HALLMARK FINANCIAL SERVICES INC
Form 10KSB40
March 28, 2001

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U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-KSB

Annual Report under Section 13 or 15(d) of the
Securities Exchange Act of 1934
For the fiscal year ended December 31, 2000

Commission file number 0-16090

HALLMARK FINANCIAL SERVICES, INC.
(Name of Small Business Issuer in Its Charter)

Nevada	87-0447375
(State or Other Jurisdiction of Incorporation Organization)	(I.R.S. Employer I.D. No.)

14651 Dallas Parkway, Suite 900, Dallas, Texas	75240
(Address of Principal Executive Offices)	(Zip Code)

Issuer's Telephone Number, Including Area Code: (972) 404-1637

Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock $.03 par value	American Stock Exchange Emerging Company Marketplace

Securities registered under Section 12(g) of the Exchange Act: None

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.
Yes [XX] No [ ]

Check if there is no disclosure of delinquent filers in response to Item 40 of Regulation S-B contained in this form, and no disclosure will 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-KSB or any amendment to this Form 10-KSB.
Yes [XX] No [ ]

State issuer's revenues for its most recent fiscal year - $23,885,406.

State the aggregate market value of the voting stock held by non-affiliate - $4,657,765 as of March 23, 2001.

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date. Common Stock, $.03 par

value - 11,049,133 shares outstanding as of March 23, 2001.

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.

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

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

Item 1. Description of Business.

Introduction

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

Overview

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

Hallmark writes non-standard automobile liability and physical damage coverages. Hallmark provides insurance through a reinsurance arrangement with an unaffiliated company, State & County Mutual Fire Insurance Company ("State & County"). Through State & County, Hallmark provides insurance

primarily for high risk drivers who do not qualify for standard-rate insurance.

AHGA holds an appointment from State & County to manage the sale and servicing of State & County policies. Hallmark reinsures 100% of the State & County policies produced by AHGA under a related reinsurance agreement. AHGA markets the policies produced by Hallmark through the Hallmark Agencies and through independent agents operating under their own names. Additionally, AHGA provides premium processing, underwriting, reinsurance accounting, and cash management for unaffiliated managing general agencies ("MGAs"). Hallmark assumes a portion of the business produced by these unaffiliated MGA's.

HFC offers premium financing for policies sold by the Hallmark Agencies and independent agents managed by AHGA.

HCS provides fee-based claims adjustment, salvage and subrogation recovery, and litigation services to Hallmark and unaffiliated MGA's.

Insurance Group Operations

Formed in 1987, HFS commenced its current operations in 1990 when it acquired, through several transactions, most of the companies now referred to as the Insurance Group. HFS manages Hallmark, AHGA, the Hallmark Agencies, HFC and HCS as an integrated Insurance Group that shares common management, computer facilities and corporate offices. AHGA manages the sale of State & County policies by the Hallmark Agencies and by independent agents and provides premium processing, underwriting, reinsurance accounting, and cash management to unaffiliated third parties. HFC offers a premium finance program for State & County policies marketed by the Hallmark Agencies and independent agents. HCS provides claims services to Hallmark and unaffiliated MGA's.

The Company offers both liability and physical damage (comprehensive and collision) coverages. Hallmark's bodily injury liability coverage is limited to $20,000 per person and $40,000 per accident, and property damage liability coverage is limited to $15,000 per accident. Physical damage coverage is limited to $40,000 and $30,000 for vehicles insured under annual/six-month and monthly policies, respectively.

Substantially all purchasers of Hallmark policies are individuals. No single customer or group of related customers has accounted for more than 1% of its net premiums written during any of the last three years.

The Company writes annual, monthly and six-month policies. The Company's core net premium volume was composed of a policy mix of 57% annual, 42% monthly and 1% six-month policies in 2000, and 51% annual, 47% monthly and 2% six-month policies in 1999. The Company's typical customer is unable or unwilling to pay either a half- or full-year's premium in advance, and thus a monthly policy, or an annual or six-month policy subject to financing, suits his/her budgetary needs.

The Company finances annual and six-month policy premiums produced by AHGA through a premium finance program offered by HFC. During 2000, 93% of Hallmark's annual and six-month policyholders financed their premiums through HFC's premium finance program. During both 1999 and 1998 the percentage was 92%.

HCS provides claims adjustment and related litigation services to both the Company and unaffiliated MGAs. Fees are charged either on a per-file basis, as a percentage of earned premiums or, in certain instances, a

combination of both methods. When the Company receives notice of a loss, HCS personnel establish a claim file and an estimated loss reserve. HCS's adjusters review, investigate and initiate claim payments, with the Company utilizing a third-party claims service only in unusual circumstances. The Company has an in-house legal department that closely manages its claims-related litigation. Management believes that the Company achieves superior efficiency and cost effectiveness by principally utilizing trained employee-adjusters and an in-house litigation department.

Underwriting and Other Ratios

An insurance company's underwriting experience is traditionally measured by its statutory "combined ratio". The combined ratio under statutory accounting practices ("SAP") is the sum of (1) the ratio of net losses and loss adjustment expenses ("LAE") incurred to net premiums earned (referred to as the "statutory loss ratio"), and (2) the ratio of underwriting and operating expenses to net premiums written (referred to as the "statutory expense ratio"). The approximate SAP underwriting profit or loss is affected to the extent the combined ratio is less or more than 100%. During 2000, 1999 and 1998, Hallmark experienced statutory loss ratios of 84.7%, 66.5% and 69.0%, respectively. During the same periods, it experienced statutory expense ratios of 16.4 %, 29.1% and 38.2%, respectively, and statutory combined ratios of 101%, 96% and 107%, respectively. These statutory ratios do not reflect the deferral of policy acquisition costs, investment income, premium finance revenues, or the elimination of intercompany transactions required by accounting principles generally accepted in the United States of America ("GAAP").

As discussed more fully below under Reinsurance Arrangements, Hallmark's reinsurance treaties were changed effective July 1, 2000 to include 100% of policy fees in the reinsurance treaty premium base thus directly impacting the Company's 2000 statutory loss ratio. If treatment of policy fees had not been changed during the last half of 2000, the statutory loss ratio after reinsurance would have been 79%. The increase in loss ratios is attributable to increased loss ratios on both the core State & County business and the unaffiliated MGA programs. The increase in the loss ratio of the core State & County business is the combined result of the following: (1) the change in retention of policy fees from 100% to 30% effective July 1, 2000 as previously discussed; (2) depressed premium rates in 1999 and part of 2000 that were still being earned throughout 2000; (3) weather-related losses due to hail claims during the spring of 2000 and ice-related claims during the fourth quarter of 2000; (4) increasing claim costs principally due to rising medical, labor and repair costs; (5) unusually high cancellation rate during the fourth quarter principally due to enforcement of more stringent underwriting guidelines; and (6) some adverse development of 1999 losses. Additionally, the loss ratios of assumed unaffiliated MGA programs continued to adversely affect loss ratios. Two of the unaffiliated MGA programs were cancelled effective July 1, 2000, but are still in run-off. The loss ratios on these two programs for 2000 were 106% and 99%, respectively. Another of the unaffiliated MGA programs had a loss ratio during 2000 of 113%. This program has been cancelled effective March 1, 2001. Hallmark's 1999 statutory loss ratio decreased in relation to 1998 principally due to the change in retention of policy fees to 100% effective January 1, 1999 which increased net earned premium. This decrease was partially offset by (1) generally lower premium rates in 1999, (2) the assumption of increased third party MGA business (which has a higher overall loss ratio than the core State & County business), and (3) hail-related claims incurred in May and June 1999.

The decrease in the 2000 statutory expense ratio is primarily attributable to the increase in the minimum ceding commission rate to 31%

from 27.5% effective July 1, 2000 as well as an overall increase in ceding commission income resulting from higher premium volume during 2000. The increased ceding commission income is partially offset by increased commission expenses, front fees, premium taxes and other variable expenses directly related to premium volume. The decrease in the 1999 statutory expense ratio as compared to 1998 was primarily attributable to (1) decreases in salaries and related expenses and increased management resources spent on premium finance and unaffiliated MGA operations, (2) a 1% increase in the minimum ceding commission, and (3) change in certain underwriting procedures which served to decrease underwriting expenses.

Under Texas Department of Insurance ("TDI") guidelines, property and casualty insurance companies are expected to maintain a premium-to-surplus ratio of not more than 3 to 1. The premium-to-surplus ratio measures the relationship between net premiums written in a given period (premiums written, less returned premiums and reinsurance ceded to other carriers) to surplus (admitted assets less liabilities), all determined on the basis of SAP. For 2000, 1999, and 1998, Hallmark's premium-to-surplus ratios were 2.98 to 1, 2.57 to 1 and 2.13 to 1, respectively. The increase in the 2000 premium-to-surplus ratio is attributable primarily to increased core State & County premium volume as well as funds expended by Hallmark on systems development and, to a lesser extent, the increase in unaffiliated MGA premium volume assumed during 2000. For statutory purposes, systems development is treated as a non-admitted asset and thus reduces statutory surplus. For GAAP purposes, the systems development qualifies as an asset.

Reinsurance Arrangements

Hallmark shares its claims risk with non-affiliated insurance companies. Commencing March 1, 1992, Hallmark and AHGA entered into a reinsurance arrangement with State & County. Effective July 1, 1996, this arrangement was supplemented by separate risk-sharing agreements between Hallmark and three unaffiliated companies, all of which are rated A- or better by A.M. Best: GE Reinsurance Company ("GE RE"), Dorinco Reinsurance Company ("Dorinco"), and Odyssey Reinsurance Corporation ("Odyssey"). Effective July 1, 1997, the treaty was renewed with GE RE and Dorinco under substantially the same terms and conditions. Effective July 1, 2000, the treaty was renewed solely with Dorinco under modified terms and conditions.

Under the Company's arrangement with State & County, AHGA is a managing general agency appointed by State & County to issue State & County policies, as well as to appoint producing agents to sell these policies. As compensation for acting as the managing general agency, AHGA receives from Hallmark commissions equal to a percentage of premiums written. It uses the majority of these commissions to compensate its producing agents for selling State & County policies. AHGA issues State & County policies in accordance with Hallmark's underwriting standards and pursuant to rates approved by State & County. Although State & County is required to file periodic rate adjustments with the state, TDI approval is not required. Hallmark reinsures 100% of the State & County business produced by AHGA. Ceding fees paid by Hallmark to State & County are equal to a percentage of premiums written (including policy origination fees).

Effective July 1, 2000, the Company entered into a new reinsurance agreement with Dorinco whereby the Company, upon mutual agreement with Dorinco, may elect on a quarterly basis to retain 30% to 45% of the risk. During the period of July 1, 2000 through December 31, 2000, the Company elected to retain 30%, and Dorinco assumed 70% of the State & County business produced by AHGA. In addition, Dorinco unconditionally guarantees Hallmark's and AHGA's obligations to State & County. Under the current reinsurance agreement, 100% of policy origination fees are included in the

reinsurance treaty premium base. Policy origination fees are fees that the Company is permitted by law to charge in addition to premiums to cover or defray certain costs associated with producing policies. The minimum commission rate under the new reinsurance agreement is 31% through February 28, 2001. Effective March 1, 2001, the minimum commission rate is 26%. The commission rate increases 1:1 to any percentage decrease in the loss ratio from an established benchmark to a provisional/maximum commission rate of 41%. From July 1, 1997 through June 30, 2000, GE RE and Dorinco, collectively, assumed 75% of the State & County business produced by AHGA. From July 1, 1996 through June 30, 1997, GE RE, Dorinco and Odyssey, collectively, assumed 75% of the State & County business. For the period of January 1, 1999 through June 30, 2000, Hallmark retained 100% of the policy origination fees, paid premium taxes and ceding fees on 100% of the business produced, and received a 30% provisional commission on the portion of the business ceded. Prior to 1999, Hallmark retained 62.5% and ceded 37.5% of policy origination fees to the reinsurers. During 1999 and the first six months of 2000, the minimum commission rates were 29% and 26%, respectively, under the GE RE and Dorinco agreements. During 1998, the minimum commission rates were 28% and 25%, respectively.

Marketing

Customers for non-standard automobile insurance typically fall into two groups. The first are drivers who do not qualify for standard auto insurance due to driving record, claims history, residency status, type of vehicle or adverse credit history. The second group is drivers who live in areas of Texas in which there is limited availability of standard rate insurance.

As the managing general agency, AHGA manages the marketing of the Company's non-standard automobile insurance program through a retail network of affiliated and independent agencies. At December 31, 2000, there were four affiliated offices operating under the American Hallmark Agencies name in Amarillo, Corpus Christi, Lubbock and the Dallas metropolitan area. In addition, the Company is represented by more than 400 independent agents with offices located throughout the State of Texas.

The Hallmark Agencies' business is developed primarily through advertising in regional and local publications, direct-mail, telephone solicitation, referrals and existing customers. In addition, field marketing representatives promote the Company's insurance programs to prospective independent agents and service existing agents. Both the Hallmark Agencies and the independent agents represent other insurers and sell other insurance products in addition to Hallmark policies. The Company's appointed independent agents are located throughout Texas in major cities, as well as suburban and some rural areas, with an emphasis in the central and southern regions of Texas.

Competition

For the last several years, through mid-2000, the Texas non-standard insurance market was characterized by an acceleration in competition. A significant number of companies, many of which were newly formed, entered the market place introducing programs with drastically reduced pricing. In turn, existing competitors offered more competitive pricing of existing programs and introduced increasingly competitive new programs. This climate of intense competition occurred principally as a by-product of excess capital and surplus of major insurance and reinsurance companies. However, beginning approximately mid-2000, this trend started to abate. A number of companies have withdrawn their non-standard automobile programs from Texas and others are no longer writing business due to the inability to obtain

reinsurance. In this changing environment, the company has implemented several rate increases and strengthened its underwriting standards while continuing to provide superior service to its agents and insureds.

Insurance Regulation

The operations of Hallmark, AHGA and HFC are regulated by TDI. HFC is also subject to further regulation under the Texas Credit Code. Hallmark is required to file quarterly and annual statements of its financial condition with TDI, prepared in accordance with SAP. Hallmark's financial condition, including the adequacy of its surplus, premium-to-surplus ratio, loss reserves, deposits and investments, is subject to review by TDI. Since Hallmark does not write its insurance directly, but rather writes through a county mutual, its premium rates and underwriting guidelines are not subject to the same degree of regulation imposed on standard insurance companies. However, State & County must file rate changes with TDI. AHGA and the producing agents who staff the Hallmark Agencies offices are also subject to TDI's licensing requirements. In addition, HFC is subject to licensing, financial reporting and certain financial requirements required by TDI. Interest rates, note forms and disclosures, among other things, are regulated by the Office of Consumer Credit Commissioner.

TDI has broad authority to enforce its 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. In extreme cases, including actual or pending insolvency, TDI may take over, or appoint a receiver to take over, the management or operations of an insurer or an agent's business or assets. In addition, all insurance companies which write insurance in the State of Texas are subject to assessments for a state administered fund which covers 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. Payments to the fund may be recovered by the insurer through deductions from its premium taxes at a rate of 10% per year over ten years. There were no assessments during 2000 and 1999, thus Hallmark made no payments to the fund during those years.

HFS is also regulated as an insurance holding company under the Texas Insurance Code. Financial transactions between HFS or any of its affiliates and Hallmark are subject to regulation by TDI. Applicable regulations require TDI's approval of management and expense sharing contracts, intercompany loans and asset transactions, investments in the Company's securities by Hallmark and similar transactions. Further, dividends and distributions by Hallmark to HFS are restricted.

On May 11, 2000, TDI issued its formal report on the results of TDI's regular, triennial examination of Hallmark's books and records as of December 31, 1998. The report indicated that no significant items or discrepancies were noted during the examination. On January 29, 2001, TDI issued its formal report on the results of TDI's market conduct examination of AHGA. The report indicated that AHGA was materially in compliance with TDI regulations governing market conduct.

Effective December 31, 1994, the National Association of Insurance Commissioners ("NAIC") requested property/casualty insurers to file a risk-based capital ("RBC") calculation according to a specified formula. The purpose of the NAIC-designed 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 (the "Model Act") by providing thresholds at which a state commissioner is authorized and expected to take regulatory action. TDI adopted the Model Act during 1998. Hallmark's 2000 and 1999 adjusted capital under the RBC calculation exceeded the minimum TDI requirement by 79% and 67%, respectively.

Analysis of Hallmark's Losses and LAE

The Company's consolidated financial statements include an estimated reserve for unpaid losses and LAE of the Company's non-standard automobile insurance subsidiary, Hallmark. Hallmark estimates its reserve for unpaid losses and LAE by using case-basis evaluations and statistical projections, which include inferences from both losses paid and losses incurred. Hallmark also uses recent historical cost data, periodic reviews of underwriting standards and claims management to modify the statistical projections. Hallmark gives consideration to the impact of inflation in determining its loss reserves, but does not discount reserve balances.

The amount of Hallmark's reserves represents management's estimates of the ultimate net cost of all unpaid losses and LAE incurred through December of each year. These estimates are subject to the effect of trends in claim severity and frequency. Management continually reviews the estimates and adjusts 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. (See Note 1 to the Consolidated Financial Statements.)

The Company seeks to continually improve its loss estimation process by refining its ability to analyze loss development patterns, claim payments, and other information within a legal and regulatory environment which affects development of ultimate liabilities. During late-1997 and 1998, the Company significantly accelerated its use of voluntary mediations (prior to court-ordered mediations) and began to more aggressively participate in "settlement weeks" sponsored by the courts in various counties throughout the state. These actions have increased the timeliness in which litigation claims settle and have favorably impacted ultimate settlements.

Changes in loss development patterns and claim payments can significantly affect the ability of insurers to estimate reserves for unpaid losses and related expenses. 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 2000 and 1999 reconciliation of the beginning and ending reserve balances, on a gross-of-reinsurance basis, to the gross amounts reported in the Company's balance sheet at December 31, 2000 and 1999:

	2000	1999
	(Thousands of dollars)	
Reserve for unpaid losses and LAE, net of recoverables, January 1	$ 5,409	$ 4,580
Provision for losses and LAE for claims occurring in the current period	14,460	9,330

Increase in reserve for unpaid losses and LAE for claims occurring in prior periods	97	14
Payments for losses and LAE, net of reinsurance:		
Current period	(9,286)	(5,724)
Prior periods	(3,229)	(2,791)
	(12,515)	(8,515)
Reserve for unpaid losses and LAE, net of reinsurance recoverable, December 31	$ 7,451	$ 5,409
Reinsurance recoverable on unpaid losses and LAE at December 31	14,847	12,395
Reserve for unpaid losses and LAE, gross of reinsurance at December 31	$22,298	$17,804

SAP/GAAP Reserve Reconciliation. The differences between the reserves for unpaid losses and LAE reported in the Company's consolidated financial statements prepared in accordance with GAAP and those reported in the annual statement filed with TDI in accordance with SAP for years 2000 and 1999 are summarized below:

	December 31	
	2000	1999
	(Thousands of Dollars)	
Reserve for unpaid losses and LAE on a SAP basis (net of reinsurance recoverables on unpaid losses)	$ 7,213	$ 5,196
Add estimated future unallocated LAE reserve for which HCS is contractually liable	238	213
Reserve for unpaid losses and LAE on a GAAP basis (net of reinsurance recoverables on unpaid losses)	$ 7,451	$ 5,409

Analysis of Loss and LAE Reserve Development

The following table shows the development of Hallmark's loss reserves, net of reinsurance, for 1990 through 2000. Section A of the table shows the estimated liability for unpaid losses and LAE, net of reinsurance, recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of losses and LAE 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 Hallmark. 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. The effects on income in the past two years of changes in estimates of the liabilities for losses and LAE are shown in the table under reconciliation of reserves for unpaid losses and LAE.

ANALYSIS OF LOSS AND LAE DEVELOPMENT
(Thousands of dollars)

Year Ended December 31	'90	'91	'92	'93	'94	'95	'96	'97
A. Reserve for Unpaid Losses & LAE, Net of Reinsurance Recoverables	2968	3353	4374	4321	4297	5923	5096	4668
B. Net Reserve Re-estimated as of :								
One year later	3126	2815	3423	4626	5175	5910	6227	4985
Two years later	3001	2885	3285	4499	5076	6086	6162	4954
Three years later	3090	2813	3147	4288	5029	6050	6117	4884
Four years later	3052	2700	3095	4251	5034	6024	6070	
Five years later	2988	2699	3067	4238	5031	6099		
Six years later	2994	2685	3065	4239	5038			
Seven years later	2987	2686	3065	4234				
Eight years later	2990	2686	3057					
Nine years later	2990	2686						
Ten years later	2990							
C. Net Cumulative Redundancy (Deficiency)	(22)	667	1317	87	(741)	(176)	(974)	(216)
D. Cumulative Amount of Claims Paid, Net of Reserve Recoveries, through:								
One year later	2100	1958	2109	3028	3313	3783	4326	3326
Two years later	2760	2472	2768	3883	4442	5447	5528	4287
Three years later	2956	2654	2958	4147	4861	5856	5860	4387
Four years later	2990	2668	3027	4207	4975	5933	5699	
Five years later	2983	2669	3054	4218	5005	6018		
Six years later	2981	2685	3056	4223	5030			
Seven years later	2987	2686	3056	4234				
Eight years later	2990	2686	3057					
Nine years later	2990	2686						
Ten years later	2990							

Net Reserve-December 31

Reinsurance Recoverables
Gross Reserve - December 31

Net Re-estimated Reserve

Re-estimated Reinsurance Recoverable
Gross Re-estimated Reserve

Gross Cumulative Redundancy

Investment Policy

Hallmark's investment objective is to maximize current yield while maintaining safety of capital together with sufficient liquidity for ongoing insurance operations. Accordingly, the investment portfolio is composed of fixed income securities: U.S. Government and U.S. Government agency debentures and agency mortgage-backed securities, municipal securities and U.S. Government bond mutual funds. The average maturity of the portfolio (after taking into account current assumptions regarding anticipated principal prepayments on mortgage-backed securities and the call dates of certain securities held), including short-term investments, is approximately three years, which approximates Hallmark's claims payment patterns. It is Hallmark's intent to hold investments until maturity. Maturities, bond calls and prepayments of mortgage-backed securities totaling approximately $3.4 million represent the securities liquidated in 2000. In addition, as part of the Company's overall investment strategy, the Company utilizes an integrated cash management system to maximize investment earnings on all available cash. During 2000, the Company's investment income totaled approximately $1.3 million compared to approximately $0.8 million for 1999.

Employees

On December 31, 2000, the Company employed 144 people on a full-time basis. None of the Company's employees are represented by labor unions. The Company considers its employee relations to be excellent.

Item 2. Description of Property.

The Company's corporate headquarters are located at 14651 Dallas Parkway, Suite 900, Dallas, Texas. The suite is located in a high-rise office building and contains approximately 25,570 square feet of space. Effective June 7, 2000, the Company renegotiated its lease for a period of 71 months to expire November 30, 2007. The rent is currently $42,617 per month. The Hallmark Agencies' offices are located in four Texas cities, including Corpus Christi, Amarillo, Lubbock and the Dallas metropolitan area. These offices are located in office buildings, shopping centers, store fronts and similar commercial structures in low and middle income neighborhoods. They contain an average of 900 square feet. All are leased, some on a month-to-month basis and others for remaining terms ranging up to 36 months. The type of space the Hallmark Agencies occupy is generally available at moderate rentals. The Company does not consider the location of any particular agency office to be material to its insurance marketing operations.

Item 3. Legal Proceedings.

Except for routine litigation incidental to the business of the Company and as described in Note 10 to the Consolidated Financial Statements, neither the Company nor any of the properties of the Company was subject to any material pending or threatened legal proceedings as of the date of this report.

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

During the fourth quarter of 2000, the Company did not submit any matter to a vote of its security holders.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters.

The Company's Common Stock has traded on the American Stock Exchange's Emerging Company Marketplace under the symbol "HAF.EC" since January 6, 1994. The following table shows the Common Stock's high and low sales prices on the AMEX Emerging Company Marketplace for each quarter since January 1, 1999.

Period	High Sale	Low Sale
1999		
First Quarter	$ 0.68	$ 0.19
Second Quarter	0.50	0.31
Third Quarter	0.50	0.31
Fourth Quarter	0.50	0.31
2000		
First Quarter	$ 0.44	$ 0.38
Second Quarter	0.50	0.38
Third Quarter	0.69	0.50
Fourth Quarter	0.69	0.44
2001		
First Quarter (thru March 23)	$ 0.63	$ 0.50

On March 23, 2001 there were 158 record holders and approximately 560 beneficial shareholders of the Company's Common Stock.

The Company has never paid dividends on its Common Stock. The Board of Directors intends to continue this policy for the foreseeable future in order to retain earnings for development of the Company's business.

Item 6. Management's Discussion and Analysis or Plan of Operation.

The following discussion of the Company's financial condition and the results of its operations should be read in conjunction with the consolidated financial statements and related notes included in this report.

Financial Condition and Liquidity

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

Net cash flow provided by the Company's consolidated operating activities was approximately $1.3 million greater for the year ended

December 31, 2000 as compared to the same period of 1999. This increase is principally due to the increase in annual policy production. Additionally, the Company commuted one of its reinsurance treaties during the third quarter of 2000, thus generating additional cash flow from operations. During the same time period, net cash used by investing activities increased approximately $0.8 million. As a result of increased annual policy premium volume during 2000, HFC originated more premium finance notes than it received in premium finance payments. Cash provided by financing activities was approximately $1.6 million greater for the year ended December 31, 2000 as compared to the same respective period of 1999 as a result of net advances under HFC's secured financing arrangement with an unaffiliated third party. (See Note 5 to the Consolidated Financial Statements.)

On a consolidated basis, the Company's liquidity increased 26% as of December 31, 2000 as compared to December 31, 1999. The Company's consolidated cash, cash equivalents and investments at December 31, 2000 and 1999 were $20.4 million and $16.1 million, respectively, excluding restricted cash of approximately $4.3 million and $3.4 million, respectively.

A substantial portion of the Company's 2000 consolidated liquid assets are held by Hallmark and are not available for general corporate purposes. Of the Company's consolidated liquid assets of $20.4 million at December 31, 2000, approximately $1.4 million (as compared to approximately $0.9 million in 1999) represents non-restricted cash. Since state insurance regulations restrict financial transactions between an insurance company and its affiliates, HFS is limited in its ability to use Hallmark funds for its own working capital purposes. Furthermore, dividends and loans by Hallmark to HFS are also restricted and, in certain instances, subject to TDI approval. Based on surplus at December 31, 2000, Hallmark could pay a dividend of up to $0.6 million to HFS during 2001 without TDI approval. Although, TDI has sanctioned the payment of management fees, commissions and claims handling fees by Hallmark to HFS and affiliates, during the second half of 2000, Hallmark did not pay all of the commissions allowed to AHGA. Additionally, HFS made a capital contribution of $250,000 to Hallmark. These steps were taken in order to bolster Hallmark's surplus to accommodate increased premium volume and systems development expenditures. Management fees to HFS of $150,000 were paid or accrued in 2000, and management fees of $425,000 were paid or accrued in 1999. Management anticipates that Hallmark will continue to pay management fees periodically during 2001, and this should continue to be a moderate source of unrestricted liquidity.

During the third quarter of 2000, the Company commuted loss reserves under its previous reinsurance agreement (effective March 1, 1992 through June 30, 1996) with Vesta Fire Insurance Corporation. The reserves were commuted at 100%. The Company received approximately $0.5 million in cash which was subsequently invested in government securities. It is anticipated that related outstanding claims will be settled over the next two years.

Commissions from the Company's annual policy program for independent agents represent a source of unrestricted liquidity when annual policy production is level or increasing from the most recent previous quarters. Under this program, AHGA offers independent agents the ability to write annual and six-month policies, but commissions to substantially all independent agents are paid monthly on an "earned" basis. However, consistent with customary industry practice, Hallmark pays total commissions up-front to AHGA based on the entire annual/six-months premiums written. Independent agent production of annual/six month policies was approximately $24.8 million in 2000 compared to approximately $16.5 million in 1999. During 2000, AHGA received approximately $4.5 million in commissions related to this annual policy program from Hallmark and paid earned commissions of

$3.4 million. This has resulted in increased unrestricted liquidity for the Company during 2000. During 1999, AHGA received $3.4 million in commissions related to this program from Hallmark and paid earned commissions of $2.1 million to independent agents.

Ceding commission income represents a significant source of funds to the Company. Ceding commission income for 2000 increased $3.1 million (representing a 50% increase) as compared to 1999. This increase is the combined result of the increase in the minimum commission rate to 31% from 27.5% and the increase in premium volume of the core State & County business. In accordance with GAAP, a portion of ceding commission income and policy acquisition costs is deferred and recognized as income and expense, respectively, as related net premiums are earned. Deferred ceding commission income increased to $3.5 million at December 31, 2000 from $2.1 million at December 31, 1999. The increase in deferred ceding commission income is the result of an increase in the minimum commission rate and an increase in the Company's core State & County annual premium volume. Deferred policy acquisition costs as of December 31, 2000 increased $1.1 million in relation to the prior year. This increase is also primarily attributable to the increase in the Company's core State & County annual premium volume.

Premium receivable from lender increased approximately $4.5 million during 2000 as a result of increased annual policy production during 2000 as compared to 1999. Prepaid reinsurance premiums, unpaid losses and LAE, reinsurance recoverable and unearned premiums increased as expected in relation to increased premium writings. (See Notes 3 and 4 to the Consolidated Financial Statements.) Accounts payable and other accrued expenses increased as a result of increased commissions due to independent agents under the earned commission program.

During 2000, the amount of funding available to fund premium finance notes under the secured financing arrangement with the unaffiliated third party was increased to $12.0 million from $8.0 million. As of December 31, 2000, HFC had an outstanding balance on advances under the financing arrangement of $ 11.4 million at an interest rate of 10%. Under the financing arrangement, the maximum additional advances available to HFC at December 31, 2000 were $0.6 million. At December 31, 1999, HFC had an outstanding balance on advances under the financing arrangement of $6.3 million.

During 2000, the court ruled against the Company in its appeal of a 1997 verdict against the Company in favor of a former director and officer of Hallmark. The increase in the accrued litigation costs during 2000 represents additional post-judgment interest and legal fees associated with the appeal. This judgment will be paid out of restricted funds (which includes accrued interest) that have been on deposit with the court and earning interest since 1997. (See Note 10 to the Consolidated Financial Statements.)

At December 31, 2000, Hallmark reported statutory capital and surplus of approximately $6.4 million, which reflects an increase of $0.4 million over the $6.0 million reported at December 31, 1999. Hallmark reported statutory net income of $0.1 million during 2000 compared to $0.4 million in 1999. During 2000, HFS made a capital contribution of approximately $0.3 million to Hallmark. At December 31, 2000, Hallmark showed a premium-to-surplus ratio of 2.98 to 1, as compared to 2.57 to 1 for the year ended December 31, 1999. The increase in Hallmark's premium to surplus ratio during 2000 is a result of increased core State & County premium volume as well as funds expended by Hallmark on systems development and, to a lesser extent, the increase in unaffiliated MGA premium volume assumed during 2000.

For statutory purposes, systems development is treated as a non-admitted asset and thus reduces statutory surplus. For GAAP purposes, the systems development qualifies as an asset to the extent permitted by Statement of Position 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use".

The Company provides program administration and claims handling for unaffiliated MGAs. The Company provides these services for one unaffiliated MGA program which is currently producing new business. Under this contract, the Company, as program administrator, performs certain administrative functions, including cash management, underwriting and rate-setting reviews, underwriting and policy processing and claims handling. Hallmark assumes a 20% pro-rata share of the business produced under the unaffiliated MGA program, and Dorinco assumes the remainder. Effective July 1, 2000, two other unaffiliated MGA programs discontinued writing new business due to non-renewal of their reinsurance treaties. Additionally, another unaffiliated MGA program discontinued writing new business effective March 1, 2001 due to non-renewal of its reinsurance treaty. The Company will continue to perform functions as defined in their respective contracts during the run-off period.

Management is continuing to investigate opportunities to enhance and expand its operations. While additional capital or strategic alliances may be required to fund future company expansion, operational enhancements through increased information technology capabilities is in progress. The first phase is designed to enhance Company and agency relationships by improving content and timeliness of information to support agents in servicing their customers. The Company and selected agents have been testing this web-based information system (named e-Integrity and referred to as the Integrity System) for several months. The first of several stages of full roll-out to all Company agents will commence late first quarter 2001. The second phase of the Integrity System is to implement point-of-sale technology to support agents in more promptly and efficiently producing new business, as well as to improve the quality and timeliness of service to existing policyholders. The Company anticipates that full implementation of Phase I will be completed during second quarter of 2001. Implementation of Phase II is targeted to commence by year end 2001 with full roll-out to be completed early 2002.

Results of Operations

Gross premiums written (prior to reinsurance) of approximately $50.5 million for the year ended December 31, 2000 increased approximately 33% in relation to gross premiums written in 1999. This increase in 2000 was primarily due to an increase in core State & County premium volume. The increase in core premium volume is principally attributable to a reduction of competitive programs in the Texas marketplace. During 2000, softness in nonstandard automobile rates due to intense competition over the last several years prompted some companies to cease writing nonstandard automobile insurance in Texas due to unacceptable underwriting results and/or the inability to either obtain reinsurance at acceptable terms, or in some instances, at any terms. Net premiums written (after reinsurance) increased approximately 24% during 2000 as compared to 1999. The disparity between the percentage increase in gross written premiums and net written premiums is primarily due to a change in reinsurance terms governing treatment of policy fees. Effective July 1, 2000, the reinsurance treaty was amended to include 100% of policy fees as subject reinsurance premium (compared to 0% during 1999 and the first six months of 2000). Thus, 100% of the policy fees are included in both gross and net premiums written for all of 1999 and the first half of 2000; only policy fees equal to Hallmark's retention percentage are included in net premiums written during the last

half of 2000. Partially offsetting the impact of the change in policy fees is an increase in Hallmark's retention rate to 30% from 25% effective July 1, 2000 and the assumption of business produced by unaffiliated MGA's.

Gross premiums earned (prior to reinsurance) of approximately $45.5 million increased 34% during 2000 as compared to 1999, and net premiums earned (after reinsurance) increased 24%. The disproportionate change in premiums earned prior to and after reinsurance is primarily due to the change in policy fees discussed above partially offset by an increase in retention by Hallmark and the assumption of premiums produced by third party unaffiliated MGAs.

Incurred loss ratios (computed on premiums earned both prior to and after reinsurance), on a GAAP basis, for the year ended December 31, 2000, were approximately 95% and 84%, respectively, as compared to 79% prior to and 65% after reinsurance for 1999. As noted above, Hallmark's reinsurance treaties were changed effective July 1, 2000 to include 100% of policy fees in the reinsurance treaty premium base. If treatment of policy fees had not been changed during the last half of 2000, the loss ratio after reinsurance would have been 79%. The increase in loss ratios is attributable to increased loss ratios on both the core State & County business and the unaffiliated MGA programs. The increase in the loss ratio of the core State & County business is the combined result of the following: (1) the change in retention of policy fees from 100% to 30% effective July 1, 2000 as previously discussed; (2) depressed premium rates in 1999 and part of 2000 that were still being earned throughout 2000; (3) weather-related losses due to hail claims during the spring of 2000 and ice-related claims during the fourth quarter of 2000; (4) increasing claim costs principally due to rising medical, labor and repair costs; (5) unusually high cancellation rate during the fourth quarter principally due to enforcement of more stringent underwriting guidelines; and (6) some adverse development of 1999 losses. Additionally, the loss ratios of assumed unaffiliated MGA programs continued to adversely affect loss ratios. Two of the unaffiliated MGA programs were cancelled effective July 1, 2000 but are still in run-off. The loss ratios on these two programs for 2000 were 106% and 99%, respectively. Another of the unaffiliated MGA programs had a loss ratio during 2000 of 113%. This program has been cancelled effective March 1, 2001.

Investment income increased 60% during 2000 as compared to 1999. The increase is attributable to the combined effect of an increase in funds available for investment resulting from increased premium volume and an overall increase in the effective yield of the Company's investment portfolio.

Finance charges, which increased 39% during 2000, represent interest earned on premium notes issued by HFC. This increase is directly correlated to the increase in the core State & County premium volume.

Processing and service fees, which decreased slightly during 2000, represent fees earned on processing and servicing contracts with unaffiliated MGAs.

Acquisition costs, net represents the amortization of acquisition costs (and credits) deferred over the past twelve months and the deferral of acquisition costs (and credits) incurred in the current period. The increase in acquisition costs, net is primarily due to an increase in ceding commission as a result of changes in the Company's reinsurance terms partially offset by an increase in acquisition costs related to increased annual premium volume.

Other acquisition and underwriting expenses decreased approximately 26%

as compared to the prior year. The decrease in other acquisition and underwriting expenses is primarily attributable to increased ceding commission income as a result of increased core State & County premium volume and increased minimum commission rate to 31% from 27.5% due to changes in the Company's reinsurance terms effective July 1, 2000. These decreases are partially offset by an increase in commission expenses and other variable expenses associated with increased premium volume.

Operating expenses include non-insurance expenses related to premium finance operations, general corporate overhead, and third party administrative and claims handling contracts. Related revenues are derived from finance charges and service/consulting fees. Operating expenses for 2000 increased 25% in relation to the prior year. The majority of this increase in operating expenses is attributable to variable expenses related to increased volume in the Company's premium finance operations and the development of technological improvements in information systems.

Interest expense increased approximately $0.5 million during 2000 as compared to 1999. This increase is a direct result of an increase in premium finance secured borrowings associated with the increase in annual premium volume.

Litigation costs increased $0.4 million during 2000 as compared to 1999. During 2000, the court ruled against the Company in its appeal of a 1997 verdict against the Company in favor of a former director and officer of Hallmark. The additional accrual primarily represents additional post-judgment interest and legal fees associated with the appeal. This judgment will be paid out of restricted funds (which includes accrued interest) that have been on deposit with the court and earning interest since 1997.

The Company recognized a slight federal income tax benefit during 2000 despite a net pre-tax loss of $0.2 million principally due to differences between financial statement and tax treatment of acquisition costs, net, and changes in unearned premium reserves and loss/LAE reserves. Additionally, the pre-tax loss included the additional $0.4 million of accrued litigation costs as discussed above and directly impacted the Company's tax calculation for 2000. Most of the additional $0.4 million is not deductible for tax purposes in 2000 as the Company recognized the full deduction equal to funds placed on deposit with the court in 1997 as allowed by federal tax regulations.

Item 7. Financial Statements

The following consolidated financial statements of the Company and its subsidiaries are filed as part of this report.

Description	Page Number
Report of Independent Accountants	F-2
Consolidated Balance Sheets at December 31, 2000 and 1999	F-3
Consolidated Statements of Operations for the Years Ended December 31, 2000 and 1999	F-4
Consolidated Statements of Stockholders' Equity for the Years December 31, 2000 and 1999	F-5

Consolidated Statements of Cash Flows for the Years Ended December 31, 2000 and 1999 F-6

Notes to Consolidated Financial Statements F-7

Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None

PART III

Item 9. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act.

The information required by Part III, Item 9 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.

Item 10. Executive Compensation.

The information required by Part III, Item 10 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.

Item 11. Security Ownership of Certain Beneficial Owners and Management.

The information required by Part III, Item 11 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.

Item 12. Certain Relationships and Related Transactions.

The information required by Part III, Item 12 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.

Item 13. Exhibits and Reports on Form 8-K.

(a) Exhibits. The exhibits listed in the Exhibit Index appearing at page 17 of this report are filed with or incorporated by reference in this Report.

(b) Reports on Form 8-K. The Company did not file any Form 8-K Current Reports during the fourth quarter of 2000.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HALLMARK FINANCIAL SERVICES, INC.
(Registrant)

Date:	March 27, 2001	/s/ Linda H. Sleeper Linda H. Sleeper, President (Chief Executive Officer)
Date:	March 27, 2001	/s/ Johnny J. DePuma Johnny J. DePuma, Vice President (Chief Financial Officer/Principal Accounting Officer)

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date:	March 27, 2001	/s/ Ramon D. Phillips Ramon D. Phillips, Director
Date:	March 27, 2001	/s/ Linda H. Sleeper Linda H. Sleeper, Director
Date:	March 27, 2001	/s/ Raymond A. Kilgore Raymond A. Kilgore, Director
Date:	March 27, 2001	/s/ James H. Graves James H. Graves, Director
Date:	March 27, 2001	/s/ C. Jeffrey Rogers C. Jeffrey Rogers, Director
Date:	March 27, 2001	/s/ George R. Manser George R. Manser, Director
Date:	March 27, 2001	/s/ Scott T. Berlin Scott T. Berlin, Director
Date:	March 27, 2001	/s/ Mark E. Schwarz Mark E. Schwarz, Director

EXHIBIT INDEX

The following exhibits are either filed with this report or incorporated by reference.

Exhibit Number	Description

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3(a) Articles of Incorporation of the registrant, as amended (incorporated by reference to Exhibit 3(a) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1993).

3(b) By-Laws of the registrant, as amended (incorporated by reference to Exhibit 3(b) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1993).

4 Specimen certificate for Common Stock, $.03 par value, of the registrant (incorporated by reference to Exhibit 4 to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1991).

10(a) Office Lease for 14651 Dallas Parkway, Suite 900, dated January 1, 1995, between American Hallmark Insurance Company of Texas and Fults Management Company, as agent for The Prudential Insurance Company of America (incorporated by reference to Exhibit 10(a) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).

10(b) 100% Quota Share Reinsurance Agreement, as Restated, between State & County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas, effective March 1, 1992 (incorporated by reference to Exhibit 10(a) to Amendment No. 1 on Form 8 to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 1992).

10(c) General Agency Agreement, effective March 1, 1992, between State & County Mutual Fire Insurance Company and Brokers General, Inc. (incorporated by reference to Exhibit 10(b) to Amendment No. 1 on Form 8 to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 1992).

10(d) Quota Share Retrocession Agreement, effective March 1, 1992 between American Hallmark Insurance Company of Texas and Liberty National Fire Insurance Company (incorporated by reference to Exhibit 10(c) to Amendment No. 1 on Form 8 to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 1992).

10(e) 1991 Key Employee Stock Option Plan of the registrant (incorporated by reference to Exhibit C to the definitive Proxy Statement relating to the registrant's Annual Meeting of Shareholders held May 20, 1991).

10(f) 1994 Key Employee Long Term Incentive Plan (incorporated by reference to Exhibit 10(f) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).

10(g) 1994 Non-employee Director Stock Option Plan (incorporated by reference to Exhibit 10(g) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).

10(h) Addendum No. 2 to the Quota Share Retrocession Agreement, effective March 1, 1993, between American Hallmark Insurance Company of Texas and Liberty National Fire Insurance Company (incorporated by reference to Exhibit 10(o) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1993).

10(i) Addendum No. 3 to the Quota Share Retrocession Agreement, effective

August 1, 1993, between American Hallmark Insurance Company of Texas and Liberty National Fire Insurance Company (incorporated by reference to Exhibit 10(p) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1993).

Exhibit Number	Description
10(j)	Administrative Services and Consulting Agreement, dated December 23, 1993, between American Southwest Insurance Managers, Inc., Liberty National Fire Insurance Company, Hallmark Financial Services, Inc., Brokers General, Inc. and Citizens Adjustment and Reporting Service, Inc. (incorporated by reference to Exhibit 10(q) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1993).
10(k)	Form of Executive Compensation Agreement representing respective agreements dated August 23, 1994, between registrant and Ramon D. Phillips, Raymond A. Kilgore, Linda H. Sleeper, and Johnny J. DePuma (incorporated by reference to Exhibit 10(p) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).
10(l)	Addendum No. 1 to the 100% Quota Share Reinsurance Agreement, as restated between State & County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas effective November 22, 1994 (incorporated by reference to Exhibit 10(q) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994).
10(m)	Second, Third, Fourth and Fifth Amendments to Office Lease for 14651 Dallas Parkway, Suite 900, dated January 1, 1995, between American Hallmark Insurance Company of Texas and Fults Management Company, as agent for The Prudential Insurance Company of America (incorporated by reference to Exhibit 10(t) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1995).
10(n)	Form of Shareholders Agreement dated January 1, 1996, between American Hallmark General Agency, Inc., Robert D. Campbell, Margaret Jones and American Hallmark Agencies, Inc. (incorporated by reference to Exhibit 10(u) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1995).
10(o)	Form of Facilities & Services Agreement dated January 1, 1996, between American Hallmark General Agency, Inc., Robert D Campbell, Margaret Jones and American Hallmark Agencies, Inc. (incorporated by reference to Exhibit 10(v) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1995).
10(p)	Form of Indemnification Agreement dated January 1, 1996, between American Hallmark General Agency, Inc., Hallmark Financial Services, Inc., Robert D. Campbell, Margaret Jones and American Hallmark Agencies, Inc. (incorporated by reference to Exhibit 10(w) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1995).
10(q)	Form of Shareholders Agreement dated January 3, 1996, between American Hallmark General Agency, Inc., Robert D. Campbell,

Richard Mason, Sr. and Hallmark Underwriters, Inc. (incorporated by reference to Exhibit 10(x) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1995).

10(r) Form of Facilities and Services Agreement dated January 3, 1996, between American Hallmark General Agency, Inc., Robert D Campbell, Richard Mason, Sr. and Hallmark Underwriter, Inc. (incorporated by reference to Exhibit 10(y) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1995).

10(s) Form of Indemnification Agreement dated January 3, 1996, between American Hallmark General Agency, Inc., Hallmark Financial Services, Inc., Robert D. Campbell, Richard Mason, Sr. and Hallmark Underwriters, Inc. (incorporated by reference to Exhibit 10(z) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1995).

10(t) Form of 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas effective July 1, 1996 (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).

Exhibit Number	Description
10(u)	Form of Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurer (specifically identified as follows: Dorinco, Kemper and Skandia), effective July 1, 1996 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(v)	Form of Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurer (specifically identified as follows: Dorinco, Kemper and Skandia), effective July 1, 1996 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(w)	Guaranty Agreement effective July 1, 1996 provided by Dorinco Reinsurance Company in favor of State & County Mutual Fire Insurance Company (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(x)	Guaranty Agreement effective July 1, 1996 provided by Skandia America Reinsurance Corporation in favor of State & County Mutual Fire Insurance Company (incorporated by reference to Exhibit 10(e) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(y)	Form of Guaranty of Performance and Hold Harmless Agreement effective July 1, 1996 between Hallmark Financial Services, Inc. and Dorinco America Reinsurance Corporation (incorporated by reference to Exhibit 10(f) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).
10(z)	Form of Guaranty of Performance and Hold Harmless Agreement

effective July 1, 1996 between Hallmark Financial Services, Inc. and Kemper Reinsurance Company (incorporated by reference to Exhibit 10(g) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).

10(aa) Form of Guaranty of Performance and Hold Harmless Agreement effective July 1, 1996 between Hallmark Financial Services, Inc. and Skandia America Reinsurance Corporation (incorporated by reference to Exhibit 10(h) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).

10(ab) Form of Addendum No. 4 - Termination to Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and Vesta Fire Insurance Company (incorporated by reference to Exhibit 10(I) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).

10(ac) Form of Addendum No. 3 - Termination to 100% Quota Share Reinsurance Agreement between American Hallmark Insurance Company and State & County Mutual Fire Insurance Company (incorporated by reference to Exhibit 10(j) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1996).

10(ad) Automobile Physical Damage Catastrophe Excess of Loss Reinsurance Agreement effective July 1, 1996 between American Hallmark Insurance Company of Texas and Kemper Reinsurance Company (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter and ended September 30, 1996).

10(ae) Form of 100% Quota Share Reinsurance Agreement, effective January 1, 1997, between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc. and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(am) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1996).

10(af) Form of General Agency Agreement, effective January 1, 1997, between Dorinco Reinsurance Company, State & County Mutual Fire Insurance Company and Vaughn General Agency, Inc. (incorporated by reference to Exhibit 10(an) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1996).

Exhibit Number	Description
10(ag)	Form of Administrative Services Agreement between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc. and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(ao) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1996).
10(ah)	Form of Loan Agreement dated March 11, 1997, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company, (incorporated by reference to Exhibit 10(ap) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1996).
10(ai)	Form of Promissory Note dated March 11, 1997, with Hallmark Financial Services, Inc. as Maker and Dorinco Reinsurance Company as Payee. (incorporated by reference to Exhibit 10(aq) to the

registrant's Annual Report on Form 10-KSB for the year ended December 31, 1996).

10(aj) Stock Pledge and Security Agreement dated March 11, 1997, between ACO Holdings, Inc. and Dorinco Reinsurance Company. (incorporated by reference to Exhibit 10(ar) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1996).

10(ak) Form of Endorsement No. 1, effective July 1, 1996, to the 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas, effective July 1, 1996. (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).

10(al) Form of Endorsement No 1, effective July 1, 1997, to the Guaranty of Performance and Hold Harmless Agreement between Hallmark Financial Services, Inc. and Skandia America Reinsurance Corporation, effective July 1, 1996. (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).

10(am) Form of Endorsement No. 1, effective July 1, 1997, to the Guaranty Agreement provided by Skandia America Reinsurance Corporation in favor of State & County Mutual Fire Insurance Company, effective July 1, 1996. (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).

10(an) Form of Endorsement No. 1, effective July 1, 1997, to the Guaranty Agreement provided by Dorinco Reinsurance Corporation in favor of State & County Mutual Fire Insurance Company, effective July 1, 1996. (incorporated by reference to Exhibit 10(d) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).

10(ao) Form of Endorsement No. 1 - Termination, effective January 1, 1997, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurers (Dorinco Reinsurance Company and Odyssey Reinsurance Corporation), effective July 1, 1996. (incorporated by reference to Exhibit 10(e) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).

10(ar) Form of Endorsement No. 1, effective July 1, 1997, to the Quota Share Retrocession Agreementt between American Hallmark Insurance Company of Texas and the Reinsurer (Dorinco Reinsurancee Company) effective July 1, 1996. (incorporated by reference to Exhibit 10(h) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1997).

10(as) Automobile Physical Damage Catastrophe Excess of Loss Reinsurance Agreement effective July 1, 1997 between American Hallmark Insurance Company and Kemper Reinsurance Company. (incorporated by reference to Exhibit 10(bf) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997).

Exhibit Number	Description
10(at)	Endorsement No. 1, effective July 1, 1997, to the Quota Share

Retrocession Agreement between American Hallmark Insurance Company of Texas and Kemper Reinsurance Company, effective July 1, 1996. (incorporated by reference to Exhibit 10(bg) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997).

10(au) Endorsement No. 2, effective January 1, 1997, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective January 1, 1997. (incorporated by reference to Exhibit 10(bh) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997).

10(av) Endorsement No. 1, effective January 1, 1997, to the 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc. and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(bi) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997).

10(aw) Form of Endorsement No. 2, effective July 1, 1997, to the 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc., American Hallmark General Agency, Inc. and the Reinsurers (Dorinco Reinsurance Company and Kemper Reinsurance Company) effective July 1, 1997. (incorporated by reference to Exhibit 10(bj) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1997).

10(ax) Form of Amendment No. 1 to the Loan Agreement dated March 11, 1997, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company. (Incorporated by reference to Exhibit 10(bg) to the registrant's annual Report on Form 10KSB for the fiscal year ended December 31, 1998.)

10(ay) Form of Retrocession Agreement effective March 1, 1998, between American Hallmark Insurance Company of Texas, Dorinco Reinsurance Company and Associated General Agency, Inc. (Incorporated by reference to Exhibit 10(bh) to the registrant's annual Report on Form 10KSB for the fiscal year ended December 31, 1998.)

10(az) Form of Retrocession Agreement effective June 1, 1998, between American Hallmark Insurance Company of Texas, Dorinco Reinsurance Company and Harold Loving, d/b/a Texas Insurance Facilities. (Incorporated by reference to Exhibit 10(bi) to the registrant's annual Report on Form 10KSB for the fiscal year ended December 31, 1998.)

10(ba) Form of Quota Share Retrocession Agreement effective September 1, 1998, between American Hallmark Insurance Company of Texas, Dorinco Reinsurance Company and Van Wagoner Companies, Inc. (Incorporated by reference to Exhibit 10(bj) to the registrant's annual Report on Form 10KSB for the fiscal year ended December 31, 1998.)

10(bb) Endorsement No. 5, effective January 1, 1999, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurer (Dorinco Reinsurance Company), effective January 1, 1997. (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1999).

10(bc)	Endorsement No. 4, effective January 1, 1999, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and the Reinsurer (GE Re Reinsurance Company), effective January 1, 1996.(incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 1999).
10(bd)	Addendum No. 1 to the Retrocession Contract effective June 1, 1998 between Dorinco Re and American Hallmark Insurance Company of Texas and Harold Loving, d/b/a Texas Insurance Facilities. (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 1999).

Exhibit Number	Description
10(be)	Endorsement No. 1 to the Retrocession Contract effective March 1, 1998 between Dorinco Re and American Hallmark Insurance Company of Texas and Associated General Agency, Inc. (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 1999).
10(bf)	Automobile Physical Damage Catastrophe Excess of Loss Reinsurance Contract effective January 1, 1999 between American Hallmark Insurance Company of Texas and GE Reinsurance Corporation. (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 1999).
10(bg)	Form of Endorsement No. 2, effective July 1, 1997, to the 100% Quota Share Reinsurance Agreement between State & County Mutual Fire Insurance Company, Vaughn General Agency, Inc. and American Hallmark General Agency, Inc. (incorporated by reference to Exhibit 10(bg) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1999)
10(bh)	Form of Amendment No. 3 to the Loan Agreement dated March 11, 1997, between Hallmark Financial Services, Inc. and Dorinco Reinsurance Company. (incorporated by reference to Exhibit 10(bh) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1999)
10(bi)	Form of Endorsement No. 6, effective January 1, 1999, to the Quota Share Retrocession Agreement between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company, effective January 1, 1997. (incorporated by reference to Exhibit 10(bi) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1999)
10(bj)	Form of the Second Renewal Promissory Note dated November 19, 1999, with Hallmark Financial Services, Inc. as Maker and Dorinco Reinsurance Company as Payee. (incorporated by reference to Exhibit 10(bj) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1999)
10(bk)	Form of Sale and Assignment Agreement dated November 18, 1999, with Hallmark Finance Corporation as Seller and FPF, Inc. (incorporated by reference to Exhibit 10(bk) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1999)

10(bl)	Form of Premium Receivable Servicing Agreement dated November 18, 1999 between Hallmark Finance Corporation and FPF, Inc. (incorporated by reference to Exhibit 10(bl) to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1999)	
10(bm)	Automobile Physical damage catastrophe Excess of Loss Reinsurance Contract effective July 1, 1999 between American Hallmark Insurance Company of Texas and GE Reinsurance Corporation (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended March 31, 2000).	
10(bn)	Seventh Amendment to Office Lease for 14651 Dallas Parkway, Suite 900, dated January 1, 1995, between American Hallmark Insurance Company of Texas and Fults Management Company, as agent for The Prudential Insurance Company of America (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended June 30, 2000).	
10(bo)	Quota Share Retrocession Agreement, effective July 1, 2000, between American Hallmark Insurance Company of Texas and Dorinco Reinsurance Company (incorporated by reference to Exhibit 10(a) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2000).	
10(bp)	Addendum No. 2 to the Retrocession Contract, effective June 1, 1998, issued to Dorinco Reinsurance Company by American Hallmark Insurance Company of Texas, effective October 1, 1999 (incorporated by reference to Exhibit 10(b) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2000).	
10(bq)	Commutation Agreement, effective April 30, 2000, between Vesta Fire Insurance Corporation and American Hallmark Insurance Company of Texas (incorporated by reference to Exhibit 10(c) to the registrant's Quarterly Report on Form 10-QSB for the quarter ended September 30, 2000).	
10(br)	Form of Eighth Amendment to Office Lease for 14651 Dallas Parkway, Suite 900, dated January 1, 1995, between American Hallmark Insurance Company of Texas and Fults Management Company, as agent for The Prudential Insurance Company of America.	*
10(bs)	Form of Quota Share Retrocession Contract between Dorinco Reinsurance Company and American Hallmark Insurance Company of Texas, effective September 1, 2000.	*
10(bt)	Form of Endorsement No. 5, effective July 1, 2000, to the 100% Quota Share Reinsurance Agreement issued to State and County Mutual Fire Insurance Company, effective January 1, 1997.	*
10(bu)	Form of Endorsement No. 4, effective July 1, 2000, to the 100% Quota Share Reinsurance Agreement between State and County Mutual Fire Insurance Company and American Hallmark Insurance Company of Texas, effective July 1,1996.	*
10(bv)	Form of Termination Addendum to the Quota Share Retrocession Agreement, effective May 28, 1999, issued to American Hallmark Insurance Company of Texas by Kemper Reinsurance Company, effective July 1, 1996.	*

10(bw)	Form of Termination Addendum to the Quota Share Retrocession Agreement, effective June 30, 2000, issued to Dorinco Reinsurance Company by American Hallmark Insurance Company of Texas, effective January 1, 1997.	*
10(bx)	Form of Termination Addendum to the Quota Share Retrocession Contract, effective September 1, 2000, issued to Dorinco Reinsurance Company by American Hallmark Insurance Company of Texas, effective September 1, 1998.	*
10(by)	Form of Termination Addendum to the Interests and Liability Agreement, effective June 30, 2000, of GE Reinsurance Corporation with respect to the 100% Quota Share Reinsurance Agreement, effective January 1, 1997.	*
10(bz)	Form of Third Amendment to Executive Compensation Agreement, effective November 26, 2000, between Ramon D. Phillips and Hallmark Financial Services Inc., dated August 24, 1994.	*
10(ca)	Form of Third Amendment to Executive Compensation Agreement, effective November 26, 2000, between Linda H. Sleeper and Hallmark Financial Services Inc., dated August 24, 1994.	*
10(cb)	Form of Termination Endorsement, effective July 1, 2000, to the Guaranty of Performance and Hold Harmless Agreement between Hallmark Financial Services, Inc. and GE Reinsurance Corporation (formerly Kemper Reinsurance Company), effective July 1, 1996.	*
10(cc)	Form of Termination Endorsement, effective July 1, 2000, to the Guaranty Agreement provided by GE Reinsurance Corporation (formerly Kemper Reinsurance Company) in favor of State and County Mutual Fire Insurance Company, effective July 1, 1996.	*
22	List of subsidiaries of the registrant (incorporated by reference to Exhibit 22 to the registrant's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1991).	
28	Schedule P of American Hallmark Insurance Company of Texas as filed with the Texas Department of Insurance for the year ended December 31, 2000.	*
*	Filed herewith	

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES

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Report of Independent Accountants

To the Board of Directors
Hallmark Financial Services, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, stockholders' equity, and cash flows, present fairly, in all material respects, the financial position of Hallmark Financial Services, Inc. and Subsidiaries (the "Company") at December 31, 2000 and 1999, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

Dallas, Texas
March 23, 2001

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2000 and 1999

ASSETS	2000	1999
Investments:		
Debt securities, held-to-maturity, at amortized cost	$ 7,243,373	$ 3,831,657
Equity securities, available-for-sale, at market value	145,302	142,901
Short-term investments, at cost which approximates market value	6,188,764	6,373,491
Total investments	13,577,439	10,348,049

Cash and cash equivalents	6,830,712	5,786,069
Restricted cash	4,276,397	3,422,297
Prepaid reinsurance premiums	10,943,902	7,673,196
Premiums receivable from lender (net of allowance for doubtful accounts of $168,648 in 2000 and $68,287 in 1999)	13,544,985	9,058,958
Premiums receivable	799,140	741,613
Reinsurance recoverable	19,212,172	15,673,241
Deferred policy acquisition costs	3,867,033	2,741,076
Excess of cost over net assets acquired (net of accumulated amortization of $1,642,093 in 2000 and $1,485,080 in 1999)	4,588,121	4,745,134
Current federal income tax recoverable	95,232	-
Deferred federal income taxes	572,112	212,059
Accrued investment income	108,364	52,721
Other assets	642,205	547,820
	$ 79,057,814	$ 61,002,233
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes payable	$ 13,032,999	$ 9,288,366
Unpaid losses and loss adjustment expenses	22,297,816	17,804,254
Unearned premiums	16,710,581	11,761,723
Reinsurance balances payable	3,341,437	2,623,603
Deferred ceding commissions	3,505,421	2,142,097
Drafts outstanding	1,534,721	901,471
Current federal income taxes payable	-	46,124
Accrued ceding commission refund	2,503,128	1,251,614
Accounts payable and other accrued expenses	3,258,475	2,516,222
Accrued litigation costs	1,385,840	950,000
	67,570,418	49,285,474
Stockholders' equity:		
Common stock, $.03 par value, authorized issued 11,855,610 shares in 2000 and 11,854,610 in 1999	355,668	355,638
Capital in excess of par value	10,875,432	10,875,212
Retained earnings	1,309,934	1,543,304
Accumulated other comprehensive income	(10,471)	(14,228)
Treasury stock, 806,477 shares in 2000 and 1999, at cost	(1,043,167)	(1,043,167)
Total stockholders' equity	11,487,396	11,716,759
	$ 79,057,814	$ 61,002,233

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
for the years ended December 31, 2000 and 1999

	2000	1999

	2000	1999
Gross premiums written	$ 50,468,652	$ 37,956,953
Ceded premiums written	(31,395,654)	(22,512,285)
Net premiums written	$ 19,072,998	$ 15,444,668
Revenues:		
Gross premiums earned	$ 45,519,795	$ 33,928,854
Ceded premiums earned	(28,124,949)	(19,949,293)
Net premiums earned	17,394,846	13,979,561
Investment income, net of expenses	1,264,138	789,584
Finance charges	2,925,772	2,098,944
Processing and service fees	1,952,388	1,969,930
Other income	348,262	362,675
Total revenues	23,885,406	19,200,694
Benefits, losses and expenses:		
Losses and loss adjustment expenses	43,184,638	26,777,314
Reinsurance recoveries	(28,627,143)	(17,658,138)
Net losses and loss adjustment expenses	14,557,495	9,119,176
Acquisition costs, net	237,366	140,781
Other acquisition and underwriting expenses (net of ceding commission of $9,413,890 in 2000 and $6,291,236 in 1999)	3,274,272	4,397,249
Operating expenses	4,347,345	3,473,515
Interest expense	1,137,787	625,770
Amortization of intangible assets	157,015	157,015
Litigation costs	435,840	-
Total benefits, losses and expenses	24,147,120	17,913,506
Income (loss) from operations before federal income taxes	(261,714)	1,287,188
Federal income tax expense (benefit)	(28,344)	499,878
Net income (loss)	$ (233,370)	$ 787,310
Basic and diluted earnings per share (11,049,133 shares outstanding):		
Net income (loss)	$ (.02)	$ .07

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
for the years ended December 31, 2000 and 1999

	Number of Shares	Par Value	Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Tre St
Balance at December 31, 1998	11,854,610	$355,638	$10,875,212	$ 755,994	($9,429)	($1,0
Comprehensive income:						
Net income				787,310		
Other comprehensive income, net of tax						
Unrealized losses on securities, net of tax of ($2,473)					(4,799)	
Comprehensive income						
Balance at December 31, 1999	11,854,610	$355,638	$10,875,212	$1,543,304	($14,228)	($1,0
Comprehensive loss:						
Net loss				(233,370)		
Other comprehensive income, net of tax						
Unrealized gains on securities, net of tax of $1,936					3,757	
Comprehensive loss						
Issuance of common stock	1,000	30	220			
Balance at December 31, 2000	11,855,610	$355,668	$10,875,432	$1,309,934	($10,471)	($1,0

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
for the years ended December 31, 2000 and 1999

	2000	1999
Cash flows from operating activities:		
Net income (loss)	$ (233,370)	$ 787,310
Adjustments to reconcile net income (loss) to cash provided by (used in) operating activities:		
Depreciation and amortization expense	304,773	314,385
Change in deferred Federal income taxes	(360,053)	(168,423)

Change in prepaid reinsurance premiums	(3,270,706)	(2,562,992)
Change in premiums receivable	(57,527)	307,076
Change in deferred policy acquisition	(1,125,957)	(652,174)
Change in deferred ceding commissions	1,363,324	792,955
Change in unpaid losses and loss	4,493,562	1,789,685
Change in unearned premiums	4,948,858	4,028,099
Change in reinsurance recoverable	(3,538,931)	(1,772,745)
Change in reinsurance balances payable	717,834	526,039
Change in current federal income tax	(95,232)	150,031
Change in current federal income tax	(46,124)	46,124
Change in accrued ceding commission	1,251,514	506,928
Change in litigation costs	435,840	-
Change in all other liabilities	1,375,503	718,955
Change in all other assets	(60,713)	14,471
Net cash provided by operating	6,102,595	4,825,724
Cash flows from investing activities:		
Purchases of property and equipment	(237,073)	(80,610)
Premium finance notes originated	(40,608,079)	(26,416,178)
Premium finance notes repaid	36,122,051	22,645,165
Change in restricted cash	(854,100)	(1,653,370)
Purchases of debt securities	(6,803,480)	(1,810,839)
Maturities and redemptions of investment securities	3,393,119	2,426,532
Purchase of short-term investments	(22,604,042)	(14,337,813)
Maturities of short-term investments	22,788,769	11,221,201
Net cash used in investing activities	(8,802,835)	(8,005,912)
Cash flows from financing activities:		
Proceeds from note payable	-	6,500,000
Net advances from lender	4,323,931	(238,263)
Repayment of borrowings	(579,298)	(4,071,754)
Issuance of common stock	250	-
Cash provided by financing activities	3,744,883	2,189,983
Increase (decrease) in cash and cash equivalents	1,044,643	(990,205)
Cash and cash equivalents at beginning of year	5,786,069	6,776,274
Cash and cash equivalents at end of year	$ 6,830,712	$ 5,786,069
Supplemental cash flow information:		
Interest paid	$ 1,107,374	$ 653,424
Income taxes paid	$ 428,877	$ 675,000

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

HALLMARK FINANCIAL SERVICES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Accounting Policies:

General

Hallmark Financial Services, Inc. ("HFS") and its subsidiaries (collectively, the "Company"), are engaged primarily in the marketing, underwriting and premium financing of non-standard automobile insurance, as well as claims adjusting and other insurance related services. The Company pursues its business activities through an integrated insurance group (collectively, the "Insurance Group"), the members of which are an authorized Texas property and casualty insurance company, American Hallmark Insurance Company of Texas ("Hallmark"); a managing general agency, American Hallmark General Agency, Inc.("AHGA"); a network of affiliated insurance agencies known as the American Hallmark Agencies ("Hallmark Agencies"); a premium finance company, Hallmark Finance Corporation ("HFC"); and a claims handling and adjusting firm, Hallmark Claims Service, Inc. ("HCS"). The Company operates only in Texas.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts and operations of HFS and its subsidiaries. Intercompany accounts and transactions have been eliminated.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America which, as to Hallmark, differ from statutory accounting practices prescribed or permitted for insurance companies by insurance regulatory authorities.

Investments

Debt securities are reported at amortized cost. The Company has the intent and ability to hold all investments in debt securities to maturity. Provisions for possible losses are recorded only on other-than-temporary declines in the value of an investment.

Equity securities available-for-sale are reported at market value. Unrealized gains and losses are recorded as a component of stockholder's equity.

Short-term investments are carried at cost which approximates market. Short-term investments include U.S. Government securities maturing within one year.

Realized investment gains and losses are recognized in operations on the specific identification method.

Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Recognition of Premium Revenues

Insurance premiums and policy fees are earned pro rata over the terms of the policies. Upon cancellation, any unearned premium and policy fee is refunded to the insurer. Insurance premiums written include gross policy fees of $5,744,493 and $4,718,289 and policy fees, net of reinsurance, of $3,695,031 and $4,741,428 for the years ended December 31, 2000 and 1999, respectively.

Finance Charges

The majority of Hallmark's annual insurance premiums are financed through the Company's premium finance program offered by its wholly-owned subsidiary, HFC. Finance charges on the premium finance notes are recorded as interest earned. This interest is earned on the Rule of 78's method which approximates the interest method for such short-term notes.

Property and Equipment

Property and equipment, aggregating $1,544,413 and $1,307,340, at December 31, 2000 and 1999, respectively, which is included in other assets, is recorded at cost and is depreciated using the straight-line method over the estimated useful lives of the assets (five to ten years). Depreciation expense for 2000 and 1999 was $147,278 and $156,781, respectively. Accumulated depreciation was $1,191,762 and $1,044,484 at December 31, 2000 and 1999, respectively.

Premiums Receivable from Lender

Premiums receivable from lender represents premiums due to HFC as a result of a secured financing agreement with an unaffiliated third party. (See Note 5.)

Premiums Receivable

The majority of the balance in premiums receivable is premiums due to Hallmark on unaffiliated MGA business assumed from Dorinco. (See Note 4.)

Deferred Policy Acquisition Costs

Policy acquisition costs (mainly commissions, 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. The method followed in computing deferred acquisition costs limits the amount of such deferred costs to their estimated realizable value. In determining estimated realizable value, the computation gives effect to the premium to be earned, related investment income, losses and loss expenses and certain other costs expected to be incurred as the 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 change in deferred ceding commission income is netted against the change in deferred policy acquisition costs.

Losses and Loss Adjustment Expenses

Losses and loss adjustment expenses represent the estimated ultimate net cost of all reported and unreported losses incurred through December 31, 2000 and 1999. The liabilities for unpaid losses and loss adjustment expenses are estimated using individual case-basis valuations and statistical analyses.

These estimates are subject to the effects of trends in loss severity and frequency. Although considerable variability is inherent in such estimates, management believes that the liabilities for unpaid losses and loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops

or new information becomes known; such adjustments are included in current operations. The liabilities for unpaid losses and loss adjustment expenses at December 31, 2000 and 1999 are reported net of recoverables for salvage and subrogation of approximately $300,000 and $180,000, respectively.

Reinsurance

Hallmark is routinely involved in reinsurance transactions with other companies. Reinsurance premiums, losses, and loss adjustment expenses are accounted for on bases consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. (See Note 4.)

Income Taxes

The Company files 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.

Net Income Per Share

The computation of net income per share is based upon the weighted average number of common shares outstanding during the period, plus (in periods in which they have a dilutive effect) the effect of common shares potentially issuable, primarily from stock options and exercise of warrants. (See Notes 6 and 8.)

Intangible Assets

When Hallmark, AHGA, HFC, and HCS were purchased by HFS, the excess cost over the fair value of the net assets acquired was recorded as goodwill and is being amortized on a straight-line basis over forty years. Other intangible assets consist of a trade name, a managing general agent's license, and non-compete arrangements all of which were fully amortized at December 31, 2000.

The Company continually reevaluates the propriety of the carrying amount of goodwill and other intangibles as well as the amortization period to determine whether current events and circumstances warrant adjustments to the carrying value and/or revised estimates of useful lives. At this time, the Company believes that no significant impairment of the goodwill has occurred and that no reduction of the estimated useful life is warranted.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date(s) of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Fair Value of Financial Instruments

Cash and Short-term Investments: The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Investment Securities: Fair values are obtained from an independent pricing service. (See Note 2.)

Premiums Receivable from Lender: The carrying amount reported in the balance sheet for this instrument approximates its fair value as the term of the receivable is less than one year.

Notes Payable: The carrying amounts reported in the balance sheet for these instruments approximate their fair values. (See Note 5.)

Stock-based Compensation

The Company recognizes its compensation expense for grants of stock, stock options, and other equity instruments in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB 25"). (See Note 8.)

Codification of Statutory Accounting Principles

In 1998 the National Association of Insurance commissioners (the "NAIC") adopted the Codification of Statutory Accounting Principles (the "Codification") guidance, which will replace the NAIC's primary guidance on statutory accounting. The Texas Department of Insurance adopted the Codification guidance, effective January 1, 2001. The Company has not estimated the potential effect of the Codification guidance.

Reclassification

Certain previously reported 1999 amounts have been reclassified to conform to current year presentation. Such reclassification had no effect on net income or stockholders' equity.

2. Investments:

Major categories of net investment income are summarized as follows:

	Years ended December 31,	
	2000	1999
Debt securities	$ 293,494	$ 199,629
Equity securities	8,961	8,170
Short-term investments	524,543	375,252
Cash equivalents	319,351	204,643
Other	125,149	2,730
	1,271,498	790,424
Investment expenses	(7,360)	(840)
Net investment income	$ 1,264,138	$ 789,584

No investment in any entity or its affiliates exceeded 10% of stockholders' equity at December 31, 2000 and 1999.

The amortization cost and estimated market value of investments in debt and equity securities by category is as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market
At December 31, 2000				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$6,420,988	$13,864	$ (10,452)	$6,424,400
Mortgage backed securities	822,385	4,348	(5,832)	820,901
Total debt securities	7,243,373	18,212	(16,284)	7,245,301
Equity securities	161,167	2,040	(17,905)	145,302
Total debt and equity securities	$7,404,540	$20,252	$ (34,189)	$7,390,603
At December 31, 1999				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$2,944,133	$19,527	$ (9,599)	$2,954,061
Mortgage backed securities	887,524	6,780	(38,303)	856,001
Total debt securities	3,831,657	26,307	(47,902)	3,810,062
Equity securities	164,459	-	(21,558)	142,901
Total debt and equity securities	$3,996,116	$26,307	$ (69,460)	$3,952,963

The amortized cost and estimated market value of debt securities at December 31, 2000, by contractual maturity, are as follows. Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalities.

Maturity:	Amortized Cost	Market Value
Due in one year or less	$ 2,358,865	$ 2,353,386
Due after one year through five years	3,944,275	3,946,647
Due after five years through ten years	117,848	124,367
Mortgage backed securities	822,385	820,901
	$ 7,243,373	$ 7,245,301

At December 31, 2000 and 1999, investments in debt securities, with a approximate carrying value of $100,000 were on deposit with the Texas

Department of Insurance (the "TDI") as required by insurance regulations.

Proceeds from investment securities of $3,393,119 and $2,426,532 during 2000 and 1999, respectively, were primarily from maturities, bond call and prepayments of mortgage-backed securities.

3. Liability for Unpaid Losses and Loss Adjustment Expenses:

Activity in the liability for unpaid losses and loss adjustment expense (in thousands) is summarized as follows:

	2000	1999
Balance at January 1	$ 17,804	$ 16,015
Less reinsurance recoverables	12,395	11,435
Net Balance at January 1	5,409	4,580
Incurred related to:		
Current year	14,460	9,330
Prior years	97	14
Total incurred	14,557	9,344
Paid related to:		
Current year	9,286	5,724
Prior years	3,229	2,791
Total paid	12,515	8,515
Net Balance at December 31	7,451	5,409
Plus reinsurance recoverables	14,847	12,395
Balance at December 31	$ 22,298	$ 17,804

4. Reinsurance:

Hallmark is involved in the assumption and cession of reinsurance from/to other companies. The Company remains obligated to its policyholders in the event that the reinsurers do not meet their obligations under the reinsurance agreements.

Effective March 1, 1992, Hallmark entered into a reinsurance arrangement with State & County Mutual Fire Insurance Company ("State & County"), an unaffiliated company, to assume 100% of the nonstandard auto business produced by AHGA and underwritten by State & County. The earned premiums assumed under this agreement in 2000 and 1999 were $41,577,697 and $30,859,991, respectively. Funds generated from business produced under this agreement are maintained in accounts for the benefit of State & County. At December 31, 2000 and 1999, Hallmark held for the benefit of State & County, cash and cash equivalents of $4,283,299 and $4,280,910, respectively, and investment securities at amortized cost of $8,441,189 and $7,831,540, respectively.

The arrangement is supplemented by a separate retrocession agreement effective July 1, 2000 between Hallmark and Dorinco Reinsurance Company ("Dorinco"), under which Hallmark currently retains 30% and cedes 70% of the risk to Dorinco. Prior to July 1, 2000, Hallmark retroceded 75% to its reinsurers (GE Reinsurance and Dorinco) under a separate retrocession agreement effective January 1,1999 through June 30, 2000.

Under the retrocession agreement with Dorinco effective July 1, 2000, Hallmark receives a provisional ceding commission of 41%. This provisional commission is adjusted annually on a sliding scale based on annual loss ratios. Based upon its loss experience, Hallmark can earn a maximum commission of 41% and is guaranteed a minimum commission of 31% regardless of loss experience on business reinsured by Dorinco. During 1999 and the first half of 2000, the guaranteed minimum commission rates were 29% and 26%, respectively. As of December 31, 2000 and 1999, the accrued ceding commission refund was $2,503,128 and $1,251,614, respectively. This accrual represents the difference between the ceding commission received and the ceding commission earned based on current loss ratios.

Hallmark assumes business from Dorinco on various unaffiliated MGA programs. Under these programs, HCS also provides claims processing, and AHGA provides premium processing. At December 31, 2000 and 1999, Dorinco held cash of $2,819,086 and $2,049,291, respectively, to secure balances ceded to Hallmark. These amounts were included in restricted cash in the accompanying Consolidated Balance Sheets.

During 2000, the Company commuted loss reserves under its previous reinsurance arrangement (effective March 1, 1992 through June 30, 1996) with Vesta Fire Insurance Corporation. The reserves were commuted at 100%. The Company commuted outstanding loss and LAE reserves of $506,932 as of the date of commutation.

5. Notes Payable:

A summary of the Company's notes

	December 31, 2000	December 31, 1999
Note payable to unaffiliated insurance	$ 2,447,331	$ 2,993,330
Balance under Financing Arrangement	10,585,668	6,261,737
Note payable to individual	-	33,299
	$13,032,999	$ 9,288,366

Scheduled annual principal payments on note payable to unaffiliated insurance company are as follows at December 31,

2001	727,999
2002	727,999
2003	727,999
2004	263,334
	$ 2,447,331

The balance under the Financing Arrangement will be repaid during the coming year as associated premium finance notes are repaid (See below).

Effective March 11, 1997, the Company entered into a loan agreement with Dorinco, whereby the Company borrowed $7,000,000 (the "Dorinco Loan") to contribute to HFC. Proceeds from this loan were used by HFC primarily to fund premium finance notes. The loan agreement provides for a seven-year term at a fixed interest rate of 8.25%. During the fourth quarter of 1999, the Company paid $4,006,670 on the principal, reducing the note balance to $2,993,330. During 2000, the Company paid $545,999 of principal reducing the note balance to $2,447,331.

As long as certain financial covenants defined as "triggering events" are maintained, collateral for the Dorinco Loan is limited to the stock of HFC and a covenant by the Company not to pledge the stock of Hallmark or AHGA. To avoid a triggering event, Hallmark must (1) maintain a combined ratio and loss ratio which do not exceed 107% and 83%, respectively, and (2) maintain statutory surplus of $4,200,000 and experience no decreases to surplus in any one year that exceeds 15% of the prior year surplus. If a triggering event should occur, the Company has ten days to pledge the stock of AHGA and Hallmark as additional collateral for the Dorinco Loan. Changes in the Company's reinsurance terms negatively impacted the Company's statutory loss ratio which was 84.7% for 2000. Dorinco waived the maximum loss ratio covenant for 2000. The loan agreement also contains covenants which require the Company to satisfy certain financial ratios which are less restrictive than the triggering event ratios and, among other things, restrict capital expenditures, payment of dividends, and incurrence of additional debt. For the years ended, December 31, 2000 and 1999, the Company was in compliance with the covenants of the loan with the exception of the loss ratio covenant as explained above.

Effective November 18, 1999, HFC entered into a secured financing arrangement (the "Financing Arrangement") and a servicing agreement with an unaffiliated third party in order to fund HFC's premium finance activities. The Financing Arrangement provides that HFC sell to the third party all eligible premium finance notes generated by HFC in connection with the financing of insurance policies. Though structured as a sale, the transaction is accounted for as a secured financing transaction as it does not meet the requirements for application of SFAS 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Under the Financing Arrangement, HFC may from time to time specify the amount to be advanced by the third party and secured by the premium finance notes (up to maximum of 90% of the face amount of the premium finance notes). Collections on the premium finance notes are remitted to HFC to the extent they exceed the sum of (a) the aggregate amount of all prior advances, (b) interest on the aggregate advance balance from time to time outstanding, and (c) certain other fees and expenses payable to the third party. The interest payable under the Financing Arrangement is at the prime rate plus a spread ranging from one-half percent to one percent depending on the unpaid balance of the advances. As of December 31, 2000 and 1999, HFC had an outstanding balance on advances under the Financing Arrangement of $10,585,668 and $6,261,737, respectively, and the applicable interest rates were 10% and 9.5%, respectively. Under the Financing Arrangement, the maximum advances available to HFC were $0.6 million and $1.5 million at December 31, 2000 and 1999, respectively.

6. Earnings per Share:

The Company has adopted the provisions of SFAS No. 128, Earnings Per Share, requiring presentation of both basic and diluted earnings per share. A reconciliation of the numerators and denominators of the basic and diluted per-share computations as required by SFAS No. 128 is presented below:

	Income (Numerator)	Shares (Denominator)	Per-Share Amount
For the year ended December 31, 2000:			
Basic Earnings per Share			
Income available to common stockholders:			
Net loss	($233,370)	11,049,133	$ (.02)
Effect of Dilutive Securities:			
Options and warrants	-	-	-
Diluted Earnings per Share			
Income available to common stockholders + assumed conversions:			
Net loss	($233,370)	11,049,133	$ (.02)
For the year ended December 31, 1999:			
Basic Earnings per Share			
Income available to common stockholders:			
Net income	$787,310	11,048,133	$ .07
Effect of Dilutive Securities:			
Options and warrants	-	-	-
Diluted Earnings per Share			
Income available to common stockholders + assumed conversions:			
Net income	$787,310	11,048,133	$ .07

7. Regulatory Capital Restrictions:

Hallmark's 2000 and 1999 net income and stockholders' equity (capital and surplus), as determined in accordance with statutory accounting practices, were $138,959 and $357,451, and $6,390,374 and $6,013,143, respectively. The minimum statutory capital and surplus required for Hallmark by the TDI is $2,000,000. Texas state law limits the payment of dividends to stockholders by property and casualty insurance companies. The maximum dividend that may be paid without prior approval of the Commissioner of Insurance is limited to the greater of 10% of statutory surplus as regards policyholders as of the preceding calendar year end or the statutory net income of the preceding calendar year. No dividends were declared or paid by Hallmark in 2000 or 1999.

Effective December 31, 1994, the NAIC requested property/casualty insurers to file a risk-based capital ("RBC") calculation according to

a specified formula. The purpose of the NAIC-designed 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 (the "Model Act") by providing thresholds at which a state commissioner is authorized and expected to take regulatory action. The TDI adopted the Model Act during 1998. The Company's 2000 and 1999 adjusted capital under the RBC calculation exceeded the minimum TDI requirement by 79% and 67%, respectively.

8. Stock Option Plans:

The Company has two stock option plans for key employees, the 1991 Key Employee Stock Option Plan and the 1994 Key Employee Long Term Incentive Plan, and a non-qualified plan for non-employee directors. The number of shares reserved for future issuance under the 1991 employee plan, the 1994 employee plan and the non-employee director plan is 500,000, 1,500,000 and 1,350,000, respectively. The option prices under the plans are not to be less than the closing price of the common stock on the day preceding the grant date. Pursuant to the stock option plans, the Company has granted incentive stock options under Section 422 of the Internal Revenue Code of 1986. The stock options granted to employees vest over a 3 year period on a graded schedule, 40% in the first 6 months and 20% on each anniversary date of the grant date. The stock options granted to the directors vest over a 6 year period on a graded schedule, 40% in the first 6 months and 10% on each anniversary date of the grant date. In accordance with APB 25, the Company has not recognized compensation expense for the stock options granted in 2000.

Pursuant to SFAS No. 123, Accounting for Stock-based Compensation, a company may elect to continue expense recognition under APB 25, or to recognize compensation expense for grants of stock, stock options, and other equity instruments to employees based on fair value methodology outlined in SFAS No. 123. The Company has elected to continue expense recognition pursuant to APB 25.

A summary of the status of the Company's stock options as of December 31, 2000 and December 31, 1999 and the changes during the years ended on those dates is presented below:

	2000		1999	
	Number of Shares of Underlying Options and Warrants	Weighted Average Exercise Prices	Number of Shares of Underlying Options and Warrants	Weighted Average Exercise Prices
Outstanding at beginning of the year	1,275,000	$ .468	1,840,000	$ .525
Exercised	(1,000)	$ .250	-	$ -
Granted	1,157,500	$ .429	-	$ -
Forfeited	-	$ -	(63,000)	$ .988
Expired	-	$ -	(502,000)	$ .558

Outstanding at end of year	2,431,500	$ .468	1,275,000	$ .504
Exercisable at end of year	1,774,500	$ .467	1,132,100	$ .468

	2000	1999
Weighted average fair value of all options granted	$ 0.22	$ -

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	2000	1999
Expected Term	5.00	-
Expected Volatility	51.48%	-
Expected Dividend Yield	0.00%	-
Risk-Free Interest Rate	6.37%	-

The following table summarizes information about stock options outstanding at December 31, 200

	Options Outstanding			Options Exer	
Range of Exercise Prices	Outstanding at 12/31/00	Weighted Avg. Remaining Contr. Actual Life	Weighted Avg. Exercise Price	Exercisable at 12/31/99	Wei Exe
$ .25 to $ .70	2,280,500	6.56	$ .43	1,653,500	
$ .71 to $ 1.00	151,000	5.03	$ 1.00	121,000	
$ .25 to $ 1.00	2,431,500	6.47	$ .47	1,774,500	

The pro forma effects on net income and earnings per share for 2000 and 1999 from compensation expense computed pursuant to SFAS No. 123 is as follows:

	December 31, 2000		December 31, 1999	
	As Reported	Pro Forma	As Reported	Pro Forma
SFAS No. 123 charge	$ -	$ 187,557	$ -	$ 14,044
Net income (loss)	$ (233,370)	$(357,158)	$ 787,310	$ 778,041
Net income (loss)	$ (.02)	$ (.03)	$ .07	$ .07

The effects of applying SFAS No. 123 in this pro forma disclosure are not indicative of future amounts. SFAS No. 123 does not apply to awards prior to 1995, and the Company anticipates making awards in the future under its stock-based compensation plan.

9. Income Taxes:

The composition of deferred tax assets and liabilities and the related tax effects as of December 31, 2000 and 1999, are as follows:

	2000	1999
Deferred tax liabilities:		
Deferred policy acquisition costs	($ 1,314,791)	($ 931,966)
Other	(41,972)	(121,781)
Total deferred tax liabilities	(1,356,763)	(1,053,747)
Deferred tax assets:		
Unearned premiums	392,133	278,020
Loss reserve discounting, net of salvage and subrogation	216,310	175,934
Deferred ceding commissions	1,191,843	728,313
Unrealized gains (losses) on securities	3,560	4,857
Net operating loss carry forward	33,171	33,171
Other	125,028	78,681
Total deferred tax assets	1,962,045	1,298,976
Net deferred tax asset	605,282	245,229
Valuation allowance	33,170	33,170
Net deferred tax asset	$ 572,112	$ 212,059

A valuation allowance is provided against the Company's deferred tax asset to the extent that management does not believe it is more likely than not that future taxable income will be adequate to realize these future tax benefits. This allowance was $33,170 in 2000 and 1999.

A reconciliation of the income tax provisions based on the prevailing corporate tax rate of 34 percent to the provision reflected in the consolidated financial statements for the years ended December 31, 2000 and 1999, is as follows:

	2000	1999
Computed expected income tax expense (benefit) at statutory regulatory tax rate	($ 88,983)	$ 437,644
Amortization of excess cost over net assets acquired	53,597	53,385
Meals and entertainment	2,807	2,243
Adjustment to prior year's deferred taxes	-	(5,235)
Other	4,235	11,841
Income tax expense (benefit)	($ 28,344)	$ 499,878

The Company has available, for federal income tax purposes, unused net operating losses of $97,562 at December 31, 2000, which may be used to offset future taxable income. The net operating losses will expire, if unused, as follows:

Year	
2002	$ 1,325

2003	96,237
	$ 97,562

10. Commitments and Contingencies:

The Company has several leases, primarily for office facilities and computer equipment, which expire in various years through 2007. Certain of these leases contain renewal options. Rental expense amounted to $570,923 and to $595,572 for the years ended December 31, 2000 and 1999, respectively.

Future minimum lease payments under noncancelable operating leases as of December 31, 2000 are as follows:

Year	
2001	$ 598,724
2002	573,154
2003	530,942
2004	600,895
2005	600,895
2006 and thereafter	1,151,715
Total minimum lease payments	$ 4,056,325

The Company has a 401(K) savings plan. Employees who have completed three months of service are eligible to participate. Under this plan employees may contribute a portion of their compensation, and the Company may contribute a discretionary amount each year. The Company's contribution for 2000 to be paid in 2001 was $80,000 and for 1999 was $84,000.

In March 1997, a jury returned a verdict against the Company and in favor of a former director and officer of Hallmark in the amount of approximately $517,000 on the basis of contractual and statutory indemnification claims. The court subsequently granted the plaintiff's motion for attorneys' fees of approximately $271,000, court costs of approximately $39,000 and pre-judgment and post-judgment interest, and rendered final judgment on the verdict. The Company believed the outcome in this case was both legally and factually incorrect and appealed the judgment. During the fourth quarter of 1997, the Company deposited $1,248,758 into the registry of the court in order to stay execution on the judgment pending the result of appeals. The amount on deposit with the court of $1,457,311 as of December 31, 2000 has been included as restricted cash in the accompanying balance sheet. During February 2001, the court ruled against the Company in its appeal. In anticipation of the verdict, the Company accrued an additional amount of $435,840 at December 31, 2000 which primarily represents additional post-judgment interest and legal fees associated with the appeal. This judgment will be paid out of the restricted funds (which includes accrued interest) that have been on deposit with the court and earning interest since 1997.

The Company is involved in various other claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's financial position or results of operations.

From time to time, assessments are levied on the Company by the guaranty association of the State of Texas. Such assessments are made primarily to cover the losses of policyholders of insolvent or rehabilitated insurers. These assessments can be partially recovered

through a reduction in future premium taxes. There were no assessments for 2000 and 1999.

11. Concentrations of Credit Risk:

The Company maintains cash equivalents in accounts with two financial institutions in excess of the amount insured by the Federal Deposit Insurance Corporation. The Company monitors the financial stability of the depository institutions regularly, and management does not believe excessive risk of depository institution failure exists at December 31, 2000.

All of the Company's business activity is with customers and independent agents located within the State of Texas.