HALLMARK FINANCIAL SERVICES INC
Form 10-K
March 14, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended **DECEMBER 31, 2017**

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	**87-0447375**

(State or Other Jurisdiction of Incorporation or Organization)	(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
Common Stock $.18 par value	**Nasdaq Global Market**

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 x

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 x

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 x 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 x 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 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 x Non-accelerated filer ¨ Smaller reporting company ¨

Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

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. $ 148.3 million

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. 18,169,028 shares of common stock, $.18 par value per share, outstanding as of March 14, 2018.

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 expression 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 Contract Binding 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, financial professional liability insurance products and services and primary/excess commercial property coverages for both catastrophe and non-catastrophe exposures. Our Standard Commercial P&C operating unit offers industry-specific commercial insurance products and services in the standard market. Our Workers Compensation operating unit specializes in small and middle market workers compensation business. Effective July 1, 2015, the Workers Compensation operating unit ceased marketing or retaining 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. Each operating unit is responsible for marketing, distribution and underwriting while we provide capital management, claims 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 Contract Binding 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 Contract Binding 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 Contract Binding operating unit primarily writes commercial automobile, general liability, commercial property and excess casualty coverages. Our Contract Binding operating unit markets its products in 24 states through 11 wholesale brokers and 88 general agency offices, as well as 34 independent retail agents in Texas.

Our Specialty Commercial operating unit offers small and middle market commercial excess liability, umbrella, general liability and public entity excess 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 and financial 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 and 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 and umbrella products through 136 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 188 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. Our Specialty Commercial operating unit markets these products through 28 wholesale and retail brokers in 49 states. The Specialty Commercial operating unit also provides medical professional liability to senior care facilities through a program where a managing general agent underwrites on our behalf risks that meet specific underwriting criteria. The financial professional liability insurance underwritten on an excess and surplus lines basis by our Specialty Commercial operating unit focuses on management and professional liability products that include directors & officers , employment practices and retirement and benefit plan fiduciary services for private, public and non-profit entities as well as miscellaneous professional liability insurance for most non-financial institution service industries. Our Specialty Commercial operating unit distributes its financial professional liability insurance products through 26 wholesale brokers in 49 states. 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 22 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 150 independent agency groups 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 provides occupational accident coverage in Texas through an underwriting agency that specializes in the occupational accident insurance market. Effective June 1, 2016, we ceased marketing new or renewal occupational accident policies.

Our Specialty Personal Lines operating unit primarily 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. Our Specialty Personal Lines operating unit markets and services these policies through 3,575 independent retail agent locations in 10 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 Contract Binding 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, 2017, 2016 and 2015.

	Year Ended December 31,		
	2017	2016	2015
	(dollars in thousands)		
Gross Premiums Written:			
Specialty Commercial Segment	$464,714	$388,914	$351,050
Standard Commercial Segment	78,228	76,891	81,892
Personal Segment	61,214	83,272	81,281
Total	$604,156	$549,077	$514,223
Net Premiums Written:			
Specialty Commercial Segment	$265,022	$249,072	$241,775
Standard Commercial Segment	69,288	68,490	71,097
Personal Segment	31,273	44,267	44,072
Total	$365,583	$361,829	$356,944

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, 2017.

Specialty Commercial Segment

The Specialty Commercial Segment of our business includes our Contract Binding operating unit and our Specialty Commercial operating unit. During 2017, our Contract Binding operating unit accounted for 46% and our Specialty Commercial operating unit accounted for 54% of the aggregate premiums produced by the Specialty Commercial Segment.

Contract Binding operating unit. Our Contract Binding operating unit markets, underwrites, finances and services commercial lines insurance in 24 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 Contract Binding 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 89% of the premium volume financed by PAAC.

Our Contract Binding 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 2017, commercial automobile, general liability and all other property/casualty accounted for 88%, 9% and 3%, respectively, of the premiums produced by our Contract Binding 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 Contract Binding 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 Contract Binding operating unit markets its products in 24 states through 11 wholesale brokers and 88 general agency offices, as well as 34 independent retail agents in Texas. Our Contract Binding 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 2017, general agents produced 86%, retail agents produced 3% and wholesale brokers produced 11% of total premiums produced by our Contract Binding operating unit. During 2017, the top ten general agents produced 41%, the eleven wholesale brokers produced 11% and no general agent produced more than

8%, of the total premium volume of our Contract Binding operating unit. During the same period, the top ten retail agents produced 2%, and no retail agent produced more than 1%, of the total premium volume of our Contract Binding operating unit.

The majority of the commercial policies written by our Contract Binding 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 excess liability and general liability insurance on both an admitted and non-admitted basis. This operating unit focuses primarily on trucking, specialty automobile and non-fleet automobile coverage, excess liability for most classes of public entity risks, general aviation property/casualty insurance primarily for private and small commercial aircraft and airports, satellite launch insurance products, medical and financial 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 2017, the top ten wholesale brokers accounted for 40% of our primary and excess casualty premium volume, with no single wholesale broker accounting for more than 8%. During 2017, commercial transportation excess liability risks accounted for 72% of the premiums, with the remaining 28% coming from non-transportation commercial excess, public entity and general liability risks.

The commercial excess, umbrella, general liability and public entity excess 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.

- ***Public Entity Excess Liability.*** Public entity excess liability is designed to provide an extra layer of protection for target classes of public entities for auto liability, general liability, public officials' liability, wrongful acts, employment practice liability, law enforcement liability, educators' legal liability and related coverages.

We generally cede 80% of the commercial excess, umbrella, general liability and public entity excess 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 188 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 2017, the top ten independent specialty brokers produced 37%, and no broker produced more than 7%, 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 93% of the aircraft written in 2017 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 2017 was approximately $153,000. 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 28 wholesale brokers in 49 states. The Specialty Commercial operating unit also provides medical professional liability to senior care facilities through a program where a managing general agent underwrites on our behalf risks that meet specific underwriting criteria. We generally cede 73.5% of the medical professional liability risk on policies written by our Specialty Commercial operating unit.

Our Specialty Commercial operating unit markets financial professional liability insurance on an excess and surplus lines basis. Financial professional liability insurance provides liability insurance for management liability and professional liability on a claim made basis. Our financial professional liability products target miscellaneous professional liability classes. Our Specialty Commercial operating unit distributes its financial professional liability insurance products through 26 wholesale brokers in 49 states. We presently cede 40% of the financial professional liability risk on policies written by our Specialty Commercial operating unit.

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 22 wholesale brokers in 50 states. We presently cede 70% of the primary/excess commercial property risk on policies underwritten by our insurance companies and 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 17 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 ceased marketing or retaining any risk on new or renewal policies. During 2017, our Standard Commercial P&C operating unit accounted for substantially all of the 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 provided occupational accident coverage in Texas through an underwriting agency that is a specialist in the occupational accident insurance market. Effective June 1, 2016, we ceased marketing 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 ceased marketing new or renewal occupational accident policies.

Our Standard Commercial P&C operating unit markets its property/casualty insurance products through 150 independent agency groups 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 24 year average tenure of the 19 agency groups that each produced more than $1.0 million in premium during the year ended December 31, 2017. During 2017, the top ten agency groups produced 38%, and no individual agency group produced more than 8%, 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.

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 ceased marketing or retaining 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 10 states. Our Specialty Personal Lines operating unit provides management, policy and claims administration services and includes the operations of AHGA and HCS. 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 60% 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 3,575 independent retail agent locations operating in its target geographic markets. Non-standard automobile represented 96% of the premiums produced during 2017. 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 2017, the top ten independent agency locations produced 28%, and no individual agency location produced more than 7%, of the total premium volume of our Specialty Personal Lines operating unit.

During 2017, personal automobile liability coverage accounted for 73% and personal automobile physical damage coverage accounted for the remaining 27% 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 10 states directly for HIC, AHIC and HCM.

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 Contract Binding 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. 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 Specialty Personal Lines operating unit has a thorough understanding of the unique characteristics of the non-standard personal automobile market.

- ***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 tailored to the needs of each operating unit 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, 2017, five states accounted for approximately 56% 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, 2017.

State	Specialty Commercial Segment	Standard Commercial Segment	Personal Segment	Total	Percent of Total
	(dollars in thousands)				
Texas	$207,611	$ 19,173	$ 11,980	$238,764	39.5 %
California	36,738	-	-	36,738	6.1 %
Arizona	2,816	-	22,172	24,988	4.1 %
Oklahoma	14,007	-	6,967	20,974	3.5 %
Oregon	2,602	16,908	-	19,510	3.2 %
All other states	200,940	42,147	20,095	263,182	43.6 %
Total gross premiums written	$464,714	$ 78,228	$ 61,214	$604,156	
Percent of total	76.9 %	13.0 %	10.1 %	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, aviation or public entity 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,					
	2017		2016		2015	
Gross premiums written	$604,156		$549,077		$514,223	
Net statutory loss & LAE ratio	79.1	%	71.2	%	65.4	%
Net statutory expense ratio	27.0	%	29.4	%	30.6	%
Net statutory combined ratio	106.1	%	100.6	%	96.0	%

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, 2017, 2016 and 2015, our consolidated premium-to-surplus ratios were 157%, 146% and 144%, 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 centrally 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, 2017, we had a total of 87 claims managers, supervisors and adjusters with an average experience of approximately 15 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.

Additional information relating to our loss reserve development is included under Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and Note 6, “Reserves for Losses and Loss Adjustment Expenses,” in the Notes to Consolidated Financial Statements.

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, 2017 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		
	2017	2016	2015
Gross premiums written	$604,156	$549,077	$514,223
Ceded premiums written	(238,573)	(187,248)	(157,279)
Net premiums written	$365,583	$361,829	$356,944
Gross premiums earned	$568,769	$524,229	$494,643
Ceded premiums earned	(207,732)	(170,859)	(145,562)
Net premiums earned	$361,037	$353,370	$349,081
Reinsurance recoveries	$144,948	$116,057	$89,892

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 securities, equity securities and other investments. As of December 31, 2017, we had total invested assets of $661.3 million. If market rates were to increase by 1%, the fair value of our fixed-income securities as of December 31, 2017 would decrease by approximately $9.6 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, 2017 and 2016.

	As of December 31, 2017						As of December 31, 2016					
	Fair Value (in thousands)	Percent of Total		Yield			Fair Value (in thousands)	Percent of Total		Yield		
Category:												
Corporate bonds	$279,073	46.1	%	2.5	%		$226,062	37.8	%	3.0	%	
Collateralized corporate bank loans	125,937	20.8	%	3.9	%		106,009	17.8	%	3.5	%	
Municipal bonds	134,256	22.2	%	2.9	%		163,895	27.4	%	4.4	%	
US Treasury securities and obligations of U.S. Government	49,947	8.2	%	1.8	%		42,022	7.0	%	1.2	%	
Mortgage backed	16,533	2.7	%	2.6	%		59,469	10.0	%	2.4	%	
	-			-			-			-		
Total	$605,746	100.0	%	2.9	%		$597,457	100.0	%	3.3	%	

The weighted average credit rating for our fixed-income portfolio was BBB+ at December 31, 2017. The following table shows the distribution of our fixed-income portfolio by rating as a percentage of total fair value as of December 31, 2017 and 2016:

	As of December 31, 2017		As of December 31, 2016	
Rating:				
"AAA"	4.3	%	9.5	%
"AA"	20.3	%	22.4	%
"A"	8.4	%	7.4	%
"BBB"	46.3	%	39.8	%
"BB"	15.0	%	12.6	%
"B"	1.3	%	0.9	%
"CCC"	0.1	%	0.1	%
"CC"	0.0	%	1.6	%
"D"	0.7	%	0.0	%
"NR"	3.6	%	5.7	%
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, 2017 and 2016.

	As of December 31, 2017			As of December 31, 2016		
	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	$ 116,060	19.2	%	$ 97,849	16.4	%
One to five years	308,829	51.0	%	272,168	45.5	%
Five to ten years	124,168	20.5	%	115,248	19.3	%
More than ten years	40,156	6.6	%	52,723	8.8	%
Mortgage-backed	16,533	2.7	%	59,469	10.0	%
Total	$ 605,746	100.0	%	$ 597,457	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, 2017, 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, 2017.

Category	Net Unrealized Gain Balance **(in thousands)**	
U.S. Treasury securities and obligations of U.S. Government	$ (141	)
Corporate bonds	462	
Collateralized corporate bank loans	401	
Municipal bonds	204	
Mortgage-backed	(179	)
Equity securities	21,510	
Other investments	61	

Total	$ 22,318

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.

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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 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.

Our business is highly dependent upon the successful and uninterrupted functioning of our information technology systems. Publicly reported cybersecurity intrusions have increased recently and the insurance sector as a whole is more exposed than in the past. Cybersecurity threats extend from individual attempts to gain unauthorized access to our information technology systems through coordinated, elaborate and targeted activity. We retain highly trained staff committed to the development and maintenance of our information technology systems. We maintain and regularly review recovery plans which are intended to enable us to restore critical systems with minimal disruption. We have established an information security committee to oversee and steer risk management plans to manage these exposures on an ongoing basis. We also employ comprehensive employee engagement and training programs to guard against the potential for malicious attempts to extort sensitive information from our systems using social engineering techniques (also known as “phishing”) and have increased our cyber liability insurance to seek to minimize our post-event financial impacts.

We recognize the potential for new risks arising alongside the benefits we derive from technological and digital development. We employ technological security measures to prevent, detect and mitigate such threats, including independent and in-house vulnerability assessments, access controls, data encryption, continuous monitoring of our information technology networks and systems and maintenance of backup and protective systems. Nonetheless, the infrastructure may be vulnerable to security incidents which could result in the disruption of business operations and the corruption, unavailability, misappropriation or destruction of critical data and confidential information (both our own and of third parties). The compromise of personal and confidential information could lead to legal liability or regulatory action under evolving cybersecurity, data protection and privacy laws and regulations enacted in the various jurisdictions in which we operate. In this respect on March 1, 2017, new cybersecurity rules were implemented by the New York Department of Financial Services (the “NYS Cybersecurity Regulation”). These NYS

Cybersecurity Regulations impose additional regulatory requirements that seek to protect confidentiality, integrity and availability of information systems. We also anticipate additional NAIC regulations as a result of the Insurance Data Security Model Law which will require insurers to meet state requirements beyond those imposed by New York. The implementation of these various regulations impose additional compliance obligations which have necessitated ongoing review of our policies and procedures.

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 3,008 property/casualty insurance companies and 2,050 property/casualty insurance groups operating in North America as of July 12, 2017. The primary competition for our Contract Binding operating unit includes such carriers as American Millennium Insurance Company, Canal Insurance Company, Commercial Alliance Insurance Company, National Casualty Company, National Liability & Fire Insurance Company, Northland Insurance Company, Progressive County Mutual, State National Insurance Company, Prime 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 Old Republic Aviation Managers, Starr Aviation, American International Group, Inc., 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 includes such carriers as Admiral Insurance Company, Catlin Insurance Company, CNA Financial Corporation, Evanston Insurance Company, Iron Health, Kinsale Insurance Company, Lexington Insurance Company, Medical Protective Insurance Company, One Beacon Insurance Group, ProAssurance Corporation, RSUI Group and TDC Companies. The primary competition for the financial professional liability insurance products produced by our Specialty Commercial operating unit are Admiral Insurance Company, American International Group Companies, Argonaut Insurance Company, Berkley Insurance Company, CNA Financial Corporation, Evanston Insurance Company, Kinsale Insurance Company, RSUI Group and XL Catlin Insurance Company. 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. 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, 2017, 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;

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- 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, 2017, we employed 418 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. 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. 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, 2017 unpaid losses and LAE would have produced a $5.3 million change to pretax earnings. Our gross loss and LAE reserves totaled $527.1 million at December 31, 2017. Our loss and LAE reserves, net of reinsurance recoverable on unpaid loss and LAE, were $372.5 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 3,008 property/casualty insurance companies and 2,050 property/casualty insurance groups operating in North America as of July 12, 2017. 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, 2017, we had a total of $295.2 million due us from reinsurers, including $182.9 million of recoverables from losses and $112.3 million in ceded unearned premiums. The largest amount due us from a single reinsurer as of December 31, 2017 was $55.5 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 affect 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 2018 by our insurance company subsidiaries is $19.7 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 any 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, 2017, 92% 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, 23% 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, 2017 was $605.7 million. If market interest rates were to increase 1%, the fair value of our fixed-income securities would decrease by approximately $9.6 million as of December 31, 2017. 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, 2017, Hallmark had $0.1 million in its investment portfolio exposed to sub-prime mortgages and $16.5 million total exposure in mortgage-backed securities.

Future changes in the fair value of our available-for-sale fixed income 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 approximately 56% of our gross written premiums for 2017: Texas (40%), California (6%), Arizona (4%), Oklahoma (3%) and Oregon (3%). 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 perform accounting, policy administration, actuarial and other modeling functions necessary for underwriting business, as well as to process and make claims and other payments. Our systems could fail of their own accord or might be disrupted by factors such as natural disasters, power disruptions or surges, cybersecurity intrusions 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 successful 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 and Standard Commercial P&C 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 $52,140 per month pursuant to a lease which expires June 30, 2022.

Our Contract Binding 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 $34,798 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 $29,202 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
Chicago, Illinois	$ 12,227	June 30, 2020
Atlanta, Georgia	$ 12,052	November 30, 2022
Jersey City, New Jersey	$ 5,036	December 31, 2020
Glendale, California	$ 2,627	July 31, 2020

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 $28,769 per month pursuant to a lease that expires December 31, 2020.

Item 3. Legal Proceedings.

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.

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, 2016.

Period	High Sale	Low Sale
Year Ended December 31, 2017:		
First quarter	$ 11.98	$ 10.14
Second quarter	11.62	9.94
Third quarter	11.83	9.91
Fourth quarter	11.76	9.95
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

Holders

As of March 1, 2018, there were 2,016 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, 2017.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)](1) (c)
Equity compensation plans approved by security holders	406,731	$ 7.85	1,498,971
Equity compensation plans not approved by security holders	-	-	-
Total	406,731	$ 7.85	1,498,971

(1) Securities remaining available for future issuance are net of a maximum of 501,029 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.

There were no purchases made pursuant to the Stock Repurchase Plan during the quarter ended December 31, 2017.

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, 2012 and its relative performance is tracked through December 31, 2017.

Item 6. Selected Financial Data

	Year Ended December 31				
	2017	2016	2015	2014	2013
	(in thousands, except per share data)				
Statement of Operations Data:					
Gross premiums written	$604,156	$549,077	$514,223	$473,218	$460,027
Ceded premiums written	(238,573)	(187,248)	(157,279)	(148,866)	(99,262)
Net premiums written	365,583	361,829	356,944	324,352	360,765
Change in unearned premiums	(4,546)	(8,459)	(7,863)	(3,135)	(224)
Net premiums earned	361,037	353,370	349,081	321,217	360,541
Investment income, net of expenses	18,874	16,342	13,969	12,383	12,884
Net realized gains	5,672	2,519	5,826	408	10,540
Other-than-temporary impairments	(5,877)	(2,888)	(3,323)	(274)	-
Finance charges	3,867	4,977	5,952	5,279	5,830
Commission and fees	1,679	1,427	213	(1,694)	(487)
Other income	269	205	684	47	120
Total revenues	385,521	375,952	372,402	337,366	389,428
Loss and loss adjustment expenses	288,308	253,688	230,149	210,055	261,345
Operating expenses	106,805	106,769	103,993	101,427	109,289
Interest expense	4,512	4,549	3,906	4,576	4,599
Amortization of intangible assets	2,468	2,468	2,468	2,526	3,115
Total expenses	402,093	367,474	340,516	318,584	378,348
(Loss) income before tax	(16,572)	8,478	31,886	18,782	11,080
Income tax (benefit) expense	(5,019)	1,952	10,023	5,353	2,835
Net (loss) income	(11,553)	6,526	21,863	13,429	8,245
Net (loss) income per share:					
Basic	$(0.63)	$0.35	$1.14	$0.70	$0.43
Diluted	$(0.63)	$0.34	$1.13	$0.69	$0.43

	As of December 31				
Balance Sheet Items:	2017	2016	2015	2014	2013
Total investments	$661,333	$654,119	$578,829	$507,229	$461,325
Total assets (1)	$1,231,126	$1,162,460	$1,075,547	$979,765	$907,867
Reserves for unpaid loss and loss adjustment expenses	$527,100	$481,567	$450,878	$415,135	$382,640
Unearned premiums	$276,642	$241,254	$216,407	$196,826	$185,303
Total liabilities (1)	$980,008	$896,724	$813,521	$727,728	$669,749
Total stockholders' equity	$251,118	$265,736	$262,026	$252,037	$238,118
Book value per share	$13.82	$14.28	$13.72	$13.11	$12.36

(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.

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 Contract Binding operating unit and the general aviation, satellite launch, commercial umbrella and primary/excess liability, medical and financial professional liability and primary/excess commercial property insurance products and services handled by our Specialty Commercial operating unit. Certain specialty programs are also managed by our Specialty Commercial operating unit. Our Contract Binding 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 ceased marketing new or renewal occupational accident policies. Effective July 1, 2015, the Workers Compensation operating unit ceased retaining 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. 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, 2017 and 2016, 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, 2017 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; Contract Binding operating unit - $19.9 million; Specialty Commercial operating unit - $17.4 million (comprised of $7.7 million for the primary/excess and umbrella component and $9.7 million for the general aviation and satellite component); and Specialty Personal Lines operating unit - $5.3 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 2017 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 2017. 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 (including factors such as prior year loss reserve development), expectations of future performance (including premium growth rates, premium rate increases and loss costs), 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 2017. However, an 8% decline in the fair value of our Standard Commercial P&C operating unit, a 5% decline in the fair value of our Contract Binding operating unit, a 6% decline in the fair value of our Specialty Personal Lines operating unit, a 69% decline in the fair value of our excess and umbrella component or a 23% 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 2017. 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 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, 2017. Through December 31, 2017, 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 Note 6 to the audited consolidated financial statements included in this report.)

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, 2017 reserves for unpaid losses and LAE would have produced a $5.3 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, 2017 was $427.1 million to $547.4 million. Our best estimate of unpaid losses and LAE as of December 31, 2017 is $527.1 million. Our carried reserve for unpaid losses and LAE as of December 31, 2017 is comprised of $268.9 million in case reserves and $258.2 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 $39.9 million higher than the midpoint, or 96.3% of the high end, of the actuarial range at December 31, 2017 as compared to $36.8 million above the midpoint, or 96.6% of the high end, of the actuarial range at December 31, 2016. 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.

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.

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, 2017	63.5 %	64.5 %	61.2 %	66.2 %	61.4 %
Effect of actual 5.0% above estimated loss ratio at December 31, 2017	$ -	$ -	$ (3,360)	$ (3,790)	$ (546)
Effect of actual 5.0% below estimated loss ratio at December 31, 2017	$ 1,850	$ 3,055	$ 2,734	$ 3,790	$ 546

Through 2008, all business of our Contract Binding operating unit was produced under a fronting agreement with member companies of the Republic Group ("Republic"), which granted our Contract Binding 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 Contract Binding operating unit wrote a portion of its policies under a fronting arrangement with Republic pursuant to which we assumed 100% of the risk. Our Contract Binding operating unit earns a commission based on a percentage of the earned premium it produced for Republic which was not assumed by AHIC. The commission percentage is determined by the underwriting results of the policies produced.

The following table details the profit sharing commission revenue sensitivity of the Contract Binding 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, 2017	59.4 %	65.6 %	61.4 %
Effect of actual 5.0% above estimated loss ratio at December 31, 2017	$(3,096)	$ -	$(1,169)
Effect of actual 5.0% below estimated loss ratio at December 31, 2017	$3,096	$ 2,082	$ 1,618

Results of Operations

Comparison of Years ended December 31, 2017 and December 31, 2016

Management overview. During fiscal 2017, our total revenues were $385.5 million, which was $9.5 million more than the $376.0 million in total revenues for fiscal 2016. During the year ended December 31, 2017, we reported a net loss before tax of $16.6 million as compared to income before tax of $8.5 million during the same period of 2016.

This increase in revenue was primarily attributable to higher net earned premiums in our Specialty Commercial Segment, partially offset by lower net earned premiums in our Standard Commercial Segment and our Personal Segment during the year ended December 31, 2017 as compared to the same period during 2016. Net earned premiums for the year ended December 31, 2017 include the impact of $1.3 million of ceded reinstatement premium attributable to Hurricane Harvey. Further contributing to this increase in revenues was higher net investment income, higher commission and fee revenue and higher net realized gains recognized on our investment portfolio during the year ended December 31, 2017 as compared to the same period during 2016. These increases in revenue during the year ended December 31, 2017 were partially offset by lower finance charges, and higher other-than-temporary impairments of the investment portfolio.

The pre-tax loss reported for the year ended December 31, 2017 was due primarily to increased loss and LAE of $34.6 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 Contract Binding operating unit. During the twelve months ended December 31, 2017, we recorded unfavorable prior year net loss reserve development of $40.1 million as compared to $7.6 million of unfavorable prior year net loss reserve development for the same period of 2016. The unfavorable prior year reserve development during the twelve months ended December 31, 2017 was primarily driven by the continued emergence of increased frequency and severity trends in our primary commercial auto lines of business within our Contract Binding operating unit, which was representative of industry trends. These trends had an amplified impact on our consolidated result because this is the largest line of retained business in our portfolio. We incurred an aggregate of $7.8 million of net catastrophe losses during the year ended December 31, 2017 as compared to $11.0 million for the same period the prior year. Operating expenses during the year ended December 31, 2017 were unchanged from the same period during 2016 mostly as a result of a $1.8 million payment to settle the earn-out related to the previous acquisition of TBIC during the second quarter of 2016 and lower production related expenses due primarily to increased ceding commissions in our Specialty Commercial Segment, partially offset by increased salary and related expenses and other operating expenses driven by our investment in technology for the year ended December 31, 2017 as compared to the same periods during 2016.

We reported a net loss of $11.6 million for the year ended December 31, 2017, as compared to net income of $6.5 million for the year ended December 31, 2016. On a diluted per share basis, net loss was $0.63 per share for fiscal

2017 as compared to net income of $0.34 per share for fiscal 2016. Net loss for the year ended December 31, 2017 included a charge of $1.3 million from the revaluation of deferred tax balances from a 35% statutory tax rate to the new 21% statutory tax rate under the Tax Cuts and Jobs Act of 2017.

Segment information

The following is additional business segment information for the years ended December 31, 2017 and 2016 (in thousands):

	Year Ended December 31								
	Specialty Commercial Segment		Standard Commercial Segment		Personal Segment		Corporate		Consolidated
	2017	2016	2017	2016	2017	2016	2017	2016	2017
Gross premiums written	$464,714	$388,914	$78,228	$76,891	$61,214	$83,272	$-	$-	$604,156
Ceded premiums written	(199,692)	(139,842)	(8,940)	(8,401)	(29,941)	(39,005)	-	-	(238,573)
Net premiums written	265,022	249,072	69,288	68,490	31,273	44,267	-	-	365,583
Change in unearned premiums	(5,936)	(7,182)	(3,070)	(980)	4,460	(297)	-	-	(4,546)
Net premiums earned	259,086	241,890	66,218	67,510	35,733	43,970	-	-	361,037
Total revenues	277,946	255,897	70,302	71,966	40,462	49,826	(3,189)	(1,737)	385,521
Losses and loss adjustment expenses	213,050	169,125	45,227	41,173	30,031	43,390	-	-	288,308
Pre-tax income (loss)	2,012	24,417	2,440	8,866	(3,058)	(6,839)	(17,966)	(17,966)	(16,572)
Net loss ratio (1)	82.2%	69.9%	68.3%	61.0%	84.0%	98.7%			79.9%
Net expense ratio (1)	23.7%	25.3%	34.5%	33.0%	29.3%	21.5%			28.0%
Net combined ratio (1)	105.9%	95.2%	102.8%	94.0%	113.3%	120.2%			107.9%

Favorable (Unfavorable) Prior Year Development	(40,477)	(12,502)	970	9,901	(598)	(5,007)			(40,105)

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

Specialty Commercial Segment.

Gross premiums written for the Specialty Commercial Segment were $464.7 million for the year ended December 31, 2017, which was $75.8 million, or 19%, more than the $388.9 million reported for the same period in 2016. Net premiums written were $265.0 million for the year ended December 31, 2017 as compared to $249.1 million reported for the same period in 2016. The increase in gross and net premiums written was due to increased premium production in our Specialty Commercial operating unit.

The $277.9 million of total revenue for the year ended December 31, 2017 was $22.0 million higher than the $255.9 million reported for 2016. This increase in revenue was due to higher net premiums earned of $17.2 million due predominately to increased earned premium in both our Specialty Commercial and Contract Binding operating units. Further contributing to this increased revenue was higher net investment income of $3.8 million, higher commission and fees of $1.0 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 $2.0 million for the year ended December 31, 2017 was $22.4 million lower than the $24.4 million reported for the same period in 2016. This decrease in pre-tax income was primarily due to higher loss and LAE expenses of $43.9 million and higher operating expense of $0.5 million, partially offset by the increased revenue discussed above.

Our Contract Binding operating unit reported a $35.9 million increase in loss and LAE due primarily to $38.6 million of unfavorable prior year net loss reserve development recognized during the year ended December 31, 2017 as compared to $11.3 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 $8.0 million increase in loss and LAE which consisted of (a) a $4.5 million increase in losses and LAE in our commercial umbrella and primary/excess liability line of business, (b) a $2.1 million increase in losses and LAE attributable to our primary/excess property insurance products due primarily to increased premium production and higher net catastrophe losses, (c) a $2.2 million increase in our general aviation line of business, (d) a $0.1 million increase in losses and LAE in our satellite launch insurance line of business, partially offset by (e) a $0.8 million decrease in losses and LAE attributable to our professional liability insurance products and (f) a $0.1 million decrease in losses and LAE in our specialty programs. The $0.5 million increase in operating expense was primarily the result of higher salary and related expenses of $3.3 million, higher occupancy and other operating expenses of $0.7 million and higher travel related expenses of $0.2 million, partially offset by lower production related expenses of $3.7 million due primarily to increased ceding commissions in our Specialty Commercial operating unit.

The Specialty Commercial Segment reported a net loss ratio of 82.2% for the year ended December 31, 2017 as compared to 69.9% for the same period during 2016. The gross loss ratio before reinsurance was 76.5% for the year ended December 31, 2017 as compared to 67.3% for the same period in 2016. The higher gross and net loss ratios for the year ended December 31, 2017 were primarily the result of $40.5 million unfavorable prior year net loss reserve development recognized for the year ended December 31, 2017 as compared to $12.5 million unfavorable prior year net loss reserve development for the same period of 2016, as well as higher current accident year loss trends driven mostly by our commercial auto line of business and increased net catastrophe losses. The net unfavorable prior year development for 2017 was primarily driven by the continued emergence of increased frequency and severity trends for 2016 and prior accident years in the primary commercial auto lines of business of our Contract Binding operating unit. Our Specialty Commercial operating unit experienced net unfavorable development in general aviation primarily in the 2016, 2013 and 2010 and prior accident years, commercial excess liability primarily in the 2013 accident year and specialty risk programs primarily in the 2015 and prior accident years, partially offset by net favorable development in the medical professional liability and primary/excess commercial property lines of business primarily in the 2016 accident years. The Specialty Commercial Segment reported $3.8 million of net catastrophe losses during the year ended December 31, 2017, of which $1.3 million was attributable to Hurricane Harvey, as compared to $1.6 million of net catastrophe losses during the same period of 2016. The Specialty Commercial Segment reported a net expense ratio of 23.7% during the year ended December 31, 2017 as compared to 25.3% for the same period of 2016. The decrease in the expense ratio was due predominately to the impact of higher net premiums earned as well as increased ceding commission in our Specialty Commercial operating unit.

Standard Commercial Segment.

Gross premiums written for the Standard Commercial Segment were $78.2 million for the year ended December 31, 2017, which was $1.3 million, or 2%, more than the $76.9 million reported for the same period in 2016. The gross premiums written for the Standard Commercial P&C operating unit increased $6.8 million, offset by a decrease of $5.0 million due to the discontinued marketing of new and renewal occupational accident policies and a $0.5 million decrease in gross premiums written due to the discontinued marketing of workers compensation policies. Net premiums written were $69.3 million for the year ended December 31, 2017 as compared to $68.5 million reported for the same period in 2016. The net premiums written include a $5.6 million increase in our Standard Commercial P&C operating unit for the year ended December 31, 2017 as compared to the same period during 2016, offset by a decrease in premium volume of $4.8 million due to the discontinued marketing of new and renewal occupational accident policies. The net premiums written in our Standard Commercial P&C Operating unit includes the impact of $0.7 million of ceded reinstatement premium attributable to Hurricane Harvey.

Total revenue for the Standard Commercial Segment of $70.3 million for the year ended December 31, 2017 was $1.7 million less than the $72.0 million reported during the year ended December 31, 2016. This 2% decrease in total revenue was mostly due to a $1.3 million decrease in net premiums earned primarily as a result of a $4.8 million decrease in net premiums earned due to the discontinued marketing of new and renewal occupational accident policies, partially offset by $3.5 million higher net premiums earned in our Standard Commercial P&C operating unit due to increased premium production, which includes the impact of $0.7 million of ceded reinstatement premium attributable to Hurricane Harvey. Further contributing to the decrease in revenue was lower commission and fees of $0.8 million, partially offset by higher net investment income of $0.4 million for the year ended December 31, 2017 as compared to the same period in 2016.

Our Standard Commercial Segment reported pre-tax income of $2.4 million for the year ended December 31, 2017 was $6.5 million lower than the $8.9 million reported for the same period of 2016. Higher loss and LAE of $4.1 million was the primary driver for the lower pre-tax income, as well as higher operating expenses of $0.7 million and the decreased revenue discussed above.

The net loss ratio for the year ended December 31, 2017 was 68.3% as compared to the 61.0% reported for the year ended December 31, 2016. The gross loss ratio before reinsurance was 63.3% for the year ended December 31, 2017 as compared to 59.6% for the prior year. Our Standard Commercial Segment’s net loss ratio included 4.9 additional loss ratio points attributable to the discontinued workers compensation and occupational accident business for the year ended December 31, 2017 as compared to 1.7 fewer loss ratio points for the same period the prior year. During the year ended December 31, 2017 the Standard Commercial Segment reported favorable prior year net loss reserve development of $1.0 million as compared to favorable prior year net loss reserve development of $9.9 million for the same period of 2016. During 2017, our Standard Commercial P&C operating unit experienced net favorable development primarily in the general liability line of business in the 2016 and prior accident years, partially offset by net unfavorable development in the 2016 and prior accident years in the occupational accident line of business. The Standard Commercial Segment reported $3.6 million of net catastrophe losses during the year ended December 31, 2017, of which $1.7 million was attributable to Hurricane Harvey, as compared to $8.4 million of net catastrophe losses during the same period of 2016. The Standard Commercial Segment reported a net expense ratio of 34.5% for the year ended December 31, 2017 as compared to 33.0% for the same period of 2016. The increase in the expense ratio is primarily due to increased salary and related expense of $0.9 million and increased other general expenses of $0.6 million primarily due to investments in technology, as well as the decreased earned premium.

Personal Segment.

Gross premiums written for the Personal Segment were $61.2 million for the year ended December 31, 2017, which was $22.1 million less than the $83.3 million reported for the same period in 2016. Net premiums written for our Personal Segment were $31.3 million for the year ended December 31, 2017, which was a decrease of $13.0 million from the $44.3 million reported for the same period of 2016. The decline in gross and net written premiums was primarily due to the intentional reduction in certain underperforming portions of this business to address loss ratio performance.

Total revenue for the Personal Segment decreased 19% to $40.4 million for the year ended December 31, 2017 from $49.8 million for the same period during 2016. The decrease in revenue was primarily due to lower net premiums earned of $8.2 million as a result of lower net premium volume discussed above, lower finance charges of $1.1 million and lower net investment income of $0.1 million.

Our Personal Segment reported a pre-tax loss of $3.1 million for the year ended December 31, 2017 as compared to pre-tax loss of $6.8 million for the same period of 2016. The lower pre-tax loss was the result of decreased losses and LAE of $13.3 million, partially offset by higher operating expenses of $0.2 million and the decreased revenue discussed above.

The Personal Segment reported a net loss ratio of 84.0% for the year ended December 31, 2017 as compared to 98.7% for the same period of 2016. The gross loss ratio before reinsurance was 80.1% for the year ended December 31, 2017 as compared to 94.8% for the same period in 2016. The lower gross and net loss ratios were primarily the result of lower unfavorable prior year net loss reserve development of $0.6 million for the year ended December 31, 2017 as compared to unfavorable development of $5.0 million for the same period in the prior year, as well as lower current accident year loss trends. During 2017, net unfavorable development in our Specialty Personal Lines operating unit was mostly attributable to the 2016, 2014, 2013 and 2010 and prior accident years, partially offset by favorable development in the 2015 and 2011 accident years. The Personal Segment reported $0.3 million of net catastrophe losses for the year ended December 31, 2017, of which $0.1 million was attributable to Hurricane Harvey, as compared to $1.0 million of net catastrophe losses during the same period of 2016. The Personal Segment reported a net expense ratio of 29.3% for the year ended December 31, 2017 as compared to 21.5% for the same period of 2016. The increase in the expense ratio was due predominately to lower finance charges and lower net premiums earned.

Corporate.

Total revenue for Corporate decreased by $1.5 million for the year ended December 31, 2017 as compared to the same period the prior year. This decrease in total revenue was due to lower net investment income of $1.6 million, and higher other-than-temporary impairments of the investment portfolio of $3.0 million, partially offset by a $3.2 million increase in net realized gains recognized on our investment portfolio for the year ended December 31, 2017 as compared to the same period of 2016.

Corporate pre-tax loss of $18.0 million for the year ended December 31, 2017 was unchanged from the same period of 2016. The pre-tax loss was primarily due to the decreased revenue discussed above, partially offset by lower operating expenses of $1.5 million. The lower operating expenses of $1.5 million were primarily a result of an additional $1.8 million earn-out payment in 2016 related to the previous acquisition of TBIC and lower salary and related expenses of $0.2 million for the year ended December 31, 2017 as compared to the same period during 2016, partially offset by higher professional service fees of $0.2 million and other operating expenses of $0.3 million.

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, and lower other-than-temporary impairments on our investment portfolio, partially offset by lower realized gains recognized on our investment portfolio during fiscal 2016 as compared to fiscal 2015 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								
	Specialty Commercial Segment		Standard Commercial Segment		Personal Segment		Corporate		Consolidate
	2016	2015	2016	2015	2016	2015	2016	2015	2016
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%
	95.2%	88.2%	94.0%	97.4%	120.2%	107.6%			99.8%

Net combined ratio (1)							
Favorable (Unfavorable) Prior Year Development	(12,502)	2,147	9,901	7,416	(5,007)	(2,610)	(7,608)

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

Specialty Commercial Segment.

Gross premiums written for the Specialty Commercial Segment were $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 Contract Binding 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 Contract Binding 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. During 2016, our Standard Commercial P&C operating unit experienced net favorable development primarily in the general liability line of business in the 2011-2015 accident years and the 2009 and prior accident years, partially offset by net unfavorable development in the occupational accident line of business in the 2014 and 2015 accident years. Our Workers Compensation operating unit experienced net favorable development in the 2015 and prior accident years. 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. During 2016, our Specialty Personal Lines operating unit experienced net unfavorable development attributable to the 2015 and prior accident years in the private passenger auto liability line of business. 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 lower net realized gains recognized on our investment portfolio of $3.3 million for the year ended December 31, 2016 as compared to the same period of 2015, partially offset by higher net investment income of $1.1 million and lower other-than-temporary impairments of $0.4 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.

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, 2017, we had $11.8 million in unrestricted cash and cash equivalents, as well as $0.1 million in debt securities, at the holding company and our non-insurance subsidiaries. As of that date, our insurance subsidiaries held $53.2 million of unrestricted cash and cash equivalents as well as $605.6 million in debt securities with an average modified duration of 1.6 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 2018, the aggregate ordinary dividend capacity of these subsidiaries is $27.6 million, of which $19.7 million is available to Hallmark. As a county mutual, dividends from HCM are payable to policyholders. During the years ended December 31, 2017 and 2016 our insurance company subsidiaries paid $11.4 million and $10.5 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. During 2017 our insurance subsidiaries did not pay management fees to Hallmark or our non-insurance company subsidiaries. The net amount paid in management fees by our insurance subsidiaries to Hallmark and our non-insurance company subsidiaries was $1.1 million and $1.3 million during 2016 and 2015, 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, 2017, our insurance company subsidiaries reported statutory capital and surplus of $233.3 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, 2017, 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, 2017 and 2016 was 157% and 146%, respectively.

Comparison of December 31, 2017 to December 31, 2016

On a consolidated basis, our cash and investments, excluding restricted cash and investments, at December 31, 2017 were $726.3 million compared to $733.8 million at December 31, 2016. The primary reasons for the decrease in unrestricted cash and investments were settlement of prior year investment trades, capital expenditures and repurchases of common stock, partially offset by cash flow from operations.

Comparison of Years Ended December 31, 2017 and December 31, 2016

Net cash provided by our consolidated operating activities was $7.2 million for the year ended December 31, 2017 compared to $30.9 million for the year ended December 31, 2016. The decrease in operating cash flow was primarily due to increased paid losses including timing of reinsurance claim settlements, lower collected net premiums and lower finance charges collected, partially offset by 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, 2017 was $16.8 million as compared to $58.2 million for the prior year. The decrease in cash used by investing activities during the year ended December 31, 2017 was comprised of an increase of $100.9 million in maturities, sales and redemptions of investment securities, a decrease in purchases of property and equipment of $1.6 million and an increase in transfers from restricted cash of $3.5 million, partially offset by an increase in purchases of debt and equity securities of $64.6 million.

Cash used in financing activities during the year ended December 31, 2017 was $5.1 million as a result of $5.3 million related to the repurchase of our common stock, partially offset by $0.2 million related to proceeds from the exercise of employee stock options. 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.

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, which expires on June 30, 2018. 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. All principal and accrued interest on Facility A becomes due and payable on June 30, 2018. As of December 31, 2017, we had no outstanding borrowings under Facility A.

On December 17, 2015, we entered into a First Amendment to Second Restated Credit Agreement and a Revolving Facility B Agreement (the "Facility B Agreement") with Frost to provide a new $30.0 million revolving credit facility ("Facility B"), in addition to Facility A. On November 1, 2016, we amended the Facility B Agreement with Frost to extend by one year the termination date for draws under Facility B and the maturity date for amounts outstanding thereunder. We paid Frost a commitment fee of $75,000 when Facility B was established and an additional $30,000 fee when Facility B was extended. On December 20, 2017, we entered into a Second Amendment to Second Restated Credit Agreement and a Second Amendment to Revolving Facility B Agreement with Frost. The Second Amendment to Second Restated Credit Agreement revised certain definitions in the Second Restated Credit Agreement. The Second Amendment to Revolving Facility B Agreement amended the Revolving Facility B Agreement to further extend by one year the termination date for draws thereunder and the maturity date for amounts outstanding thereunder. During the fourth quarter of 2017 we accrued a $30,000 fee payable to Frost 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, 2019, at which time all amounts outstanding under Facility B are converted to a term loan. Through December 17, 2019, 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, 2019, 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, 2019 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, 2024. As of December 31, 2017, we had $30.0 million outstanding under Facility B.

The obligations under both Facility A and Facility B are secured by a security interest in the capital stock of AHIC and HIC. Both Facility A and Facility B contain covenants that, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. We are in compliance with or have obtained a waiver of 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 Hallmark Statutory Trust I (“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 uncollaterized and do not require maintenance of minimum financial covenants. As of December 31, 2017, the principal balance of our Trust I subordinated debt was $30.9 million and the interest rate was 4.84% 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 bore an initial interest rate of 8.28% until September 15, 2017, after which interest adjusts 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, 2017, the principal balance of our Trust II subordinated debt was $25.8 million and the interest rate was 4.49% per annum.

Long-Term Contractual Obligations

Set forth below is a summary of long-term contractual obligations as of December 31, 2017. 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	2018	2019-2020	2021-2022	After 2023
Revolving credit facility payable	$30,000	$-	$3,214	$ 8,571	$ 18,215
Interest on revolving credit facility payable	8,477	1,607	3,127	2,352	1,391
Subordinated debt securities (1)	56,702	-	-	-	56,702
Interest on subordinated debt securities	56,751	3,063	6,125	6,125	41,438
Unpaid losses and LAE (2)	527,100	210,592	189,523	71,762	55,223
Operating leases (3)	8,462	2,398	4,402	1,662	-
Purchase obligations	6,067	3,650	1,965	452	-

(1) The subordinated debt securities excludes unamortized debt issuance costs of $0.9 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 $35 thousand due in the future under non-cancelable subleases.

Based on 2018 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, 2017 was $605.7 million. The effective duration of our portfolio as of December 31, 2017 was 1.6 years. Should interest rates increase 1.0%, our fixed-income investment portfolio would be expected to decline in market value by 1.6%, or $9.6 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 1.6%, or $9.6 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, 2017, our fixed-income investments were in the following: U.S. Treasury bonds – 8.2%; municipal bonds – 22.2%; collateralized corporate bank loans –20.8%; corporate bonds – 46.1%; and mortgage-backed –2.7%. As of December 31, 2017, 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, 2017 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 8.4% of our portfolio as of December 31, 2017. 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, 2017 was $55.6 million. The fair value of these securities would increase or decrease by $16.7 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 4.3%. 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.

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, 2017, 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, 2017.

BDO USA, LLP, the independent registered public accounting firm that audited our consolidated financial statements as of December 31, 2017 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, 2017. The BDO USA, LLP attestation report, which expresses an unqualified opinion on the effectiveness of our internal control over financial reporting as of December 31, 2017, is included in this Item under the heading “ Report of Independent Registered Public Accounting Firm.”

Report of Independent Registered Public Accounting Firm

Stockholders and Board of Directors

Hallmark Financial Services, Inc. and subsidiaries

Fort Worth, Texas

Opinion on Internal Control over Financial Reporting

We have audited Hallmark Financial Services, Inc. and subsidiaries' (the "Company's") internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). In our opinion the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of the Company as of December 31, 2017, the related consolidated statements of operations, comprehensive income (loss), stockholders' equity, and cash flows for the year ended December 31, 2017, and the related notes and financial statement schedules listed in the accompanying index and our report dated March 14, 2018 expressed an unqualified opinion thereon.

Basis for Opinion

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 Item 9A, "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 are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit of internal control over financial reporting in accordance with the standards of the PCAOB. 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, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control over Financial Reporting

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.

/s/ BDO USA, LLP
Dallas, Texas
March 14, 2018

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:

Reports of Independent Registered Public Accounting Firms

Consolidated Balance Sheets at December 31, 2017 and 2016

Consolidated Statements of Operations for the Years Ended December 31, 2017, 2016 and 2015

Consolidated Statements of Comprehensive Income (Loss) for the Years Ended December 31, 2017, 2016 and 2015

Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2017, 2016 and 2015

Consolidated Statements of Cash Flows for the Years Ended December 31, 2017, 2016 and 2015

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 Number	Description
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 March 28, 2017).
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).
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).
4.14	Second Amendment to Second Restated Credit Agreement between Hallmark Financial Services, Inc. and Frost Bank dated December 20, 2017 (incorporated by reference to Exhibit 10.1 to the registrant's Current Report on Form 8-K filed December 20, 2017).
4.15	Second Amendment to Revolving Facility B Agreement between Hallmark Financial Services, Inc. and Frost Bank dated December 20, 2017 (incorporated by reference to Exhibit 10.2 to the registrant's Current Report on Form 8-K filed December 20, 2017).
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	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).
10.3	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).
10.4	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).
10.5	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).
10.6	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).

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10.7	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).
10.8*	Form of Indemnification Agreement between Hallmark Financial Services, Inc. and its officers and directors, 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).
10.9*	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).
10.10*	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).
10.11*	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).
10.12*	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).
10.13*	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).
10.14*	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).
10.15*	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).
10.16*	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).
10.17	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).
10.18	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).
10.19*	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*	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.
23 (b)+	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.
101 INS+	XBRL Instance Document.
101 SCH+	XBRL Taxonomy Extension Schema Document.
101 CAL+	XBRL Taxonomy Extension Calculation Linkbase Document.
101 LAB+	XBRL Taxonomy Extension Label Linkbase Document.
101 PRE+	XBRL Taxonomy Extension Presentation Linkbase Document.
101 DEF+	XBRL Taxonomy Extension Definition Linkbase Document.

* 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 14, 2018	By:	/s/ Naveen Anand Naveen Anand, Chief Executive Officer and President
Date:	March 14, 2018	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 14, 2018	/s/ Naveen Anand Naveen Anand, Chief Executive Officer and President (Principal Executive Officer)
Date:	March 14, 2018	/s/ Jeffrey R. Passmore Jeffrey R. Passmore, Chief Accounting Officer and Senior Vice President (Principal Financial Officer and Principal Accounting Officer)
Date:	March 14, 2018	/s/ Mark E. Schwarz Mark E. Schwarz, Executive Chairman
Date:	March 14, 2018	/s/ James H. Graves James H. Graves, Director
Date:	March 14, 2018	/s/ Mark E. Pape Mark E. Pape, Director
Date:	March 14, 2018	/s/ Scott T. Berlin Scott T. Berlin, Director

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

Stockholders and Board of Directors

Hallmark Financial Services, Inc. and subsidiaries

Fort Worth, Texas

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheet of Hallmark Financial Services, Inc. (the "Company") and subsidiaries as of December 31, 2017, the related consolidated statements of operations, comprehensive income (loss), stockholders' equity, and cash flows for the year ended December 31, 2017, and the related notes and financial statement schedules listed in the accompanying index (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company and subsidiaries at December 31, 2017, and the results of their operations and their cash flows for the year ended December 31, 2017**,** in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and our report dated March 14, 2018 expressed an unqualified opinion thereon.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audit provides a reasonable basis for our opinion.

/s/ BDO USA, LLP

We have served as the Company's auditor since 2017.

Dallas, Texas

March 14, 2018

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 the related consolidated statements of operations, comprehensive income (loss), stockholders' equity and cash flows for each of the two 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 the consolidated results of their operations and their cash flows for each of the two 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.

/s/ Ernst & Young LLP

Fort Worth, Texas
March 9, 2017

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

December 31, 2017 and 2016

($ in thousands)

	2017	2016
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value (amortized cost; $604,999 in 2017 and $597,784 in 2016)	$605,746	$597,457
Equity securities, available-for-sale, at fair value (cost; $30,253 in 2017 and $31,449 in 2016)	51,763	51,711
Other investments (cost; $3,763 in 2017 and $3,763 in 2016)	3,824	4,951
Total investments	661,333	654,119
Cash and cash equivalents	64,982	79,632
Restricted cash	2,651	7,327
Ceded unearned premiums	112,323	81,482
Premiums receivable	104,373	89,715
Accounts receivable	1,513	2,269
Receivable for securities	5,235	3,047
Reinsurance recoverable	182,928	147,821
Deferred policy acquisition costs	16,002	19,193
Goodwill	44,695	44,695
Intangible assets, net	10,023	12,491
Deferred federal income taxes, net	1,937	1,365
Federal income tax recoverable	7,532	3,951
Prepaid expenses	1,743	1,552
Other assets	13,856	13,801
Total assets	$1,231,126	$1,162,460
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Revolving credit facility payable	$30,000	$30,000
Subordinated debt securities (less unamortized debt issuance cost of $949 in 2017 and $1,001 in 2016)	55,753	55,701
Reserves for unpaid losses and loss adjustment expenses	527,100	481,567
Unearned premiums	276,642	241,254
Reinsurance balances payable	52,487	46,488
Pension liability	1,605	2,203
Payable for securities	7,488	14,215
Accounts payable and other accrued expenses	28,933	25,296

Total liabilities	980,008	896,724
Commitments and contingencies (Note 16)		
Stockholders’ equity:		
Common stock, $.18 par value, authorized 33,333,333 shares; issued 20,872,831 shares in 2017 and 2016	3,757	3,757
Additional paid-in capital	123,180	123,166
Retained earnings	136,474	148,027
Accumulated other comprehensive income	12,234	10,371
Treasury stock (2,703,803 shares in 2017 and 2,260,849 in 2016), at cost	(24,527	