013 and prior accident years.

***Short-Duration Contract Disclosures***

ASU 2015-09, "Disclosures about Short-Duration Contracts" (Topic 944), requires insurers to make disclosures about their liability for unpaid claims and claim adjustment expenses for short-duration insurance contracts. These disclosures include tables showing incurred and paid claims development information (net of reinsurance and excluding unallocated loss adjustment expenses) which are disaggregated based on the characteristics of the insurance contracts that the insurer writes and other factors specific to the reporting entity. The information should be disclosed by accident year for the number of years claims typically remain outstanding, but need not be more than 10 years, including a reconciliation of the disaggregated information to the consolidated statement of financial position. The basis for our disaggregation of this information is by each of our three reportable segments. See Note 10, "Segment Information," for additional information regarding our three reportable segments.

***Reserves for Incurred But Not Reported ("IBNR") Claims***

Reserves for IBNR claims are based on the estimated ultimate cost of settling claims, including the effects of inflation and other social and economic factors, using past experience adjusted for current trends and any other factors that would modify past experience. We use a variety of statistical and actuarial techniques to analyze current claims costs, including frequency and severity data and prevailing economic, social and legal factors. Each such method has its own set of assumptions and outputs, and each has strengths and weaknesses in different areas. Since no single estimation method is superior to another method in all situations, the methods and assumptions used to project loss reserves will vary by coverage and product. We use what we believe to be the most appropriate set of actuarial methods and assumptions for each product line grouping and coverage. While the loss projection methods may vary by product line and coverage, the general approach for calculating IBNR remains the same: ultimate losses are forecasted first, and that amount is reduced by the amount of cumulative paid claims and case reserves. Reserves established in prior years are adjusted as loss experience develops and new information becomes available. Adjustments to previously estimated reserves are reflected in the results of operations in the year in which they are made.

As described above, various actuarial methods are utilized to determine the reserves for losses and LAE recorded in our Consolidated Balance Sheets. Weightings of methods at a detailed level may change from evaluation to evaluation based on a number of observations, measures, and time elements. There were no significant changes to the methods and assumptions underlying our consolidated reserve estimations and selections as of December 31, 2016.

#### ***Methodology for Determining Cumulative Number of Reported Claims***

A claim file is created when the Company is notified of an actual demand for payment, notified of an event that may lead to a demand for payment or when it is determined that a demand for payment could possibly lead to a future demand for payment on another coverage on the same policy or on another policy. The cumulative number of reported claims is predominately measured at a coverage level by occurrence, with the exception of our Specialty Commercial operating unit which is predominately measured at the claim level. Reported occurrences that do not result in a liability are included in reported claims. The Company does not generate claim counts for ceded business.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014***Incurred & Paid Claims Development Disclosures***

The following tables provide information about incurred and cumulative paid losses and allocated loss adjustment expenses ("ALAE"), net of reinsurance for our three reportable segments, our Specialty Commercial Segment, our Standard Commercial Segment and our Personal Segment. The incurred and paid losses by accident year information presented for all segments in the below tables for calendar years prior to 2016 is required supplementary information and is unaudited. The following tables also include IBNR reserves plus expected development on reported claims and the cumulative number of reported claims as of December 31, 2016 (\$ in thousands):

**Specialty Commercial Segment**

## Incurred Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance

Accident Year	For the Years Ended December 31,										As of
	Unaudited										IBNR
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2016
2007	\$51,458	\$52,141	\$51,813	\$52,673	\$50,158	\$49,654	\$49,096	\$49,056	\$49,290	\$49,544	\$68
2008		55,617	56,150	58,143	57,923	56,579	55,157	55,425	55,457	55,864	(102)
2009			60,950	62,679	61,196	59,471	59,831	59,635	59,988	61,361	87
2010				74,187	78,089	75,695	77,593	78,003	77,972	77,631	1,22
2011					88,679	87,558	91,059	90,713	89,737	87,793	1,64
2012						106,371	111,253	111,841	115,709	116,320	2,02
2013							140,546	135,114	137,230	143,983	2,12
2014								144,996	133,464	138,842	6,54
2015									147,304	146,610	23,4
2016										151,494	52,2
									Total	\$1,029,442	

## Cumulative Paid Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance

Accident Year	For the Years Ended December 31,									
	Unaudited									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
2007	\$18,851	\$33,504	\$41,344	\$44,861	\$47,453	\$48,612	\$48,612	\$48,783	\$48,860	\$49,025
2008		24,134	37,803	44,903	51,280	53,723	53,577	54,080	54,909	55,372
2009			21,259	34,411	45,757	53,135	56,791	57,641	59,149	60,785
2010				24,818	45,234	58,139	68,625	73,398	74,513	75,787
2011					27,454	53,509	71,697	80,004	83,787	84,936
2012						37,655	60,923	82,066	97,680	109,060
2013							40,475	76,366	101,725	126,025
2014								42,097	73,631	99,521
2015									39,515	74,906
2016										41,397
<b>Total</b>										\$776,814
<b>All outstanding liabilities before 2007, net of reinsurance</b>										(26 )
<b>Liabilities for claims and claim adjustment expenses, net of reinsurance</b>										\$252,602

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014**Standard Commercial Segment**

## Incurred Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance

Accident Year	For the Years Ended December 31,										As of Decem	
	Unaudited										IBNR	Cu
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2016	Nu
2007	\$48,423	\$45,280	\$42,632	\$42,898	\$41,814	\$39,476	\$37,894	\$36,798	\$37,321	\$36,419	\$576	3,
2008		49,452	47,557	46,762	45,556	42,758	41,597	40,387	40,001	39,195	1,826	3,
2009			44,719	45,674	46,772	46,778	45,970	44,159	43,851	43,107	2,102	2,
2010				45,263	45,235	44,847	43,164	43,459	42,426	42,175	2,252	2,
2011					60,236	56,489	55,156	49,268	47,266	47,423	3,387	4,
2012						51,998	52,554	48,222	45,990	44,272	5,144	3,
2013							55,482	57,528	56,703	53,174	6,379	3,
2014								55,488	55,808	53,568	8,979	3,
2015									49,571	49,857	11,946	3,
2016										46,880	16,885	2,
									Total	\$456,070		

## Cumulative Paid Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance

Accident Year	For the Years Ended December 31,									
	Unaudited									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
2007	\$13,883	\$20,362	\$25,484	\$28,908	\$31,311	\$32,288	\$32,949	\$33,561	\$33,982	\$34,483
2008		17,182	25,624	29,058	32,523	34,056	34,762	35,360	36,276	36,859
2009			15,242	28,313	32,075	35,818	38,316	40,389	40,575	40,629
2010				21,302	28,342	30,957	33,428	37,166	39,115	39,706
2011					24,899	35,119	38,909	40,301	41,140	42,441
2012						23,445	32,203	34,789	37,191	38,526
2013							23,123	36,411	41,809	44,475



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2014	24,255	37,122	41,514
2015		19,085	34,245
2016			21,508
Total			\$374,386
All outstanding liabilities before 2007, net of reinsurance			538
Liabilities for claims and claim adjustment expenses, net of reinsurance			\$82,222

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014**Personal Segment**

## Incurred Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance

Accident Year	For the Years Ended December 31,										IBNR	As of Decem Cur Num Rep Clas
	Unaudited											
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2016	201
2007	\$28,774	\$31,603	\$31,252	\$31,485	\$31,651	\$31,931	\$32,272	\$32,517	\$32,528	\$32,528	\$-	15
2008		36,247	36,976	38,329	39,412	39,793	40,170	40,239	40,324	40,369	-	17
2009			40,436	42,092	46,244	47,977	48,930	49,694	49,772	49,891	-	21
2010				63,862	78,294	80,765	84,724	83,903	84,252	84,591	6	30
2011					75,746	77,652	87,810	86,757	86,804	86,948	(28 )	31
2012						58,604	73,795	70,552	71,513	72,042	50	23
2013							55,706	59,132	60,100	60,211	234	23
2014								5,452	5,340	6,243	406	19
2015									23,104	25,682	1,813	23
2016										32,260	6,638	21
									Total	\$490,765		

## Cumulative Paid Claims and Allocated Claim Adjustment Expenses, Net of Reinsurance

Accident Year	For the Years Ended December 31,									
	Unaudited									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
2007	\$18,106	\$27,757	\$30,043	\$30,975	\$31,355	\$31,523	\$32,056	\$31,213	\$32,531	\$32,530
2008		20,005	32,555	36,782	38,925	39,511	40,210	40,309	40,323	40,347
2009			23,306	37,621	44,689	47,967	49,287	49,539	49,704	49,853
2010				38,643	67,755	75,199	82,624	83,511	84,111	84,556
2011					46,416	67,939	83,497	85,533	86,217	86,593
2012						37,860	64,278	68,849	70,807	71,995
2013							45,901	54,514	58,047	59,775

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2014	2,515	4,418	5,631
2015		11,570	22,281
2016			21,669
Total			\$475,230

All outstanding liabilities before 2007, net of reinsurance

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Liabilities for claims and claim adjustment expenses, net of reinsurance

\$15,544

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

The reconciliation of the net incurred and paid development tables to the liability for unpaid losses and LAE in our Consolidated Balance Sheets is as follows (in thousands):

	2016
Net outstanding liabilities for losses and LAE	
Specialty Commercial Segment	\$252,602
Standard Commercial Segment	82,222
Personal Segment	15,544
Liabilities for unpaid losses and allocated loss adjustment expenses, net of reinsurance	350,368
Reinsurance recoverable on unpaid losses and LAE	
Specialty Commercial Segment	102,597
Standard Commercial Segment	8,540
Personal Segment	12,100
Total reinsurance recoverable on unpaid losses and LAE	123,237
Unallocated loss adjustment expenses	
Specialty Commercial Segment	3,831
Standard Commercial Segment	3,031
Personal Segment	1,100
Total unallocated loss adjustment expenses	7,962
Total reserves for unpaid losses and loss adjustment expenses	\$481,567

***Claims Duration***

The following table provides supplementary unaudited information about the annual percentage payout of incurred losses and ALAE, net of reinsurance, as of December 31, 2016:

Average Annual Percentage Payout of Incurred Claims by Age, Net of Reinsurance (1)

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	Unaudited									
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Specialty Commercial Segment	32.4 %	24.8 %	17.4 %	12.0 %	6.0 %	1.2 %	1.2 %	1.5 %	0.5 %	-0.3 %
Standard Commercial Segment	44.6 %	23.0 %	8.7 %	6.6 %	5.0 %	3.3 %	1.3 %	1.4 %	1.3 %	-1.4 %
Personal Segment	51.5 %	29.2 %	10.9 %	4.3 %	1.4 %	0.8 %	0.7 %	-0.7 %	1.9 %	0.0 %

(1) The average annual percentage payout is calculated from a paid losses and ALAE development pattern based on an actuarial analysis of the paid losses and ALAE movements by accident year for each disaggregation category. The paid losses and ALAE development pattern provides the expected percentage of ultimate losses and ALAE to be paid in each year. The pattern considers all accident years included in the claims development tables.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014**7. 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 December 31, 2016 was with reinsurers that had an A.M. Best rating of “A-” or better. We also mitigate our credit risk for the remaining reinsurance recoverable by obtaining letters of credit.

The following table presents our gross and net premiums written and earned and reinsurance recoveries for each of the last three years (in thousands):

	2016	2015	2014
Premium Written :			
Direct	\$549,077	\$514,223	\$473,233
Assumed	-	-	(15 )
Ceded	(187,248)	(157,279)	(148,866)
	\$361,829	\$356,944	\$324,352
Premium Earned:			
Direct	\$524,229	\$494,643	\$461,367
Assumed	-	-	327
Ceded	(170,859)	(145,562)	(140,477)
	\$353,370	\$349,081	\$321,217
Reinsurance recoveries	\$116,057	\$89,892	\$99,911

Included in reinsurance recoverable on the consolidated balance sheets are paid loss recoverables of \$24.4 million and \$11.1 million as of December 31, 2016 and 2015, respectively.

**8. Revolving Credit Facility and Notes Payable:**

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 December 31, 2016, 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.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

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 December 31, 2016 and 2015, respectively, 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 December 31, 2016, we were in compliance with all of these covenants.

**9. 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 December 31, 2016, the principal balance of our Trust I subordinated debt was \$30.9 million and the interest rate was 4.21% 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 December 31, 2016, the principal balance of our Trust II subordinated debt was \$25.8 million.

#### **10. Segment Information:**

We pursue our business activities primarily through subsidiaries whose operations are organized into producing units and are supported by our insurance carrier subsidiaries. Our non-carrier insurance activities are organized 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 professional liability and primary/excess commercial property insurance products and services handled by our Specialty Commercial operating unit. Certain specialty programs are also managed by our Specialty Commercial operating unit. Our MGA Commercial Products operating unit is comprised of our HSU, PAAC and TGASRI subsidiaries. Our Specialty Commercial operating unit is comprised of our Aerospace Insurance Managers, ASRI, ACMG, HXS and HDS subsidiaries.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

**Standard Commercial Segment.** The 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. Effective June 1, 2016, we no longer market new or renewal occupational accident policies. Effective July 1, 2015, the Workers Compensation operating unit no longer retains any risk on new or renewal policies. Our Standard Commercial P&C operating unit is comprised of our American Hallmark Insurance Services and ECM subsidiaries. Our Workers Compensation operating unit is comprised of our TBIC Holdings, TBIC and TBICRM subsidiaries.

**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. During the fourth quarter of 2014, our Specialty Personal Lines operating unit discontinued the low value dwelling/homeowners and manufactured homes insurance products it previously offered. Our Specialty Personal Lines operating unit is comprised of AHGA and HCS.

The retained premium produced by these reportable segments is supported by our AHIC, HSIC, HIC, HNIC and TBIC insurance company subsidiaries. In addition, control and management of 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 net premiums written by any of them, HIC retains 32% of the net premiums written by any of them, HSIC retains 24% of the net premiums written by any of them and HNIC retains 10% of the net premiums written by any of them. Neither HCM nor TBIC is a party to the intercompany pooling arrangement.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

The following is additional business segment information for the twelve months ended December 31, 2016, 2015 and 2014 (in thousands):

	2016	2015	2014
Revenues			
Specialty Commercial Segment	\$255,897	\$249,910	\$241,920
Standard Commercial Segment	71,966	76,864	81,464
Personal Segment	49,826	45,538	20,404
Corporate	(1,737 )	90	(6,422 )
Consolidated	\$375,952	\$372,402	\$337,366
Depreciation and Amortization Expense			
Specialty Commercial Segment	\$2,579	\$2,537	\$2,503
Standard Commercial Segment	101	136	183
Personal Segment	1,070	779	515
Corporate	144	64	23
Consolidated	\$3,894	\$3,516	\$3,224
Interest Expense			
Specialty Commercial Segment	\$-	\$-	\$-
Standard Commercial Segment	-	-	-
Personal Segment	-	-	-
Corporate	4,549	3,906	4,576
Consolidated	\$4,549	\$3,906	\$4,576
Tax Expense (Benefit)			
Specialty Commercial Segment	\$7,886	\$11,609	\$9,690
Standard Commercial Segment	3,011	1,436	622
Personal Segment	(3,821 )	(1,345 )	(574 )
Corporate	(5,124 )	(1,677 )	(4,385 )
Consolidated	\$1,952	\$10,023	\$5,353

Pre-tax Income (Loss)			
Specialty Commercial Segment	\$24,417	\$40,277	\$34,237
Standard Commercial Segment	8,866	6,687	4,595
Personal Segment	(6,839 )	(885 )	1,226
Corporate	(17,966 )	(14,193 )	(21,276 )
Consolidated	\$8,478	\$31,886	\$18,782

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

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

	December 31	
	2016	2015
Assets		
Specialty Commercial Segment	\$734,763	\$660,263
Standard Commercial Segment	164,295	156,722
Personal Segment	241,686	239,632
Corporate	21,716	18,930
Consolidated	\$1,162,460	\$1,075,547

**11. Earnings Per Share:**

We have adopted the provisions of ASC 260, "Earnings Per Share," requiring presentation of both basic and diluted earnings per share. A reconciliation of the numerators and denominators of the basic and diluted per share calculations is presented below (in thousands, except per share amounts):

	2016	2015	2014
Numerator for both basic and diluted earnings per share:			
Net income	\$6,526	\$21,863	\$13,429
Denominator, basic shares	18,780	19,211	19,197
Effect of dilutive securities:			
Stock-based compensation awards	161	194	169
Denominator, diluted shares	18,941	19,405	19,366
Basic earnings per share:	\$0.35	\$1.14	\$0.70
Diluted earnings per share:	\$0.34	\$1.13	\$0.69

We had 272,500 shares, 267,500 shares and 544,999 shares of common stock potentially issuable upon exercise of employee stock options for years ended December 31, 2016, 2015 and 2014, respectively, that were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive. These instruments expire at varying times from 2017 to 2021.

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HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

**12. Regulatory Capital Restrictions:**

Hallmark, as a holding company, is dependent on dividend payments and management fees from its subsidiaries to fund its operating expenses, debt obligations and capital needs, including the ability to pay dividends to its stockholders. Hallmark has never paid dividends on its common stock. Hallmark intends to continue this policy for the foreseeable future in order to retain earnings for development of its business. There are no regulatory or contractual restrictions on the ability of Hallmark to pay dividends other than customary default provisions and the impact of any dividend payment on financial ratio covenants in certain credit agreements. However, there are restrictions on the ability of Hallmark's insurance carrier subsidiaries to transfer funds to the holding company. The amount of retained earnings that is unrestricted for the payment of dividends by Hallmark to its shareholders was \$68.4 million as of December 31, 2016.

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. 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. For all our insurance companies, dividends may only be paid from unassigned surplus funds. 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 years ended December 31, 2016 and 2015 our insurance company subsidiaries paid \$10.5 million and \$8.0 million, respectively, in dividends to Hallmark. The total restricted net assets of our insurance company subsidiaries as of December 31, 2016, was \$197.3 million.

The state insurance departments also regulate financial transactions between our insurance subsidiaries and their affiliated companies. Applicable regulations require approval of management fees, expense sharing contracts and similar transactions. The net amount paid in management fees by our insurance subsidiaries to Hallmark and our non-insurance company subsidiaries was \$1.1 million, \$1.3 million and \$1.1 million during each of 2016, 2015 and 2014, respectively.

Statutory capital and surplus is calculated as statutory assets less statutory liabilities. The various state insurance departments that regulate our insurance company subsidiaries require us to maintain a minimum statutory capital and surplus. As of December 31, 2016 and 2015, our insurance company subsidiaries reported statutory capital and surplus of \$248.4 million and \$247.2 million, respectively, substantially greater than the minimum requirements for each state. For the years ended December 31, 2016, 2015, 2014, respectively, our insurance company subsidiaries reported statutory net income of \$8.7 million, \$24.6 million and \$22.3 million, respectively.

The National Association of Insurance Commissioners requires property/casualty insurers to file a risk-based capital calculation according to a specified formula. The purpose of the formula is twofold: (1) to assess the adequacy of an insurer's statutory capital and surplus based upon a variety of factors such as potential risks related to investment portfolio, ceded reinsurance and product mix; and (2) to assist state regulators under the RBC for Insurers Model Act by providing thresholds at which a state commissioner is authorized and expected to take regulatory action. As of December 31, 2016, the adjusted capital under the risk-based capital calculation of each of our insurance company subsidiaries substantially exceeded the minimum requirements.



HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

**13. 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 December 31, 2016, there were outstanding incentive stock options to purchase 335,074 shares of our common stock, non-qualified stock options to purchase 289,157 shares of our common stock and restricted stock units representing the right to receive up to 151,901 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 December 31, 2016, 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 December 31, 2016.

**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 December 31, 2016 and changes during the year then ended is presented below:

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	Number of Shares	Weighted Average Exercise Price	Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (\$000)
Outstanding at January 1, 2016	869,113	\$ 9.51		
Granted	-			
Exercised	(70,000)	) \$ 6.66		
Forfeited or expired	(174,882)	) \$ 11.96		
Outstanding at December 31, 2016	624,231	\$ 9.14	1.7	\$ 1,714
Exercisable at December 31, 2016	624,231	\$ 9.14	1.7	\$ 1,714

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):

	2016	2015	2014
Intrinsic value of options exercised	\$250	\$393	\$412
Cost of share-based payments (non-cash)	\$38	\$157	\$173
Income tax benefit of share-based payments recognized in income	\$8	\$30	\$30

As of December 31, 2016, 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.

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of Hallmark's and similar companies' common stock for a period equal to the expected term. The risk-free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options' expected lives on the dates of grant. Expected term is determined based on the simplified method as we do not have sufficient historical exercise data to provide a basis for estimating the expected term. There were no stock options granted in 2016, 2015 or 2014.

**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 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, 2015, 8,616 shares of common stock were issued with respect to 8,616 restricted stock units which were granted on July 27, 2012 and vested on March 31, 2015. 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, the restricted stock units granted on September 8, 2014 (except for one grant) will vest on March 31, 2017, 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 2012 and 2013 is \$9.20 per unit. 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 (benefit) expense of (\$156) thousand, \$226 thousand and \$49 thousand related to restricted stock units during the year ended December 31, 2016, 2015 and 2014, respectively. We recorded income tax (expense) benefit of (\$55) thousand, \$79 thousand and \$17 thousand related to restricted stock units during the year ended December 31, 2016, 2015 and 2014, respectively.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

A summary of the status of our restricted stock units as of December 31, 2016 and changes during the year then ended is presented below:

	Number of Restricted Stock Units	
Nonvested at January 1, 2016	296,571	
Granted	122,770	
Vested	(7,144	)
Forfeited	(115,623	)
Nonvested at December 31, 2016	296,574	

As of December 31, 2016, there was \$141 thousand of total unrecognized compensation cost related to unvested restricted stock units granted under our 2005 LTIP and 2015 LTIP, of which \$80 thousand is expected to be recognized in 2017, \$50 thousand is expected to be recognized in 2018 and \$11 thousand is expected to be recognized in 2019.

**14. Retirement Plans:**

Certain employees of the Standard Commercial Segment were participants in a defined cash balance plan covering all full-time employees who had completed at least 1,000 hours of service. This plan was frozen in March 2001 in anticipation of distribution of plan assets to members upon plan termination. All participants were vested when the plan was frozen.

The following tables provide detail of the changes in benefit obligations, components of benefit costs, weighted-average assumptions, and plan assets for the retirement plan as of and for the twelve months ending December 31, 2016, 2015 and 2014 (in thousands) using a measurement date of December 31.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

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	2016	2015	2014
Assumptions (end of period):			
Discount rate used in determining benefit obligation	3.88 %	4.12 %	3.86 %
Rate of compensation increase	N/A	N/A	N/A
Reconciliation of funded status (end of period):			
Accumulated benefit obligation	\$(12,618)	\$(12,915)	\$(13,909)
Projected benefit obligation	\$(12,618)	\$(12,915)	\$(13,909)
Fair value of plan assets	10,415	10,419	11,290
Funded status	\$(2,203 )	\$(2,496 )	\$(2,619 )
Net actuarial loss	(4,102 )	(3,957 )	(4,000 )
Accumulated other comprehensive loss	(4,102 )	(3,957 )	(4,000 )
Prepaid pension cost	1,899	1,461	1,381
Net amount recognized as of December 31	\$(2,203 )	\$(2,496 )	\$(2,619 )
Changes in projected benefit obligation:			
Benefit obligation as of beginning of period	\$12,915	\$13,909	\$12,284
Interest cost	512	518	532
Actuarial liability loss/(gain)	19	(646 )	1,947
Benefits paid	(828 )	(866 )	(854 )
Benefit obligation as of end of period	\$12,618	\$12,915	\$13,909
Change in plan assets:			
Fair value of plan assets as of beginning of period	\$10,419	\$11,290	\$10,851
Actual return on plan assets (net of expenses)	415	(5 )	760
Employer contributions	409	-	533
Benefits paid	(828 )	(866 )	(854 )
Fair value of plan assets as of end of period	\$10,415	\$10,419	\$11,290
Net periodic pension cost:			
Service cost - benefits earned during the period	\$-	\$-	\$-
Interest cost on projected benefit obligation	512	518	532
Expected return on plan assets	(653 )	(701 )	(698 )
Recognized actuarial loss	112	103	162

Net periodic pension cost	\$	(29	)	\$	(80	)	\$	(4	)
Discount rate	4.12	%	3.86	%	4.49	%			
Expected return on plan assets	6.50	%	6.50	%	6.50	%			
Rate of compensation increase	N/A		N/A		N/A				

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HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

Estimated future benefit payments by fiscal year (in thousands):

2017	\$884
2018	\$883
2019	\$875
2020	\$862
2021	\$863
2022-2026	\$4,071

As of December 31, 2016, the fair value of the plan assets was composed of cash and cash equivalents of \$0.3 million, debt securities of \$3.4 million and equity securities of \$6.7 million.

Our investment objectives are to preserve capital and to achieve long-term growth through a favorable rate of return equal to or greater than 5% over the long-term (60 year) average inflation rate as measured by the consumer price index. The objective of the equity portion of the portfolio is to achieve a return in excess of the Standard & Poor's 500 index. The objective of the fixed income portion of the portfolio is to add stability, consistency, safety and total return to the total fund portfolio.

We prohibit investments in options, futures, precious metals, short sales and purchase on margin. We also restrict the investment in fixed income securities to "A" rated or better by Moody's or Standard & Poor's rating services and restrict investments in common stocks to only those that are listed and actively traded on one or more of the major United States stock exchanges, including NASDAQ. We manage to an asset allocation of 45% to 75% in equity securities. An investment in any single stock issue is restricted to 5% of the total portfolio value and 90% of the securities held in mutual or commingled funds must meet the criteria for common stocks.

To develop the expected long-term rate of return on assets assumption, we consider the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. This resulted in the selection of the 6.5% long-term rate of return on assets assumption. The expected return on plan assets uses the fair market value as of December 31, 2016. To develop the discount rate used in determining the benefit obligation we used the BPS&M AA Pension Discount Curve at the measurement date to match the timing and



amounts of projected future benefits. A corridor approach is used to amortize actuarial gains and losses. We are applying the 10% threshold set forth in ASC 715. In addition, since all accrued benefits under the plan are frozen, we are amortizing the unrecognized gains and losses outside of the corridor by the average life expectancy of the plan participants.

We expect that we will not be required to make a contribution to the defined benefit cash balance plan during 2017. We expect our 2017 periodic pension cost to be \$(63) thousand, the components of which are interest cost of \$444 thousand, expected return on plan assets of (\$649) thousand and amortization of actuarial loss of \$142 thousand.

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

The following table shows the weighted-average asset allocation for the defined benefit cash balance plan held as of December 31, 2016 and 2015.

Asset Category:	December	
	2016	2015
Debt securities	33 %	33 %
Equity securities	64 %	64 %
Other	3 %	3 %
Total	100 %	100 %

We determine the fair value of our financial instruments based on the fair value hierarchy established in ASC 820. (See Note 3.)

The following table presents, for each of the fair value hierarchy levels, our plan assets that are measured at fair value on a recurring basis at December 31, 2016 and December 31, 2015 (in thousands).

	As of December 31, 2016			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	
Debt securities	\$-	\$ 3,438	\$ -	\$3,438
Equity securities	6,653	-	-	6,653
Total	\$6,653	\$ 3,438	\$ -	\$10,091

	As of December 31, 2015			Total
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	
Debt securities	\$-	\$ 3,423	\$ -	\$3,423

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Equity securities	6,697	-	-	6,697
Total	\$6,697	\$ 3,423	\$ -	\$10,120

Our plan assets also include cash and cash equivalents of \$0.3 million and \$0.3 million at December 31, 2016 and 2015, respectively, and are carried at cost which approximates fair value.

We sponsor a defined contribution plan. Under this plan, employees may contribute a portion of their compensation on a tax-deferred basis, and we may contribute a discretionary amount each year. We contributed \$0.4 million, \$0.3 million and \$0.3 million for the years ended December 31, 2016, 2015 and 2014, respectively

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014**15. Income Taxes:**

The composition of deferred tax assets and liabilities and the related tax effects as of December 31, 2016 and 2015, are as follows (in thousands):

	2016	2015
Deferred tax liabilities:		
Deferred policy acquisition costs	\$(6,717 )	\$(7,128 )
Net unrealized holding gain on investments	(7,395 )	(5,339 )
Agency relationship	(56 )	(66 )
Intangible assets	(4,623 )	(5,118 )
Goodwill	(559 )	(519 )
Fixed assets	(1,106 )	(861 )
Other	(435 )	(367 )
Total deferred tax liabilities	(20,891)	(19,398)
Deferred tax assets:		
Unearned premiums	11,184	10,592
Amortization of non-compete agreements	238	298
Pension liability	1,436	1,385
Net operating loss carry-forward	319	426
Unpaid loss and loss adjustment expense	6,208	6,920
Rent reserve	247	297
Bond amortization	434	421
Bonus accrual	291	759
Investment impairments	1,419	1,120
Other	480	540
Total deferred tax assets	22,256	22,758
Deferred federal income taxes, net	\$1,365	\$3,360

We concluded that no valuation allowance was necessary to provide against our deferred tax assets as of December 31, 2016.



## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

A reconciliation of the income tax provisions based on the 35% statutory tax rate to the provision reflected in the consolidated financial statements for the years ended December 31, 2016, 2015 and 2014, is as follows (in thousands):

	2016	2015	2014
Computed expected income tax expense at statutory regulatory tax rate	\$2,967	\$11,160	\$6,574
Meals and entertainment	81	32	27
Tax exempt interest	(1,164)	(1,259)	(1,276)
Dividends received deduction	(133 )	(141 )	(107 )
State taxes (net of federal benefit)	203	176	259
Other	(2 )	55	(124 )
Income tax expense	\$1,952	\$10,023	\$5,353
Current income tax expense	\$1,547	\$11,053	\$5,746
Deferred tax expense (benefit)	405	(1,030)	(393 )
Income tax expense	\$1,952	\$10,023	\$5,353

We have available, for federal income tax purposes, unused net operating loss of \$0.9 million at December 31, 2016. The losses were acquired as part of the HIC and HCM acquisitions and may be used to offset future taxable income. Utilization of the losses is limited under Internal Revenue Code Section 382. The Internal Revenue Code provides that effective with tax years beginning September 1997, the carry-back and carry-forward periods are 2 years and 20 years, respectively, with respect to newly generated operating losses. The net operating losses will expire if unused, as follows (in thousands):

Year	
2022	\$553
2028	2
2029	25
2031	45
2032	77
2033	73
2034	59
2035	33

2036 44  
\$911

We are no longer subject to U.S. federal, state, local or non-U.S. income tax examinations by tax authorities for years prior to 2013. The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. There were no uncertain tax positions at December 31, 2016.

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HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

**16. Commitments and Contingencies:**

We have several leases, primarily for office facilities and computer equipment, which expire in various years through 2022. Certain of these leases contain renewal options. Rental expense amounted to \$2.5 million, \$2.2 million and \$2.3 million for the years ended December 31, 2016, 2015, and 2014, respectively.

Future minimum lease payments under non-cancelable operating leases as of December 31, 2016 are as follows (in thousands):

Year	
2017	\$2,281
2018	1,948
2019	1,874
2020	1,841
2021	994
2022 and thereafter	341

Total minimum lease payments (a) \$9,279

(a) Minimum lease payments have not been reduced by minimum sublease rentals of \$0.5 million due in the future under noncancelable subleases.

From time to time, assessments are levied on us by the guaranty association of the states where we offer our insurance products. Such assessments are made primarily to cover the losses of policyholders of insolvent or rehabilitated insurers. Since these assessments can generally be recovered through a reduction in future premium taxes paid, we capitalize the assessments that can be recovered as they are paid and amortize the capitalized balance against our premium tax expense. We paid an assessment of \$0.1 million in 2016. There were no assessments during 2015.



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.

We disagree with the Comptroller and intend to vigorously fight their assertion that HSU is liable for the surplus lines premium taxes. We are currently in negotiations with the Comptroller to settle the matter. However, we are presently unable to reasonably estimate the possible loss or legal costs that are likely to arise out of the surplus lines tax audit or any future proceedings relating to this matter. Therefore we have not accrued any amount as of December 31, 2016 related to this matter.

## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014

We are engaged in 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.

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

The changes in accumulated other comprehensive income balances as of December 31, 2016, 2015, and 2014 were as follows (in thousands):

	Pension Liability	Unrealized Gains (Loss)	Accumulated Other Comprehensive Income (Loss)
Balance at January 1, 2014	\$ (1,480 )	\$ 18,363	\$ 16,883
Other comprehensive income:			
Change in net actuarial loss	(1,723 )	-	(1,723 )
Tax effect on change in net actuarial loss	603	-	603
Unrealized holding gains arising during the period	-	3,543	3,543
Tax effect on unrealized gains arising during the period	-	(1,240 )	(1,240 )
Reclassification adjustment for gains included in net realized gains	-	(408 )	(408 )
Tax effect on reclassification adjustment for gains included in income tax expense	-	143	143
Other comprehensive income, net of tax	(1,120 )	2,038	918
Balance at December 31, 2014	\$ (2,600 )	\$ 20,401	\$ 17,801
Other comprehensive loss:			
Change in net actuarial gain	43	-	43
Tax effect on change in net actuarial gain	(15 )	-	(15 )
Unrealized holding losses arising during the period	-	(10,191 )	(10,191 )
Tax effect on unrealized losses arising during the period	-	3,567	3,567
Reclassification adjustment for gains included in net realized gains	-	(5,826 )	(5,826 )
Tax effect on reclassification adjustment for gains included in income tax expense	-	2,039	2,039
Other comprehensive loss, net of tax	28	(10,411 )	(10,383 )

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Balance at December 31, 2015	\$ (2,572 )	\$ 9,990	\$ 7,418
Other comprehensive income:			
Change in net actuarial loss	(145 )	-	(145 )
Tax effect on change in net actuarial loss	51	-	51
Unrealized holding gains arising during the period	-	6,019	6,019
Tax effect on unrealized gains arising during the period	-	(2,107 )	(2,107 )
Reclassification adjustment for gains included in net realized gains	-	(1,331 )	(1,331 )
Tax effect on reclassification adjustment for gains included in income tax expense	-	466	466
Other comprehensive income, net of tax	(94 )	3,047	2,953
Balance at December 31, 2016	\$ (2,666 )	\$ 13,037	\$ 10,371

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## HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2016, 2015, and 2014**18. Concentrations of Credit Risk:**

We maintain cash and cash equivalents in accounts with four financial institutions in excess of the amount insured by the Federal Deposit Insurance Corporation. We monitor the financial stability of the depository institutions regularly and do not believe excessive risk of depository institution failure existed at December 31, 2016.

We are also subject to credit risk with respect to reinsurers to whom we have ceded underwriting risk. Although a reinsurer is liable for losses to the extent of the coverage it assumes, we remain obligated to our policyholders in the event that the reinsurers do not meet their obligations under the reinsurance agreements. In order to mitigate credit risk to reinsurance companies, we monitor the financial condition of reinsurers on an ongoing basis and review our reinsurance arrangements periodically. Most of our reinsurance recoverable balances as of December 31, 2016 were with reinsurers that had an A.M. Best rating of "A-" or better. We also mitigate our credit risk for the remaining reinsurance recoverable by obtaining letters of credit.

**19. Unaudited Selected Financial Quarterly Information:**

Following is a summary of the unaudited interim results of operations for the years ended December 31, 2016 and 2015 (in thousands, except per share data). In the opinion of management, all adjustments necessary to present fairly the results of operations for such periods have been made.

	2016				2015			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Total revenue	\$90,028	\$91,052	\$97,618	\$97,254	\$91,450	\$97,197	\$93,684	\$90,071
Total expense	84,039	89,565	90,442	103,428	83,761	87,922	83,849	84,984
Income (loss) before tax	5,989	1,487	7,176	(6,174 )	7,689	9,275	9,835	5,087
Income tax expense (benefit)	1,915	421	2,128	(2,512 )	2,346	2,899	3,137	1,641
Net income (loss)	\$4,074	1,066	\$5,048	(3,662 )	\$5,343	6,376	\$6,698	3,446
Basic earnings (loss) per share:	\$0.21	\$0.06	\$0.27	\$(0.20 )	\$0.28	\$0.33	\$0.35	\$0.18
Diluted earnings (loss) per share:	\$0.21	\$0.06	\$0.27	\$(0.20 )	\$0.28	\$0.33	\$0.35	\$0.17

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## FINANCIAL STATEMENT SCHEDULES

## Schedule II – Condensed Financial Information of Registrant (Parent Company Only)

## HALLMARK FINANCIAL SERVICES, INC.

## BALANCE SHEETS

December 31, 2016 and 2015

(In thousands)

	2016	2015
<b>ASSETS</b>		
Cash and cash equivalents	\$9,034	\$8,014
Investment in subsidiaries	363,078	361,769
Deferred federal income taxes	333	942
Federal income tax recoverable	2,756	-
Other assets	3,878	3,435
<b>Total assets</b>	<b>\$379,079</b>	<b>\$374,160</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
Revolving credit facility payable	\$30,000	\$30,000
Subordinated debt securities (less unamortized debt issuance cost of \$1,001 in 2016 and \$1,053 in 2015)	55,701	55,649
Current federal income tax payable	-	72
Accounts payable and other accrued expenses	27,642	26,413
<b>Total liabilities</b>	<b>113,343</b>	<b>112,134</b>
<b>Stockholders' equity:</b>		
Common stock, \$.18 par value, authorized 33,333,333 shares; issued 20,872,831 shares in 2016 and in 2015	3,757	3,757
Additional paid-in capital	123,166	123,480
Retained earnings	148,027	141,501
Accumulated other comprehensive income	10,371	7,418
Treasury stock (2,260,849 shares in 2016 and 1,775,512 in 2015), at cost	(19,585 )	(14,130 )
<b>Total stockholders' equity</b>	<b>265,736</b>	<b>262,026</b>

Total liabilities and stockholders' equity	\$379,079	\$374,160
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See accompanying report of independent registered public accounting firm.

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## FINANCIAL STATEMENT SCHEDULES

## Schedule II (Continued) – Condensed Financial Information of Registrant (Parent Company Only)

## HALLMARK FINANCIAL SERVICES, INC.

## STATEMENTS OF OPERATIONS

For the years ended December 31, 2016, 2015 and 2014

(In thousands)

	2016	2015	2014
Investment income, net of expenses	\$70	\$120	\$133
Dividend income from subsidiaries	10,500	8,000	8,000
Management fee income	10,711	10,053	9,614
Total revenues	21,281	18,173	17,747
Operating expenses	9,878	10,222	9,759
Interest expense	4,549	3,906	4,576
Total expenses	14,427	14,128	14,335
Income before equity in undistributed earnings (loss) of subsidiaries and income tax benefit	6,854	4,045	3,412
Income tax benefit	(1,315)	(1,273)	(1,623)
Income before equity in undistributed earnings (loss) of subsidiaries	8,169	5,318	5,035
Equity in undistributed share of (loss) earnings in subsidiaries	(1,643)	16,545	8,394
Net income	\$6,526	\$21,863	\$13,429
Comprehensive income	\$9,479	\$11,480	\$14,347

See accompanying report of independent registered public accounting firm.



## FINANCIAL STATEMENT SCHEDULES

## Schedule II (Continued) – Condensed Financial Information of Registrant (Parent Company Only)

## HALLMARK FINANCIAL SERVICES, INC.

## STATEMENTS OF CASH FLOWS

For the years ended December 31, 2016, 2015 and 2014

(In thousands)

	2016	2015	2014
Cash flows from operating activities:			
Net income	\$6,526	\$21,863	\$13,429
Adjustments to reconcile net income to cash provided by (used in) operating activities:			
Depreciation and amortization expense	148	65	68
Deferred income tax expense (benefit)	609	(195 )	183
Undistributed share of loss (earnings) of subsidiaries	1,643	(16,545)	(8,394 )
Change in current federal income tax (recoverable) payable	(2,828)	8	(3,290 )
Change in all other liabilities	1,228	(7,080 )	4,134
Change in all other assets	814	188	(184 )
Net cash provided by (used in) operating activities	8,140	(1,696 )	5,946
Cash flows from investing activities:			
Purchases of property and equipment, net	(1,469)	(159 )	(47 )
Capital contribution to subsidiaries	-	(30,000)	-
Net cash used in investing activities	(1,469)	(30,159)	(47 )
Cash flows from financing activities:			
Proceeds from exercise of employee stock options	466	658	1,155
Purchase of treasury shares	(6,117)	(2,532 )	(1,805 )
Activity under revolving credit facility, net	-	30,000	(1,473 )
Payment of debt issuance costs	-	(96 )	-
Net cash (used in) provided by financing activities	(5,651)	28,030	(2,123 )
Increase (decrease) in cash and cash equivalents	1,020	(3,825 )	3,776
Cash and cash equivalents at beginning of year	8,014	11,839	8,063

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Cash and cash equivalents at end of year	\$9,034	\$8,014	\$11,839
Supplemental cash flow information:			
Interest paid	\$4,287	\$3,906	\$4,576
Income taxes paid (recovered)	\$904	\$(1,086 )	\$1,481

See accompanying report of independent registered public accounting firm.

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## FINANCIAL STATEMENT SCHEDULES

**Schedule III - Supplementary Insurance Information***(In thousands)*

Column A Segment	Column B Deferred Policy Acquisition Costs	Column C Future Policy Benefits, Losses, Claims, and Loss Adjustment Expenses	Column D Unearned Premiums	Column E Other Policy Claims and Benefits Payable	Column F Premium Revenue	Column G Net Investment Income	Column H Benefits, Claims, Settlement Expenses	Column I Amortization of Deferred Policy Acquisition Costs	Column J Other Operating Expenses	Column K Net Premiums Written
2016										
Specialty Commercial Segment	\$11,961	\$358,961	\$185,634	\$-	\$241,890	\$12,962	\$169,125	\$27,474	\$58,678	\$249,072
Standard Commercial Segment	5,849	93,793	34,334	-	67,510	3,471	41,173	12,199	22,117	68,490
Personal Segment	1,383	28,813	21,286	-	43,970	1,276	43,390	(597 )	13,119	44,267
Corporate	-	-	-	-	-	(1,367 )	-	-	11,682	-
Consolidated	\$19,193	\$481,567	\$241,254	\$-	\$353,370	\$16,342	\$253,688	\$39,076	\$105,596	\$361,829
2015										
Specialty Commercial Segment	\$13,501	\$314,975	\$161,730	\$-	\$237,640	\$11,524	\$148,664	\$23,371	\$58,212	\$241,775
Standard Commercial Segment	5,633	105,971	33,701	-	72,613	3,623	47,071	4,237	22,820	71,097
Personal Segment	1,232	29,932	20,976	-	38,828	1,235	34,414	5,066	12,205	44,072
Corporate	-	-	-	-	-	(2,413 )	-	-	10,377	-
Consolidated	\$20,366	\$450,878	\$216,407	\$-	\$349,081	\$13,969	\$230,149	\$32,674	\$103,614	\$356,944

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2014										
Specialty										
Commercial Segment	\$ 14,125	\$ 275,868	\$ 146,521	\$ -	\$ 228,823	\$ 12,643	\$ 149,961	\$ 28,186	\$ 53,851	\$ 230,638
Standard										
Commercial Segment	5,892	109,672	34,822	-	78,311	4,663	51,130	3,389	25,479	76,912
Personal Segment	729	29,595	15,483	-	14,083	1,633	8,964	9,315	9,977	16,802
Corporate	-	-	-	-	-	(6,556)	-	-	10,279	-
Consolidated	\$ 20,746	\$ 415,135	\$ 196,826	\$ -	\$ 321,217	\$ 12,383	\$ 210,055	\$ 40,890	\$ 99,586	\$ 324,352

See accompanying report of independent registered public accounting firm.

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## FINANCIAL STATEMENT SCHEDULES

**Schedule IV – Reinsurance***(In thousands)*

	Column B Gross Amount	Column C Ceded to Other Companies	Column D Assumed from Other Companies	Column E Net Amount	Column F Percentage of Amount Assumed to Net	
Year Ended December 31, 2016						
Life insurance in force	\$ -	\$ -	\$ -	\$ -		
Premiums						
Life insurance	\$ -	\$ -	\$ -	\$ -		
Accident and health insurance	-	-	-	-		
Property and liability insurance	524,229	170,859	-	353,370	0.00	%
Title Insurance	-	-	-	-		
Total premiums	\$ 524,229	\$ 170,859	\$ -	\$ 353,370	0.00	%
Year Ended December 31, 2015						
Life insurance in force	\$ -	\$ -	\$ -	\$ -		
Premiums						
Life insurance	\$ -	\$ -	\$ -	\$ -		
Accident and health insurance	-	-	-	-		
Property and liability insurance	494,643	145,562	-	349,081	0.00	%
Title Insurance	-	-	-	-		
Total premiums	\$ 494,643	\$ 145,562	\$ -	\$ 349,081	0.00	%
Year Ended December 31, 2014						
Life insurance in force	\$ -	\$ -	\$ -	\$ -		
Premiums						
Life insurance	\$ -	\$ -	\$ -	\$ -		

Accident and health insurance	-	-	-	-		
Property and liability insurance	461,367	140,477	327	321,217	0.10	%
Title Insurance	-	-	-	-		
Total premiums	\$ 461,367	\$ 140,477	\$ 327	\$ 321,217	0.10	%

See accompanying report of independent registered public accounting firm.

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FINANCIAL STATEMENT SCHEDULES

**Schedule VI - Supplemental Information Concerning Property-Casualty Insurance Operations**

(In thousands)

Column A	Column B	Column C	Column D	Column E	Column F	Column G	Column H	Column I	Column J	Column K	
Affiliation With Registrant	Reserves for Deferred Unpaid Policy Claims and Claim	Discount if any, Claim	Unpaid Claims and Claim	Net	Earned Premiums	Investment Income	Claims and Claim Adjustment Expenses Incurred Related to (1) Current Year (2) Prior Years	Amortization of Deferred Policy Claims	Net Claims	Premiums Written	
(a) Consolidated property-casualty Entities	Acquisition Costs	Adjustment Expenses	Deductibles	Unpaid Claims	Earned Premiums	Investment Income	Claims and Claim Adjustment Expenses Incurred Related to (1) Current Year (2) Prior Years	Amortization of Deferred Policy Claims	Net Claims	Premiums Written	
2016	\$19,193	\$481,567	\$-	\$241,254	\$353,370	\$16,342	\$246,080	\$ 7,608	\$39,076	\$243,445	\$361,829
2015	\$20,366	\$450,878	\$-	\$216,407	\$349,081	\$13,969	\$237,102	\$ (6,953)	\$32,674	\$205,254	\$356,944
2014	\$20,746	\$415,135	\$-	\$196,826	\$321,217	\$12,383	\$215,258	\$ (5,203)	\$40,890	\$199,331	\$324,352

See accompanying report of independent registered public accounting firm.