HALLMARK FINANCIAL SERVICES INC
Form 10-K
March 18, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended **DECEMBER 31, 2007**
Or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ________________________ to ________________________

Commission file number **001-11252**
Hallmark Financial Services, Inc.
(Exact name of registrant as specified in its charter)

Nevada	**87-0447375**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
777 Main Street, Suite 1000, Fort Worth, Texas	**76102**
(Address of Principal Executive Offices)	(Zip Code)

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

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock $.18 par value	**Nasdaq Global Market**

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

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

Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yeso No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer o 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 o No x

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant’s most recently completed second fiscal quarter. $71,259,673

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. 20,785,753 shares of common stock, $.18 par value per share, outstanding as of March 15, 2008.

DOCUMENTS INCORPORATED BY REFERENCE

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

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

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

This Form 10-K contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which are intended to be covered by the safe harbors created thereby. Forward-looking statements include statements which are predictive in nature, which depend upon or refer to future events or conditions, or which include words such as "expect," "anticipate," "intend," "plan," "believe," "estimate" or similar express These statements include the plans and objectives of management for future operations, including plans and objectives relating to future growth of our business activities and availability of funds. Statements regarding the following subjects are forward-looking by their nature:

- our business and growth strategies;
- our performance goals;
- our projected financial condition and operating results;
- our understanding of our competition;
- industry and market trends;
- the impact of technology on our products, operations and business; and
- any other statements or assumptions that are not historical facts.

The forward-looking statements included in this Form 10-K are based on current expectations that involve numerous risks and uncertainties. Assumptions relating to these forward-looking statements involve judgments with respect to, among other things, future economic, competitive and market conditions, regulatory framework, weather-related events and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying these forward-looking statements are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included in this Form 10-K will prove to be accurate. In light of the significant uncertainties inherent in these forward-looking statements, the inclusion of such information should not be regarded as a representation that our objectives and plans will be achieved.

PART I

Item 1. Business.

Who We Are

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

We market, distribute, underwrite and service our property/casualty insurance products through four operating units, each of which has a specific focus. Our HGA Operating Unit primarily handles standard commercial insurance, our TGA Operating Unit concentrates on excess and surplus lines commercial insurance, our Aerospace Operating Unit specializes in general aviation insurance and our Phoenix Operating Unit focuses on non-standard personal automobile insurance. The subsidiaries comprising our TGA Operating Unit and our Aerospace Operating Unit were acquired effective January 1, 2006.

Each operating unit has its own management team with significant experience in distributing products to its target markets and proven success in achieving underwriting profitability and providing efficient claims management. Each operating unit is responsible for marketing, distribution, underwriting and claims management while we provide capital management, reinsurance, actuarial, investment, financial reporting, technology and legal services and back office support at the parent level. We believe this approach optimizes our operating results by allowing us to effectively penetrate our selected specialty and niche markets while maintaining operational controls, managing risks, controlling overhead and efficiently allocating our capital across operating units.

We expect future growth to be derived from increased retention of the premiums we write, organic growth in the premium production of our existing operating units and selected, opportunistic acquisitions that meet our criteria. In 2005, we increased the capital of our insurance company subsidiaries, enabling them to retain significantly more of the business produced by our operating units. For the year ended December 31, 2007, approximately 80% of the total premium we produced was retained by our insurance company subsidiaries, while the remaining 20% was written for or ceded to unaffiliated insurers. We expect to continue to increase our retention of the total premium we produce. We believe increasing our overall retention will drive greater near-term profitability than focusing solely on growth in premium production and market share.

What We Do

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

Our HGA Operating Unit primarily underwrites low-severity, short-tailed commercial property/casualty insurance products in the standard market. These products have historically produced stable loss results and include general liability, commercial automobile, commercial property and umbrella coverages. Our HGA Operating Unit currently markets its products through a network of approximately 200 independent agents primarily serving businesses in the non-urban areas of Texas, New Mexico, Oregon, Idaho, Montana and Washington.

Our TGA Operating Unit primarily offers commercial property/casualty insurance products in the excess and surplus lines market. Excess and surplus lines insurance provides coverage for difficult to place risks that do not fit the underwriting criteria of insurers operating in the standard market. Our TGA Operating Unit focuses on small- to medium-sized commercial businesses that do not meet the underwriting requirements of standard insurers due to factors such as loss history, number of years in business, minimum premium size and types of business operation. Our TGA Operating Unit primarily writes general liability, commercial automobile and commercial property policies. Our TGA Operating Unit markets its products through 39 independent general agencies with offices in Texas, Louisiana, Oklahoma and Arkansas, as well as approximately 730 independent retail agents in Texas.

Our Aerospace Operating Unit offers general aviation property/casualty insurance primarily for private and small commercial aircraft and airports. The aircraft liability and hull insurance products underwritten by our Aerospace Operating Unit are targeted to transitional or non-standard pilots who may have difficulty obtaining insurance from a standard carrier. Airport liability insurance is marketed to smaller, regional airports. Our Aerospace Operating Unit markets these general aviation insurance products through approximately 200 independent specialty brokers in 47 states.

Our Phoenix Operating Unit offers non-standard personal automobile policies which generally provide the minimum limits of liability coverage mandated by state law to drivers who find it difficult to obtain insurance from standard carriers due to various factors including age, driving record, claims history or limited financial resources. Our Phoenix Operating Unit markets this non-standard personal automobile insurance through approximately 1,640 independent retail agents in 11 states.

Our insurance company subsidiaries are American Hallmark Insurance Company of Texas (“AHIC”), Phoenix Indemnity Insurance Company (“PIIC”) and Hallmark Specialty Insurance Company (“HSIC”) (formerly known as Gulf States Insurance Company). 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 would retain 46.0% of the net premiums written, PIIC would retain 34.1% of the net premiums written and HSIC would retain 19.9% of the net premiums written. As of June 5, 2006, A.M. Best Company (“A.M. Best”), a nationally recognized insurance industry rating service and publisher, pooled its ratings of our three insurance company subsidiaries and assigned a financial strength rating of “A-” (Excellent) and an issuer credit rating of “a-” to each of our individual insurance company subsidiaries and to the pool formed by our insurance company subsidiaries.

Our four 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 both our TGA Operating Unit and our Aerospace Operating Unit. The following table displays the gross premiums produced by these reportable segments for affiliated and unaffiliated insurers for the years ended December 31, 2007, 2006 and 2005, as well as the gross premiums written and net premiums written by our insurance subsidiaries for these reportable segments for the same periods.

	Year Ended December 31,		
	2007	**2006**	**2005**
		(dollars in thousands)	
Gross Premiums Produced:			
Standard Commercial Segment	$ 90,985	$ 91,679	$ 81,721
Specialty Commercial Segment (1)	151,003	156,490	-
Personal Segment	55,916	45,135	36,345
Total	$ 297,904	$ 293,304	$ 118,066
Gross Premiums Written:			
Standard Commercial Segment	$ 90,868	$ 91,070	$ 52,952
Specialty Commercial Segment (1)	102,688	77,740	-
Personal Segment	55,916	45,135	36,515
Total	$ 249,472	$ 213,945	$ 89,467
Net Premiums Written:			
Standard Commercial Segment	$ 84,222	$ 82,220	$ 51,249
Specialty Commercial Segment (1)	98,005	75,573	-
Personal Segment	55,916	45,135	37,003

Total	$	238,143	$	202,928	$	88,252

[1] The subsidiaries included in the Specialty Commercial Segment were acquired effective January 1, 2006 and, therefore, are not included in the year ended December 31, 2005.

Operational Structure

Our insurance company subsidiaries retain a portion of the premiums produced by our operating units. The following chart reflects the operational structure of our organization, the subsidiaries comprising our operating units and the operating units included in each reportable segment as of December 31, 2007.

Standard Commercial Segment / HGA Operating Unit

The Standard Commercial Segment of our business presently consists solely of our HGA Operating Unit. Our HGA Operating Unit markets, underwrites and services standard commercial lines insurance primarily in the non-urban areas of Texas, New Mexico, Idaho, Oregon, Montana and Washington. The subsidiaries comprising our HGA Operating Unit include American Hallmark Insurance Services, a regional managing general agency, and ECM, a claims administration company. American Hallmark Insurance Services targets customers that are in low-severity classifications in the standard commercial market, which as a group have relatively stable loss results. The typical customer is a small- to medium-sized business with a policy that covers property, general liability and automobile exposures. Our HGA Operating Unit underwriting criteria exclude lines of business and classes of risks that are considered to be high-severity or volatile, or which involve significant latent injury potential or other long-tailed liability exposures. ECM administers the claims on the insurance policies produced by American Hallmark Insurance Services. Products offered by our HGA Operating Unit include the following:

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

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

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

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

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

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

Our HGA Operating Unit markets its property/casualty insurance products through approximately 200 independent agencies operating in its target markets. Our HGA Operating Unit applies a strict agent selection process and seeks to provide its independent agents some degree of non-contractual geographic exclusivity. Our HGA Operating Unit also strives to provide its independent agents with convenient access to product information and personalized service. As a result, the Standard Commercial Segment has historically maintained excellent relationships with its producing agents, as evidenced by the 19-year average tenure of the 24 agency groups which each produced more than $1.0 million in premium during the year ended December 31, 2007. During 2007, the top ten agency groups produced approximately 39%, and no individual agency group produced more than 8%, of the total premium volume of our HGA Operating Unit.

Our HGA Operating Unit writes most risks on a package basis using a commercial multi-peril policy or a business owner’s policy. Umbrella policies are written only when our HGA Operating Unit also writes the insured’s underlying general liability and commercial automobile coverage. Through December 31, 2005, our HGA Operating Unit marketed policies on behalf of Clarendon National Insurance Company (“Clarendon”), a third-party insurer. Our HGA Operating Unit earns a commission based on a percentage of the earned premium it produced for Clarendon. The commission percentage is determined by the underwriting results of the policies produced. ECM receives a claim servicing fee based on a percentage of the earned premium produced, with a portion deferred for casualty claims. On July 1, 2005, our HGA Operating Unit began marketing new policies for AHIC and presently markets all new and renewal policies exclusively for AHIC.

All of the commercial policies written by our HGA Operating Unit are for a term of 12 months. If the insured is unable or unwilling to pay for the entire premium in advance, we provide an installment payment plan that allows the insured to pay 20% down and the remaining payments over eight months. We charge a flat $7.50 installment fee per payment for the installment payment plan.

Specialty Commercial Segment

The Specialty Commercial Segment of our business includes both our TGA Operating Unit and our Aerospace Operating Unit. All of the subsidiaries comprising our TGA Operating Unit and our Aerospace Operating Unit were acquired effective January 1, 2006. Our TGA Operating Unit and our Aerospace Operating Unit were reported as separate segments during the first three quarters of 2006, but were aggregated into a single segment commencing in the fourth quarter of 2006 in accordance with U.S. generally accepted accounting principles (“GAAP”). During 2007, our TGA Operating Unit accounted for approximately 80% of the aggregate premiums produced by the Specialty Commercial Segment, with the remaining 20% coming from our Aerospace Operating Unit.

TGA Operating Unit. Our TGA Operating Unit markets, underwrites, finances and services commercial lines insurance in Texas, Louisiana, Arkansas and Oklahoma with a particular emphasis on commercial automobile, general liability and commercial property risks produced on an excess and surplus lines basis. Excess and surplus lines insurance provides coverage for difficult to place risks that do not fit the underwriting criteria of insurers operating in the standard market. Our TGA Operating Unit also markets, underwrites and services certain non-strategic legacy personal lines insurance products in Texas, including dwelling fire, homeowners and non-standard personal automobile coverages. During 2007, our TGA Operating Unit completed the transition of new and renewal business for non-standard personal automobile coverages to our Phoenix Operating Unit. The subsidiaries comprising our TGA Operating Unit include Texas General Agency, which is a regional managing general agency, TGASRI, which brokers mobile home insurance, and PAAC, which provides premium financing for policies marketed by Texas General Agency and certain unaffiliated general and retail agents. Texas General Agency accounts for approximately 95% of the premium volume financed by PAAC.

Our TGA Operating Unit focuses on small- to medium-sized commercial businesses that do not meet the underwriting requirements of traditional standard insurers due to issues such as loss history, number of years in business, minimum premium size and types of business operation. During 2007, commercial automobile, general liability and commercial property insurance accounted for approximately 97% of the premiums produced by our TGA Operating Unit, with the remaining 3% coming from legacy personal lines products. Target risks for commercial automobile insurance are small- to medium-sized businesses with ten or fewer vehicles which include artisan contractors, local light- to medium-service vehicles and retail delivery vehicles. Target risks for general liability insurance are small business risk exposures including artisan contractors, sales and service organizations, and building and premiums exposures. Target risks for commercial property insurance are low- to mid-value structures including office buildings, mercantile shops, restaurants and rental dwellings, in each case with aggregate property limits of less than $500 thousand. The commercial insurance products offered by our TGA Operating Unit include the following:

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

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

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

Our TGA Operating Unit produces business through a network of 39 general agents with 57 offices in four states, as well as through approximately 730 retail agents in Texas. Our TGA Operating Unit strives to simplify the placement of its excess and surplus lines policies by providing prompt quotes and signature-ready applications to its independent agents. During 2007, general agents accounted for approximately 79% of total premiums produced by our TGA Operating Unit, with the remaining 21% being produced by retail agents. During 2007, the top ten general agents produced approximately 47%, and no general agent produced more than 10%, of the total premium volume of our TGA Operating Unit. During the same period, the top ten retail agents produced approximately 4%, and no retail agent produced more than 1%, of the total premium volume of our TGA Operating Unit.

All business of our TGA Operating Unit is currently produced under a fronting agreement with member companies of the Republic Group ("Republic") which grants our TGA Operating Unit the authority to develop underwriting programs, set rates, appoint retail and general agents, underwrite risks, issue policies and adjust and pay claims. During 2006 and 2007, AHIC assumed 50% and 60%, respectively, of the premium written under this fronting agreement pursuant to a reinsurance agreement with Republic which expires on December 31, 2008. AHIC may assume a maximum of 70% of the written premium produced in 2008. Commission revenue is also generated under the fronting agreement on the portion of premiums not assumed by AHIC. An additional commission may be earned if certain loss ratio targets are met. Additional revenue is generated from fully earned policy fees and installment billing fees charged on the legacy personal lines products.

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

Aerospace Operating Unit. Our Aerospace Operating Unit markets, underwrites and services general aviation property/casualty insurance in 47 states. The subsidiaries comprising our Aerospace Operating Unit include Aerospace Insurance Managers, which markets standard aviation coverages, ASRI, which markets excess and surplus lines aviation coverages, and ACMG, which handles claims management. Aerospace Insurance Managers is one of only a few similar entities in the U.S. and has focused on developing a well-defined niche centering on transitional pilots, older aircraft and small airports and aviation-related businesses. Products offered by our Aerospace Operating Unit include the following:

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

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

Our Aerospace Operating Unit generates its business through approximately 200 aviation specialty brokers. These specialty brokers submit to Aerospace Insurance Managers requests for aviation insurance quotations received from the states in which we operate and our Aerospace Operating Unit selectively determine the risks fitting its target niche for which it will prepare a quote. During 2007, the top ten independent specialty brokers produced approximately

31%, and no broker produced more than 6%, of the total premium volume of our Aerospace Operating Unit.

Our Aerospace Operating Unit independently develops, underwrites and prices each coverage written. We target pilots who may lack experience in the type of aircraft they have acquired or are transitioning between types of aircraft. We also target pilots who may be over the age limits of other insurers. We do not accept aircraft that are used for hazardous purposes such as crop dusting or heli-skiing. Liability limits are controlled, with approximately 93% of the aircraft written in 2007 bearing per-occurrence limits of $1,000,000 and per-passenger limits of $100,000 or less. The average insured aircraft hull value for aircraft written in 2007 was approximately $141,000.

Prior to July 1, 2006, our Aerospace Operating Unit produced policies for American National Property & Casualty Insurance Company ("ANPAC") under a reinsurance program which ceded 100% of the business to several reinsurers. Under this arrangement, revenue was generated primarily from commissions based on written premiums net of cancellations and endorsement return premiums. An additional commission may be earned based upon the profitability of the business to the reinsurers. Beginning July 1, 2006, we began issuing general aviation policies through our insurance companies and currently 35 of the 47 states are written through our insurance companies with the remaining 12 states written under a fronting arrangement with ANPAC and reinsured by AHIC.

Personal Segment / Phoenix Operating Unit

The Personal Segment of our business presently consists solely of our Phoenix Operating Unit. Our Phoenix Operating Unit markets and services non-standard personal automobile policies in Texas, Arizona, New Mexico, Oklahoma, Arkansas, Idaho, Oregon, Washington, Louisiana, Missouri and Montana. We conduct this business under the name Phoenix General Agency. Phoenix General Agency provides management, policy and claims administration services to PIIC and includes the operations of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc. Our non-standard personal automobile insurance generally provides for the minimum limits of liability coverage mandated by state laws to drivers who find it difficult to purchase automobile insurance from standard carriers as a result of various factors, including driving record, vehicle, age, claims history, or limited financial resources. Products offered by our Phoenix Operating Unit include the following:

- ***Personal automobile liability.*** Personal automobile liability insurance provides coverage primarily at the minimum limits required by law for automobile liability exposures, including bodily injury and property damage, arising from accidents involving the insured.

- ***Personal automobile physical damage.*** Personal automobile physical damage insurance provides collision and comprehensive coverage for physical damage exposure to the insured vehicle as a result of an accident with another vehicle or object or as a result of causes other than collision such as vandalism, theft, wind, hail or water.

Our Phoenix Operating Unit markets its non-standard personal automobile policies through approximately 1,640 independent agents operating in its target geographic markets. Subject to certain criteria, our Phoenix Operating Unit seeks to maximize the number of agents appointed in each geographic area in order to more effectively penetrate its highly competitive markets. However, our Phoenix Operating Unit periodically evaluates its independent agents and discontinues the appointment of agents whose production history does not satisfy certain standards. During 2007, the top ten independent agency groups produced approximately 14%, and no individual agency group produced more than 3%, of the total premium volume of our Phoenix Operating Unit.

During 2007, personal automobile liability coverage accounted for approximately 75% and personal automobile physical damage coverage accounted for the remaining 25% of the total premiums produced by our Phoenix Operating Unit. Phoenix General Agency currently offers one-, two-, three-, six- and twelve-month policies. Our typical non-standard personal automobile customer is unable or unwilling to pay a full or half year's premium in advance. Accordingly, we currently offer a direct bill program where the premiums are directly billed to the insured on a monthly basis. We charge installment fees for each payment under the direct bill program.

Our Phoenix Operating Unit markets non-standard personal automobile policies in Arizona, New Mexico, Oklahoma, Arkansas, Idaho, Oregon, Washington, Louisiana, Missouri, and Montana directly for PIIC. In Texas, our Phoenix Operating Unit markets non-standard personal automobile policies both through reinsurance arrangements with unaffiliated companies and, since the fourth quarter of 2005, directly for PIIC. We provide non-standard personal automobile coverage in Texas through a reinsurance arrangement with Old American County Mutual Fire Insurance Company ("OACM"). Phoenix General Agency holds a managing general agency appointment from OACM to manage the sale and servicing of OACM policies. PIIC reinsures 100% of the OACM policies produced by Phoenix General

Agency under these reinsurance arrangements.

Our Competitive Strengths

We believe that we enjoy the following competitive strengths:

· ***Specialized market knowledge and underwriting expertise.*** All of our operating units possess extensive knowledge of the specialty and niche markets in which they operate, which we believe allows them to effectively structure and market their property/casualty insurance products. Our Phoenix Operating Unit has a thorough understanding of the unique characteristics of the non-standard personal automobile market. Our HGA Operating Unit has significant underwriting experience in its target markets for standard commercial property/casualty insurance products. In addition, our TGA Operating Unit and Aerospace Operating Unit have developed specialized underwriting expertise which enhances their ability to profitably underwrite non-standard property/casualty insurance coverages.

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

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

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

· ***Experienced management team.*** Our senior corporate management has an average of over 20 years of insurance experience. In addition, our operating units have strong management teams, with an average of more than 25 years of insurance industry experience for the heads of our operating units and an average of more than 15 years of underwriting experience for our underwriters. Our management has significant experience in all aspects of property/casualty insurance, including underwriting, claims management, actuarial analysis, reinsurance and regulatory compliance. In addition, Hallmark's senior management has a strong track record of acquiring businesses that expand our product offerings and improve our profitability profile.

Our Strategy

We are striving to become a leading diversified property/casualty insurance group offering products in specialty and niche markets through the following strategies:

· ***Focusing on underwriting discipline and operational efficiency.*** We seek to consistently generate an underwriting profit on the business we write in hard and soft markets. Our operating units have a strong track record of underwriting discipline and operational efficiency which we seek to continue. We believe that in soft markets our competitors often offer policies at a low or negative underwriting profit in order to maintain or increase their premium volume and market share. In contrast, we seek to write business based on its profitability rather than focusing solely on premium production. To that end, we provide financial incentives to many of our underwriters and independent agents based on underwriting profitability.

· ***Increasing the retention of business written by our operating units.*** Our operating units have a strong track record of writing profitable business in their target markets. Historically, the majority of those premiums were retained by unaffiliated insurers. During 2005, we increased the capital of our insurance company subsidiaries which has enabled us to retain significantly more of the premiums our operating units produce. We expect to continue to increase the portion of our premium production retained by our insurance company subsidiaries. We believe that the underwriting profit earned from this newly retained business will drive our profitability growth in the near-term.

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

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

Distribution

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

Except for the products of our Aerospace Operating Unit, the distribution of property/casualty insurance products by our business segments is geographically concentrated. For the twelve months ended December 31, 2007, five states accounted for approximately 79% of the gross premiums retained by our insurance subsidiaries. The following table reflects the geographic distribution of our insured risks, as represented by direct and assumed premiums written by our business segments for the twelve months ended December 31, 2007.

State	**Standard Commercial Segment**	**Specialty Commercial Segment**	**Personal Segment**	**Total**	**Percent of Total**
		(dollars in thousands)			
Texas	$ 22,870	$ 70,346	$ 15,839	$ 109,055	43.7%
Oregon	32,467	500	512	33,479	13.4%
New Mexico	14,623	381	9,091	24,095	9.7%
Idaho	14,062	439	1,781	16,282	6.5%
Arizona	-	1,154	12,824	13,978	5.6%
All other states	6,846	29,868	15,869	52,583	21.1%
Total gross premiums written	$ 90,868	$ 102,688	$ 55,916	$ 249,472	
Percent of total	36.4%	41.2%	22.4%	100.0%	

Underwriting

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

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

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

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

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

	Year Ended December 31,		
	2007	**2006**	**2005**
Gross premiums written	$ 249,472	$ 213,945	$ 89,467
Statutory loss & LAE ratio	61.7%	61.5%	60.3%
Statutory expense ratio	30.1%	29.4%	32.8%
Statutory combined ratio	91.8%	90.9%	93.1%

Our HSIC insurance company subsidiary was acquired effective January 1, 2006 and, therefore, is not included in the statutory ratios for 2005. These statutory ratios do not reflect the deferral of policy acquisition costs, investment income, premium finance revenues, or the elimination of inter-company transactions required by GAAP.

The premium-to-surplus percentage measures the relationship between net premiums written in a given period (premiums written, less returned premiums and reinsurance ceded to other carriers) to policyholders surplus (admitted assets less liabilities), determined on the basis of statutory accounting practices prescribed or permitted by insurance regulatory authorities. Insurance companies are expected to maintain a premium-to-surplus percentage of not more than 300%. For the years ended December 31, 2007, 2006, and 2005, our consolidated premium-to-surplus ratios were 151%, 151%, 81%, respectively. The increase in premium-to-surplus percentage in 2006 reflects additional retention of premiums produced by the Standard Commercial Segment and Specialty Commercial Segment, as well as increased premiums written in the Personal Segment.

Claims Management and Administration

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

Each of our operating units uses its own staff of specialized claims personnel to manage and administer claims arising under policies produced through their respective operations. The claims process is managed through a combination of experienced claims managers, seasoned claims supervisors, trained staff adjusters and independent adjustment or appraisal services, when appropriate. All adjusters are licensed in those jurisdictions for which they handle claims that require licensing. Limits on settlement authority are established for each claims supervisor and staff adjuster based on their level of experience. Independent adjusters have no claim settlement authority. Claim exposures are periodically and systematically reviewed by claim supervisors and managers as a method of quality and loss control. Large loss exposures are reviewed at least quarterly with senior management of the operating unit and monitored by Hallmark senior management.

Claims personnel receive in-house training and are required to attend various continuing education courses pertaining to topics such as best practices, fraud awareness, legal environment, legislative changes and litigation management. Depending on the criteria of each operating unit, our claims adjusters are assigned a variety of claims to enhance their knowledge and ensure their continued development in efficiently handling claims. As of December 31, 2007, our operating units had a total of 49 claims managers, supervisors and adjusters with an average of approximately 19 years experience.

Analysis of Losses and LAE

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

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

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

Reconciliation of reserve for unpaid losses and LAE. The following table provides a reconciliation of our beginning and ending reserve balances on a net-of-reinsurance basis for the years ended December 31, 2007, 2006 and 2005, to the gross-of-reinsurance amounts reported in our balance sheets at December 31, 2007, 2006 and 2005.

	As of and for Year Ended December 31, 2007	2006	2005
	(dollars in thousands)		
Reserve for unpaid losses and LAE, net of reinsurance recoverables, January 1	$ 72,801	$ 25,997	$ 17,700
Acquisitions of subsidiaries effective January 1	-	4,562	-
Provision for losses and LAE for claims occurring in the current period	139,332	88,294	36,184
Increase (decrease) in reserve for unpaid losses and LAE for claims occurring in prior periods	(6,414)	(1,177)	(2,400)
Payments for losses and LAE, net of reinsurance:			
Current period	(54,809)	(28,154)	(17,414)
Prior periods	(30,061)	(16,721)	(8,073)
Reserve for unpaid losses and LAE at December 31, net of reinsurance recoverable	$ 120,849	$ 72,801	$ 25,997
Reinsurance recoverable on unpaid losses and LAE at December 31	4,489	4,763	324
Reserve for unpaid losses and LAE at December 31, gross of reinsurance	$ 125,338	$ 77,564	$ 26,321

The $6.4 million, $1.2 million and $2.4 million favorable development in prior accident years recognized in 2007, 2006 and 2005, respectively, represent normal changes in our loss reserve estimates attributable to favorable loss development in each of our segments. The loss reserve estimates for prior years were decreased to reflect this favorable loss development when the available information indicated a reasonable likelihood that the ultimate losses would be less than the previous estimates.

SAP/GAAP reserve reconciliation. The differences between the reserves for unpaid losses and loss adjustment expenses reported in our consolidated financial statements prepared in accordance with GAAP and those reported in our annual statements filed with the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department in accordance with statutory accounting practices ("SAP") as of December 31, 2007 and 2006 are summarized below.

	As of December 31, 2007	2006
	(in thousands)	
Reserve for unpaid losses and LAE on a SAP basis (net of reinsurance recoverables on unpaid losses)	$ 120,798	$ 72,796
Loss reserve discount from the PIIC acquisition	-	(11)
Unamortized risk premium reserve discount from the PIIC acquisition	1	16
Estimated future unallocated LAE reserve for claim service subsidiaries	50	-
Reserve for unpaid losses and LAE on a GAAP basis (net of reinsurance recoverables on unpaid losses)	$ 120,849	$ 72,801

Analysis of loss and LAE reserve development. The following table shows the development of our loss reserves, net of reinsurance, for years ended December 31, 1997 through 2007. Section A of the table shows the estimated liability for unpaid losses and loss adjustment expenses, net of reinsurance, recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of losses and loss adjustment expenses for claims arising in prior years that are unpaid at the balance sheet date, including losses that have been incurred but not yet reported to us. Section B of the table shows the re-estimated amount of the previously recorded liability, based on experience as of the end of each succeeding year. The estimate is increased or decreased as more information becomes known about the frequency and severity of claims.

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

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

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
						(dollars in thousands)					
A. Reserve for Unpaid Losses & LAE, Net of Reinsurance Recoverables	$ 4,668	$ 4,580	$ 5,409	$ 7,451	$ 7,919	$ 8,411	$ 21,197	$ 17,700	$ 25,997	$ 72,801	$ 120,849
B. Net Reserve Re-estimated as of :											
One year later	4,985	4,594	5,506	7,974	8,096	8,875	20,003	15,300	24,820	66,387	
Two years later	4,954	4,464	5,277	7,863	8,620	8,881	19,065	15,473	24,903		
Three years later	4,884	4,225	5,216	7,773	8,856	8,508	19,698	13,962			
Four years later	4,757	4,179	5,095	7,901	8,860	8,446	18,551				
Five years later	4,732	4,111	5,028	7,997	8,855	8,478					
Six years later	4,687	4,101	5,153	7,999	8,884						
Seven years later	4,695	4,209	5,153	8,026							
Eight years later	4,675	4,203	5,182								
Nine years later	4,674	4,227									
Ten years later	4,698										
C. Net Cumulative Redundancy (Deficiency)	(30)	353	227	(575)	(965)	(67)	2,646	3,738	1,094	6,414	
D. Cumulative Amount of Claims Paid, Net of Reinsurance Recoveries, through:											
One year later	3,326	2,791	3,229	5,377	5,691	5,845	12,217	8,073	16,721	30,061	
Two years later	4,287	3,476	4,436	7,070	7,905	7,663	15,814	12,004	22,990		
Three years later	4,387	3,911	4,909	7,584	8,603	8,228	18,162	13,113			
Four years later	4,571	4,002	5,014	7,810	8,798	8,374	17,997				
Five years later	4,618	4,051	4,966	7,960	8,821	8,417					
Six years later	4,643	4,061	5,116	7,970	8,853						

Seven years later	4,664	4,204	5,124	7,995
Eight years later	4,675	4,203	5,151	
Nine years later	4,674	4,227		
Ten years later	4,698			

	2007	2006
Net Reserve, December 31	$ 120,849	$ 72,801
Reinsurance Recoverables	4,489	4,763
Gross Reserve, December 31	$ 125,338	$ 77,564
Net Re-estimated Reserve		66,387
Re-estimated Reinsurance Recoverable		8,052
Gross Re-estimated Reserve		$ 74,439
Gross Cumulative Redundancy		$ 3,125

Reinsurance

We reinsure a portion of the risk we underwrite in order to control our exposure to losses and to protect our 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. Our reinsurance facilities are subject to annual renewal.

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

	Year Ended December 31,		
	2007	2006	2005
Gross premiums written	$ 249,472	$ 213,945	$ 89,467
Ceded premiums written	(11,329)	(11,017)	(1,215)
Net premiums written	$ 238,143	$ 202,928	$ 88,252
Gross premiums earned	$ 238,080	$ 162,216	$ 59,632
Ceded premiums earned	(12,777)	(10,155)	(448)
Net premiums earned	$ 225,303	$ 152,061	$ 59,184
Reinsurance recoveries	$ 3,862	$ 5,225	$ (492)

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, 2007, are:

· We retain the first $2.0 million of property catastrophe losses; and

· Our reinsurers reimburse us 100% for each $1.00 of loss in excess of our $2.0 million retention up to $28.0 million for each catastrophic occurrence, subject to a maximum of two events for the contractual term.

· ***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, 2007, are:

· We retain the first $1.0 million of loss for each commercial property risk;

· Our reinsurers reimburse us for the next $5.0 million for each commercial property risk; and

· Individual risk facultative reinsurance is purchased on any commercial property with limits above $6.0 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, 2007, are:

· We retain the first $1.0 million of any commercial liability risk: and

· 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:

- We retain the first $350,000 of each aircraft hull or liability loss or airport liability loss;
- Our reinsurers reimburse us for the next $1.15 million of each aircraft hull loss and for the next $650,000 of each airport liability loss; and
- Our reinsurers provide additional reimbursement of $4.0 million for each airport liability loss and aircraft liability loss, excluding passenger liability.

Investment Portfolio

Our investment objective is to maximize current yield while maintaining safety of capital together with sufficient liquidity for ongoing insurance operations. Our investment portfolio is composed of fixed-income and equity securities. As of December 31, 2007, we had total invested assets of $267.6 million. If market rates were to increase by 1%, the fair value of our fixed-income securities as of December 31, 2007 would decrease by approximately $5.5 million. The following table shows the fair values of various categories of fixed-income securities, the percentage of the total fair value of our invested assets represented by each category and the tax equivalent book yield based on fair value of each category of invested assets as of December 31, 2007 and 2006.

	As of December 31, 2007			As of December 31, 2006		
	Fair Value	Percent of Total (in thousands)	Yield	Fair Value	Percent of Total (in thousands)	Yield
Category						
Corporate bonds	50,096	20.0%	6.8%	40,483	25.6%	6.6%
Municipal bonds	98,923	39.5%	7.2%	52,132	32.9%	6.5%
US Treasury bonds	99,047	39.5%	4.7%	40,407	25.5%	4.0%
US Treasury bills and other short-term	2,625	1.0%	4.8%	25,275	16.0%	3.8%
Mortgage backed securities	3	0.0%	6.8%	8	0.0%	7.6%
Total	$ 250,694	100.0%	6.1%	$ 158,305	100.0%	5.5%

The weighted average credit rating for our fixed-income portfolio, using ratings assigned by Standard and Poor's Rating Services (a division of the McGraw-Hill Companies, Inc.), was AA at December 31, 2007. The following table shows the distribution of our fixed-income portfolio by Standard and Poor's rating as a percentage of total market value as of December 31, 2007 and 2006:

	As of December 31, 2007	As of December 31, 2006
Rating:		
"AAA"	73.6%	68.5%
"AA"	6.4%	6.4%
"A"	6.3%	3.4%
"BBB"	4.7%	11.6%
"BB"	6.1%	8.8%
"B"	2.9%	1.3%
"CCC"	0.0%	0.0%
Total	100.0%	100.0%

The following table shows the composition of our fixed-income portfolio by remaining time to maturity as of December 31, 2007 and 2006.

	As of December 31, 2007		As of December 31, 2006	
	Fair Value	Percentage of Total Fair Value	Fair Value	Percentage of Total Fair Value
	(in thousands)		(in thousands)	
Remaining time to maturity:				
Less than one year	15,189	6.1%	67,060	42.4%
One to five years	162,524	64.8%	44,018	27.8%
Five to ten years	53,305	21.3%	42,616	26.9%
More than ten years	19,673	7.8%	4,603	2.9%
Mortgage-backed securities	3	0.0%	8	0.0%
Total	250,694	100.0%	158,305	100.0%

Our investment strategy is to conservatively manage our investment portfolio by investing primarily in readily marketable, investment-grade fixed-income securities. As of December 31, 2007, 6.3% of our investment portfolio was invested in equity securities. Our investment portfolio is managed internally. We regularly review our portfolio for declines in value. If a decline in value is deemed temporary, we record the decline as an unrealized loss in other comprehensive income on our consolidated statement of stockholders' equity and comprehensive income and accumulated other comprehensive income on our consolidated balance sheet. If the decline is deemed other than temporary, we write down the carrying value of the investment and record a realized loss in our consolidated statements of operations. As of December 31, 2007, we had a net unrealized loss of $1.1 million on our investments. The following table details the net unrealized loss (gain) balance by invested asset category as of December 31, 2007.

Category	Net Unrealized Loss (Gain) Balance (in thousands)
Corporate bonds	$ 1,690
Municipal bonds	(376)
Equity securities	(79)
US Treasury securities	(147)
Short term	(3)
	$ 1,085

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

Technology

The majority of our technology systems are based on products licensed from insurance-specific technology vendors which have been substantially customized to meet the unique needs of our various operating units. Our technology systems primarily consist of integrated central processing computers, a series of server-based computer networks and various communications systems that allow our branch offices to share systems solutions and communicate to the home office in a timely, secure and consistent manner. We maintain backup facilities and systems through a contract with a leading provider of computer disaster recovery services. Each operating unit bears the information services expenses specific to its operations as well as a portion of the corporate services expenses. Vendor license and service fees are capped per annum and are not directly tied to premium volume or geographic expansion.

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

Ratings

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they are considering purchasing insurance. As of June 5, 2006, A.M. Best pooled its ratings of our three insurance company subsidiaries and assigned a financial strength rating of “A-” (Excellent) and an issuer credit rating of “a-” to each of our individual insurance company subsidiaries and to the pool formed by our insurance company subsidiaries. An “A-” rating is the fourth highest of 15 rating categories used by A.M. Best. In evaluating an insurer’s financial and operating performance, A.M. Best reviews the company’s profitability, indebtedness and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its loss reserves, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. A.M. Best’s ratings reflect its opinion of an insurer’s financial strength, operating performance and ability to meet its obligations to policyholders and are not an evaluation directed at investors or recommendations to buy, sell or hold an insurer’s stock.

Competition

The property/casualty insurance market, our primary source of revenue, is highly competitive and, except for regulatory considerations, has very few barriers to entry. According to A.M. Best, there were 3,141 property/casualty insurance companies and 2,017 property/casualty insurance groups operating in North America as of July 23, 2007. Our HGA Operating Unit competes with a variety of large national standard commercial lines carriers such as The Hartford, Zurich North America, St. Paul Travelers and Safeco, as well as numerous smaller regional companies. The primary competition for our TGA Operating Unit’s excess and surplus lines products includes such carriers as Atlantic Casualty Insurance Company, Colony Insurance Company, Burlington Insurance Company, Penn America Insurance Group and, to a lesser extent, a number of national standard lines carriers such as Zurich North America and The Hartford. Our Aerospace Operating Unit considers its primary competitors to be Houston Casualty Corp., Britt-Paulk, Global Aerospace, Phoenix Aviation, W. Brown & Company, AIG and London Aviation Underwriters. Although our Phoenix Operating Unit competes with large national insurers such as Allstate, State Farm and Progressive, as a participant in the non-standard personal automobile marketplace its competition is most directly associated with numerous regional companies and managing general agencies. Our competitors include entities which have, or are affiliated with entities which have, greater financial and other resources than we have.

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

Insurance Regulation

Our insurance operations are regulated by the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department, as well as the applicable insurance department of each state in which we issue policies. AHIC, PIIC and HSIC are required to file quarterly and annual statements of their financial condition prepared in accordance with statutory accounting practices with the Texas Department of Insurance, the Arizona Department of Insurance and the Oklahoma Insurance Department, respectively, and the applicable insurance department of each state in which they write business. The financial conditions of AHIC, PIIC and HSIC, including the adequacy of surplus, loss reserves and investments, are subject to review by the insurance department of their respective states of domicile. We do not write the majority of our Texas non-standard personal automobile insurance directly, but assume business written through a county mutual insurance company. Under Texas insurance regulation, premium rates and underwriting guidelines of county mutuals have historically not been subject to the same degree of regulation imposed on standard insurance companies.

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

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

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

Dividends. Dividends and distributions to Hallmark by AHIC, PIIC or HSIC are restricted by the insurance regulations of the respective state in which each insurance company subsidiary is domiciled. As a property/casualty insurance company domiciled in the State of Texas, AHIC is limited in the payment of dividends to the amount of surplus profits arising from its business. In estimating such profits, AHIC must exclude all unexpired risks, all unpaid losses and all other debts due and payable or to become due and payable by AHIC. In addition, AHIC must obtain the approval of the Texas Department of Insurance before the payment of extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the greater of: (1) statutory net income as of the prior December 31st or (2) 10% of statutory policyholders' surplus as of the prior December 31st. PIIC, domiciled in Arizona, may pay dividends out of that part of its available surplus funds which is derived from realized net profits on its business. Without prior written approval from the Arizona Department of Insurance, PIIC may not pay extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the lesser of: (1) 10% of statutory policyholders’ surplus as of the prior December 31st or (2) net investment income as of the prior December 31st. HSIC, domiciled in Oklahoma, may only pay dividends out of that part of its available surplus funds which is derived from realized net profits on its business. Without prior written approval from the Oklahoma Insurance Department, HSIC may not pay extraordinary dividends, which are defined as dividends or distributions of cash or other property the fair market value of which combined with the fair market value of each other dividend or distribution made in the preceding 12 months exceeds the greater of: (1) 10% of statutory policyholders’ surplus as of the prior December 31st or (2) statutory net income as of the prior December 31st, not including realized capital gains.

Risk-based capital requirements. The National Association of Insurance Commissioners requires property/casualty insurers to file a risk-based capital calculation according to a specified formula. The purpose of the formula is twofold: (1) to assess the adequacy of an insurer’s statutory capital and surplus based upon a variety of factors such as potential risks related to investment portfolio, ceded reinsurance and product mix; and (2) to assist state regulators under the RBC for Insurers Model Act by providing thresholds at which a state commissioner is authorized and expected to take regulatory action. As of December 31, 2007, the adjusted capital under the risk-based capital calculation of each of our insurance company subsidiaries substantially exceeded the minimum requirements.

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

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

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

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

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

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

- misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;
- failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;
- failing to adopt and implement reasonable standards for the prompt investigation and settlement of claims arising under insurance policies;
-

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

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

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

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

- refusing to pay claims without conducting a reasonable investigation;

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

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

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

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

Employees

As of December 31, 2007, we employed 361 people on a full-time basis. None of our employees are represented by labor unions. We consider our employee relations to be good.

Item 1A. Risk Factors.

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

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

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

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

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

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

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

We maintain loss reserves to cover our estimated ultimate liability for unpaid losses and loss adjustment expenses for reported and unreported claims incurred as of the end of each accounting period. Reserves represent management's estimates of what the ultimate settlement and administration of claims will cost and are not reviewed by an independent actuary. These estimates, which generally involve actuarial projections, are based on management's assessment of facts and circumstances then known, as well as estimates of future trends in claim severity and frequency, judicial theories of liability, and other factors. These variables are affected by both internal and external events, such as changes in claims handling procedures, inflation, judicial trends and legislative changes. Many of these factors are not quantifiable. Additionally, there may be a significant lag between the occurrence of an event and the time it is reported to us. The inherent uncertainties of estimating reserves are greater for certain types of liabilities, particularly those in which the various considerations affecting the type of claim are subject to change and in which long periods of time may elapse before a definitive determination of liability is made. Reserve estimates are continually refined in a regular and ongoing process as experience develops and further claims are reported and settled. Adjustments to reserves are reflected in the results of the periods in which such estimates are changed. For example, a 1% change in December 31, 2007 unpaid losses and loss adjustment expenses would have produced a $1.3 million change to pretax earnings. Our gross loss and loss adjustment expense reserves totaled $125.3 million at December 31, 2007. Our loss and loss adjustment expense reserves, net of reinsurance recoverables, were $120.4 million at that date. Because setting reserves is inherently uncertain, there can be no assurance that the current reserves will prove adequate.

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

Third-party rating agencies assess and rate the claims-paying ability of insurers based upon criteria established by the agencies. During 2005, A.M. Best upgraded the financial strength rating of PIIC from “B” (Fair) to “B+” (Very Good) and upgraded the financial strength rating of AHIC from “B” (Fair) to “A-” (Excellent). Our insurance company subsidiaries have historically been rated on an individual basis. However, effective January 1, 2006, our insurance company subsidiaries entered into a pooling arrangement, which was subsequently amended on December 15, 2006, whereby AHIC would retain 46.0% of the net premiums written, PIIC would retain 34.1% of the net premiums written and HSIC would retain 19.9% of the net premiums written. In June 2006, A.M. Best notified us that our insurance company subsidiaries would be rated on a pooled basis and assigned a rating of “A-” (Excellent) to each of our individual insurance company subsidiaries and to the pool formed by our insurance company subsidiaries.

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

The loss of key executives could disrupt our business.

Our success will depend in part upon the continued service of certain key executives. Our success will also depend on our ability to attract and retain additional executives and personnel. We do not have employment agreements with our Chief Executive Officer or any of our executive officers other than employment agreements entered into in connection with the acquisitions of the subsidiaries now comprising our TGA Operating Unit and our Aerospace Operating Unit. The loss of key personnel, or our inability to recruit and retain additional qualified personnel, could cause disruption in our business and could prevent us from fully implementing our business strategies, which could materially and adversely affect our business, growth and profitability.

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

The property/casualty insurance market, our primary source of revenue, is highly competitive and, except for regulatory considerations, has very few barriers to entry. According to A.M. Best, there were 3,141 property/casualty insurance companies and 2,017 property/casualty insurance groups operating in North America as of July 23, 2007. Our HGA Operating Unit competes with a variety of large national standard commercial lines carriers such as The Hartford, Zurich North America, St. Paul Travelers and Safeco, as well as numerous smaller regional companies. The primary competition for our TGA Operating Unit's excess and surplus lines products includes such carriers as Atlantic Casualty Insurance Company, Colony Insurance Company, Burlington Insurance Company, Penn America Insurance Group and, to a lesser extent, a number of national standard lines carriers such as Zurich North America and The Hartford. Our Aerospace Operating Unit considers its primary competitors to be Houston Casualty Corp., Phoenix Aviation, W. Brown & Company, AIG and London Aviation Underwriters. Although our Phoenix Operating Unit competes with large national insurers such as Allstate, State Farm and Progressive, as a participant in the non-standard personal automobile marketplace its competition is most directly associated with numerous regional companies and managing general agencies. Our competitors include entities which have, or are affiliated with entities which have, greater financial and other resources than we have. In addition, competitors may attempt to increase market share by lowering rates. In that case, we could experience reductions in our underwriting margins, or sales of our insurance policies could decline as customers purchase lower-priced products from our competitors. Losing business to competitors offering similar products at lower prices, or having other competitive advantages, could adversely affect our results of operations.

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

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

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

We purchase reinsurance by transferring, or ceding, part of the risk we have assumed to a reinsurance company in exchange for part of the premium we receive in connection with the risk. Although reinsurance makes the reinsurer liable to us to the extent the risk is transferred or ceded to the reinsurer, it does not relieve us of our liability to our policyholders. Accordingly, we bear credit risk with respect to our reinsurers. We cannot assure that our reinsurers will pay all of our reinsurance claims, or that they will pay our claims on a timely basis. At December 31, 2007, we had a total of $5.2 million due us from reinsurers, including $5.0 million of recoverables from losses and $0.2 million in prepaid reinsurance premiums. The largest amount due us from a single reinsurer as of December 31, 2007 was $1.8 million reinsurance and premium recoverable from QBE Reinsurance Corporation. If any of our reinsurers are unable or unwilling to pay amounts they owe us in a timely fashion, we could suffer a significant loss or a shortage of liquidity, which would have a material adverse effect on our business and results of operations.

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

Property/casualty insurance companies are subject to claims arising out of catastrophes that may have a significant effect on their results of operations, liquidity and financial condition. Catastrophes can be caused by various events, including hurricanes, windstorms, earthquakes, hail storms, explosions, severe winter weather and fires, and may include man-made events, such as the September 11, 2001 terrorist attacks on the World Trade Center. The incidence, frequency, and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Claims from catastrophic events could reduce our net income, cause substantial volatility in our financial results for any fiscal quarter or year or otherwise adversely affect our financial condition, liquidity or results of operations. Catastrophes may also negatively affect our ability to write new business. Increases in the value and geographic concentration of insured property and the effects of inflation could increase the severity of claims from catastrophic events in the future.

Catastrophe models may not accurately predict future losses.

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

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

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

- approval of policy forms and rates;

- standards of solvency, including risk-based capital measurements, which are a measure developed by the National Association of Insurance Commissioners and used by the state insurance regulators to identify insurance companies that potentially are inadequately capitalized;
- licensing of insurers and their agents;
- restrictions on the nature, quality and concentration of investments;
- restrictions on the ability of insurance company subsidiaries to pay dividends;
- restrictions on transactions between insurance company subsidiaries and their affiliates;
- requiring certain methods of accounting;
- periodic examinations of operations and finances;
- the use of non-public consumer information and related privacy issues;
- the use of credit history in underwriting and rating;
- limitations on the ability to charge policy fees;
- the acquisition or disposition of an insurance company or of any company controlling an insurance company;
- involuntary assignments of high-risk policies, participation in reinsurance facilities and underwriting associations, assessments and other governmental charges;
- restrictions on the cancellation or non-renewal of policies and, in certain jurisdictions, withdrawal from writing certain lines of business;
- prescribing the form and content of records of financial condition to be filed;
- requiring reserves for unearned premium, losses and other purposes; and
- with respect to premium finance business, the federal Truth-in-Lending Act and similar state statutes. In states where specific statutes have not been enacted, premium finance is generally subject to state usury laws that are applicable to consumer loans.

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

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

Hallmark is a holding company and a legal entity separate and distinct from its subsidiaries. As a holding company without significant operations of its own, Hallmark's principal sources of funds are dividends and other sources of funds from its subsidiaries. State insurance laws limit the ability of Hallmark's insurance company subsidiaries to pay dividends and require our insurance company subsidiaries to maintain specified minimum levels of statutory capital and surplus. The aggregate maximum amount of dividends permitted by law to be paid by an insurance company does not necessarily define an insurance company's actual ability to pay dividends. The actual ability to pay dividends may be further constrained by business and regulatory considerations, such as the impact of dividends on surplus, by our competitive position and by the amount of premiums that we can write. Without regulatory approval, the aggregate maximum amount of dividends that could be paid to Hallmark in 2008 by our insurance company subsidiaries is $16.3 million. State insurance regulators have broad discretion to limit the payment of dividends by insurance companies and Hallmark's right to participate in any distribution of assets of one of our insurance company subsidiaries is subject to prior claims of policyholders and creditors except to the extent that its rights, if any, as a creditor are recognized. Consequently, Hallmark's ability to pay debts, expenses and cash dividends to our stockholders may be limited.

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

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

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

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

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

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

Our results of operations depend in part on the performance of our invested assets. As of December 31, 2007, 93.7% of our investment portfolio was invested in fixed-income securities. Certain risks are inherent in connection with fixed-income securities, including loss upon default and price volatility in reaction to changes in interest rates and general market factors. In general, the fair market value of a portfolio of fixed-income securities increases or decreases inversely with changes in the market interest rates, while net investment income realized from future investments in fixed-income securities increases or decreases along with interest rates. In addition, 19.5% of our fixed-income securities have call or prepayment options. This subjects us to reinvestment risk should interest rates fall and issuers call their securities. Furthermore, actual net investment income and/or cash flows from investments that carry prepayment risk, such as mortgage-backed and other asset-backed securities, may differ from those anticipated at the time of investment as a result of interest rate fluctuations. An investment has prepayment risk when there is a risk that cash flows from the repayment of principal might occur earlier than anticipated because of declining interest rates or later than anticipated because of rising interest rates. The fair value of our fixed-income securities as of December 31, 2007 was $250.7 million. If market interest rates were to change 1%, for example, from 5% to 6%, the fair value of our fixed-income securities would change approximately $5.5 million as of December 31, 2007. The calculated change in fair value was determined using duration modeling assuming no prepayments.

In addition to the general risks described above, although 91.0% of our portfolio is investment-grade, our fixed-income securities are nonetheless subject to credit risk. If any of the issuers of our fixed-income securities suffer financial setbacks, the ratings on the fixed-income securities could fall (with a concurrent fall in market value) and, in a worst case scenario, the issuer could default on its obligations. Hallmark has no exposure in its investment portfolio to sub-prime mortgages and $3 thousand total exposure in mortgage backed securities. Future changes in the fair market value of our available-for-sale securities will be reflected in other comprehensive income. Similar treatment is not available for liabilities. Therefore, interest rate fluctuations could adversely affect our stockholders' equity, total comprehensive income and/or our cash flows.

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

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

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

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

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

The following states accounted for 78.9% of our gross written premiums for 2007: Texas (43.7%), Oregon (13.4%), New Mexico (9.7%), Idaho (6.5%) and Arizona (5.6%). Our revenues and profitability are subject to the prevailing regulatory, legal, economic, political, demographic, competitive, weather and other conditions in the principal states in which we do business. Changes in any of these conditions could make it less attractive for us to do business in such states and would have a more pronounced effect on us compared to companies that are more geographically diversified. In addition, our exposure to severe losses from localized natural perils, such as windstorms or hailstorms, is increased in those areas where we have written significant numbers of property/casualty insurance policies.

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

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

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

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

Item 1B. Unresolved Staff Comments.

Not applicable

Item 2. Properties.

Our corporate headquarters and HGA Operating Unit are located at 777 Main Street, Suite 1000, Fort Worth, Texas. The suite is located in a high-rise office building and contains approximately 27,808 square feet of space. The rent is currently $33,485 per month pursuant to a lease which expires June 30, 2011. Our corporate headquarters also occupies ten offices in an executive suite located in the same building for $9,675 per month under a lease which expires September 30, 2008.

Our TGA Operating Unit is located at 7411 John Smith, San Antonio, Texas. The suite is located in a high-rise office building and contains approximately 18,904 square feet of space. The rent is currently $27,175 per month pursuant to a lease which expires June 30, 2010. Our TGA Operating Unit also maintains a small branch office in Lubbock, Texas. Rent on this branch office is currently $1,025 per month under a lease which expires April 30, 2009.

Our Aerospace Operating Unit is located at 14990 Landmark Boulevard, Suite 300, Addison, Texas. The suite is located in a low-rise office building and contains approximately 8,925 square feet of space. The rent is currently $13,666 per month pursuant to a lease which expires September 30, 2010. Our Aerospace Operating Unit also maintains a branch office in Glendale, California. Rent on the 1,196 square foot suite is currently $2,392 per month pursuant to a lease which expires August 1, 2009.

Our Phoenix Operating Unit is located at 14651 Dallas Parkway, Suite 400, Dallas, Texas. The suite is located in a high-rise office building and contains approximately 25,559 square feet of space. The rent is currently $50,075 per month pursuant to a lease which expires November 30, 2008.

Item 3. Legal Proceedings.

We are engaged in various legal proceedings which are routine in nature and incidental to our business. None of these proceedings, either individually or in the aggregate, are believed, in our opinion, to have a material adverse effect on our consolidated financial position or our results of operations.

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

During the fourth quarter of 2007, we did not submit any matter to a vote of our security holders.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Market for Common Stock

Our common stock is currently traded on the Nasdaq Global Market under the symbol "HALL." Prior to October 6, 2006, our common stock traded on the American Stock Exchange under the symbol "HAF". The following table shows the high and low sales prices of our common stock on the Nasdaq Global Market or the American Stock Exchange for each quarter since January 1, 2006.

Period	High Sale	Low Sale
Year Ended December 31, 2007:		
First quarter	$ 12.25	$ 9.64
Second quarter	13.15	11.86
Third quarter	15.29	9.97
Fourth quarter	17.62	13.29
Year Ended December 31, 2006:		
First quarter	$ 12.30	$ 8.16
Second quarter	12.00	8.52
Third quarter	14.40	10.15
Fourth quarter	11.40	8.50

Holders

As of March 7, 2008 there were approximately 2,418 shareholders of record of our common stock.

Dividends

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

Hallmark is a holding company and a legal entity separate and distinct from its subsidiaries. As a holding company, Hallmark is dependent on dividend payments and management fees from its subsidiaries to pay dividends and make other payments. State insurance laws limit the ability of our insurance company subsidiaries to pay dividends to Hallmark. As a property/casualty insurance company domiciled in the State of Texas, AHIC is limited in the payment of dividends to Hallmark in any 12-month period, without the prior written consent of the Texas Department of Insurance, to the greater of statutory net income for the prior calendar year or 10% of statutory policyholders surplus as of the prior year end. Dividends may only be paid from unassigned surplus funds. PIIC, domiciled in Arizona, is limited in the payment of dividends to the lesser of 10% of prior year policyholders surplus or prior year's net investment income, without prior written approval from the Arizona Department of Insurance. HSIC, domiciled in Oklahoma, is limited in the payment of dividends to the greater of 10% of prior year policyholders surplus or prior year's statutory net income, without prior written approval from the Oklahoma Insurance Department.

Equity Compensation Plan Information

The following table sets forth information regarding shares of our common stock authorized for issuance under our equity compensation plans as of December 31, 2007.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)		Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans [excluding securities reflected in column (a)] (c)
Equity compensation plans approved by security holders[1]	831,334	$	10.58	115,834
Equity compensation plans not approved by security holders[2]	16,666	$	2.25	- 0 -
Total	848,000	$	10.41	115,834

[1] Includes shares of our common stock authorized for issuance under our 2005 Long Term Incentive Plan, as well as shares of our common stock issuable upon exercise of options outstanding under our 1994 Key Employee Long Term Incentive Plan and our 1994 Non-Employee Director Stock Option Plan, both of which terminated in accordance with their terms in 2004.

[2] Represents shares of our common stock issuable upon exercise of non-qualified stock options granted to our non-employee directors in lieu of cash compensation for their service on the board of directors during fiscal 1999. The options became fully exercisable on August 16, 2000, and terminate on March 15, 2010, to the extent not previously exercised.

Issuer Repurchases

We did not repurchase any shares of our common stock during the fourth quarter of 2007.

Performance Graph

The line graph below compares the cumulative total stockholder return on our common stock from January 1, 2003, through December 31, 2007, with the return on the Nasdaq Composite Index, Nasdaq Insurance Index, and S&P Property & Casualty Insurance Index for the same period. In accordance with Securities and Exchange Commission rules, the measurement assumes a $100 initial investment in our common stock with all dividends reinvested, and a $100 initial investment in the indices.

Item 6. Selected Financial Data

	Year Ended December 31,				
	2007 (1)	2006 (1)	2005	2004	2003
	(in thousands, except per share data)				
Statement of Operations Data:					
Gross premiums written	$ 249,472	$ 213,945	$ 89,467	$ 33,389	$ 43,338
Ceded premiums written	(11,329)	(11,017)	(1,215)	(322)	(6,769)
Net premiums written	238,143	202,928	88,252	33,067	36,569
Change in unearned premiums	(12,840)	(50,867)	(29,068)	(622)	5,406
Net premiums earned	225,303	152,061	59,184	32,445	41,975
Investment income, net of expenses	13,180	10,461	3,836	1,386	1,198
Realized gains (losses)	2,586	(1,466)	58	(27)	(88)
Finance charges	4,702	3,983	2,044	2,183	3,544
Commission and fees	28,054	35,343	16,703	21,100	17,544
Processing and service fees	657	2,330	5,183	6,003	4,900
Other income	16	29	27	31	486
Total revenues	274,498	202,741	87,035	63,121	69,559
Loss and loss adjustment expenses	132,918	87,117	33,784	19,137	30,188
Other operating costs and expenses	94,272	83,583	38,492	35,290	37,386
Interest expense	3,914	5,798	1,264	64	1,271
Interest expense from amortization of discount on convertible notes (2)	-	9,625	-	-	-
Amortization of intangible assets	2,293	2,293	27	28	28
Total expenses	233,397	188,416	73,567	54,519	68,873
Income before income tax and extraordinary gain	41,101	14,325	13,468	8,602	686
Income tax expense	13,672	5,134	4,282	2,753	25
Income before extrordinary gain	27,429	9,191	9,186	5,849	661
Extraordinary gain (3)	-	-	-	-	8,084
Net income	$ 27,429	$ 9,191	$ 9,186	$ 5,849	$ 8,745
Common stockholders basic earnings per share:					
Income before extraordinary gain	$ 1.32	$ 0.53	$ 0.76	$ 0.83	$ 0.14
Extraordinary gain (3)	-	-	-	-	1.66
Net income	$ 1.32	$ 0.53	$ 0.76	$ 0.83	$ 1.80
Common stockholders diluted earnings per share:					

Income before extraordinary gain	$	1.32	$	0.53	$	0.76	$	0.82	$	0.13
Extraordinary gain (3)		-		-		-		-		1.64
Net income	$	1.32	$	0.53	$	0.76	$	0.82	$	1.77

	As of December 31, 2007				
Balance Sheet Items:	**2007**	**2006**	**2005**	**2004**	**2003**
Total investments (4)	$ 267,562	$ 162,885	$ 102,956	$ 34,727	$ 34,958
Total assets	$ 606,314	$ 415,953	$ 208,906	$ 82,511	$ 83,853
Unpaid loss and loss adjustment expenses	$ 125,338	$ 77,564	$ 26,321	$ 19,648	$ 28,456
Unearned premiums	$ 102,998	$ 91,606	$ 36,027	$ 6,192	$ 5,862
Total liabilities	$ 427,127	$ 265,222	$ 123,718	$ 49,855	$ 56,456
Total stockholders' equity	$ 179,187	$ 150,731	$ 85,188	$ 32,656	$ 27,397
Book value per share (5)	$ 8.63	$ 7.26	$ 5.89	$ 5.37	$ 4.52

[1] Includes the results of the Specialty Commercial Segment, all of which was acquired effective as of January 1, 2006.

[2] In accordance with Financial Accounting Standards Board Emerging Issues Task Force Issue No. 98-5, “Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios,” and Issue No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments,” at the time of issuance we booked a $9.6 million deemed discount to convertible notes attributable to their conversion feature. Prior to conversion, this deemed discount was amortized as interest expense over the term of the notes, resulting in a $1.1 million non-cash interest expense during the first quarter of 2006. As a result of the subsequent conversion of the convertible notes, the $8.5 million balance of the deemed discount was written off as a non-cash interest expense during the quarter ending June 30, 2006. Neither the deemed discount on the convertible notes nor the resulting interest expense have any ultimate impact on cash flow or book value.

[3] In January 2003, we acquired PIIC in satisfaction of $7.0 million of a $14.85 million balance on a note receivable due from Millers American Group, Inc. This resulted in us recognizing an $8.1 million extraordinary gain in 2003.

[4] Investment balances that we reported in Restricted Cash and Investments on the balance sheet prior to 2007 have been reclassified to debt securities, available-for-sale, at market value, to conform to current year presentation.

[5] Book value per share is calculated as consolidated stockholders’ equity on the basis of U.S. generally accepted accounting principles divided by the number of outstanding common shares. Book value per share for years prior to 2006 has been adjusted to reflect a one-for-six reverse stock split effected July 31, 2006.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read together with our consolidated financial statements and the notes thereto. This discussion contains forward-looking statements. Please see "Risks Associated with Forward-Looking Statements in this Form 10-K" and "Item 1A. Risk Factors" for a discussion of some of the uncertainties, risks and assumptions associated with these statements.

Overview

Hallmark is an insurance holding company which, through its subsidiaries, engages in the sale of property/casualty insurance products to businesses and individuals. Our business involves marketing, distributing, underwriting and servicing commercial insurance in nine states; marketing, distributing, underwriting and servicing non-standard personal automobile insurance in 11 states; marketing, distributing, underwriting and servicing general aviation insurance in 47 states; and providing other insurance related services. We pursue our business activities through subsidiaries whose operations are organized into producing units and are supported by our insurance carrier subsidiaries.

Our non-carrier insurance activities are organized by producing units into the following reportable segments:

- ***Standard Commercial Segment.*** The 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 and ECM subsidiaries.

- ***Specialty Commercial Segment.*** The Specialty Commercial Segment primarily includes the excess and surplus lines commercial property/casualty insurance products and services handled by our TGA Operating Unit and the general aviation insurance products and services handled by our Aerospace Operating Unit. The Specialty Commercial Segment also includes a relatively small amount of non-strategic legacy personal lines insurance products handled by our TGA Operating Unit. Our TGA Operating Unit is comprised of our Texas General Agency, PAAC and TGARSI subsidiaries. Our Aerospace Operating Unit is comprised of our Aerospace Insurance Managers, ASRI and ACMG subsidiaries. All of the subsidiaries included in the Specialty Commercial Segment were acquired effective January 1, 2006.

- ***Personal Segment.*** The Personal Segment includes the non-standard personal automobile insurance products and services handled by our Phoenix Operating Unit which is comprised of American Hallmark General Agency, Inc. and Hallmark Claims Services, Inc., both of which do business as Phoenix General Agency.

The retained premium produced by these reportable segments is supported by the following insurance company subsidiaries:

- ***American Hallmark Insurance Company of Texas*** presently retains all of the risks on the commercial property/casualty policies marketed within the Standard Commercial Segment and assumes a portion of the risks on the commercial and aviation property/casualty policies marketed within the Specialty Commercial Segment.

- ***Hallmark Specialty Insurance Company***, which was acquired effective January 1, 2006, presently assumes a portion of the risks on the commercial property/casualty policies marketed within the Specialty Commercial Segment.

- ***Phoenix Indemnity Insurance Company*** presently assumes all of the risks on the non-standard personal automobile policies marketed within the Personal Segment and assumes a portion of the risks on the aviation property/casualty products marketed within the Specialty Commercial Segment.

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 46.0% of the total net premiums written, PIIC retains 34.1% of our total net premiums written and HSIC retains 19.9% of our total net premiums written.

Prior to January 1, 2006, the Standard Commercial Segment was referred to as our Commercial Insurance Operation and the Personal Segment was referred to as our Personal Insurance Operation. The retained premium produced by our operating units prior to January 1, 2006 was supported by our AHIC and PIIC insurance subsidiaries. Discussions for periods prior to January 1, 2006 do not include the operations of the Specialty Commercial Segment, all of which was acquired on January 1, 2006.

Each of our four operating units was reported as a separate segment during the first three quarters of 2006. Commencing in the fourth quarter of 2006, our HGA Operating Unit was designated as the sole component of the Standard Commercial Segment, our TGA Operating Unit and our Aerospace Operating Unit were aggregated in the Specialty Commercial Segment and our Phoenix Operating Unit was designated as the sole component of the Personal Segment.

Critical Accounting Estimates and Judgments

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

Valuation of investments. We complete a detailed analysis each quarter to assess whether any decline in the fair value of any investment below cost is deemed other-than-temporary. All securities with an unrealized loss are reviewed. 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.

Risks and uncertainties are inherent in our other-than-temporary decline in value assessment methodology. Risks and uncertainties include, but are not limited to, incorrect or overly optimistic assumptions about financial condition or liquidity, incorrect or overly optimistic assumptions about future prospects, unfavorable changes in economic or social conditions and unfavorable changes in interest rates or credit ratings.

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

The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value. A premium deficiency exists if the sum of expected claim costs and claim adjustment expenses, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums and expected investment income on those unearned premiums, as computed on a product line basis. We routinely evaluate the realizability of deferred policy acquisition costs. At December 31, 2007 and 2006, there was no premium deficiency related to deferred policy acquisition costs.

Goodwill. Our consolidated balance sheet as of December 31, 2007 includes goodwill of acquired businesses of $30.0 million. This amount has been recorded as a result of prior business acquisitions accounted for under the purchase method of accounting. Under Statement of Financial Accounting Standards No. 142, which we adopted as of January 1, 2002, goodwill is tested for impairment annually. We completed our last annual test for impairment during the fourth quarter of 2007 and determined that there was no indication of impairment.

A significant amount of judgment is required in performing goodwill impairment tests. Such tests include estimating the fair value of our reporting units. As required by Statement of Financial Accounting Standards No. 142, we compare the estimated fair value of each reporting unit with its carrying amount, including goodwill. Under Statement of Financial Accounting Standards No. 142, fair value refers to the amount for which the entire reporting unit may be bought or sold. Methods for estimating reporting unit values include market quotations, asset and liability fair values and other valuation techniques, such as discounted cash flows and multiples of earnings or revenues. With the exception of market quotations, all of these methods involve significant estimates and assumptions.

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

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

Although considerable variability is inherent in such estimates, we believe that our reserves for unpaid losses and loss adjustment expenses are adequate. Due to the inherent uncertainty in estimating unpaid losses and loss adjustment expenses, the actual ultimate amounts may differ from the recorded amounts. A small percentage change could result in a material effect on reported earnings. For example, a 1% change in December 31, 2007 reserves for unpaid losses and loss adjustment expenses would have produced a $1.3 million change to pretax earnings. The estimates are continually reviewed and adjusted as experience develops or new information becomes known. Such adjustments are included in current operations.

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

The range of unpaid losses and loss adjustment expenses estimated by our actuary as of December 31, 2007 was $106.0 million to $135.4 million. Our best estimate of unpaid losses and loss adjustment expenses as of December 31, 2007 is $125.3 million. Our carried reserve for unpaid losses and loss adjustment expenses as of December 31, 2007 is comprised of $61.5 million in case reserves and $63.8 million in incurred but not reported reserves. In setting this estimate of unpaid losses and loss adjustment expenses, we have assumed, among other things, that current trends in loss frequency and severity will continue and that the actuarial analysis was empirically valid. In the absence of any specific factors indicating actual experience at either extreme of the actuarial range, we have established a best estimate of unpaid losses and loss adjustment expenses which is approximately $4.6 million higher than the midpoint of the actuarial range. It would be expected that management's best estimate would move within the actuarial range from year to year due to changes in our operations and changes within the marketplace. Due to the inherent uncertainty in reserve estimates, there can be no assurance that the actual losses ultimately experienced will fall within the actuarial range. However, because of the breadth of the actuarial range, we believe that it is reasonably likely that actual losses will fall within such range.

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

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

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

Treaty Effective Dates

	7/1/01	7/1/02	7/1/03	7/1/04
Provisional loss ratio	60.0%	59.0%	59.0%	64.2%
Estimated ultimate loss ratio booked to at December 31, 2007	63.5%	64.5%	67.0%	54.6%
Effect of actual 5.0% above estimated loss ratio at December 31, 2007	-	-	-	($2,793)
Effect of actual 5.0% below estimated loss ratio at December 31, 2007	$ 1,850	$ 3,055	$ 3,360	$ 2,793

36

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

	Treaty Effective Date 1/1/06	Treaty Effective Date 1/1/07
Provisional loss ratio	65.0%	65.0%
Estimated ultimate loss ratio booked to at December 31, 2007	56.0%	65.0%
Effect of actual 5.0% above estimated loss ratio at December 31, 2007	($3,092)	-
Effect of actual 5.0% below estimated loss ratio at December 31, 2007	$ 1,237	$ 1,897

Results of Operations

Comparison of Years ended December 31, 2007 and December 31, 2006

Management overview. During fiscal 2007, our total revenues were $274.5 million, representing an approximately 35% increase over the $202.7 million in total revenues for fiscal 2006. Increased retention of business produced by our Specialty Commercial Segment and Standard Commercial Segment and increased production by our Personal Segment were the primary causes of the increase in revenue. Specialty Commercial Segment revenues increased $45.6 million during 2007 as compared to 2006. Revenues from our Personal Segment increased $11.3 million during 2007, due largely to geographic expansion into new states. The retention of business produced by the Standard Commercial Segment that was previously retained by third parties was the primary reason for that segment’s $10.8 million increase in revenue during 2007. Net gain on investments of $2.6 million for the period ended December 31, 2007, as compared to a net loss on investments of $1.5 million for 2006, was the primary reason for an increase in revenue for Corporate.

We reported net income of $27.4 million for the year ended December 31, 2007, compared to $9.2 million for the year ended December 31, 2006. On a diluted per share basis, net income was $1.32 for fiscal 2007 as compared to $0.53 for fiscal 2006. During the period ended December 31, 2006, we recorded $9.6 million of interest expense from amortization attributable to the deemed discount on convertible promissory notes issued in January, 2006 and subsequently converted to common stock during the second quarter of 2006. The increase in net income was also attributable to increased revenue as discussed above, including additional investment income from a larger investment portfolio, primarily resulting from increased retention of premiums. Prior year favorable loss reserve development of $6.4 million during 2007 as compared to $1.2 million of prior year favorable development recognized during 2006 also contributed to the increase in net income.

Segment information. The following is additional business segment information for the years ended December 31, 2007 and 2006:

	Year Ended December 31, 2007		
	Standard Commercial Segment	Specialty Commercial	Personal