HALLMARK FINANCIAL SERVICES INC
Form 10-Q
August 09, 2011
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the

Securities Exchange Act of 1934

For the quarterly period ended June 30, 2011

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark 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 x
Non-accelerated filer ¨	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o Nox

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 – 19,263,457 shares outstanding as of August 8, 2011.

PART I
FINANCIAL INFORMATION

Item 1. Financial Statements

INDEX TO FINANCIAL STATEMENTS

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

	June 30 2011 (unaudited)	December 31 2010
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value (cost: $393,497 in 2011 and $383,530 in 2010)	$395,975	$ 388,399
Equity securities, available-for-sale, at fair value (cost: $31,573 in 2011 and $32,469 in 2010)	42,943	44,042
Total investments	438,918	432,441
Cash and cash equivalents	50,885	60,519
Restricted cash	6,346	5,277
Ceded unearned premiums	20,262	25,504
Premiums receivable	57,444	47,337
Accounts receivable	6,020	7,051
Receivable for securities	473	2,215
Reinsurance recoverable	42,726	39,505
Deferred policy acquisition costs	24,047	21,679
Goodwill	43,564	43,564
Intangible assets, net	28,448	30,241
Federal income tax recoverable	13,138	4,093
Prepaid expenses	1,699	1,987
Other assets	13,159	15,207
Total assets	$747,129	$ 736,620
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Note payable	$2,800	$ 2,800
Subordinated debt securities	56,702	56,702
Reserves for unpaid losses and loss adjustment expenses	278,894	251,677
Unearned premiums	148,205	140,965
Unearned revenue	93	116
Reinsurance balances payable	5,493	3,122
Accrued agent profit sharing	1,277	1,301
Accrued ceding commission payable	4,230	4,231
Pension liability	2,623	2,833
Payable for securities	8,357	2,493
Payable for acquisition	-	14,000
Deferred federal income taxes, net	1,836	3,471
Accounts payable and other accrued expenses	17,005	15,786
Total liabilities	527,515	499,497

Commitments and Contingencies (Note 18)		
Redeemable non-controlling interest	1,223	1,360
Stockholders' equity:		
Common stock, $.18 par value, authorized 33,333,333 shares in 2011 and 2010; issued 20,872,831 in 2011 and 2010	3,757	3,757
Additional paid-in capital	122,292	121,815
Retained earnings	94,567	105,816
Accumulated other comprehensive income	7,843	9,637
Treasury stock (1,418,003 shares in 2011 and 748,662 shares in 2010), at cost	(10,068)	(5,262)
Total stockholders' equity	218,391	235,763
	$747,129	$ 736,620

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

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

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2010	2011	2010
Gross premiums written	$ 91,371	$ 83,180	$ 181,083	$ 165,039
Ceded premiums written	(12,415)	(10,047)	(25,893)	(19,111)
Net premiums written	78,956	73,133	155,190	145,928
Change in unearned premiums	(7,378)	(3,185)	(13,499)	(8,965)
Net premiums earned	71,578	69,948	141,691	136,963
Investment income, net of expenses	3,778	3,276	7,785	6,477
Net realized gains	1,664	1,643	2,783	5,446
Finance charges	1,725	1,771	3,465	3,414
Commission and fees	(243)	(963)	172	(812)
Other income	11	12	25	22
Total revenues	78,513	75,687	155,921	151,510
Losses and loss adjustment expenses	61,920	52,058	125,705	95,156
Other operating expenses	23,788	22,872	46,961	44,354
Interest expense	1,153	1,150	2,311	2,296
Amortization of intangible assets	896	916	1,793	1,832
Total expenses	87,757	76,996	176,770	143,638
Income (loss) before tax	(9,244)	(1,309)	(20,849)	7,872
Income tax (benefit) expense	(9,229)	(953)	(9,622)	1,937
Net (loss) income	(15)	(356)	(11,227)	5,935
Less: Net income attributable to non-controlling interest	8	32	22	37
Net (loss) income attributable to Hallmark Financial Services, Inc.	$ (23)	$ (388)	$ (11,249)	$ 5,898
Net (loss) income per share attributable to Hallmark Financial Services, Inc. common stockholders:				
Basic	$ -	$ (0.02)	$ (0.56)	$ 0.29
Diluted	$ -	$ (0.02)	$ (0.56)	$ 0.29

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

	Three Months Ended June 30, 2011	Three Months Ended June 30, 2010	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Common Stock				
Balance, beginning of period	$ 3,757	$ 3,757	$ 3,757	$ 3,757
Issuance of common stock upon option exercises	-	-	-	-
Balance, end of period	3,757	3,757	3,757	3,757
Additional Paid-In Capital				
Balance, beginning of period	122,074	121,196	121,815	121,016
Accretion of redeemable noncontrolling interest	(3)	(84)	(6)	(162)
Equity based compensation	227	291	489	589
Exercise of stock options	(6)	-	(6)	(40)
Balance, end of period	122,292	121,403	122,292	121,403
Retained Earnings				
Balance, beginning of period	94,590	104,768	105,816	98,482
Net (loss) income attributable to Hallmark Financial Services, Inc.	(23)	(388)	(11,249)	5,898
Balance, end of period	94,567	104,380	94,567	104,380
Accumulated Other Comprehensive Income				
Balance, beginning of period	8,207	11,083	9,637	8,589
Additional minimum pension liability, net of tax	47	37	93	73
Net unrealized holding gains (losses) arising during period	1,253	(2,511)	896	3,750
Reclassification adjustment for losses included in net income	(1,664)	(1,643)	(2,783)	(5,446)
Balance, end of period	7,843	6,966	7,843	6,966
Treasury Stock				
Balance, beginning of period	(5,262)	(5,268)	(5,262)	(5,327)
Acquistion of treasury shares	(4,911)	-	(4,911)	-
Issuance of treasury stock upon option exercises	105	6	105	65
Balance, end of period	(10,068)	(5,262)	(10,068)	(5,262)
Total Stockholders' Equity	$ 218,391	$ 231,244	$ 218,391	$ 231,244
Net (loss) income	$ (15)	$ (356)	$ (11,227)	$ 5,935
Additional minimum pension liability, net of tax	47	37	93	73

Net unrealized holding gains (losses) arising during period	1,253	(2,511)	896	3,750
Reclassification adjustment for gains included in net income	(1,664)	(1,643)	(2,783)	(5,446)
Comprehensive (loss) income	(379)	(4,473)	(13,021)	4,312
Less: Comprehensive income attributable to non-controlling interest	8	32	22	37
Comprehensive (loss) income attributable to Hallmark Financial Services, Inc.	$ (387)	$ (4,505)	$ (13,043)	$ 4,275

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

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

	Six Months Ended June 30 2011	Six Months Ended June 30 2010
Cash flows from operating activities:		
Net (loss) income	$(11,227)	$5,935
Adjustments to reconcile net (loss) income to cash (used) provided by operating activities:		
Depreciation and amortization expense	2,463	2,326
Deferred federal income taxes	(977)	(734)
Realized gains on investments	(2,783)	(5,446)
Change in ceded unearned premiums	5,242	(2,136)
Change in premiums receivable	(10,107)	(7,758)
Change in accounts receivable	1,031	244
Change in deferred policy acquisition costs	(2,368)	(1,944)
Change in unpaid losses and loss adjustment expenses	27,217	29,786
Change in unearned premiums	7,240	11,101
Change in unearned revenue	(23)	(22)
Change in accrued agent profit sharing	(24)	(558)
Change in reinsurance recoverable	(3,221)	(6,141)
Change in reinsurance payable	2,371	(465)
Change in current federal income tax recoverable/payable	(9,045)	(4,508)
Change in accrued ceding commission payable	(1)	(4,365)
Change in all other liabilities	1,009	(1,996)
Change in all other assets	4,195	4,130
Net cash provided by operating activities	10,992	17,449
Cash flows from investing activities:		
Purchases of property and equipment	(1,162)	(841)
Net transfers into restricted cash	(1,069)	(3,825)
Payment for acquisition of subsidiaries	(14,000)	-
Purchases of investment securities	(166,834)	(123,337)
Maturities, sales and redemptions of investment securities	167,410	73,637
Net cash used in investing activities	(15,655)	(54,366)
Cash flows from financing activities:		
Proceeds from exercise of employee stock options	105	25
Purchase of treasury shares	(4,911)	-
Distribution to non-controlling interest	(165)	(144)
Net cash used in financing activities	(4,971)	(119)

Decrease in cash and cash equivalents	(9,634)	(37,036)
Cash and cash equivalents at beginning of period	60,519	112,270
Cash and cash equivalents at end of period	$50,885	$75,234
Supplemental cash flow information:		
Interest paid	$2,309	$2,303
Income taxes paid	$400	$7,179
Supplemental schedule of non-cash investing activities:		
Change in receivable for securities related to investment disposals that settled after the balance sheet date	$1,742	$31
Change in payable for securities related to investment purchases that settled after the balance sheet date	$5,864	$25,601

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

1. General

Hallmark Financial Services, Inc. (“Hallmark” and, together with subsidiaries, “we,” “us” or “our”) is an insurance holding company engaged in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing our insurance products, as well as providing other insurance related services.

We pursue our business activities through subsidiaries whose operations are organized into six business units that are supported by our insurance company subsidiaries. Our Standard Commercial business unit handles commercial insurance products and services in the standard market. Our Workers Comp business unit specializes in small and middle market workers compensation business. Our E&S Commercial business unit handles primarily commercial and medical professional liability insurance products and services in the excess and surplus lines market. Our General Aviation business unit handles general aviation insurance products and services. Our Excess & Umbrella business unit offers low and middle market commercial umbrella and excess liability insurance on both an admitted and non-admitted basis focusing primarily on trucking, specialty automobile and non-fleet automobile coverage. Our Personal Lines business unit handles personal insurance products and services. Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas (“AHIC”), Hallmark Insurance Company (“HIC”), Hallmark Specialty Insurance Company (“HSIC”), Hallmark County Mutual Insurance Company (“HCM”), Hallmark National Insurance Company (“HNIC”) and Texas Builders Insurance Company (“TBIC”).

These six business units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment consists of the Standard Commercial business unit and the Workers Comp business unit. The Personal Segment presently consists solely of the Personal Lines business unit and the Specialty Commercial Segment includes the E&S Commercial, General Aviation and Excess & Umbrella business units.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission (“SEC”) for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2010 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of June 30, 2011 and 2010 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended June 30, 2011 are not necessarily indicative of the operating results to be expected for the full year.

Redeemable non-controlling interest

We are accreting the redeemable non-controlling 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 non-controlling interest carrying amount that reflects a redemption in excess of fair value as being akin to an actual dividend. (See Note 3, “Business Combinations.”)

Income taxes

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end. Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes in effect for the year in which these temporary differences are expected to be recovered or settled.

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Refer to “Critical Accounting Estimates and Judgments” under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2010 for information on accounting policies that we consider critical in preparing our consolidated financial statements. Actual results could differ materially from those estimates.

Fair Value of Financial Instruments

Fair value estimates are made at a point in time, based on relevant market data as well as the best information available about the financial instruments. Fair value estimates for financial instruments for which no or limited observable market data is available are based on judgments regarding current economic conditions, credit and interest rate risk. These estimates involve significant uncertainties and judgments and cannot be determined with precision. As a result, such calculated fair value estimates may not be realizable in a current sale or immediate settlement of the instrument. In addition, changes in the underlying assumptions used in the fair value measurement technique, including discount rate and estimates of future cash flows, could significantly affect these fair value estimates.

Investment Securities: Fair values for debt securities and equity securities are obtained from an independent pricing service or based on quoted market prices. (See Note 4, “Fair Values” and Note 5, “Investments.”)

Cash and Cash Equivalents: The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Restricted Cash : The carrying amount for restricted cash reported in the balance sheet approximates the fair value.

Notes Payable: The carrying value of our bank credit facility of $2.8 million approximates the fair value based on the current interest rate.

Subordinated Debt Securities: Our trust preferred securities have a carried value of $56.7 million and a fair value of $55.7 million as of June 30, 2011. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.0% based on similar issues to discount future cash flows.

For reinsurance recoverable, federal income tax payable and receivable, other assets and other liabilities, the carrying amounts approximate fair value because of the short maturity of such financial instruments.

Variable Interest Entities

On June 21, 2005, we formed Hallmark Statutory Trust I ("Trust I"), an unconsolidated trust subsidiary, for the sole purpose of issuing $30.0 million in trust preferred securities. Trust I used the proceeds from the sale of these securities and our initial capital contribution to purchase $30.9 million of subordinated debt securities from Hallmark. The debt securities are the sole assets of Trust I, and the payments under the debt securities are the sole revenues of Trust I.

On August 23, 2007, we formed Hallmark Statutory Trust II ("Trust II"), an unconsolidated trust subsidiary, for the sole purpose of issuing $25.0 million in trust preferred securities. Trust II used the proceeds from the sale of these securities and our initial capital contribution to purchase $25.8 million of subordinated debt securities from Hallmark. The debt securities are the sole assets of Trust II, and the payments under the debt securities are the sole revenues of Trust II.

We evaluate on an ongoing basis our investments in Trust I and II (collectively the "Trusts") and we do not have variable interests in the Trusts. Therefore, the Trusts are not included in our consolidated financial statements.

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

Adoption of New Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board ("FASB") updated Accounting Standards Codification ("ASC") Topic 820, "Fair Value Measurements and Disclosures" ("ASC 820") to require additional disclosures about fair value measurements regarding transfers between fair value categories, as well as purchases, sales, issuances and settlements related to fair value measurements of financial instruments with non-observable inputs. This update was effective for interim and annual periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances and settlements of financial instruments with non-observable inputs, which are effective for years beginning after December 15, 2010. The adoption of ASC 820 did not have a material impact on our financial position or results of operations but did require additional disclosures.

In January 2010, we adopted new guidance issued by the FASB providing that a company should include a VIE in its consolidated accounts if the company is the primary beneficiary of the VIE. A company is considered the primary beneficiary of a VIE if it has both of the following characteristics: (a) the power to direct the activities of the VIE that most significantly impact the VIE's economic performance; and (b) the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. Ongoing reassessment of whether a company is the primary beneficiary of a VIE is required. The new guidance replaces the quantitative-based approach previously required for determining which company, if any, has a controlling financial interest in a VIE. The adoption of this guidance did not have a material impact on our financial position or results of operations.

In July 2010, the FASB issued Accounting Standards Update (ASU) 2010-20, which requires additional disclosures about the credit quality of financing receivables and allowances for credit losses. The additional requirements include disclosure of the nature of credit risks inherent in financing receivables, how credit risk is analyzed and assessed when determining the allowance for credit losses, and the reasons for the change in the allowance for credit losses. The disclosures are effective for us for interim and annual reporting periods ending on or after December 15, 2010. The adoption of ASU 2010-20 did not have a material impact on our financial position or results of operations.

In April 2009, FASB issued FASB Staff Position No. FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments", which was codified into ASC 320, "Investment Securities" ("ASC 320"), amending prior other-than-temporary impairment guidance for debt in order to make the guidance more operational and improve the presentation and disclosure of other-than-temporary impairments in the financial statements. ASC 320 does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The provisions of ASC 320 are effective for interim periods ending after June 15, 2009. We adopted ASC 320 effective April 1, 2009, which resulted in a cumulative effect adjustment to the beginning balances of retained earnings and accumulated other comprehensive income (loss) of approximately $2.6 million before tax and $1.7 million net of tax.

Accounting Pronouncements Not Yet Adopted

In October 2010, the FASB issued new guidance related to the accounting for costs associated with acquiring or renewing insurance contracts. The guidance identifies those costs relating to the successful acquisition of new or renewal insurance contracts which are to be capitalized. The guidance will be effective for us for the year beginning January 1, 2012 and may be applied prospectively or retrospectively. We are in the process of assessing the effect that the implementation of the new guidance will have on our financial position and results of operations. The amount of acquisition costs we would defer under the new guidance may be less than the amount deferred under our current accounting practice.

3. Business Combinations

We account for business combinations using the purchase method of accounting pursuant to ASC Topic 805, "Business Combinations." 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 of the amounts assigned to assets acquired and liabilities assumed is an asset referred to as "Goodwill". Indirect and general expenses related to business combinations are expensed as incurred. Prior to 2009 indirect and general expenses were capitalized.

Effective August 29, 2008, we acquired 80% of the issued and outstanding membership interests in the subsidiaries now comprising our Excess & Umbrella business unit for consideration of $15.0 million. In connection with the acquisition, we executed an operating agreement for each subsidiary. The operating agreements grant us the right to purchase the remaining 20% membership interests in the subsidiaries and grant to an affiliate of the seller the right to require us to purchase such remaining membership interests (the "Put/Call Option"). The Put/Call Option becomes exercisable by either us or the affiliate of the seller upon the earlier of August 29, 2012, the termination of the employment of the seller by the Excess & Umbrella business unit or a change of control of Hallmark. If the Put/Call Option is exercised, we will have the right or obligation to purchase the remaining 20% membership interests in the Excess & Umbrella business unit for an amount equal to nine times the average Pre-Tax Income (as defined in the operating agreements) for the previous 12 fiscal quarters. We estimate the ultimate redemption value of the Put/Call Option to be $1.4 million at June 30, 2011.

Effective June 5, 2009, we acquired all of the issued and outstanding shares of CYR Insurance Management Company ("CYR"). CYR has as its primary asset a management agreement with Hallmark County Mutual Insurance Company ("HCM"), which provides for CYR to have management and control of HCM. We acquired all of the issued and outstanding shares of CYR for consideration of a base purchase price of $4.0 million paid at closing plus an override commission in an amount equal to 1% of the net premiums and net policy fees of HCM for the years 2010 and 2011 subject to a maximum of $1.25 million. The override commission is paid monthly as the subject premiums and policy fees are written. The fair value of the management agreement acquired is $3.2 million and is being amortized over four years. HCM is used to front certain lines of business in our Specialty Commercial and Personal Segments in Texas where we previously produced policies for third party county mutual insurance companies and reinsured 100% for a fronting fee.

Effective December 31, 2010, we acquired all of the issued and outstanding capital stock of HNIC for initial consideration of $14.0 million paid in cash on January 3, 2011 to State Auto Financial Corporation, Inc. ("SAFCI"). In addition, an earnout of up to $2.0 million is payable to SAFCI quarterly in an amount equal to 2% of gross collected premiums on new or renewal personal lines insurance policies written by HNIC agents during the three years following closing. HNIC is an Ohio domiciled insurance company that writes non-standard personal automobile policies through independent agents in 21 states.

4. Fair Value

ASC 820 defines fair value, establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. ASC 820, among other things, requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. In addition, ASC 820 precludes the use of block discounts when measuring the fair value of instruments traded in an active market, which were previously applied to large holdings of publicly traded equity securities.

We determine the fair value of our financial instruments based on the fair value hierarchy established in ASC 820. In accordance with ASC 820, we utilize the following fair value hierarchy:

- Level 1: quoted prices in active markets for identical assets;
- Level 2: inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, inputs of identical assets for less active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument; and
- Level 3: inputs to the valuation methodology that are unobservable for the asset or liability.

This hierarchy requires the use of observable market data when available.

Under ASC 820, we determine fair value based on the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. It is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy described above. Fair value measurements for assets and liabilities where there exists limited or no observable market data are calculated based upon our pricing policy, the economic and competitive environment, the characteristics of the asset or liability and other factors as appropriate. These estimated fair values may not be realized upon actual sale or immediate settlement of the asset or liability.

Where quoted prices are available on active exchanges for identical instruments, investment securities are classified within Level 1 of the valuation hierarchy. Level 1 investment securities include common and preferred stock.

Level 2 investment securities include corporate bonds, collateralized corporate bank loans, municipal bonds, and U.S. Treasury securities for which quoted prices are not available on active exchanges for identical instruments. We use a third party pricing service to determine fair values for each Level 2 investment security in all asset classes. Since quoted prices in active markets for identical assets are not available, these prices are determined using observable market information such as quotes from less active markets and/or quoted prices of securities with similar characteristics, among other things. We have reviewed the processes used by the pricing service and have determined that they result in fair values consistent with the requirements of ASC 820 for Level 2 investment securities.

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 June 30, 2011 (in thousands):

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	$ -	$ 23,155	$ -	$ 23,155
Corporate bonds	-	72,947	-	72,947
Collateralized corporate bank loans	-	107,910	1,305	109,215
Municipal bonds	-	170,496	19,457	189,953
Mortgage-backed	-	705	-	705
Total debt securities	-	375,213	20,762	395,975
Financial services	18,048	-	-	18,048
All other	24,895	-	-	24,895
Total equity securities	42,943	-	-	42,943
Total debt and equity securities	$ 42,943	$ 375,213	$ 20,762	$ 438,918

Due to significant unobservable inputs into the valuation model for certain municipal bonds and a collateralized corporate bank loan in illiquid markets, we classified these investments as level 3 in the fair value hierarchy. We used an income approach in order to derive an estimated fair value of the municipal bonds classified as Level 3, which included inputs such as expected holding period, benchmark swap rate, benchmark discount rate and a discount rate premium for illiquidity. The fair value of the collateralized corporate bank loan classified as level 3 is based on discounted cash flows using current yield to maturity of 10.4%, which is based on the relevant spread over LIBOR for this particular loan to discount future cash flows.

The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the six months ended June 30, 2011 (in thousands):

Beginning balance as of January 1, 2011	$21,981
Settlements	(224)
Total realized/unrealized gains included in net income	-
Net losses included in other comprehensive income	(995)
Transfers into Level 3	-
Transfers out of Level 3	-
Ending balance as of June 30, 2011	$20,762

5. Investments

We complete a detailed analysis each quarter to assess whether any decline in the fair value of any investment below cost is deemed other-than-temporary. All securities with an unrealized loss are reviewed. We recognize an impairment loss when an investment's value declines below cost, adjusted for accretion, amortization and previous other-than-temporary impairments and it is determined that the decline is other-than-temporary.

Debt Investments: We assess whether we intend to sell, or it is more likely than not that we will be required to sell, a fixed maturity investment before recovery of its amortized cost basis less any current period credit losses. For fixed maturity investments that are considered other-than-temporarily impaired and that we do not intend to sell and will not be required to sell, we separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the investment's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the investment's fair value and the present value of future expected cash flows is recognized in other comprehensive income.

Equity Investments: Some of the factors considered in evaluating whether a decline in fair value for an equity investment is other-than-temporary include: (1) our ability and intent to retain the investment for a period of time sufficient to allow for an anticipated recovery in value; (2) the recoverability of cost; (3) the length of time and extent to which the fair value has been less than cost; and (4) the financial condition and near-term and long-term prospects for the issuer, including the relevant industry conditions and trends, and implications of rating agency actions and offering prices. When it is determined that an equity investment is other-than-temporarily impaired, the security is written down to fair value, and the amount of the impairment is included in earnings as a realized investment loss. The fair value then becomes the new cost basis of the investment, and any subsequent recoveries in fair value are recognized at disposition. We recognize a realized loss when impairment is deemed to be other-than-temporary even if a decision to sell an equity investment has not been made. When we decide to sell a temporarily impaired available-for-sale equity investment and we do not expect the fair value of the equity investment to fully recover prior to the expected time of sale, the investment is deemed to be other-than-temporarily impaired in the period in which the decision to sell is made.

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

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2010	2011	2010
U.S. Treasury securities and obligations of U.S. Government	$ -	$ -	$ 14	$ -
Corporate bonds	271	-	271	2,078
Collateralized corporate bank loans	206	74	640	1,290
Municipal bonds	66	24	(1)	(72)
Mortgage-backed	-	-	-	-
Equity securities-financial services	51	1,201	789	1,767
Equity securities-all other	1,070	344	1,070	383
Gain on investments	1,664	1,643	2,783	5,446
Other-than-temporary impairments	-	-	-	-
Net realized gains	$ 1,664	$ 1,643	$ 2,783	$ 5,446

We realized gross gains on investments of $1.7 million and $1.6 million during the three months ended June 30, 2011 and 2010, respectively and $2.9 million and $5.5 million for the six months ended June 30, 2011 and 2010, respectively. We realized gross losses on investments of $43 thousand and $11 thousand for the three months ended June 30, 2011 and 2010. We realized gross losses on investments of $0.1 million for the six months ended both June 30, 2011 and 2010. We recorded proceeds from the sale of investment securities of $82.9 million and $26.5 million during the three months ended June 30, 2011 and 2010, respectively, and $165.7 million and $73.6 million for the six months ended June 30, 2011 and 2010, respectively. Realized investment gains and losses are recognized in operations on the specific identification method.

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

As of June 30, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government	$ 23,098	$ 57	$ -	$ 23,155
Corporate bonds	70,647	3,079	(779)	72,947
Collateralized corporate bank loans	108,861	534	(180)	109,215
Municipal bonds	190,231	2,929	(3,207)	189,953
Mortgage-backed	660	45	-	705
Total debt securities	393,497	6,644	(4,166)	395,975
Financial services	14,522	3,860	(334)	18,048
All other	17,051	7,885	(41)	24,895
Total equity securities	31,573	11,745	(375)	42,943
Total debt and equity securities	$ 425,070	$ 18,389	$ (4,541)	$ 438,918
As of December 31, 2010				
U.S. Treasury securities and obligations of U.S. Government	$ 39,767	$ 36	$ -	$ 39,803
Corporate bonds	82,956	3,465	(844)	85,577
Collateralized corporate bank loans	106,723	1,685	(95)	108,313
Municipal bonds	153,334	2,421	(1,842)	153,913
Mortgage-backed	750	43	-	793
Total debt securities	383,530	7,650	(2,781)	388,399
Financial services	15,385	5,770	(270)	20,885
All other	17,084	6,196	(123)	23,157