HALLMARK FINANCIAL SERVICES INC
Form 10-Q
August 08, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

Securities Exchange Act of 1934

For the quarterly period ended June 30, 2013

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

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value $.18 per share – 19,263,457 shares outstanding as of August 8, 2013.

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

INDEX TO FINANCIAL STATEMENTS

Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Balance Sheets

($ in thousands, except share amounts)

	June 30 2013 (unaudited)	December 31 2012
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value (cost: $382,840 in 2013 and $397,800 in 2012)	$ 383,682	$ 401,435
Equity securities, available-for-sale, at fair value (cost: $29,567 in 2013 and $31,502 in 2012)	53,558	43,925
Total investments	437,240	445,360
Cash and cash equivalents	128,004	85,145
Restricted cash	11,416	8,707
Ceded unearned premiums	27,443	22,411
Premiums receivable	78,625	66,683
Accounts receivable	3,175	3,110
Receivable for securities	220	3
Reinsurance recoverable	58,008	51,970
Deferred policy acquisition costs	26,663	24,911
Goodwill	44,695	44,695
Intangible assets, net	21,342	23,068
Federal income tax recoverable	883	-
Deferred federal income taxes, net	273	1,940
Prepaid expenses	1,804	1,480
Other assets	9,410	10,985
Total assets	$ 849,201	$ 790,468
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Revolving credit facility payable	1,473	1,473
Subordinated debt securities	56,702	56,702
Reserves for unpaid losses and loss adjustment expenses	344,351	313,416
Unearned premiums	181,643	162,502
Reinsurance balances payable	12,210	7,330
Pension liability	3,518	3,685
Payable for securities	6,776	-
Federal income tax payable	-	1,518
Accounts payable and other accrued expenses	17,465	23,305

Total liabilities	$ 624,138	$ 569,931
Commitments and Contingencies (Note 17)		
Stockholders' equity:		
Common stock, $.18 par value, authorized 33,333,333; issued 20,872,831 shares in 2013 and 2012	3,757	3,757
Additional paid-in capital	122,611	122,475
Retained earnings	96,507	97,964
Accumulated other comprehensive income	13,746	7,899
Treasury stock (1,609,374 shares in 2013 and 2012), at cost	(11,558)	(11,558)
Total stockholders' equity	225,063	220,537
	$ 849,201	$ 790,468

The accompanying notes are an integral part

of the consolidated financial statements

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Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

($ in thousands, except per share amounts)

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2013	2012	2013	2012
Gross premiums written	$119,467	$100,815	$227,614	$198,210
Ceded premiums written	(19,922)	(15,678)	(34,173)	(28,111)
Net premiums written	99,545	85,137	193,441	170,099
Change in unearned premiums	(6,701)	(6,888)	(14,109)	(14,642)
Net premiums earned	92,844	78,249	179,332	155,457
Investment income, net of expenses	3,278	3,932	6,906	7,778
Net realized gains	1,597	991	2,773	872
Finance charges	1,487	1,524	2,912	3,164
Commission and fees	79	(184)	420	(4)
Other income	14	59	97	290
Total revenues	99,299	84,571	192,440	167,557
Losses and loss adjustment expenses	75,059	61,229	136,797	116,020
Other operating expenses	27,578	25,419	54,772	51,351
Interest expense	1,150	1,178	2,299	2,327
Amortization of intangible assets	829	896	1,726	1,793
Total expenses	104,616	88,722	195,594	171,491
Loss before tax	(5,317)	(4,151)	(3,154)	(3,934)
Income tax benefit	(2,166)	(2,351)	(1,697)	(2,328)
Net loss	(3,151)	(1,800)	(1,457)	(1,606)
Less: Net income attributable to non-controlling interest	-	43	-	66
Net loss attributable to Hallmark Financial Services, Inc.	$(3,151)	$(1,843)	$(1,457)	$(1,672)
Net loss per share attributable to Hallmark Financial Services, Inc. common stockholders:				
Basic	$(0.16)	$(0.10)	$(0.08)	$(0.09)
Diluted	$(0.16)	$(0.10)	$(0.08)	$(0.09)

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

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Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)

($ in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net loss	$ (3,151)	$ (1,800)	$ (1,457)	$ (1,606)
Other comprehensive (loss) income:				
Change in net actuarial gain	125	122	248	241
Tax effect on change in net actuarial gain	(44)	(43)	(87)	(84)
Unrealized holding gains (losses) arising during the period	2,623	(2,006)	11,522	17
Tax effect on unrealized holding gains (losses) arising during the period	(918)	702	(4,033)	(6)
Reclassification adjustment for gains included in net income	(1,597)	(1,219)	(2,773)	(1,117)
Tax effect on reclassification adjustment for gains included in net income	559	427	970	391
Other comprehensive (loss) income, net of tax	748	(2,017)	5,847	(558)
Comprehensive (loss) income	$ (2,403)	$ (3,817)	$ 4,390	$ (2,164)
Less: comprehensive (loss) income attributable to non-controlling interest	-	43	-	66
Comprehensive (loss) income attributable to Hallmark Financial Services, Inc.	$ (2,403)	$ (3,860)	$ 4,390	$ (2,230)

The accompanying notes are an integral

part of the consolidated financial statements

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Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Stockholders' Equity

(Unaudited)

($ in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Common Stock				
Balance, beginning of period	$3,757	$3,757	$3,757	$3,757
Balance, end of period	3,757	3,757	3,757	3,757
Additional Paid-In Capital				
Balance, beginning of period	122,538	122,644	122,475	122,487
Accretion of redeemable noncontrolling interest	-	(90)	-	(71)
Equity based compensation	73	115	136	253
Balance, end of period	122,611	122,669	122,611	122,669
Retained Earnings				
Balance, beginning of period	99,658	94,611	97,964	94,440
Net loss attributable to Hallmark Financial Services, Inc.	(3,151)	(1,843)	(1,457)	(1,672)
Balance, end of period	96,507	92,768	96,507	92,768
Accumulated Other Comprehensive Income				
Balance, beginning of period	12,998	7,905	7,899	6,446
Additional minimum pension liability, net of tax	81	79	161	157
Net unrealized holding gains (losses) arising during period, net of tax	1,705	(1,304)	7,489	11
Reclassification adjustment for gains included in net income, net of tax	(1,038)	(792)	(1,803)	(726)
Balance, end of period	13,746	5,888	13,746	5,888
Treasury Stock				
Balance, beginning of period	(11,558)	(11,558)	(11,558)	(11,558)
Balance, end of period	(11,558)	(11,558)	(11,558)	(11,558)
Total Stockholders' Equity	$225,063	$213,524	$225,063	$213,524

The accompanying notes are an integral part

of the consolidated financial statements

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Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

($ in thousands)

	Six Months Ended June 30	
	2013	2012
Cash flows from operating activities:		
Net loss	$(1,457)	$(1,606)
Adjustments to reconcile net loss to cash provided by operating activities:		
Depreciation and amortization expense	2,697	2,360
Deferred federal income taxes	(1,508)	(2,201)
Net realized gains	(2,773)	(872)
Share-based payments expense	136	253
Change in ceded unearned premiums	(5,032)	(2,222)
Change in premiums receivable	(11,942)	(17,164)
Change in accounts receivable	(65)	451
Change in deferred policy acquisition costs	(1,752)	(2,927)
Change in unpaid losses and loss adjustment expenses	30,935	17,164
Change in unearned premiums	19,141	16,864
Change in reinsurance recoverable	(6,038)	(5,074)
Change in reinsurance balances payable	4,880	3,050
Change in current federal income tax recoverable	(2,401)	5,619
Change in all other liabilities	(6,007)	479
Change in all other assets	5,219	3,048
Net cash provided by operating activities	24,033	17,222
Cash flows from investing activities:		
Purchases of property and equipment	(846)	(183)
Net transfers into restricted cash	(2,709)	(1,421)
Purchases of investment securities	(85,417)	(76,102)
Maturities, sales and redemptions of investment securities	107,798	64,890
Net cash provided by (used in) investing activities	18,826	(12,816)
Cash flows from financing activities:		
Activity under revolving credit facility, net	-	(2,500)
Distribution to non-controlling interest	-	(147)

Net cash used in financing activities	-	(2,647)
Increase in cash and cash equivalents	42,859	1,759
Cash and cash equivalents at beginning of period	85,145	74,471
Cash and cash equivalents at end of period	$128,004	$76,230
Supplemental cash flow information:		
Interest paid	$2,289	$2,313
Income taxes paid (recovered)	$2,212	$(6,045)
Supplemental schedule of non-cash investing activities:		
Change in receivable for securities related to investment disposals that settled after the balance sheet date	$217	$(283)
Change in payable for securities related to investment purchases that settled after the balance sheet date	$6,776	$6,216

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

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Hallmark Financial Services, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

1. General

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

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

These five business units are segregated into three reportable industry segments for financial accounting purposes. The Standard Commercial Segment includes the Standard Commercial P&C business unit and the Workers Compensation business unit. The Specialty Commercial Segment includes the E&S Commercial business unit and the Hallmark Select business unit, as well as certain specialty risk programs (“Specialty Programs”) which are managed by Hallmark. The Personal Segment consists solely of the Personal Lines business unit.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2012 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of June 30, 2013 and 2012 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended June 30, 2013 are not necessarily indicative of the operating results to be expected for the full year.

Business Combinations

We account for business combinations using the acquisition method of accounting pursuant to Accounting Standards Codification ("ASC") 805, "Business Combinations." The base cash purchase price plus the estimated fair value of any non-cash or contingent consideration given for an acquired business is allocated to the assets acquired (including identified intangible assets) and liabilities assumed based on the estimated fair values of such assets and liabilities. The excess of the fair value of the total consideration given for an acquired business over the aggregate net fair values assigned to the assets acquired and liabilities assumed is recorded as goodwill. Contingent consideration is recognized as a liability at fair value as of the acquisition date with subsequent fair value adjustments recorded in the consolidated statements of operations. The valuation of contingent consideration requires assumptions regarding anticipated cash flows, probabilities of cash flows, discount rates and other factors. Significant judgment is employed in determining the propriety of these assumptions as of the acquisition date and for each subsequent period. Accordingly, future business and economic conditions, as well as changes in any of the assumptions, can materially impact the amount of contingent consideration expense we record in any given period. Indirect and general expenses related to business combinations are expensed as incurred.

Income Taxes

We file a consolidated federal income tax return. Deferred federal income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end.

Deferred taxes are recognized using the liability method, whereby tax rates are applied to cumulative temporary differences based on when and how they are expected to affect the tax return. Deferred tax assets and liabilities are adjusted for tax rate changes in effect for the year in which these temporary differences are expected to be recovered or settled.

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Refer to “Critical Accounting Estimates and Judgments” under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2012 for information on accounting policies that we consider critical in preparing our consolidated financial statements. Actual results could differ materially from those estimates.

Fair Value of Financial Instruments

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

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

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

Revolving Credit Facility Payable: The carrying value of our bank revolving credit facility of $1.5 million approximates the fair value based on the current interest rate.

Subordinated Debt Securities: Our trust preferred securities have a carried value of $56.7 million and a fair value of $51.3 million as of June 30, 2013. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.0%, which is based on similar issues to discount future cash flows. Our trust preferred securities would be included in Level 3 of the fair value hierarchy if they were reported at fair value.

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

Variable Interest Entities

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

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

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

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

Adoption of New Accounting Pronouncements

In January 2013, we adopted new guidance issued by the Financial Accounting Standards Board (“FASB”) related to reporting and disclosure requirements about changes in accumulated other comprehensive income balances and reclassifications out of accumulated other comprehensive income. The new guidance is effective prospectively for fiscal and interim periods beginning after December 15, 2012. The adoption of this guidance did not have a material impact on our financial position or results of operations but did require additional disclosures.

3. Business Combinations

Effective August 29, 2008, we acquired 80% of the issued and outstanding membership interests in Heath XS, LLC and Hardscrabble Data Solutions, LLC for consideration of $15.0 million. In connection with the acquisition, we executed an operating agreement for each company. The operating agreements granted us the right to purchase the remaining 20% membership interests in the companies and granted an affiliate of the seller the right to require us to purchase such remaining membership interests. We exercised our call option effective September 30, 2012 and acquired the remaining 20% membership interests in the companies for $1.7 million.

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

Effective July 1, 2011, we acquired all of the issued and outstanding capital stock of TBIC Holding Corporation (“TBIC Holding”) for initial consideration of $1.6 million paid in cash on July 1, 2011. In addition, a holdback purchase price of $350 thousand was paid during the third quarter of 2012. A contingent purchase price of up to $3.0 million may become payable following 16 full calendar quarters after closing based upon a formula contained in the acquisition agreement.

4. Fair Value

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

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

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

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

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

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

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

In cases where there is limited activity or less transparency around inputs to the valuation, investment securities are classified within Level 3 of the valuation hierarchy. Level 3 investments are valued based on the best available data in order to approximate fair value. This data may be internally developed and consider risk premiums that a market participant would require. Investment securities classified within Level 3 include other less liquid investment securities.

There were no transfers between Level 1 and Level 2 securities during the periods presented.

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at June 30, 2013 and December 31, 2012 (in thousands):

	As of June 30, 2013	
	Quoted Prices in	Other

	Active Markets for Identical Assets (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	$ -	$ 37,627	$ -	$ 37,627
Corporate bonds	-	55,049	-	55,049
Collateralized corporate bank loans	-	102,295	753	103,048
Municipal bonds	-	136,880	19,628	156,508
Mortgage-backed	-	31,450	-	31,450
Total debt securities	-	363,301	20,381	383,682
Financial services	19,588	-	-	19,588
All other	33,970	-	-	33,970
Total equity securities	53,558	-	-	53,558
Total debt and equity securities	$ 53,558	$ 363,301	$ 20,381	$ 437,240

	As of December 31, 2012			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	$-	$ 40,061	$ -	$40,061
Corporate bonds	-	81,547	-	81,547
Collateralized corporate bank loans	-	105,463	908	106,371
Municipal bonds	-	144,972	18,760	163,732
Mortgage-backed	-	9,724	-	9,724
Total debt securities	-	381,767	19,668	401,435
Financial services	14,887	-	-	14,887
All other	29,038	-	-	29,038
Total equity securities	43,925	-	-	43,925
Total debt and equity securities	$43,925	$ 381,767	$ 19,668	$445,360

Due to significant unobservable inputs into the valuation model for certain municipal bonds and a collateralized corporate bank loan in illiquid markets, we classified these investments as Level 3 in the fair value hierarchy. We used an income approach in order to derive an estimated fair value of the municipal bonds classified as Level 3, which included inputs such as expected holding period, benchmark swap rate, benchmark discount rate and a discount rate premium for illiquidity. The fair value of the collateralized corporate bank loan classified as Level 3 is based on discounted cash flows using current yield to maturity of 9.3%, which is based on the relevant spread over LIBOR for this particular loan to discount future cash flows. Significant changes in the unobservable inputs in the fair value measurement of our municipal bonds and collateralized corporate bank loan could result in a significant change in the fair value measurement.

The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the six months ended June 30, 2013 and 2012 (in thousands):

Beginning balance as of January 1, 2013	$ 19,668
Sales	-
Settlements	(225)
Purchases	-
Issuances	-
Total realized/unrealized gains included in net income	-
Net gains included in other comprehensive income	938
Transfers into Level 3	-
Transfers out of Level 3	-
Ending balance as of June 30, 2013	$ 20,381
Beginning balance as of January 1, 2012	$ 20,608
Sales	-
Settlements	(236)
Purchases	-
Issuances	-
Total realized/unrealized gains included in net income	-
Net losses included in other comprehensive income	(553)
Transfers into Level 3	-
Transfers out of Level 3	-
Ending balance as of June 30, 2012	$ 19,819

5. Investments

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

As of June 30, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities and obligations of U.S. Government	$ 37,623	$ 8	$ (4)	$ 37,627
Corporate bonds	54,292	1,460	(703)	55,049
Collateralized corporate bank loans	103,045	460	(457)	103,048
Municipal bonds	155,927	2,826	(2,245)	156,508
Mortgage-backed	31,953	250	(753)	31,450

Total debt securities	382,840	5,004	(4,162)	383,682
Financial services	10,238	9,350	-	19,588
All other	19,329	15,778	(1,137)	33,970
Total equity securities	29,567	25,128	(1,137)	53,558
Total debt and equity securities	$ 412,407	$ 30,132	$ (5,299)	$ 437,240
As of December 31, 2012				
U.S. Treasury securities and obligations of U.S. Government	$ 40,050	$ 14	$ (3)	$ 40,061
Corporate bonds	79,516	2,794	(763)	81,547
Collateralized corporate bank loans	106,093	1,021	(743)	106,371
Municipal bonds	162,479	4,023	(2,770)	163,732
Mortgage-backed	9,662	97	(35)	9,724
Total debt securities	397,800	7,949	(4,314)	401,435
Financial services	11,008	3,880	(1)	14,887
All other	20,494	9,058	(514)	29,038
Total equity securities	31,502	12,938	(515)	43,925
Total debt and equity securities	$ 429,302	$ 20,887	$ (4,829)	$ 445,360

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

	Three Months Ended June 30		Six Months Ended June 30	
	2013	2012	2013	2012
U.S. Treasury securities and obligations of U.S. Government	$ -	$ -	$ -	$ -
Corporate bonds	467	(36)	825	(150)
Collateralized corporate bank loans	98	135	271	136
Municipal bonds	48	(163)	40	(243)
Equity securities-financial services	456	(22)	644	70
Equity securities-all other	528	1,305	993	1,305
Gain on investments	1,597	1,219	2,773	1,118
Other-than-temporary impairments	-	(228)	-	(246