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HALLMARK FINANCIAL SERVICES INC
Form 10QSB
October 31, 2002

CONFORMED COPY

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended September 30, 2002

Commission file number 0-16090

Hallmark Financial Services, Inc.

(Exact name of small business issuer as specified in its charter)

Nevada

87-0447375

(State or other jurisdiction of
Incorporation or organization)

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

14651 Dallas Parkway, Suite 900 Dallas, Texas

75240

(Address of principal executive offices)

(Zip Code)

Issuer's telephone number, including area code: (972) 404-1637

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act during the past 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

APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: Common Stock, par value \$.03 per share - 11,049,133 shares outstanding as of October 31, 2002.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

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HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

| ASSETS | September 30 2002 ----- (Unaudited) | December 31 2001 ----- |
|---|--|------------------------------|
| Investments: | | |
| Debt securities, held-to-maturity, at amortized cost | \$ 8,280 | \$ 876 |
| Equity securities, available-for-sale, at market value | 93 | 144 |
| Short-term investments, at cost which approximates market value | 6,442 | 15,203 |
| | ----- | ----- |
| Total investments | 14,815 | 16,223 |
| Cash and cash equivalents | 6,361 | 5,533 |
| Restricted cash | 1,607 | 1,990 |
| Prepaid reinsurance premiums | 9,068 | 11,611 |
| Premiums receivable from lender for financed premiums (net of allowance for doubtful Accounts of \$172 in 2002 and \$208 in 2001) | 11,510 | 13,740 |
| Premiums receivable | 891 | 414 |
| Reinsurance recoverable | 13,272 | 16,871 |
| Deferred policy acquisition costs | 1,246 | 761 |
| Excess of cost over net assets acquired | 4,431 | 4,431 |
| Current federal income taxes recoverable | - | 696 |
| Deferred federal income taxes | 279 | 425 |
| Accrued investment income | 69 | 6 |
| Other assets | 733 | 904 |
| | ----- | ----- |
| | \$ 64,282 | \$ 73,605 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Liabilities: | | |
| Notes payable | \$ 12,317 | \$ 13,933 |
| Unpaid losses and loss adjustment expenses | 17,202 | 20,089 |
| Unearned premiums | 15,367 | 16,793 |
| Reinsurance balances payable | 3,217 | 4,426 |
| Drafts outstanding | 610 | 890 |
| Accrued ceding commission refund | 2,217 | 4,598 |
| Accounts payable and other accrued expenses | 2,506 | 2,508 |
| Current federal income taxes payable | 67 | - |
| | ----- | ----- |

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| | | |
|---|-----------|-----------|
| Total liabilities | 53,503 | 63,237 |
| | ----- | ----- |
| Stockholders' equity | | |
| Common stock, \$.03 par value, authorized 100,000,000 shares Issued 11,855,610 in 2002 and 2001 | 356 | 356 |
| Capital in excess of par value | 10,875 | 10,875 |
| Retained earnings | 591 | 180 |
| Treasury stock, 806,477 shares in 2002 and 2001, at cost | (1,043) | (1,043) |
| | ----- | ----- |
| Total stockholders' equity | 10,779 | 10,368 |
| | ----- | ----- |
| | \$ 64,282 | \$ 73,605 |
| | ===== | ===== |

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 earnings per share)

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|--|------------------------------------|----------|-----------------------------------|-----------|
| | 2002 | 2001 | 2002 | 2001 |
| | ----- | ----- | ----- | ----- |
| Gross premiums written | \$ 12,123 | \$ 9,085 | \$ 37,542 | \$ 38,911 |
| Ceded premiums written | (7,001) | (6,146) | (22,131) | (26,401) |
| | ----- | ----- | ----- | ----- |
| Net premiums written | \$ 5,122 | \$ 2,939 | \$ 15,411 | \$ 12,510 |
| | ===== | ===== | ===== | ===== |
| Revenues: | | | | |
| Gross premiums earned | 13,193 | 12,087 | 38,682 | 37,581 |
| Ceded premiums earned | (7,986) | (8,185) | (24,388) | (24,971) |
| | ----- | ----- | ----- | ----- |
| Net premiums earned | 5,207 | 3,902 | 14,294 | 12,610 |
| Investment income, net of expenses | 146 | 275 | 417 | 81 |
| Finance charges | 514 | 763 | 1,804 | 2,451 |
| Processing and service fees | 121 | 246 | 335 | 97 |
| Other income | 92 | 184 | 257 | 29 |
| | ----- | ----- | ----- | ----- |
| Total revenues | 6,080 | 5,370 | 17,107 | 17,141 |
| Benefits, losses and expenses: | | | | |
| Losses and loss adjustment expenses | 9,316 | 10,223 | 26,584 | 34,391 |
| Reinsurance recoveries | (5,634) | (6,486) | (15,908) | (22,011) |
| | ----- | ----- | ----- | ----- |
| Net losses and loss adjustment expenses | 3,682 | 3,737 | 10,676 | 12,380 |
| Acquisition costs, net | (36) | (261) | (486) | (351) |
| Other acquisition and underwriting expenses (net of year-to-date ceding commission of | | | | |

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| | | | | |
|--|------------|------------|------------|-----------|
| \$5,795 in 2002 and \$7,176 in 2001) | 1,626 | 902 | 4,001 | 2,72 |
| Operating expenses | 490 | 822 | 1,662 | 2,83 |
| Interest expense | 205 | 266 | 630 | 81 |
| Amortization of intangible assets | - | 39 | - | 11 |
| | ----- | ----- | ----- | ----- |
| Total benefits, losses and expenses | 5,967 | 5,505 | 16,483 | 18,51 |
| | ----- | ----- | ----- | ----- |
| Income (loss) from operations before federal income taxes | 113 | (135) | 624 | (1,36 |
| Federal income tax expense (benefit) | 38 | (31) | 213 | (45 |
| | ----- | ----- | ----- | ----- |
| Net income (loss) | \$ 75 | \$ (104) | \$ 411 | \$ (91 |
| | ===== | ===== | ===== | ===== |
| | | | | |
| Basic and diluted earnings (loss) per share | \$ 0.01 | \$ (0.01) | \$ 0.04 | \$ (0.0 |
| | ===== | ===== | ===== | ===== |
| | | | | |
| Common stock shares outstanding | 11,049,133 | 11,049,133 | 11,049,133 | 11,049,13 |
| | ===== | ===== | ===== | ===== |

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

| | Nine Months Ended September 30 | |
|---|-----------------------------------|----------|
| | 2002 | 2001 |
| | ----- | ----- |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 411 | \$ (913) |
| Adjustments to reconcile net income (loss) to cash flows used in operating activities: | | |
| Depreciation and amortization expense | 120 | 216 |
| Change in deferred federal income taxes | 146 | 57 |
| Change in prepaid reinsurance premiums | 2,543 | (1,438) |
| Change in premiums receivable | (477) | (18) |
| Change in deferred policy acquisition costs | (485) | (351) |
| Change in unpaid losses and loss adjustment expenses | (2,887) | (481) |
| Change in unearned premiums | (1,426) | 1,339 |
| Change in reinsurance recoverable | 3,599 | (99) |
| Change in reinsurance balances payable | (1,209) | 948 |
| Change in current federal income tax payable/recoverable | 763 | (419) |
| Change in accrued ceding commission refund | (2,381) | 1,793 |
| Change in litigation cost | - | (1,386) |
| Change in all other liabilities | (282) | 59 |
| Change in all other assets | 138 | (265) |
| | ----- | ----- |
| Net cash used in operating activities | (1,427) | (958) |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (150) | (205) |

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| | | |
|--|----------|----------|
| Premium finance notes originated | (31,243) | (39,337) |
| Premium finance notes repaid | 33,473 | 38,234 |
| Change in restricted cash | 383 | 2,056 |
| Purchase of debt securities | (10,638) | - |
| Maturities and redemptions of investment securities | 3,285 | 4,962 |
| Purchase of short-term investments | (20,961) | (17,972) |
| Maturities of short-term investments | 29,722 | 12,751 |
| | ----- | ----- |
| Net cash provided by investing activities | 3,871 | 489 |
| | ----- | ----- |
| Cash flows from financing activities: | | |
| Net advances from lender | (1,616) | 455 |
| Repayment of borrowings | - | (546) |
| | ----- | ----- |
| Net cash used in financing activities | (1,616) | (91) |
| | ----- | ----- |
| Increase (decrease) in cash and cash equivalents | 828 | (560) |
| Cash and cash equivalents at beginning of period | 5,533 | 6,831 |
| | ----- | ----- |
| Cash and cash equivalents at end of period | \$ 6,361 | \$ 6,271 |
| | ===== | ===== |

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

Item 1. Notes to Consolidated Financial Statements (Unaudited).

Note 1 - Summary of Accounting Policies

In the opinion of management, the accompanying consolidated financial statements contain all adjustments, consisting primarily of normal recurring adjustments, necessary to present fairly the financial position of Hallmark Financial Services, Inc. and subsidiaries (the "Company") as of September 30, 2002 and the consolidated results of operations and cash flows for the periods presented. The accompanying financial statements have been prepared by the Company without audit.

Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States ("GAAP") have been condensed or omitted. Reference is made to the Company's annual consolidated financial statements for the year ended December 31, 2001 for a description of accounting policies and certain other disclosures. Certain items in the 2001 interim financial statements have been reclassified to conform to the 2002 presentation.

The results of operations for the period ended September 30, 2002 are not necessarily indicative of the operating results to be expected for the full year.

Note 2 - Reinsurance

The Company is involved in the assumption and cession of reinsurance

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from/to other companies. The Company remains obligated to its policyholders in the event that reinsurers do not meet their obligations under the reinsurance agreements.

Effective March 1, 1992, the Company entered into a reinsurance arrangement with State & County Mutual Fire Insurance Company ("State & County"), an unaffiliated company, to assume 100% of the nonstandard auto business produced by the Company and underwritten by State & County. The arrangement is supplemented by a separate retrocession agreement effective July 1, 2000 between the Company and Dorinco Reinsurance Company ("Dorinco"). Under the agreement, the Company, upon mutual agreement with Dorinco, may elect on a quarterly basis to retain 30% to 45% of the risk. The Company currently retains 40% of the risk and cedes 60% to Dorinco. For the period of January 1, 2002 through March 31, 2002, the Company retained 35% of the risk and ceded 65% to Dorinco. Prior to January 1, 2002, the Company retained 30% of the risk and ceded 70% to Dorinco.

Note 3 - Intangible Assets

When the Company's primary operating subsidiaries were purchased, the excess cost over the fair value of the net assets acquired was recorded as goodwill and was amortized on a straight-line basis over forty years. Other intangible assets consist of a trade name, a managing general agent's license and non-compete arrangements, all of which were fully amortized at September 30, 2002.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations", and No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets". SFAS 141 supersedes Accounting Principles Board Opinion ("APB") No. 16, "Business Combinations". SFAS 141 (1) requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001, (2) provides specific criteria for the initial recognition and measurement of intangible assets apart from goodwill, and (3) requires that unamortized negative goodwill be written off immediately as an extraordinary gain. SFAS 142 supersedes APB No. 17, "Intangible Assets," and is effective for fiscal years beginning after December 15, 2001. SFAS 142 primarily addresses the accounting for goodwill and intangible assets subsequent to their initial recognition. SFAS 142 (1) prohibits the amortization of goodwill and indefinite-lived intangible assets, (2) requires testing of goodwill and indefinite-lived intangible assets on an annual basis for impairment (and more frequently if the occurrence of an event or circumstance indicates an impairment), (3) requires that reporting units be identified for the purpose of assessing potential future impairments of goodwill, and (4) removes the forty-year limitation on the amortization period of intangible assets that have finite lives.

The Company adopted the provisions of SFAS 142 during the first quarter of 2002 and immediately ceased recording amortization expense of its goodwill. A reconciliation of net income and earnings per share as reported to illustrate the impact of goodwill amortization for the nine months ended September 30, 2002 and 2001 is as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|----------|-------------------|----------|
| | September 30 | | September 30 | |
| | 2002 | 2001 | 2002 | 2001 |
| | ----- | ----- | ----- | ----- |
| (In thousands except for earnings per share amounts) | | | | |
| Reported net income (loss) | \$ 75 | \$ (104) | \$ 411 | \$ (913) |
| Add back: Goodwill amortization | - | 39 | - | 118 |
| | ----- | ----- | ----- | ----- |

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| | | | | |
|---------------------------------------|---------|-----------|---------|-----------|
| Adjusted net income (loss) | \$ 75 | \$ (65) | \$ 411 | \$ (795) |
| | ===== | ===== | ===== | ===== |
| Basic and diluted earnings per share: | | | | |
| Reported net income (loss) | \$ 0.01 | \$ (0.01) | \$ 0.04 | \$ (0.08) |
| Add back: Goodwill amortization | - | - | - | 0.01 |
| | ----- | ----- | ----- | ----- |
| Adjusted net income (loss) | \$ 0.01 | \$ (0.01) | \$ 0.04 | \$ (0.07) |
| | ===== | ===== | ===== | ===== |

SFAS 142 requires that goodwill be tested annually for impairment using a two-step process. The first step is to determine reporting units and compare the fair value of each reporting unit as of the beginning of the fiscal year with its carrying amount (including goodwill) to identify any potential impairment. The Company has completed this first step and determined that an impairment of goodwill exists.

The second step of the goodwill impairment test under SFAS 142 is to quantify the amount of any impairment loss as of the beginning of the fiscal year. This process must be completed not later than the end of the fiscal year. In accordance with SFAS 142, the Company presently expects to record a significant charge to earnings resulting from the completion of this transitional impairment test. Although the amount of such charge cannot presently be reasonably estimated, the Company anticipates that the implementation of this mandatory change in accounting principle will have a material adverse impact on net income when recognized. The cumulative effect of the change in accounting principle will be recognized as of January 1, 2002.

Item 2. Management's Discussion and Analysis or Plan of Operation.

Introduction. Hallmark Financial Services, Inc. ("HFS") and its wholly owned subsidiaries (collectively referred to herein as the "Company") engage in the sale of property and casualty insurance products. The Company's business primarily involves marketing, underwriting and premium financing of non-standard automobile insurance, as well as claims adjusting and other insurance related services.

The Company pursues its business activities through an integrated insurance group (collectively, the "Insurance Group") the members of which are an authorized Texas property and casualty insurance company, American Hallmark Insurance Company of Texas ("Hallmark"); a managing general agency, American Hallmark General Agency, Inc. ("AHGA"); a network of four insurance agencies known as the American Hallmark Agencies ("Hallmark Agencies"); a premium finance company, Hallmark Finance Corporation ("HFC"); and a claims handling and adjustment firm, Hallmark Claims Service, Inc. ("HCS"). The Company operates only in Texas.

Hallmark provides non-standard automobile liability and physical damage insurance through a reinsurance arrangement with an unaffiliated company, State and County Mutual Fire Insurance Company ("State & County"). Through State & County, Hallmark provides insurance primarily for high-risk drivers who do not qualify for standard-rate insurance. Under a supplementary quota-share reinsurance agreement with Dorinco Reinsurance Company ("Dorinco"), Hallmark, upon mutual agreement with its reinsurer, may elect on a quarterly basis to retain 30% to 45% of the risk while ceding the remaining percentage to its reinsurer. HFC finances annual and six-month policy premiums through its premium finance program. AHGA manages the marketing of Hallmark policies through the Hallmark Agencies and independent agents. Additionally, AHGA provides premium processing, underwriting, reinsurance accounting and cash management for unaffiliated managing general agents ("MGAs"). HCS

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provides fee-based claims adjustment, salvage, subrogation recovery and litigation services to Hallmark and unaffiliated MGAs.

Financial Condition and Liquidity

The Company's sources of funds are principally derived from insurance related operations. Major sources of funds from operations include premiums collected (net of policy cancellations and premiums ceded), ceding commissions, and premium finance charges. Other sources of funds are from financing and investment activities, as well as service fees.

At September 30, 2002 and December 31, 2001, the Company's consolidated liquid assets consisting of cash, cash equivalents and investments (excluding restricted cash) were \$21.2 million and \$21.8 million, respectively. The Company's liquidity decreased 3% during the first nine months of 2002 as compared to December 31, 2001 principally due to the payment of an annual ceding commission adjustment with its reinsurer in the amount of \$3.4 million during the first quarter of 2002.

Net cash used by operating activities was \$1.4 million for the nine months ended September 30, 2002 as compared to approximately \$1.0 million for the same period of 2001. The approximate \$3.4 million ceding commission adjustment paid to reinsurers during the first quarter of 2002 was partially offset by an increase in the Company's retention of State & County business to 40% (from 35% at January 1, 2002 and 30% prior to 2002) effective April 1, 2002 under the Company's quota share retrocession agreement with Dorinco and by an increase in monthly policy production.

Cash provided by investing activities during the first nine months of 2002 increased approximately \$3.4 million as compared to the first nine months of 2001. This increase in cash provided by investing activities was primarily the combined result of an increase in maturities of short-term investments and an increase in repayments of premium finance notes when netted against originations of premium finance notes during the first nine months of 2002 as compared to the first nine months of 2001. This increase was partially offset by reinvestment in both intermediate and short-term investments during the first nine months of 2002.

Cash used by financing activities increased by \$1.5 million during the first nine months of 2002 as compared to the first nine months of 2001 primarily due to a decrease in net advances from the Company's premium finance lender. The decrease in net advances was attributable to decreased production of annual policies during 2002 as compared to 2001.

A substantial portion of the Company's liquid assets is held by Hallmark and is not available for general corporate purposes. Of the Company's consolidated liquid assets of \$21.2 million at September 30, 2002 and \$21.8 million at December 31, 2001, \$2.1 million and \$1.9 million, respectively, represented non-restricted cash. Since state insurance regulations restrict financial transactions between an insurance company and its affiliates, HFS is limited in its ability to use Hallmark funds for its own working capital purposes. Furthermore, dividends and loans by Hallmark to the Company are restricted and subject to Texas Department of Insurance ("TDI") approval. Although TDI has sanctioned the payment of management fees, commissions and claims handling fees by Hallmark to HFS and affiliates, since the second half of 2000, Hallmark has chosen not to pay all of the commissions allowed to AHGA. These steps were taken to preserve Hallmark's surplus. During the first nine months of 2002, Hallmark paid \$243,000 of management fees to HFS. Management anticipates that Hallmark may pay management fees during the fourth quarter of 2002. The Company has never received a dividend from Hallmark, and there is no immediate plan to pay a dividend.

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Ceding commission income represents a significant source of funds to the Company. Ceding commission income for the first nine months of 2002 decreased \$1.4 million (representing a 19% decrease) as compared to the similar period of 2001. This decrease was the result of the combined effect of (1) less favorable reinsurance terms during 2002 compared to 2001, (2) a decrease in core State & County premium volume, and (3) an increase in Hallmark's risk retention to 40% effective April 1, 2002 and to 35% effective January 1, 2002 from 30% prior to January 1, 2002. In accordance with GAAP, a portion of ceding commission income and policy acquisition costs is deferred and recognized as income and expense, respectively, as related net premiums are earned. Deferred policy acquisition costs (net of deferred ceding commission) increased to \$1.2 million at September 30, 2002 from \$0.8 million at December 31, 2001. The increase in net deferred acquisition costs was principally due to the decrease in ceding commission partially offset by a decrease in underwriting expenses.

At September 30, 2002, Hallmark's statutory capital and surplus was approximately \$6.5 million, which reflects an increase of \$0.5 million since December 31, 2001. Hallmark's premium to surplus ratio for the twelve months ended September 30, 2002 was 2.9 to 1 as compared to 2.62 for the twelve months ended December 31, 2001. Effective January 1, 2001, TDI adopted the Codification of Statutory Accounting Principles (the "Codification"), which replaced the National Association of Insurance Commissioners primary guidance on statutory accounting. As a result of the implementation of the Codification, Hallmark recognized a deferred tax asset which is recognized by TDI as an increase to surplus.

The Company provides on-going program administration and claims handling for unaffiliated MGAs. The Company currently provides these services for one unaffiliated MGA which continues to produce new business. Hallmark assumes a pro-rata share of the business produced under this unaffiliated MGA program, and Dorinco assumes the remainder. Three other unaffiliated MGAs for whom the Company provided similar services have discontinued writing new business due to the inability to obtain reinsurance and are in run-off.

Management is continuing to investigate opportunities to enhance and expand the Company's operations. While additional capital or strategic alliances may be required to fund future expansion, operational enhancements through increased information technology capabilities are in progress. During the summer of 2001, the Company rolled out its web-based information system (named e-Integrity and referred to as the "Integrity System") which is designed to enhance Company and agency relationships by improving content and timeliness of information to support agents in servicing their customers. The second phase of the Integrity System is composed of two parts. Part One relates to electronic reporting and communication capabilities, and Part Two encompasses, among other things, payment and new business upload to support agents in more promptly and efficiently producing new business, as well as to improve the quality and timeliness of service to existing policyholders. Part One alleviates certain manual processes and results in daily communication of time-sensitive information to agents, thus decreasing labor, supplies and postage costs and increasing the agent's likelihood of policyholder retention. This phase was completed during the first quarter of 2002. Payment upload by the agents, which is included in Part Two, was introduced during August 2002. The remainder of Part Two, which will further reduce processing costs, is targeted to be completed by year-end 2002 with related cost savings to commence in 2003.

Results of Operations

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Overview

The Company had profitable results for the first nine months of 2002 principally due to its focus on rate adequacy, underwriting discipline and agent management. For the first nine months ended September 30, 2002, net income was \$0.4 million compared to a net loss of \$0.9 million for the same period of 2001. Gross premiums written for the first nine months of 2002 decreased approximately 4% as compared to 2001, while net premiums written for the first nine months of 2002 increased by 23% to \$15.4 million for 2002 compared to \$12.5 million in 2001. Net premiums earned of \$14.3 million for the first nine months of 2002 increased 13% in relation to net premiums earned of \$12.6 million for the comparable period of 2001.

The Company's net incurred loss ratios declined to 74.7% for the first nine months of 2002 from 98.2% for the first nine months of 2001. Certain key financial operational ratios follow:

| | Qtr ended 9/30/02 ----- | Qtr ended 9/30/01 ----- | YTD ended 9/30/02 ----- | YTD ended 9/30/01 ----- |
|---|----------------------------------|----------------------------------|----------------------------------|----------------------------------|
| GAAP Incurred Loss Ratio (excluding storm and loss corridor) | 68.4% | 83.7% | 67.0% | 88.5% |
| GAAP Loss Corridor Incurred Loss Ratio (1) | 1.7% | 10.2% | 6.2% | 6.5% |
| GAAP Storm\Flood Incurred Loss Ratio (2) | 0.6% | 1.9% | 1.5% | 3.2% |
| | ----- | ----- | ----- | ----- |
| GAAP Incurred Loss Ratio | 70.7% | 95.8% | 74.7% | 98.2% |
| GAAP Expense Ratio (3) | 29.6% | 21.2% | 23.8% | 18.6% |
| | ----- | ----- | ----- | ----- |
| GAAP Combined Ratio | 100.3% | 117.0% | 98.5% | 116.8% |
| | ===== | ===== | ===== | ===== |

- (1) Effective April 1, 2001, the Company's reinsurance agreement was amended to include a loss corridor provision. Losses incurred within the loss corridor range are retained 100% by the Company. Losses incurred within the loss corridors for the three months ended September 30, 2002 and 2001 were \$0.1 million and \$0.4 million, respectively. Losses incurred within the loss corridors for the nine months ended September 30, 2002 and 2001 were \$0.9 million and \$0.8 million, respectively.
- (2) Net storm losses retained by the Company were approximately \$0.03 million and \$0.1 million for the three months ended September 30, 2002 and 2001, respectively. Net storm losses retained by the Company were approximately \$0.2 million and \$0.4 million for the nine months ended September 30, 2002 and 2001, respectively.
- (3) The GAAP expense ratio represents underwriting expenses and other income less certain expenses as a percentage of net premiums written. The principal reason for the increased GAAP expense ratio is the decrease in ceding commission income. As a percentage of net premiums written, ceding commission income for the three months ended September 30, 2002 declined 21.8%. As a percentage of net premiums written, ceding commission income for the nine months ended September 30, 2002 declined 19.8%, as discussed in the Financial Condition and Liquidity section.

Analysis

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Gross premiums written (prior to reinsurance) for the three months ended September 30, 2002 increased 33% as compared to the same period of 2001, while gross premium written for the nine months ended September 30, 2002 decreased approximately 4% over the same period of 2001. The 33% increase in gross premiums written during the third quarter of 2002 compared to the same period in 2001 is principally due to unusually low premium volume in 2001 as a result of (1) a one-third reduction in the agent base during the last 12 months, a significant portion of the business of the terminated agents ran-off early in the third quarter of 2001 (2) successive rate increases in June and July 2001, and (3) temporary disruption of insurance purchasing patterns as a result of the terrorist attacks of September 11, 2001. The overall year to date decrease in gross premiums written from 2001 to 2002 was principally due to the Company's strategic focus on underwriting profitability rather than market share. This focus included increased attention to rate adequacy, agent performance and underwriting discipline. Net premiums written (after reinsurance) for the three and nine months ended September 30, 2002 increased 74% and 23%, respectively, over the same periods in 2001. The disparity between gross premiums written and net premiums written is primarily due to the increase in the Company's retention of premiums from 30% to 35% effective January 1, 2002 and further to 40% effective April 1, 2002.

Despite the decrease in gross premiums written compared to 2001, gross premiums earned (prior to reinsurance) for the three and nine months ended September 30, 2002 increased 9% and 3%, respectively, as compared to the same periods of 2001. This was principally due to the combined effect of a shift in policy mix from annual to monthly policies and the continued earnings of annual premiums written at a higher volume level during 2001. For the three and nine months ended September 30, 2002, net premiums earned (after reinsurance) increased 33% and 13%, respectively, as compared to the same periods of 2001. The disproportionate change in premiums earned prior to and after reinsurance is due to the impact of the increased retention of core State & County premium volume which has reduced ceded premiums and ultimately increased net premiums written and earned.

Net incurred loss ratios (computed on net premiums earned after reinsurance) for the three and nine months ended September 30, 2002 were approximately 70.7% and 74.7%, respectively, compared to 95.8% and 98.2% for the same periods of 2001. During the second quarter of 2001, the Company's reinsurance agreement was amended to include a loss corridor provision which increases net losses incurred by the Company between certain loss ratio levels. If the loss corridor had not been in place during the first nine months of 2002 and the second and third quarters of 2001, the year to date net incurred loss ratios would have been 68.5% and 91.7%, respectively. Additionally, severe storms occurring in the spring of 2002 and the Houston flood of May 2001 impacted the 2002 and 2001 loss ratios. Excluding the impact of storms and the loss corridor, the year to date loss ratios for 2002 and 2001 would have been 67.0% and 88.5%, respectively. The significant improvement in the loss ratio in 2002 compared to 2001 is principally the result of the Company's increasing focus on underwriting profitability during 2001 which is now reflected in 2002 results. Specific strategies implemented in late 2000 and 2001 to improve the Company's loss ratio included multiple rate increases, more restrictive underwriting guidelines, reductions in agency force and emphasis on faster payment of claims.

Investment income decreased 47% and 49% during the first three and nine months of 2002, respectively, compared to the same periods of 2001. The decrease is attributable to the combined effect of the decreased yield currently available in the marketplace and maturities/calls of higher yield investments.

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Finance charges, which decreased approximately \$0.2 million (33%) and \$0.7 million (27%) during the first three and nine months of 2002, respectively, as compared to the same periods of 2001, represent interest earned on premium notes issued by HFC. This decrease is directly correlated to the decrease in annual policy premium volume.

Processing and service fees represent fees earned on third party processing and servicing contracts with unaffiliated MGAs. Processing and service fees for the three and nine months ended September 30, 2002 decreased \$0.1 million (51%) and \$0.6 million (66%), respectively, compared to the same periods of 2001, as a result of cancellation of the service contracts with three unaffiliated MGAs (which are currently in run-off).

Acquisition costs, net, represents the amortization of acquisition costs (and credits) deferred over the past twelve months and the deferral of acquisition costs (and credits) incurred in the current period. The \$0.1 million decrease in acquisition costs, net, is primarily due to the combined effect of a decrease in ceding commission income due to changes in the Company's reinsurance terms and an increase in the deferral rate as a result of the Company increasing its retention of State & County business under its quota share retrocession agreement.

Other acquisition and underwriting expenses for the three and nine months ended September 30, 2002 increased 80% and 47%, respectively, as compared to the same periods of 2001. The increase in expenses is primarily attributable to decreased ceding commission income as a result of increases in the Company's retention of its core business since year end 2001, less favorable reinsurance terms, and decreased core State & County annual premium volume.

Operating expenses include expenses related to premium finance operations, general corporate overhead, and third party administrative and claims handling contracts. Related revenues are derived from finance charges and processing and service fees. Operating expenses during the three and nine months ended September 30, 2002, decreased 40% and 41%, respectively, as compared to the same periods of 2001. The majority of this decrease in operating expenses is attributable to decreased operating costs related to third party processing and claims handling, and to a lesser extent, decreased operating costs related to premium finance.

Interest expense during the three and nine months ended September 30, 2002, decreased approximately \$0.1 million and \$0.2 million respectively, as compared to 2001. This decrease is principally the result of a decrease in the effective interest rate related to the premium finance line of credit and to lower premium note volume as a result of lower annual premium volume.

Recent Developments

The Company's retrocession reinsurance agreement with Dorinco has been modified effective October 1, 2002 with modestly improved terms. The threshold of the loss corridor has been raised to a loss ratio of 65.5% from a loss ratio of 65.01%. In addition, the ceiling of the loss corridor has been lowered to a loss ratio of 75.5%, resulting in a narrowing of the corridor from 15 percentage points to 10 percentage points. The minimum ceding commission has been increased by 0.5%, and the loss ratio threshold for minimum commissions has been raised by 0.5%. Further, Dorinco has waived any deficit loss carryforward. A deficit loss carryforward results when the loss ratio exceeds an established benchmark and the deficit is carried forward into subsequent ceding commission adjustments. As a result of the waiver of the deficit loss carryforward effective October 1, 2002, the Company will be able to recognize additional ceding commission above the

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minimum commission at established loss ratios below 65.5%. If the deficit loss carryforward had not been waived, any potential additional commission would have been applied to the deficit loss carryforward accumulated through September 30, 2002.

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

This Form 10-QSB 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 the Company's 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, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of the Company. Although the Company believes 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-QSB 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 the Company or any other person that the objectives and plans of the Company will be achieved.

Item 3. Controls and Procedures.

The Chief Executive Officer and Chief Financial Officer of the Company have evaluated the Company's disclosure controls and procedures as of a date within 90 days of the filing date of this report and have concluded that such controls and procedures are effective. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

Except for routine litigation incidental to the business of the Company, neither the Company, nor any of the properties of the Company was subject to any material pending or threatened legal proceedings as of the date of this report.

Item 2. Changes in Securities.

None.

Item 3. Defaults upon Senior Securities.

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None.

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

None

Item 5. Other Information.

None.

Item 6. Exhibits and Reports on Form 8-K.

- (a) The exhibits listed in the Exhibit Index following the signature page are filed herewith.
- (b) The Company did not file any Form 8-K Current Reports during the third quarter of 2002.

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: October 31, 2002

/s/ Linda H. Sleeper

Linda H. Sleeper, President
(Chief Executive Officer)

Date: October 31, 2002

/s/ John J. DePuma

John J. DePuma,
Chief Financial Officer

CERTIFICATIONS

I, Linda H. Sleeper, Chief Executive Officer of Hallmark Financial Services, Inc. (the "Company"), certify that:

1. I have reviewed this quarterly report on Form 10-QSB of the Company;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under

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which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: October 31, 2002

/s/ Linda H. Sleeper

Linda H. Sleeper, Chief Executive Officer

I, John J. DePuma, Chief Financial Officer of Hallmark Financial Services, Inc. (the "Company"), certify that:

1. I have reviewed this quarterly report on Form 10-QSB of the

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Company;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: October 31, 2002

/s/ John J. DePuma

John J. DePuma, Chief Financial Officer

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Exhibit Index

| Exhibit ----- | Description ----- |
|------------------|--|
| 10 (a) | Addendum No. 3 to the Quota Share Retrocession Agreement, effective July 1, 2000, between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective June 30, 2001. |
| 10 (b) | Amendment of Article VII of the Amended and Restated Bylaws of Hallmark Financial Services, Inc., adopted July 19, 2002. |
| 10 (c) | Form of Indemnification Agreement between Hallmark Financial Services, Inc. and its officers and directors, adopted July 19, 2002. |
| 99 | Certification Pursuant to 18 U.S.C. 1350 Enacted by Section 906 of the Sarbanes-Oxley Act of 2002. |