

HALLMARK FINANCIAL SERVICES INC
Form 10-Q
November 13, 2008

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

For the quarterly period ended September 30, 2008

Commission file number 001-11252

Hallmark Financial Services, Inc.
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of
Incorporation or organization)

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

777 Main Street, Suite 1000, Fort Worth, Texas
(Address of principal executive offices)

76102
(Zip Code)

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value \$.18 per share - 20,808,954 shares outstanding as of November 12, 2008.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

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Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Balance Sheets
(\$ in thousands)

| | September 30 | December 31 |
|---|---------------------|--------------------|
| | 2008 | 2007 |
| | (unaudited) | |
| <u>ASSETS</u> | | |
| Investments: | | |
| Debt securities, available-for-sale, at fair value | \$ 180,954 | \$ 248,069 |
| Equity securities, available-for-sale, at fair value | 41,568 | 15,166 |
| Short-term investments, available-for-sale, at fair value | 112,965 | 2,625 |
| Total investments | 335,487 | 265,860 |
| Cash and cash equivalents | 24,191 | 145,884 |
| Restricted cash and cash equivalents | 8,963 | 16,043 |
| Premiums receivable | 47,052 | 46,026 |
| Accounts receivable | 5,243 | 5,219 |
| Receivable for securities | - | 27,395 |
| Prepaid reinsurance premiums | 2,636 | 942 |
| Reinsurance recoverable | 11,525 | 4,952 |
| Deferred policy acquisition costs | 20,149 | 19,757 |
| Excess of cost over fair value of net assets acquired | 37,738 | 30,025 |
| Intangible assets | 29,683 | 23,781 |
| Current federal income tax recoverable | 1,586 | - |
| Deferred federal income taxes | 4,371 | 275 |
| Prepaid expenses | 941 | 1,240 |
| Other assets | 20,115 | 19,583 |
| Total assets | \$ 549,680 | \$ 606,982 |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| Liabilities: | | |
| Notes payable | \$ 61,760 | \$ 60,814 |
| Structured settlements | - | 10,000 |
| Reserves for unpaid losses and loss adjustment expenses | 155,288 | 125,338 |
| Unearned premiums | 105,293 | 102,998 |
| Unearned revenue | 2,126 | 2,949 |
| Accrued agent profit sharing | 1,935 | 2,844 |
| Accrued ceding commission payable | 12,193 | 12,099 |
| Pension liability | 1,017 | 1,669 |
| Current federal income tax | - | 864 |
| Payable for securities | 5,504 | 91,401 |
| Accounts payable and other accrued expenses | 14,439 | 16,385 |
| Total liabilities | 359,555 | 427,361 |
| Commitments and Contingencies (Note 17) | | |

| | | |
|--|------------|------------|
| Redeemable minority interest | 619 | - |
| Stockholders' equity: | | |
| Common stock, \$.18 par value (authorized 33,333,333 shares in 2008 and 2007; issued 20,816,782 in 2008 and 20,776,080 shares in 2007) | 3,747 | 3,740 |
| Capital in excess of par value | 119,649 | 118,459 |
| Retained earnings | 74,649 | 59,343 |
| Accumulated other comprehensive loss | (8,462) | (1,844) |
| Treasury stock, at cost (7,828 shares in 2008 and 2007) | (77) | (77) |
| Total stockholders' equity | 189,506 | 179,621 |
| | \$ 549,680 | \$ 606,982 |

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

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statements of Operations
(Unaudited)
(\$ in thousands, except per share amounts)

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-----------------|--------------------------|------------------|
| | September 30 | | September 30 | |
| | 2008 | 2007 | 2008 | 2007 |
| Gross premiums written | \$ 59,005 | \$ 62,304 | \$ 186,357 | \$ 193,539 |
| Ceded premiums written | (2,493) | (441) | (6,503) | (8,609) |
| Net premiums written | 56,512 | 61,863 | 179,854 | 184,930 |
| Change in unearned premiums | 2,416 | (2,100) | (1,918) | (18,209) |
| Net premiums earned | 58,928 | 59,763 | 177,936 | 166,721 |
| Investment income, net of expenses | 4,100 | 3,774 | 11,682 | 9,811 |
| Net realized gains (impairments and realized losses) | (2,496) | 418 | (1,405) | 1,299 |
| Finance charges | 1,307 | 1,206 | 3,894 | 3,477 |
| Commission and fees | 3,127 | 7,280 | 16,280 | 23,344 |
| Processing and service fees | 20 | 111 | 98 | 586 |
| Other income | 3 | 4 | 9 | 12 |
| Total revenues | 64,989 | 72,556 | 208,494 | 205,250 |
| Losses and loss adjustment expenses | 38,981 | 36,723 | 110,514 | 99,620 |
| Other operating expenses | 24,041 | 24,087 | 71,114 | 70,511 |
| Interest expense | 1,186 | 1,026 | 3,557 | 2,608 |
| Amortization of intangible assets | 620 | 573 | 1,766 | 1,719 |
| Total expenses | 64,828 | 62,409 | 186,951 | 174,458 |
| Income before tax and minority interest | 161 | 10,147 | 21,543 | 30,792 |
| Income tax expense (benefit) | (485) | 3,345 | 6,222 | 10,205 |
| Income before minority interest | 646 | 6,802 | 15,321 | 20,587 |
| Minority interest | 15 | - | 15 | - |
| Net income | \$ 631 | \$ 6,802 | \$ 15,306 | \$ 20,587 |
| Common stockholders net income per share: | | | | |
| Basic | \$ 0.03 | \$ 0.33 | \$ 0.74 | \$ 0.99 |
| Diluted | \$ 0.03 | \$ 0.33 | \$ 0.73 | \$ 0.99 |

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

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statement of Stockholders' Equity and Comprehensive Income (Loss)
(Unaudited)
(\$ in thousands)

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|-------------------|--------------------------|-------------------|
| | September 30, | | September 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| Common Stock | | | | |
| Balance, beginning of period | \$ 3,747 | \$ 3,740 | \$ 3,740 | \$ 3,740 |
| Issuance of common stock upon option exercises | - | - | 7 | - |
| Balance, end of period | 3,747 | 3,740 | 3,747 | 3,740 |
| Additional Paid-In Capital | | | | |
| Balance, beginning of period | 119,369 | 118,085 | 118,459 | 117,932 |
| Accretion of redeemable minority interest to redemption value | (25) | - | (25) | - |
| Equity based compensation | 305 | 198 | 1,078 | 351 |
| Exercise of stock options | - | - | 137 | - |
| Balance, end of period | 119,649 | 118,283 | 119,649 | 118,283 |
| Retained Earnings | | | | |
| Balance, beginning of period | 74,018 | 45,265 | 59,343 | 31,480 |
| Net income | 631 | 6,802 | 15,306 | 20,587 |
| Balance, end of period | 74,649 | 52,067 | 74,649 | 52,067 |
| Accumulated Other Comprehensive Loss | | | | |
| Balance, beginning of period | (4,756) | (2,746) | (1,844) | (2,344) |
| Additional minimum pension liability, net of tax | 10 | 33 | 31 | 97 |
| Unrealized gains (losses) on securities, net of tax | (3,716) | 1,006 | (6,649) | 540 |
| Balance, end of period | (8,462) | (1,707) | (8,462) | (1,707) |
| Treasury Stock | | | | |
| Balance, beginning of period | (77) | (77) | (77) | (77) |
| Acquisition of treasury shares | - | - | - | - |
| Balance, end of period | (77) | (77) | (77) | (77) |
| Stockholders' Equity | \$ 189,506 | \$ 172,306 | \$ 189,506 | \$ 172,306 |
| Net income | \$ 631 | \$ 6,802 | \$ 15,306 | \$ 20,587 |
| Additional minimum pension liability, net of tax | 10 | 33 | 31 | 97 |

| | | | | | | | | |
|--|----|---------|----|-------|----|---------|----|--------|
| Unrealized gains (losses) on securities, net of tax | | (3,716) | | 1,006 | | (6,649) | | 540 |
| Comprehensive Income (Loss) | \$ | (3,075) | \$ | 7,841 | \$ | 8,688 | \$ | 21,224 |

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

Hallmark Financial Services, Inc. and Subsidiaries
Consolidated Statement of Cash Flows
(Unaudited)
(\$ in thousands)

| | Nine Months Ended | |
|---|--------------------------|-------------|
| | September 30 | |
| | 2008 | 2007 |
| Cash flows from operating activities: | | |
| Net income | \$ 15,306 | \$ 20,587 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depreciation and amortization expense | 2,311 | 2,344 |
| Minority interest | 15 | - |
| Amortization of discount on structured settlement | - | 310 |
| Deferred federal income tax benefit | (1,849) | (1,170) |
| Realized (gain) loss on investments and impairment losses | 1,405 | (1,299) |
| Change in prepaid reinsurance premiums | (1,694) | 137 |
| Change in prepaid commissions | - | 487 |
| Change in premiums receivable | (1,026) | (8,492) |
| Change in accounts receivable | (24) | 1,604 |
| Change in deferred policy acquisition costs | (392) | (3,631) |
| Change in unpaid losses and loss adjustment expenses | 29,950 | 38,572 |
| Change in unearned premiums | 2,295 | 16,759 |
| Change in unearned revenue | (823) | (2,378) |
| Change in accrued agent profit sharing | (909) | 206 |
| Change in reinsurance recoverable | (6,573) | 149 |
| Change in reinsurance payable | - | (1,060) |
| Change in current federal income tax payable | (2,451) | (1,678) |
| Change in accrued ceding commission payable | 94 | 3,096 |
| Change in all other liabilities | (2,599) | 3,059 |
| Change in all other assets | 4,122 | (5,835) |
| Net cash provided by operating activities | 37,158 | 61,767 |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (477) | (367) |
| Acquisition of subsidiaries, net of cash acquired | (14,799) | - |
| Change in restricted cash | 7,080 | 12,244 |
| Purchases of debt and equity securities | (258,465) | (187,256) |
| Maturities and redemptions of investment securities | 227,061 | 115,288 |
| Net purchases of short-term investments | (110,340) | (30,713) |
| Net cash (used in) investing activities | (149,940) | (90,804) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of employee stock options | 143 | - |
| Net borrowings (repayment) of notes payable | 946 | (856) |
| Payment of structured settlement | (10,000) | (15,000) |

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| | | |
|--|-----------|-----------|
| Proceeds from issuance of trust preferred securities | - | 25,774 |
| Debt issuance costs | - | (674) |
| Net cash (used in) provided by financing activities | (8,911) | 9,244 |
| Decrease in cash and cash equivalents | (121,693) | (19,793) |
| Cash and cash equivalents at beginning of period | 145,884 | 81,474 |
| Cash and cash equivalents at end of period | \$ 24,191 | \$ 61,681 |

Supplemental Cash Flow Information:

| | | |
|---------------|-----------|-----------|
| Interest paid | \$ 3,576 | \$ 2,184 |
| Taxes paid | \$ 10,521 | \$ 13,053 |

Supplemental schedule of non-cash investing activities:

| | | |
|---|-------------|----------|
| Change in receivable for securities related to investment disposals that settled after the balance sheet date | \$ 27,395 | \$ (14) |
| Change in payable for securities related to investment purchases that settled after the balance sheet date | \$ (85,897) | \$ 8,878 |

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

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

1. General

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company 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 commercial insurance, non-standard automobile insurance and general aviation insurance, as well as providing other insurance related services. Our business is geographically concentrated in the south central and northwest regions of the United States, except for our general aviation business which is written on a national basis.

We pursue our business activities through subsidiaries whose operations are organized into five operating units which are supported by our three insurance company subsidiaries. Our HGA Operating Unit handles standard lines commercial insurance products and services and is comprised of American Hallmark Insurance Services, Inc. and Effective Claims Management, Inc. Our TGA Operating Unit handles primarily excess and surplus lines commercial insurance products and services and is comprised of TGA Insurance Managers, Inc., Pan American Acceptance Corporation (“PAAC”) and TGA Special Risk, Inc. Our Aerospace Operating Unit handles general aviation insurance products and services and is comprised of Aerospace Insurance Managers, Inc., Aerospace Special Risk, Inc. and Aerospace Claims Management Group, Inc. Our Heath XS Operating Unit handles excess commercial automobile and commercial umbrella risks on both an admitted and non-admitted basis and is comprised of Heath XS, LLC and Hardscrabble Data Solutions, LLC (collectively, “Heath Group”). Our Phoenix Operating Unit handles non-standard personal automobile insurance products and services and is comprised solely of American Hallmark General Agency, Inc. (which does business as Hallmark Insurance Company).

These five operating units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment presently consists solely of the HGA Operating Unit and the Personal Segment presently consists solely of our Phoenix Operating Unit. The Specialty Commercial Segment includes our TGA Operating Unit, Aerospace Operating Unit, and Heath XS Operating Unit.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting. These financial statements should be read in conjunction with our audited financial statements for the year ended December 31, 2007 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of September 30, 2008 and 2007 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended September 30, 2008 are not necessarily indicative of the operating results to be expected for the full year.

Redeemable minority interest

We are accreting the redeemable minority interest to its redemption value from the date of issuance to the earliest determinable redemption date, August 29, 2012, using the interest method. Changes in redemption value are considered a change in accounting estimate. We follow the two class method of computing earnings per share. We treat only the portion of the periodic adjustment to the redeemable minority interest carrying amount that reflects a redemption in excess of fair value as being akin to an actual dividend. (See Note 3, "Business Combinations.")

Reclassification

Certain previously reported amounts have been reclassified in order to conform to our current year presentation. Such reclassification had no effect on net income or stockholders' equity.

Immaterial Correction of an Error

We maintain catastrophe reinsurance for business produced by both our HGA and TGA Operating Units. Prior to July 1, 2007, the premium for our catastrophe reinsurance was based on all business produced by both operating units. Effective July 1, 2007, the premium for our catastrophe reinsurance is based only on business produced in Texas. However, in error we continued to record ceded premium for this coverage based on all business produced by the HGA and TGA Operating Units. This understated our earned premium for each quarter since July 1, 2007 through June 30, 2008.

We are correcting our prior period's financial statements and notes to reflect the reduction of ceded premium. Because the error was not material to any prior year financial statements, the corrections to prior periods will be presented in future filings, pursuant to SEC Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." Financial statements for the year ended December 31, 2007 will be revised in the December 31, 2008 Annual Report on Form 10-K.

The following table presents the effect of the correction on our previously reported consolidated statements of operations for the three months ended September 30, 2007, December 31, 2007, March 31, 2008 and June 30, 2008.

| | For the Three Months Ended | | | |
|---|----------------------------|----------------------|-------------------|------------------|
| | September 30, 2007 | December 31, 2007 | March 31, 2008 | June 30, 2008 |
| <u>As previously reported:</u> | | | | |
| Ceded premiums written | \$ (779) | \$ (2,382) | \$ (2,332) | \$ (2,327) |
| Net premiums written | 61,525 | 53,551 | 61,905 | 60,788 |
| Net premiums earned | 59,425 | 58,920 | 58,916 | 59,443 |
| Total revenues | 72,218 | 69,586 | 71,193 | 71,663 |
| Income before tax | 9,809 | 10,647 | 10,466 | 10,267 |
| Income tax expense | 3,227 | 3,585 | 3,414 | 3,066 |
| Net income | \$ 6,582 | \$ 7,062 | \$ 7,052 | \$ 7,201 |
| Common stockholders net income per share: | | | | |
| Basic | \$ 0.32 | \$ 0.34 | \$ 0.34 | \$ 0.35 |
| Diluted | \$ 0.32 | \$ 0.34 | \$ 0.34 | \$ 0.34 |
| <u>Adjustments:</u> | | | | |
| Ceded premiums written | \$ 338 | \$ 330 | \$ 328 | \$ 321 |
| Income tax expense | 118 | 116 | 115 | 112 |
| Net income impact | \$ 220 | \$ 214 | \$ 213 | \$ 209 |
| <u>As revised:</u> | | | | |
| Ceded premiums written | \$ (441) | \$ (2,052) | \$ (2,004) | \$ (2,006) |
| Net premiums written | 61,863 | 53,881 | 62,233 | 61,109 |
| Net premiums earned | 59,763 | 59,250 | 59,244 | 59,764 |
| Total revenues | 72,556 | 69,916 | 71,521 | 71,984 |
| Income before tax | 10,147 | 10,977 | 10,794 | 10,588 |
| Income tax expense | 3,345 | 3,701 | 3,529 | 3,178 |
| Net income | \$ 6,802 | \$ 7,276 | \$ 7,265 | \$ 7,410 |
| Common stockholders net income per share: | | | | |
| Basic | \$ 0.33 | \$ 0.35 | \$ 0.35 | \$ 0.36 |
| Diluted | \$ 0.33 | \$ 0.35 | \$ 0.35 | \$ 0.35 |

The following table presents the effect of the correction on our previously reported consolidated statements of operations for the nine months ended September 30, 2007, the year ended December 31, 2007, and the six months ended June 30, 2008.

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| | For the Nine Months Ended September 30, 2007 | For the Year Ended December 31, 2007 | For the Six Months Ended June 30, 2008 |
|---|---|---|---|
| <u>As previously reported:</u> | | | |
| Ceded premiums written | \$ (8,947) | \$ (11,329) | \$ (4,659) |
| Net premiums written | 184,592 | 238,143 | 122,693 |
| Net premiums earned | 166,383 | 225,303 | 118,359 |
| Total revenues | 204,912 | 274,498 | 142,856 |
| Income before tax | 30,454 | 41,101 | 20,733 |
| Income tax expense | 10,087 | 13,672 | 6,480 |
| Net income | \$ 20,367 | \$ 27,429 | \$ 14,253 |
| Common stockholders net income per share: | | | |
| Basic | \$ 0.98 | \$ 1.32 | \$ 0.69 |
| Diluted | \$ 0.98 | \$ 1.32 | \$ 0.68 |
| <u>Adjustments:</u> | | | |
| Ceded premiums written | \$ 338 | \$ 668 | \$ 649 |
| Income tax expense | 118 | 234 | 227 |
| Net income impact | \$ 220 | \$ 434 | \$ 422 |
| <u>As revised:</u> | | | |
| Ceded premiums written | \$ (8,609) | \$ (10,661) | \$ (4,010) |
| Net premiums written | 184,930 | 238,811 | 123,342 |
| Net premiums earned | 166,721 | 225,971 | 119,008 |
| Total revenues | 205,250 | 275,166 | 143,505 |
| Income before tax | 30,792 | 41,769 | 21,382 |
| Income tax expense | 10,205 | 13,906 | 6,707 |
| Net income | \$ 20,587 | \$ 27,863 | \$ 14,675 |
| Common stockholders net income per share: | | | |
| Basic | \$ 0.99 | \$ 1.34 | \$ 0.71 |
| Diluted | \$ 0.99 | \$ 1.34 | \$ 0.70 |

The following table presents the effect of the correction on our previously reported consolidated balance sheet as of December 31, 2007.

| | As previously reported | Adjustment | As revised |
|---|---------------------------|------------|------------|
| <u>Balances as of December 31, 2007</u> | | | |
| Prepaid reinsurance premiums | \$ 274 | \$ 668 | \$ 942 |
| Total assets | 606,314 | 668 | 606,982 |
| Current federal income tax payable | 630 | 234 | 864 |
| Total liabilities | 427,127 | 234 | 427,361 |
| Retained earnings | 58,909 | 434 | 59,343 |
| Total stockholders' equity | 179,187 | 434 | 179,621 |

The following table presents the effect of the correction on our previously reported consolidated statements of cash flows for the nine months ended September 30, 2007, the year ended December 31, 2007, the three months ended March 31, 2008, and the six months ended June 30, 2008.

| | For the Nine Months Ended September 30, 2007 | For the Year Ended December 31, 2007 | For the Three Months Ended March 31, 2008 | For the Six Months Ended June 30, 2008 |
|--|---|---|--|---|
| <u>As previously reported:</u> | | | | |
| Net income | \$ 20,367 | \$ 27,429 | \$ 7,052 | \$ 14,253 |
| Change in prepaid reinsurance premiums | 475 | 1,355 | (1,923) | (408) |
| Change in current federal income tax payable | (1,796) | (1,502) | 2,788 | (1,354) |
| Net cash provided by operating activities | 61,767 | 80,337 | 12,388 | 29,749 |
| <u>Adjustments:</u> | | | | |
| Net income | \$ 220 | \$ 434 | \$ 213 | \$ 422 |
| Change in prepaid reinsurance premiums | (338) | (668) | (328) | (649) |
| Change in current federal income tax payable | 118 | 234 | 115 | 227 |
| Net cash provided by operating activities | - | - | - | - |
| <u>As revised:</u> | | | | |
| Net income | \$ 20,587 | \$ 27,863 | \$ 7,265 | \$ 14,675 |
| Change in prepaid reinsurance premiums | 137 | 687 | (2,251) | (1,057) |
| Change in current federal income tax payable | (1,678) | (1,268) | 2,903 | (1,127) |
| Net cash provided by operating activities | 61,767 | 80,337 | 12,388 | 29,749 |

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Recently Issued Accounting Standards

In September 2005, the American Institute of Certified Public Accountants issued Statement of Position 05-1, "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts" ("SOP 05-01"). This Statement provides guidance on accounting for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in Statement of Financial Accounting Standards No. 97, "Accounting and Reporting by Insurance Enterprises for Certain

Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,” previously issued by the Financial Accounting Standards Board (“FASB”). SOP 05-01 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. The adoption of SOP 05-01 had no material impact on our financial condition or results of operations.

In June 2006, FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109” (“FIN 48”), was issued. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company’s financial statements in accordance with FASB Statement of Financial Accounting Standards No. 109, “Accounting for Income Taxes”. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, as well as providing guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 with earlier application permitted as long as the company has not yet issued financial statements, including interim financial statements, in the period of adoption. We adopted the provisions of FIN 48 on January 1, 2007. Since we had no unrecognized tax benefits, we recognized no additional liability or reduction in deferred tax asset as a result of the adoption of FIN 48. We are no longer subject to U. S. federal, state, local or non-U.S. income tax examinations by tax authorities for years prior to 2003.

In September 2006, FASB issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” (“SFAS 157”). SFAS 157 establishes a separate framework for determining fair values of assets and liabilities that are required by other authoritative GAAP pronouncements to be measured at fair value. In addition, SFAS 157 incorporates and clarifies the guidance in FASB Concepts Statement 7 regarding the use of present value techniques in measuring fair value. SFAS 157 does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of SFAS 157 had no impact on our financial statements or results of operations but did require additional disclosures. (See Note 5, “Fair Value”).

In February 2007, FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Liabilities” (“SFAS 159”). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value with changes in fair value included in current earnings. The election is made on specified election dates, can be made on an instrument-by- instrument basis, and is irrevocable. SFAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of SFAS 159 had no impact on our financial statements or results of operations as we did not elect to apply SFAS 159 to any eligible items.

In December 2007, the FASB issued Revised Statement of Financial Accounting Standards No. 141R, “Business Combinations” (“SFAS 141R”), a replacement of Statement of Financial Accounting Standards No. 141, “Business Combinations”. SFAS 141R provides revised guidance on how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. In addition, it provides revised guidance on the recognition and measurement of goodwill acquired in the business combination. SFAS 141R also provides guidance specific to the recognition, classification, and measurement of assets and liabilities related to insurance and reinsurance contracts acquired in a business combination. SFAS 141R applies to business combinations for acquisitions occurring on or after January 1, 2009. We do not expect the provisions of SFAS 141R to have a material effect on our results of operations or liquidity. However, SFAS 141R will impact the accounting for any future acquisitions.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, “Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51” (“SFAS 160”). SFAS 160 amends Accounting Research Bulletin No. 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. In addition, it clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. SFAS 160 is effective on a prospective basis beginning January 1, 2009, except for the presentation and disclosure requirements which are applied on a retrospective basis for all periods presented. We are currently assessing the impact of SFAS 160 on our consolidated financial statements.

3. Business Combinations

We account for business combinations using the purchase method of accounting. The cost of an acquired entity is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on their estimated fair values. The excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed is an asset referred to as "Excess of cost over fair value of net assets acquired." Indirect and general expenses related to business combinations are expensed as incurred.

On August 29, 2008, we acquired 80% of the issued and outstanding membership interests in Heath Group for cash consideration of \$15 million plus fair value of a put option of \$539 thousand included as redeemable minority interest. (See Note 1, "General - Redeemable Minority Interest.") We have the right to purchase the remaining 20% membership interests in Heath Group and have granted to an affiliate of the seller the right to require us to purchase such remaining interests (the "Put/Call Option"). The Put/Call Option becomes exercisable by either party upon the earlier of August 29, 2012, the termination of the employment of the seller by the Heath Group or a change in control of Hallmark. The Put/Call option expires on August 29, 2018. If the Put/Call Option is exercised, we will have the right or obligation to purchase the remaining membership interests in the Heath Group for an amount equal to 20% of nine times the average pre-tax income for the previous 12 fiscal quarters. We estimate the ultimate redemption value of the Put/Call option to be \$4.8 million at September 30, 2008.

The fair value of the amortizable intangible assets acquired and respective amortization periods are as follows (\$ in thousands):

| | | |
|---------------|----------|-------|
| | | 15 |
| Tradename | \$ 757 | years |
| Non-compete | | 6 |
| agreement | \$ 526 | years |
| Agency | | 15 |
| relationships | \$ 6,385 | years |

The Heath Group is an underwriting organization that produces lower hazard, middle market, excess commercial automobile and commercial umbrella insurance policies on both an admitted and non-admitted basis through a network of independent wholesale agencies throughout the United States.

4. Supplemental Cash Flow Information

Effective August 29, 2008, we acquired the Heath Group. (See Note 3, "Business Combinations.") In conjunction with the acquisition, cash and cash equivalents were used in the acquisitions as follows (in thousands):

| | |
|--|-----------|
| Fair value of tangible assets excluding cash and cash equivalents | \$ (3) |
| Fair value of intangible assets acquired | 15,381 |
| Redeemable minority interest assumed | (579) |
| Cash and cash equivalents used in acquisitions, net of \$201 thousand cash and cash equivalents acquired | \$ 14,799 |

The purchase price was preliminarily allocated to the assets acquired and the liabilities assumed based on their estimated fair values at the purchase date as summarized above. The final allocation of the purchase price will be finalized in the fourth quarter of 2008 upon completing certain Heath Group tax filings impacting the tax basis of assets and liabilities acquired.

5. Fair Value

SFAS 157 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. SFAS 157, 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, SFAS 157 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. It also requires recognition of trade-date gains related to certain derivative transactions whose fair value has been determined using unobservable market inputs. This guidance supersedes the guidance in Emerging Issues Task Force Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities", which prohibited the recognition of trade-date gains for such derivative transactions when determining the fair value of instruments not traded in an active market.

Effective January 1, 2008, we determine the fair value of our financial instruments based on the fair value hierarchy established in SFAS 157. In accordance with SFAS 157, 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 SFAS 157, we determine fair value based on the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. It is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy described above. Fair value measurements for assets and liabilities where there exists limited or no observable market data are calculated based upon our pricing policy, the economic and competitive environment, the characteristics of the asset or liability and other factors as appropriate. These estimated fair values may not be realized upon actual sale or immediate settlement of the asset or liability.

Where quoted prices are available on active exchanges for identical instruments, investment securities are classified within Level 1 of the valuation hierarchy. Level 1 investment securities include common and preferred stock. If quoted prices are not available from active exchanges for identical instruments, then fair values are estimated using quoted prices from less active markets, quoted prices of securities with similar characteristics or by pricing models utilizing other significant observable inputs. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, include corporate bonds, municipal bonds and U.S. Treasury securities. In cases where there is limited activity or less transparency around inputs to the valuation, investment securities are classified within Level 3 of the valuation hierarchy. Level 3 investments are valued based on the best available data in order to approximate fair value. This data may be internally developed and consider risk premiums that a market participant would require. Investment securities classified within Level 3 include other less liquid investment securities.

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at September 30, 2008 (in thousands).

| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Unobservable Inputs (Level 3) | Total |
|---------------------------|---|--|-------------------------------------|------------|
| Debt securities | \$ - | \$ 180,954 | \$ - | \$ 180,954 |
| Equity securities | 41,568 | - | - | 41,568 |
| Short-term investments | 335 | 112,630 | - | 112,965 |
| Total | \$ 41,903 | \$ 293,584 | \$ - | \$ 335,487 |

The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2008 (in thousands).

| | |
|--|----------|
| Beginning balance as of January 1, 2008 | \$ 4,000 |
| Purchases, issuances, sales and settlements | (4,000) |
| Total realized/unrealized gains/(losses) included in net income | - |
| Net gains/(losses) included on other comprehensive income | - |
| Transfers in and/or out of Level 3 | - |
| Ending balance as of September 30, 2008 | \$ - |

6. 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. Unless other factors cause us to reach a contrary conclusion, investments with a fair market value significantly less than cost for more than 180 days are deemed to have a decline in value that is other-than-temporary. A decline in value that is considered to be other-than-temporary is charged to earnings based on the fair value of the security at the time of assessment, resulting in a new cost basis for the security. For the three and nine months ended September 30, 2008, we recognized approximately \$3.2 million and \$3.7 million of other than temporary impairments on investments.

The following schedules summarize the gross unrealized losses showing the length of time that investments have been continuously in an unrealized loss position as of September 30, 2008 and December 31, 2007:

| | As of September 30, 2008 | | | | | |
|---------------------------|--------------------------|-------------------|---------------------|-------------------|-------------------|--------------------|
| | Less than 12 months | | 12 months or longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate debt securities | \$ 25,169 | \$ (1,063) | \$ 16,860 | \$ (2,778) | \$ 42,029 | \$ (3,841) |
| Municipal bonds | 79,655 | (3,216) | 7,488 | (232) | 87,143 | (3,448) |
| Equity securities | 29,181 | (3,976) | - | - | 29,181 | (3,976) |
| Short term securities | 354 | - | - | - | 354 | - |
| Total | \$ 134,359 | \$ (8,255) | \$ 24,348 | \$ (3,010) | \$ 158,707 | \$ (11,265) |

| | As of December 31, 2007 | | | | | |
|---------------------------|-------------------------|-------------------|---------------------|-------------------|------------------|-------------------|
| | Less than 12 months | | 12 months or longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate debt securities | \$ 19,021 | \$ (840) | \$ 18,329 | \$ (896) | \$ 37,350 | \$ (1,736) |
| Municipal bonds | 24,392 | (122) | 7,780 | (130) | 32,172 | (252) |
| Equity securities | 6,954 | (318) | - | - | 6,954 | (318) |
| Short term securities | 352 | (1) | - | - | 352 | (1) |
| Total | \$ 50,719 | \$ (1,281) | \$ 26,109 | \$ (1,026) | \$ 76,828 | \$ (2,307) |

Of the gross unrealized loss at September 30, 2008, \$3.0 million is more than twelve months old, consisting of 17 bond positions. Of the gross unrealized loss at December 31, 2007, \$1.0 million is more than twelve months old, consisting of 22 bond positions. We consider these losses as a temporary decline in value as they are predominately on bonds where we believe we have the ability to hold our positions until maturity and the debt issuers have the ability to make all contractual payments. We see no other indications that the decline in values of these securities is other than temporary.

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

Also, as a result of the challenging market conditions, including expected further weakening in the economic environment subsequent to September 30, 2008, we have experienced continued volatility in the valuation of our equity securities including increases in our unrealized investment losses. We expect the volatility in the valuation of our equity securities to continue in the foreseeable future. This volatility may lead to additional impairments on our equity securities portfolio or changes regarding retention strategies for certain equity securities.

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7. Pledged Investments

We have certain of our securities pledged for the benefit of various state insurance departments and reinsurers. These securities are included with our available-for-sale debt securities because we have the ability to trade these securities. We retain the interest earned on these securities. These securities had a carrying value of \$13.9 million at September 30, 2008 and a carrying value of \$18.5 million at December 31, 2007.

8. Share-Based Payment Arrangements

Our 2005 Long Term Incentive Plan ("2005 LTIP") is a stock compensation plan for key employees and non-employee directors that was approved by the shareholders on May 26, 2005. There are 1,500,000 shares authorized for issuance under the 2005 LTIP. Our 1994 Key Employee Long Term Incentive Plan (the "1994 Employee Plan") and 1994 Non-Employee Director Stock Option Plan (the "1994 Director Plan") both expired in 2004 but have unexercised options outstanding.

As of September 30, 2008, there were incentive stock options to purchase 927,499 shares of our common stock outstanding and non-qualified stock options to purchase 60,000 shares of our common stock outstanding under the 2005 LTIP, leaving 512,501 shares reserved for future issuance. As of September 30, 2008, there were incentive stock options to purchase 52,299 shares outstanding under the 1994 Employee Plan and non-qualified stock options to purchase 20,834 shares outstanding under the 1994 Director Plan. In addition, as of September 30, 2008, there were outstanding non-qualified stock options to purchase 16,666 shares of our common stock granted to certain non-employee directors outside the 1994 Director Plan in lieu of fees for service on our board of directors in 1999. The exercise price of all such outstanding stock options is equal to the fair market value of our common stock on the date of grant.

Options granted under the 1994 Employee Plan prior to October 31, 2003, vest 40% six months from the date of grant and an additional 20% on each of the first three anniversary dates of the grant and terminate ten years from the date of grant. Incentive stock options granted under the 2005 LTIP and the 1994 Employee Plan after October 31, 2003, vest 10%, 20%, 30% and 40% on the first, second, third and fourth anniversary dates of the grant, respectively, and terminate five to ten years from the date of grant. Non-qualified stock options granted under the 2005 LTIP vest 100% six months after the date of grant and terminate ten years from the date of grant. All non-qualified stock options granted under the 1994 Director Plan vested 40% six months from the date of grant and an additional 10% on each of the first six anniversary dates of the grant and terminate ten years from the date of grant. The options granted to non-employee directors outside the 1994 Director Plan fully vested six months after the date of grant and terminate ten years from the date of grant.

During the first quarter of 2008, we determined our previous recognition of compensation expense on share based arrangements did not conform to GAAP. As a result, we corrected our calculation to properly record compensation expense on a straight line basis over the requisite service period for the entire award in accordance with SFAS No. 123R "Share-Based Payment". The cumulative impact of this correction was recorded during the first quarter of 2008 resulting in additional compensation expense of approximately \$354 thousand which is not considered to have a material impact on our financial position or results of operations.

A summary of the status of our stock options as of September 30, 2008 and changes during the nine-months then ended is presented below:

| | Number of Shares | Average Exercise Price | Contractual Term (Years) | Intrinsic Value (\$000) |
|--------------------------------------|---------------------|------------------------------|--------------------------------|-------------------------------|
| Outstanding at January 1, 2008 | 848,000 | \$ 10.41 | | |
| Granted | 270,000 | \$ 11.46 | | |
| Exercised | (40,702) | \$ 3.54 | | |
| Forfeited or expired | - | \$ - | | |
| Outstanding at September 30, 2008 | 1,077,298 | \$ 10.93 | 8.0 | \$ 682 |
| Exercisable at September 30, 2008 | 263,549 | \$ 8.19 | 5.5 | \$ 614 |

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|--------|------------------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Intrinsic value of options exercised | \$ - | \$ - | \$ 337 | \$ - |
| Cost of share-based payments (non-cash) | \$ 305 | \$ 198 | \$ 1,078 | \$ 351 |
| Income tax benefit of share-based payments recognized in income | \$ 107 | \$ 69 | \$ 377 | \$ 123 |

As of September 30, 2008 there was \$2.8 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under our plans, of which \$0.3 million is expected to be recognized in the remainder of 2008, \$1.0 million is expected to be recognized in 2009, \$0.9 million is expected to be recognized in 2010, \$0.5 million is expected to be recognized in 2011 and \$0.1 million is expected to be recognized in 2012.

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option pricing model. Expected volatilities are based on the historical volatility of similar companies' common stock for a period equal to the expected term. The risk-free interest rates for periods within the contractual term of the options are based on rates for U.S. Treasury Notes with maturity dates corresponding to the options' expected lives on the dates of grant. Expected term is determined based on the simplified method as we do not have sufficient historical exercise data to provide a basis for estimating the expected term.

The following table details the weighted average grant date fair value and related assumptions for the periods indicated:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------|-------------------------------------|---------|------------------------------------|---------|
| | 2008 | 2007 | 2008 | 2007 |
| Grant date fair value per share | n/a | \$ 4.14 | \$ 4.74 | \$ 4.04 |
| Expected term (in years) | n/a | 6.5 | 6.4 | 6.4 |
| Expected volatility | n/a | 19.0% | 35.0% | 19.4% |
| Risk free interest rate | n/a | 4.8% | 3.4% | 4.5% |

9. Segment Information

The following is business segment information for the three and nine months ended September 30, 2008 and 2007 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenues: | | | | |
| Standard Commercial Segment | \$ 20,280 | \$ 23,718 | \$ 64,617 | \$ 65,488 |
| Specialty Commercial Segment | 30,245 | 32,910 | 94,617 | 93,986 |
| Personal Segment | 16,053 | 15,185 | 48,277 | 43,654 |
| Corporate | (1,589) | 743 | 983 | 2,122 |
| Consolidated | \$ 64,989 | \$ 72,556 | \$ 208,494 | \$ 205,250 |
| Pre-tax income (loss), net of minority interest: | | | | |
| Standard Commercial Segment | \$ 887 | \$ 3,702 | \$ 9,104 | \$ 9,125 |
| Specialty Commercial Segment | 745 | 6,500 | 12,601 | 20,627 |
| Personal Segment | 2,544 | 1,854 | 7,047 | 6,148 |
| Corporate | (4,030) | (1,909) | (7,224) | (5,108) |
| Consolidated | \$ 146 | \$ 10,147 | \$ 21,528 | \$ 30,792 |

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

| | September 30, 2008 | | December 31, 2007 | |
|------------------------------|--------------------|---------|-------------------|---------|
| <u>Assets</u> | | | | |
| Standard Commercial Segment | \$ | 157,105 | \$ | 211,761 |
| Specialty Commercial Segment | | 219,124 | | 229,473 |
| Personal Segment | | 78,143 | | 100,986 |
| Corporate | | 95,308 | | 64,762 |
| | \$ | 549,680 | \$ | 606,982 |

10. 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.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | | | | |
|------------------------|-------------------------------------|-------|------------------------------------|-------|----|-------|----|--------|
| | 2008 | 2007 | 2008 | 2007 | | | | |
| Ceded earned premiums | \$ | 2,153 | \$ | 2,035 | \$ | 6,126 | \$ | 10,059 |
| Reinsurance recoveries | \$ | 8,211 | \$ | 537 | \$ | 9,474 | \$ | 3,973 |

Our insurance company subsidiaries presently retain 100% of the risk associated with all non-standard personal automobile policies marketed by our Phoenix Operating Unit. We currently reinsure the following exposures on business generated by our HGA Operating Unit, our TGA Operating Unit and our Aerospace Operating Unit:

- Property catastrophe. Our property catastrophe reinsurance reduces the financial impact a catastrophe could have on our commercial property insurance lines. Catastrophes might include multiple claims and policyholders. Catastrophes include hurricanes, windstorms, earthquakes, hailstorms, explosions, severe winter weather and fires. Our property catastrophe reinsurance is excess-of-loss reinsurance, which provides us reinsurance coverage for losses in excess of an agreed-upon amount. We utilize catastrophe models to assist in determining appropriate retention and limits to purchase. The terms of our property catastrophe reinsurance, effective July 1, 2008, are:

- o We retain the first \$3.0 million of property catastrophe losses; and
- o Our reinsurers reimburse us 100% for each \$1.00 of loss in excess of our \$3.0 million retention up to \$10.0 million for each catastrophic occurrence, subject to an aggregate limit of \$14 million. As a result of hurricane losses we have ceded to our reinsurers losses of approximately \$7.0 million and have approximately \$7.0 million of coverage remaining under this layer of catastrophe reinsurance at September 30, 2008.
- o Our reinsurers reimburse us 100% for each \$1.00 of loss in excess of \$10.0 million up to \$35.0 million for each catastrophic occurrence subject to an aggregate limit of \$50.0 million.
- Commercial property. Our commercial property reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event or catastrophic loss may have on our results. The terms of our commercial property reinsurance, effective July 1, 2008, are:
 - o We retain the first \$1.0 million of loss for each commercial property risk;
 - o Our reinsurers reimburse us for the next \$5.0 million for each commercial property risk; and
 - o Individual risk facultative reinsurance is purchased on any commercial property with limits above \$5.0 million.
- Commercial casualty. Our commercial casualty reinsurance is excess-of-loss coverage intended to reduce the financial impact a single-event loss may have on our results. The terms of our commercial casualty reinsurance, effective July 1, 2008, are:
 - o We retain the first \$1.0 million of any commercial liability risk; and
 - o Our reinsurers reimburse us for the next \$5.0 million for each commercial liability risk.
- Aviation. We purchase reinsurance specific to the aviation risks underwritten by our Aerospace Operating Unit. This reinsurance provides aircraft hull and liability coverage and airport liability coverage on a per occurrence basis on the following terms:
 - o We retain the first \$350,000 of each aircraft hull or liability loss or airport liability loss;
 - o Our reinsurers reimburse us for the next \$2.15 million of each aircraft hull loss and for the next \$650,000 of each aircraft or airport liability loss; and
 - o Risks with liability limits greater than \$1.0 million are placed in a quota share treaty where we retain 20% of incurred losses.

11. Notes Payable

On June 21, 2005, an unconsolidated trust subsidiary completed a private placement of \$30.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed \$30.9 million from the trust subsidiary and contributed \$30.0 million to one of our insurance company subsidiaries in order to increase policyholder surplus. The note bears an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25 percentage points. Under the terms of the note, we pay interest only each quarter and the principal of the note at maturity. As of September 30, 2008, the note balance was \$30.9 million.

On January 27, 2006, we borrowed \$15.0 million under our revolving credit facility to fund the cash required to close the acquisition of the subsidiaries comprising our TGA Operating Unit. As of September 30, 2008, the balance on the revolving note was \$2.8 million, which currently bears interest at 5.78% per annum. Also included in notes payable is \$2.3 million outstanding as of September 30, 2008 under PAAC's revolving credit sub-facility, which also currently bears interest at 5.78% per annum. (See Note 13, "Credit Facilities.")

On August 23, 2007, an unconsolidated trust subsidiary completed a private placement of \$25.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed \$25.8 million from the trust subsidiary for working capital and general corporate purposes. The note bears an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. Under the terms of the note, we pay interest only each quarter and the principal of the note at maturity. As of September 30, 2008 the note balance was \$25.8 million.

12. Structured Settlements

In connection with the acquisition of the subsidiaries comprising our TGA Operating Unit, we recorded a payable for future guaranteed payments of \$25.0 million discounted at 4.4%, the rate of two-year U.S. Treasuries (the only investment permitted on the trust account securing such future payments). As of September 30, 2008 we had fully repaid our obligation to the sellers.

13. Credit Facilities

On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit facility was amended and restated on January 27, 2006 to a \$20.0 million revolving credit facility, with a \$5.0 million letter of credit sub-facility. The credit facility was further amended effective May 31, 2007 to increase the revolving credit facility to \$25.0 million and establish a new \$5.0 million revolving credit sub-facility for the premium finance operations of PAAC. The credit agreement was again amended effective February 20, 2008 to extend the termination to January 27, 2010, revise various affirmative and negative covenants and decrease the interest rate in most instances to the three month Eurodollar rate plus 1.90 percentage points, payable quarterly in arrears. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets. The revolving credit facility contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of September 30, 2008, we were in compliance with all of our financial and non-financial covenants under this credit facility. (See Note 11, "Notes Payable.")

14. Deferred Policy Acquisition Costs

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------|-------------------------------------|-------------|------------------------------------|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| Deferred | \$ (13,700) | \$ (12,197) | \$ (41,718) | \$ (37,163) |
| Amortized | 14,204 | 11,635 | 41,326 | 33,532 |
| Net | \$ 504 | \$ (562) | \$ (392) | \$ (3,631) |

15. Earnings per Share

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|--------|------------------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Weighted average shares - basic | 20,809 | 20,768 | 20,799 | 20,768 |
| Effect of dilutive securities | 62 | - | 82 | - |
| Weighted average shares - assuming dilution | 20,871 | 20,768 | 20,881 | 20,768 |

For the three and nine months ended September 30, 2008, 899,166 shares of common stock potentially issuable upon the exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive. For the three and nine months ended September 30, 2007, 520,000 shares of common stock potentially issuable upon exercise of employee stock options were excluded from the weighted average number of shares outstanding on a diluted basis because the effect of such options would be anti-dilutive.

16. Net Periodic Pension Cost

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|------------------------------------|-------------------------------------|--------|------------------------------------|--------|
| | 2008 | 2007 | 2008 | 2007 |
| Interest cost | \$ 167 | \$ 180 | \$ 501 | \$ 540 |
| Amortization of net (gain) loss | 16 | 50 | 48 | 150 |
| Expected return on plan assets | (167) | (161) | (502) | (482) |
| Net periodic pension cost | \$ 16 | \$ 69 | \$ 47 | \$ 208 |

We contributed \$414 thousand and \$31 thousand to our frozen defined benefit cash balance plan (“Cash Balance Plan”) during the three months ended September 30, 2008 and 2007, respectively. We contributed \$650 thousand and \$301 thousand to our Cash Balance Plan during the nine months ended September 30, 2008 and 2007, respectively. Refer to Note 13 to the consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2007 for more discussion of our retirement plans.

17. Contingencies

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

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

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

Introduction

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company 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 commercial insurance, non-standard automobile insurance and general aviation insurance, as well as providing other insurance related services. Our business is geographically concentrated in the south central and northwest regions of the United States, except for our general aviation business which is written on a national basis. We pursue our business activities through subsidiaries whose operations are organized into four operating units which are supported by our insurance company subsidiaries.

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

- **Standard Commercial Segment.** Our Standard Commercial Segment includes the standard lines commercial property/casualty insurance products and services handled by our HGA Operating Unit which is comprised of our American Hallmark Insurance Services, Inc. and Effective Claims Management, Inc. subsidiaries.
- **Specialty Commercial Segment.** Our Specialty Commercial Segment includes the excess and surplus lines commercial property/casualty insurance products and services handled by our TGA Operating Unit, the general aviation insurance products and services handled by our Aerospace Operating Unit, and the excess commercial automobile and commercial umbrella insurance products handled by our Heath XS Operating Unit. Our TGA Operating Unit is comprised of our TGA Insurance Managers, Inc., Pan American Acceptance Corporation (“PAAC”) and TGA Special Risk, Inc. subsidiaries. Our Aerospace Operating Unit is comprised of our Aerospace Insurance Managers, Inc., Aerospace Special Risk, Inc. and Aerospace Claims Management Group, Inc. subsidiaries. Our Heath XS Operating Unit is comprised of our Heath XS, LLC and Hardscrabble Data Solutions, LLC subsidiaries (collectively, the “Heath Group”).

·**Personal Segment.** Our Personal Segment includes the non-standard personal automobile insurance products and services handled by our Phoenix Operating Unit which is comprised solely of American Hallmark General Agency, Inc., which does business as Hallmark Insurance Company.

The retained premium produced by our operating units is supported by the following insurance company subsidiaries:

·**American Hallmark Insurance Company of Texas (“AHIC”)** presently retains all of the risks on the commercial property/casualty policies marketed by our HGA Operating Unit, retains a portion of the risks on the non-standard personal automobile policies marketed by our Phoenix Operating Unit, assumes a portion of the risks on the commercial property/casualty policies marketed by our TGA Operating Unit and assumes a portion of the risks on the aviation property/casualty products marketed by our Aerospace Operating Unit.

·**Hallmark Specialty Insurance Company (“HSIC”)** presently assumes a portion of the risks on the commercial property/casualty policies marketed by our TGA Operating Unit.

· **Hallmark Insurance Company (“HIC”) (formerly known as Phoenix Indemnity Insurance Company)** presently assumes a portion of the risks on the non-standard personal automobile policies marketed by our Phoenix Operating Unit and assumes a portion of the risks on the aviation property/casualty products marketed by our Aerospace Operating Unit.

Effective January 1, 2006, our insurance company subsidiaries entered into a pooling arrangement, which was subsequently amended on December 15, 2006, pursuant to which AHIC retains 46% of the total net premiums written by all of our operating units, HIC retains 34% of our total net premiums written and HSIC retains 20% of our total net premiums written. This pooling arrangement had no impact on our consolidated financial statements under GAAP.

Results of Operations

Management Overview. During the three and nine months ended September 30, 2008, our total revenues were \$65.0 and \$208.5 million, representing a 10% decrease and a 2% increase over the \$72.6 million and \$205.3 million in total revenues for the same periods of 2007. The decrease in total revenue for the three months ended September 30, 2008 was primarily due to a reduction in earned premium, recognized net losses on our investment portfolio and lower commission income. The increase in revenue for the nine months ended September 30, 2008 was primarily due to increased earned premium and investment income partially offset by lower commission income and recognized losses on our investment portfolio. The recognized losses on our investment portfolio included a \$3.0 million impairment for a Washington Mutual senior debt security.

Standard Commercial Segment revenues decreased \$3.4 million and \$0.9 million, or 14% and 1%, during the three and nine months ended September 30, 2008 as compared to the same periods during 2007, due primarily to lower earned premium as a result of general economic conditions and our continued underwriting discipline in an increasingly competitive marketplace. Specialty Commercial Segment revenues decreased \$2.7 million, or 8%, and increased \$0.6 million, or 1%, during the three months and nine months ended September 30, 2008 as compared to the same periods of 2007, due to lower commission income primarily as a result of retaining a higher percentage of the business produced by an agency subsidiary, partially offset by increased net premiums earned as a result of the increased retention of business. Revenues from our Personal Segment increased \$0.9 million and \$4.6 million, or 6% and 11%, during the three and nine months ended September 30, 2008 as compared to the same periods during 2007, due largely to geographic expansion into new states. Corporate revenue decreased \$2.3 million and \$1.1 million for the three and nine months ended September 30, 2008 primarily due to recognized losses on our investment portfolio of \$2.5 million and \$1.4 million during the three and nine months ended September 30, 2008 as compared to recognized gains on our investment portfolio of \$0.4 million and \$1.3 million during the same period the prior year, offset by investment income of \$0.6 million and \$1.6 million for the same periods due to changes in capital allocation.

We reported net income of \$0.6 million and \$15.3 million for the three and nine months ended September 30, 2008, which was \$6.2 million and \$5.3 million lower than the \$6.8 million and \$20.6 million reported for the same periods in 2007. On a diluted basis per share, net income was \$0.03 and \$0.73 per share for the three months and nine months ended September 30, 2008 as compared to \$0.33 and \$0.99 per share for the same periods in 2007. The decrease in net income for the three and nine months ended September 30, 2008 was primarily attributable to decreased revenue for the three month period, as discussed above, and increased loss and loss adjustment expenses for both the three and nine month periods primarily attributable to third quarter net hurricane losses..

Third Quarter 2008 as Compared to Third Quarter 2007

The following is additional business segment information for the three months ended September 30, 2008 and 2007 (in thousands):

**Hallmark Financial Services, Inc.
Consolidated Segment Data**

| | Three Months Ended September 30, 2008 | | | | |
|---|--|---|-----------------------------|------------------|---------------------|
| | Standard Commercial Segment | Specialty Commercial Segment | Personal Segment | Corporate | Consolidated |
| Produced premium (1) | \$ 18,957 | \$ 36,295 | \$ 14,763 | \$ - | \$ 70,015 |
| Gross premiums written | 18,954 | 25,288 | 14,763 | - | 59,005 |
| Ceded premiums written | (1,274) | (1,219) | - | - | (2,493) |
| Net premiums written | 17,680 | 24,069 | 14,763 | - | 56,512 |
| Change in unearned premiums | 1,784 | 650 | (18) | - | 2,416 |
| Net premiums earned | 19,464 | 24,719 | 14,745 | - | 58,928 |
| Total revenues | 20,280 | 30,245 | 16,053 | (1,589) | 64,989 |
| Losses and loss adjustment expenses | 13,239 | 16,287 | 9,455 | - | 38,981 |
| Pre-tax income (loss), net of minority interest | 887 | 745 | 2,544 | (4,030) | 146 |
| Net loss ratio (2) | 68.0% | 65.9% | 64.1% | | 66.2% |
| Net expense ratio (2) | 27.4% | 31.1% | 22.6% | | 28.8% |
| Net combined ratio (2) | 95.4% | 97.0% | 86.7% | | 95.0% |

| | Three Months Ended September 30, 2007 | | | | |
|-------------------------------------|--|---|-----------------------------|------------------|---------------------|
| | Standard Commercial Segment | Specialty Commercial Segment | Personal Segment | Corporate | Consolidated |
| Produced premium (1) | \$ 21,945 | \$ 37,919 | \$ 14,854 | \$ - | \$ 74,718 |
| Gross premiums written | 21,918 | 25,531 | 14,855 | - | 62,304 |
| Ceded premiums written | 386 | (827) | - | - | (441) |
| Net premiums written | 22,304 | 24,704 | 14,855 | - | 61,863 |
| Change in unearned premiums | (311) | (870) | (919) | - | (2,100) |
| Net premiums earned | 21,993 | 23,834 | 13,936 | - | 59,763 |
| Total revenues | 23,718 | 32,910 | 15,185 | 743 | 72,556 |
| Losses and loss adjustment expenses | 13,513 | 13,682 | 9,532 | (4) | 36,723 |

| | | | | | |
|------------------------|-------|-------|-------|---------|--------|
| Pre-tax income (loss) | 3,702 | 6,500 | 1,854 | (1,909) | 10,147 |
| Net loss ratio (2) | 61.4% | 57.4% | 68.4% | | 61.4% |
| Net expense ratio (2) | 27.1% | 30.6% | 22.9% | | 27.5% |
| Net combined ratio (2) | 88.5% | 88.0% | 91.3% | | 88.9% |

(1) Produced premium is a non-GAAP measurement that management uses to track total controlled premium produced by our operations. We believe this is a useful tool for users of our financial statements to measure our premium production whether retained by our insurance company subsidiaries or retained by third party insurance carriers where we receive commission revenue.

(2) The net loss ratio is calculated as incurred losses and loss adjustment expenses divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is calculated as underwriting expenses of our insurance company subsidiaries (which include provisional ceding commissions, direct agent commissions, premium taxes and assessments, professional fees, other general underwriting expenses and allocated overhead expenses) and 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.

Standard Commercial Segment

Gross premiums written for the Standard Commercial Segment were \$19.0 million for the three months ended September 30, 2008, which was \$2.9 million less than the \$21.9 million for the three months ended September 30, 2007. Net premiums written were \$17.7 million for the three months ended September 30, 2008 as compared to the \$22.3 million reported for the same period in 2007. The primary reasons for the decline in premiums were general economic conditions and our continued underwriting discipline in an increasingly competitive marketplace..

Total revenue for the Standard Commercial Segment was \$20.3 million for the three months ended September 30, 2008 as compared to \$23.7 million for the same period in 2007. This \$3.4 million decrease was due primarily to decreased earned premium of \$2.5 million as well as decreased contingent commissions of \$0.7 million related to unfavorable loss development on prior accident years during the third quarter of 2008 as compared to the same period for 2007.

Pre-tax income for our Standard Commercial Segment of \$0.9 million for the third quarter of 2008 decreased \$2.8 million from the \$3.7 million reported for the third quarter of 2007. The decreased revenue discussed above was the primary reason for the decrease in pre-tax income, partially offset by lower losses and loss adjustment expense of \$0.3 million for the quarter and lower operating expenses of \$0.3 million due to lower production related costs. Losses and loss adjustment expense decreased despite \$3.3 million of incurred losses net of reinsurance attributable to hurricane damage during the quarter.

The net loss ratio of 68.0% for the three months ended September 30, 2008 as compared to 61.4% for the prior year was unfavorably impacted by hurricane related losses net of reinsurance for the three months ended September 30, 2008. The gross loss ratio was 89.7% for the three months ended September 30, 2008 as compared to 59.6% for the same period the prior year. The gross loss results for the three months ended September 30, 2008 included \$8.8 million of hurricane related losses partially offset by \$0.4 million of favorable prior year development as compared to unfavorable loss development on prior accident years of \$0.4 million recognized during the same period of 2007. Hurricane losses accounted for 42.3% of the gross loss ratio and 17.1% of the net loss ratio for the quarter. The Standard Commercial Segment reported net expense ratios of 27.4% and 27.1% for the second quarters of 2008 and 2007, respectively.

Specialty Commercial Segment

Gross premiums written for the Specialty Commercial Segment for the third quarter of 2008 were \$25.3 million, which was \$0.2 million less than the \$25.5 million reported for the same period in 2007. Net premiums written for the third quarter of 2008 were \$24.1 million, which was \$0.6 million less than the \$24.7 million reported for the same period in 2007. The decrease in premium volume was due to general economic conditions and our continued underwriting discipline in an increasingly competitive marketplace in both the excess and surplus and general aviation markets.

Total revenue for the Specialty Commercial Segment of \$30.2 million for the third quarter of 2008 was \$2.7 million less than the \$32.9 million reported in the third quarter of 2007. This 8% decrease in revenue was largely due to lower commission income of \$2.2 million primarily as a result of retaining a higher percentage of the business produced by an agency subsidiary, reduced contingent commission of \$1.2 million resulting from the impact of hurricane losses, and decreased investment income of \$0.1 million, partially offset by increased net premiums earned of \$0.9 million for the quarter as a result of the increased retention of business.

Pre-tax income for the Specialty Commercial Segment of \$0.7 million for the third quarter of 2008 decreased \$5.8 million from the \$6.5 million reported for the same period in 2007. The decline in pre-tax income was primarily attributable to decreased revenue, discussed above, as well as increased losses and loss adjustment expenses of \$2.6 million. Incurred losses net of reinsurance of \$2.7 million from hurricane damage was the primary cause of the increase in losses and loss adjustment expense. Pre-tax income was also impacted by higher other operating expenses of \$1.2 million as a result of a premium receivable write-off due to the default of a producer in our TGA Operating Unit, partially offset by decreased production related expenses of \$0.8 million due to lower produced premium.

The Specialty Commercial Segment reported a net loss ratio of 65.9% for the third quarter of 2008 as compared to 57.4% for the third quarter of 2007. In addition to hurricane related losses, unfavorable prior accident year development of \$0.5 million for the third quarter of 2008 as compared to favorable prior accident year development of \$1.0 million during the same period of 2007 adversely impacted the net loss ratio. Hurricane losses accounted for 10.8% of the net loss ratio for the quarter. The Specialty Commercial Segment reported a net expense ratio of 31.1% for the third quarter of 2008, as compared to 30.6% for the third quarter of 2007.

Personal Segment

Net premium written for our Personal Segment decreased \$0.1 million during the third quarter of 2008 to \$14.8 million compared to \$14.9 million in the third quarter of 2007.

Total revenue for the Personal Segment increased 6% to \$16.1 million for the third quarter of 2008 from \$15.2 million for the same period in 2007. The primary reason for the increase was higher earned premium of \$0.8 million.

Pre-tax income for the Personal Segment was \$2.5 million for the three months ended September 30, 2008 as compared to \$1.9 million for the same period in 2007. The increased revenue, as discussed above, was partially offset by increased operating expenses of \$0.3 million.

The Personal Segment reported a net loss ratio of 64.1% for the third quarter of 2008 as compared to 68.4% for the same period in 2007. The decline in the net loss ratio results from a change in current accident year loss estimates. We recognized \$0.2 million of favorable prior accident year development in both the third quarter 2008 and 2007. The Personal Segment reported a net expense ratio of 22.6% for the third quarter of 2008 as compared to 22.9% for the third quarter of 2007. The decrease in the net expense ratio was mainly due to increased finance charges and fixed overhead allocations in relation to earned premium.

Corporate

Corporate revenue decreased \$2.3 million for the three months ended September 30, 2008. Recognized losses of \$2.5 million on our investment portfolio as compared to recognized gains of \$0.4 million during the same period in 2007 was partially offset by increased investment income of \$0.6 million due to changes in capital allocation. The recognized losses on our investment portfolio included a \$3.0 million impairment for a Washington Mutual senior debt security.

Corporate pre-tax loss was \$4.0 million for the third quarter of 2008 as compared to \$1.9 million for the same period in 2007. Contributing to the increased loss in addition to the decreased revenue discussed above was increased interest expense of \$0.2 million due primarily to the issuance of trust preferred securities in August 2007 partially offset by decreased operating expense of \$0.4 million.

Nine Months Ended September 30, 2008 as Compared to Nine Months Ended September 30, 2007

The following is additional business segment information for the nine months ended September 30, 2008 and 2007 (in thousands):

**Hallmark Financial Services, Inc.
Consolidated Segment Data**

| | Nine Months Ended September 30, 2008 | | | | |
|---|--------------------------------------|------------------------------------|---------------------|-----------|--------------|
| | Standard Commercial Segment | Specialty Commercial Segment | Personal Segment | Corporate | Consolidated |
| Produced premium (1) | \$ 62,330 | \$ 104,302 | \$ 46,643 | \$ - | \$ 213,275 |
| Gross premiums written | 62,327 | 77,387 | 46,643 | - | 186,357 |
| Ceded premiums written | (3,667) | (2,836) | - | - | (6,503) |
| Net premiums written | 58,660 | 74,551 | 46,643 | - | 179,854 |
| Change in unearned premiums | 2,224 | (1,900) | (2,242) | - | (1,918) |
| Net premiums earned | 60,884 | 72,651 | 44,401 | - | 177,936 |
| Total revenues | 64,617 | 94,617 | 48,277 | 983 | 208,494 |
| Losses and loss adjustment expenses | 36,218 | 45,266 | 29,030 | - | 110,514 |
| Pre-tax income (loss), net of minority interest | 9,104 | 12,601 | 7,047 | (7,224) | 21,528 |
| Net loss ratio (2) | 59.5% | 62.3% | 65.4% | | 62.1% |
| Net expense ratio (2) | 27.2% | 30.7% | 22.2% | | 28.9% |
| Net combined ratio (2) | 86.7% | 93.0% | 87.6% | | 91.0% |

| | Nine Months Ended September 30, 2007 | | | | |
|-------------------------------------|--------------------------------------|------------------------------------|---------------------|-----------|--------------|
| | Standard Commercial Segment | Specialty Commercial Segment | Personal Segment | Corporate | Consolidated |
| Produced premium (1) | \$ 70,246 | \$ 118,232 | \$ 43,228 | \$ - | \$ 231,706 |
| Gross premiums written | 70,139 | 80,172 | 43,228 | - | 193,539 |
| Ceded premiums written | (5,053) | (3,556) | - | - | (8,609) |
| Net premiums written | 65,086 | 76,616 | 43,228 | - | 184,930 |
| Change in unearned premiums | (2,966) | (12,100) | (3,143) | - | (18,209) |
| Net premiums earned | 62,120 | 64,516 | 40,085 | - | 166,721 |
| Total revenues | 65,488 | 93,986 | 43,654 | 2,122 | 205,250 |
| Losses and loss adjustment expenses | 37,621 | 35,398 | 26,612 | (11) | 99,620 |

| | | | | | |
|------------------------|-------|--------|-------|---------|--------|
| Pre-tax income (loss) | 9,125 | 20,627 | 6,148 | (5,108) | 30,792 |
| Net loss ratio (2) | 60.6% | 54.9% | 66.4% | | 59.8% |
| Net expense ratio (2) | 27.3% | 31.4% | 23.1% | | 27.9% |
| Net combined ratio (2) | 87.9% | 86.3% | 89.5% | | 87.7% |

(1) Produced premium is a non-GAAP measurement that management uses to track total controlled premium produced by our operations. We believe this is a useful tool for users of our financial statements to measure our premium production whether retained by our insurance company subsidiaries or retained by third party insurance carriers where we receive commission revenue.

(2) The net loss ratio is calculated as incurred losses and loss adjustment expenses divided by net premiums earned, each determined in accordance with GAAP. The net expense ratio is calculated as underwriting expenses of our insurance company subsidiaries (which include provisional ceding commissions, direct agent commissions, premium taxes and assessments, professional fees, other general underwriting expenses and allocated overhead expenses) and 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.

Standard Commercial Segment

Gross premiums written for the Standard Commercial Segment were \$62.3 million for the nine months ended September 30, 2008, or 11% less than the \$70.1 million reported for the same period in 2007. Net premiums written were \$58.7 million for the nine months ended September 30, 2008 as compared to \$65.1 million reported for the same period in 2007. The primary reasons for the decline in premiums were general economic conditions and our continued underwriting discipline in an increasingly competitive marketplace.

Total revenue for the Standard Commercial Segment of \$64.6 million for the nine months ended September 30, 2008 was \$0.9 million less than the \$65.5 million reported during the nine months ended September 30, 2007. This decrease in total revenue was primarily due to lower earned premium of \$1.2 million and lower processing and service fees of \$0.4 million. These decreases in revenue were partially offset by increased contingent commissions of \$0.6 million related to favorable loss development on prior accident years during 2008 compared to the same period for 2007 and increased net investment income of \$0.1 million.

Pre-tax income for our Standard Commercial Segment of \$9.1 million for the nine months ended September 30, 2008 remained relatively unchanged for the same period of 2007. As discussed above revenues decreased \$0.9 million and operating expenses increased \$0.6 million due predominately to employee growth. These changes were offset by lower loss and loss adjustment expenses of \$1.4 million despite \$3.3 million of incurred losses net of reinsurance attributable to hurricane damage during the third quarter.

The net loss ratio for the nine months ended September 30, 2008 was 59.5% as compared to the 60.6% reported for the same period of 2007. The gross loss ratio before reinsurance was 65.6% for the nine months ended September 30, 2008 as compared to 58.2% for the same period the prior year. The gross loss results for the nine months ended September 30, 2008 included \$8.8 million of hurricane related losses and \$2.6 million of favorable prior year development as compared to favorable prior year development of \$0.8 million recognized during the same period of 2007. Hurricane losses accounted for 13.6% of the gross loss ratio and 5.5% of the net loss ratio for the nine months ended September 30, 2008. The Standard Commercial Segment reported net expense ratios of 27.2% and 27.3% for the nine months ended September 30, 2008 and 2007, respectively.

Specialty Commercial Segment

Gross premiums written for the Specialty Commercial Segment for the first nine months of 2008 were \$77.4 million, or 3% less than the \$80.2 million reported for the same period in 2007. Net premiums written for the first nine months of 2008 were \$74.6 million, or 3% less than the \$76.6 million reported for the same period in 2007. The decrease in premium volume was due to general economic conditions and our continued underwriting discipline in an increasingly competitive marketplace in both the excess and surplus and general aviation markets.

Total revenue for the Specialty Commercial Segment of \$94.6 million for the first nine months of 2008 was \$0.6 million more than the \$94.0 million reported in the first nine months of 2007. This increase in revenue was largely due to increased net premiums earned of \$8.1 million for the first nine months of 2008 as a result of the increased retention of business. This increase in revenue was partially offset by lower ceding commission and fee revenue of \$6.4 million due primarily to the Company retaining a higher percentage of the business produced by an agency subsidiary and reduced contingent commission during the third quarter of 2008 of \$1.2 million resulting from the impact of hurricane losses.

Pre-tax income for the Specialty Commercial Segment of \$12.6 million for the first nine months of 2008 decreased \$8.0 million, or 39%, from the \$20.6 million reported for the same period in 2007. This decrease in pre-tax income was primarily due to increased losses and loss adjustment expenses of \$9.9 million, including \$2.7 million of incurred losses net of reinsurance attributable to hurricane damage during the third quarter of 2008. A \$1.2 million write-off of a premium receivable due to the default of a producer in our TGA Operating Unit, partially offset by the increased revenue discussed above and by decreased production related expenses of \$2.4 million due to lower produced premium, also contributed to the decline in pre-tax income.

The Specialty Commercial Segment reported a net loss ratio of 62.3% for the first nine months of 2008 as compared to 54.9% for the first nine months of 2007. In addition to hurricane losses, \$1.4 million of unfavorable prior year development as compared to favorable prior year development of \$1.9 million during the same period of 2007 adversely impacted the net loss ratio. Hurricane losses accounted for 3.7% of the net loss ratio for the nine months ended September 30, 2008.

The Specialty Commercial Segment reported a net expense ratio of 30.7% for the first nine months of 2008 as compared to 31.4% for the first nine months of 2007. The decrease in the net expense ratio was primarily due to increased retention on our catastrophe reinsurance and commercial property per risk reinsurance programs during the first nine months of 2008 as compared to the same period in 2007.

Personal Segment

Net premium written for our Personal Segment increased \$3.4 million during the first nine months of 2008 to \$46.6 million compared to \$43.2 million in the first nine months of 2007. The increase in premium was due mostly to continued geographic expansion that began in 2007.

Total revenue for the Personal Segment increased 11% to \$48.3 million for the first nine months of 2008 from \$43.7 million for the same period in 2007. Higher earned premium of \$4.3 million was the primary reason for the increase in revenue for the period. Increased finance charges of \$0.5 million were partially offset by lower third party commission revenue of \$0.1 million.

Pre-tax income for the Personal Segment was \$7.0 million for the nine months ended September 30, 2008 as compared to \$6.1 million for the same period in 2007. The increased revenue, as discussed above, was offset by increased losses and loss adjustment expenses of \$2.4 million and increased operating expenses of \$1.3 million due mostly to production related expenses attributable to the increased earned premium.

The Personal Segment reported a net loss ratio of 65.4% for the first nine months of 2008 as compared to 66.4% for the same period in 2007. This decrease in the net loss ratio is primarily driven by favorable prior year development and the maturing of the new business impact associated with geographic expansion. We recognized \$0.8 million of favorable prior accident year development during the first nine months 2008 as compared to \$0.3 million of favorable prior year development during the first nine months of 2007.

The Personal Segment reported a net expense ratio of 22.2% for the first nine months of 2008 as compared to 23.1% for the first nine months of 2007. The decrease in the net expense ratio was mainly due to increased finance charges in relation to earned premium, as well as fixed overhead allocations in relation to earned premium.

Corporate

Corporate revenue decreased \$1.1 million for the first nine months of 2008 as compared to the same period in 2007. The decrease was primarily due to recognized losses on our investment portfolio of \$1.4 million as compared to recognized gains of \$1.3 million during the prior year. The 2008 recognized losses include a \$3.0 million impairment of a Washington Mutual senior debt security. Net investment income increased \$1.6 million due primarily to changes in capital allocation during the first nine months of 2008 compare to the same period in 2007.

Corporate pre-tax loss was \$7.2 million for the first nine months of 2008 compared to \$5.1 million for the same period in 2007. The decrease in revenue discussed above was compounded by increased interest expense of \$1.0 million due primarily to the issuance of trust preferred securities in August 2007.

Financial Condition and Liquidity

Sources and Uses of Funds

Our sources of funds are from insurance-related operations, financing activities and investing activities. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), commissions, and processing and service fees. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to meet operating expenses and debt obligations. As of September 30, 2008, Hallmark had \$14.1 million in unrestricted cash and invested assets at the holding company. Unrestricted cash and invested assets of our non-insurance subsidiaries were \$2.4 million as of September 30, 2008.

AHIC, domiciled in Texas, is limited in the payment of dividends 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 surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. HIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year 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 surplus or prior year's statutory net income, without prior written approval from the Oklahoma Insurance Department. During 2008, our insurance company subsidiaries' ordinary dividend capacity is \$16.3 million. None of our insurance company subsidiaries paid a dividend to Hallmark during the first nine months of 2008 or the 2007 fiscal year.

Comparison of September 30, 2008 to December 31, 2007

On a consolidated basis, our cash and investments (excluding restricted cash) at September 30, 2008 were \$359.7 million compared to \$411.7 million at December 31, 2007. Settlement of receivables and payables for securities during the first quarter of 2008, as well as a decline in market value for the period, contributed to this decrease in our cash and investments. At September 30, 2008, 91% of our investments were rated investment grade and had an average duration of 3.4 years, including approximately 42% that were held in short-term investments. We classify our bond securities as available for sale. The net unrealized loss associated with the investment portfolio was \$7.3 million (net of tax effects) at September 30, 2008. (See Note 6 of Notes to Condensed Consolidated Financial Statements which appears in Item 1 of this Report.)

Comparison of Nine Months Ended September 30, 2008 and September 30, 2007

Net cash provided by our consolidated operating activities was \$37.2 million for the first nine months of 2008 compared to \$61.8 million for the first nine months of 2007. The decrease in operating cash flow was primarily due to increased paid losses from the maturing of retained business growth and hurricane related losses during the third quarter of 2008.

Net cash used in investing activities during the first nine months of 2008 was \$149.9 million as compared to \$90.8 million for the same period in 2007. Contributing to the increase in cash used in investing activities was an increase of \$71.2 million in purchases of debt and equity securities, a \$79.6 million increase in net purchases of short-term investments, a \$5.2 million reduction in restricted cash, and a net cash payment of \$14.8 million, net of cash acquired for the acquisition of the Heath Group during the third quarter of 2008, partially offset by a \$111.8 million increase in maturities and redemptions of investment securities.

Cash used in financing activities during the first nine months of 2008 was \$8.9 million as compared to \$9.2 million provided by financing activities for the same period of 2007. The cash used in both periods was primarily for the payment of deferred guaranteed consideration to the sellers of the subsidiaries comprising our TGA Operating Unit. As of September 30, 2008 we had fully repaid our obligation to the sellers. The cash provided during 2007 primarily related to the issuance of trust preferred securities in August 2007.

Based on 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.

Credit Facilities

On June 29, 2005, we entered into a credit facility with The Frost National Bank. The credit facility was amended and restated on January 27, 2006 to a \$20.0 million revolving credit facility, with a \$5.0 million letter of credit sub-facility. The credit facility was further amended effective May 31, 2007 to increase the revolving credit facility to \$25.0 million and establish a new \$5.0 million revolving credit sub-facility for the premium finance operations of PAAC. The credit agreement was again amended effective February 20, 2008 to extend the termination to January 27, 2010, revise various affirmative and negative covenants and decrease the interest rate in most instances to the three month Eurodollar rate plus 1.90 percentage points, payable quarterly in arrears. We pay letter of credit fees at the rate of 1.00% per annum. Our obligations under the revolving credit facility are secured by a security interest in the capital stock of all of our subsidiaries, guaranties of all of our subsidiaries and the pledge of substantially all of our assets. The revolving credit facility contains covenants which, among other things, require us to maintain certain financial and operating ratios and restrict certain distributions, transactions and organizational changes. As of September 30, 2008, we were in compliance with all of our covenants. As of September 30, 2008, we had \$5.1 million outstanding under this credit facility.

Trust Preferred Securities

On June 21, 2005, an unconsolidated trust subsidiary completed a private placement of \$30.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed \$30.9 million from the trust subsidiary and contributed \$30.0 million to one of our insurance company subsidiaries in order to increase policyholder surplus. The note bears an initial interest rate of 7.725% until June 15, 2015, at which time interest will adjust quarterly to the three-month LIBOR rate plus 3.25 percentage points. As of September 30, 2008, the note balance was \$30.9 million. Under the terms of the note, we pay interest only each quarter and the principal of the note at maturity.

On August 23, 2007, an unconsolidated trust subsidiary completed a private placement of \$25.0 million of 30-year floating rate trust preferred securities. Simultaneously, we borrowed \$25.8 million from the trust subsidiary for working capital and general corporate purposes. The note bears an initial interest rate of 8.28% until September 15, 2017, at which time interest will adjust quarterly to the three-month LIBOR rate plus 2.90 percentage points. As of September 30, 2008, the note balance was \$25.8 million. Under the terms of the note, we pay interest only each quarter and the principal of the note at maturity.

Structured Settlements

In connection with our acquisition of the subsidiaries now comprising our TGA Operating Unit, we issued to the sellers promissory notes in the aggregate principal amount of \$23.7 million, of which \$14.2 million was paid on January 2, 2007, and \$9.5 million was paid on January 2, 2008. We were also obligated to pay to the sellers an additional \$1.3 million, of which \$0.8 million was paid on January 2, 2007 and an additional \$0.5 million was paid on January 2, 2008, in consideration of the sellers' compliance with certain restrictive covenants, including a covenant not to compete for a period of five years after closing. We secured payment of these installments of purchase price and restrictive covenant consideration by depositing \$25.0 million in a trust account for the benefit of the sellers. We recorded a payable for future guaranteed payments to the sellers of \$25.0 million discounted at 4.4%, the rate of two-year U.S. Treasuries (the only permitted investment of the trust account). As of September 30, 2008 we had fully repaid our obligation to the sellers.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

As of September 30, 2008, there had been no material changes in the market risks described in our Annual Report on Form 10-K for the year ended December 31, 2007.

Item 4T. Controls and Procedures.

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

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

This Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, which are intended to be covered by the safe harbors created thereby. These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. The forward-looking statements included herein are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-Q will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.

**PART II
OTHER INFORMATION**

Item 1. Legal Proceedings.

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

Item 1A. Risk Factors.

This Item is omitted, as permitted for a “smaller reporting company” (as defined by the Securities and Exchange Commission).

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

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

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

| Exhibit Number | Description |
|----------------|--|
| 3(a) | Restated Articles of Incorporation of the registrant, as amended (incorporated by reference to Exhibit 3.1 to the registrant’s Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006). |
| 3(b) | Amended and Restated By-Laws of the registrant (incorporated by reference to Exhibit 3.1 to the registrant’s Current Report on Form 8-K filed October 1, 2007). |
| 4(a) | Specimen certificate for Common Stock, \$0.18 par value per share, of the registrant (incorporated by reference to Exhibit 4.1 to Amendment No. 1 to the registrant’s Registration Statement on Form S-1 [Registration No. 333-136414] filed September 8, 2006). |

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| Exhibit Number | Description |
|----------------|---|
| 4(b) | Indenture dated as of 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(c) | 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(d) | Form of Junior Subordinated Debt Security Due 2035 (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed June 27, 2005). |
| 4(e) | Form of Capital Security Certificate (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed June 27, 2005). |
| 4(f) | First Restated Credit Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and The Frost National Bank (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006). |
| 4(g) | Form of Registration Rights Agreement dated January 27, 2006, between Hallmark Financial Services, Inc. and Newcastle Special Opportunity Fund I, L.P. and Newcastle Special Opportunity Fund II, L.P. (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed February 2, 2006). |
| 4(h) | 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(i) | 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(j) | Form of Junior Subordinated Debt Security Due 2037 (incorporated by reference to Exhibit 4.1 to the registrant's Current Report on Form 8-K filed August 24, 2007). |
| 4(k) | Form of Capital Security Certificate (incorporated by reference to Exhibit 4.2 to the registrant's Current Report on Form 8-K filed August 24, 2007). |
| 31(a) | Certification of principal executive officer required by Rule 13a-14(a) or Rule 15d-14(a). |
| 31(b) | Certification of principal financial officer required by Rule 13a-14(a) or Rule 15d-14(a). |

32(a) Certification of principal executive officer Pursuant to 18 U.S.C. 1350.

32(b) Certification of principal financial officer Pursuant to 18 U.S.C. 1350.

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SIGNATURES

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

HALLMARK FINANCIAL SERVICES, INC.
(Registrant)

Date: November 12, 2008

/s/ Mark J. Morrison
Mark J. Morrison, Chief Executive Officer and
President
(Principal Executive Officer)

Date: November 12, 2008

/s/ Jeffrey R. Passmore
Jeffrey R. Passmore, Chief Accounting Officer and
Senior Vice President
(Principal Financial Officer)