HALLMARK FINANCIAL SERVICES INC
Form 10-Q
November 07, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

Securities Exchange Act of 1934

For the quarterly period ended September 30, 2016

Commission file number 001-11252

Hallmark Financial Services, Inc.

(Exact name of registrant as specified in its charter)

Nevada	87-0447375
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)

777 Main Street, Suite 1000, Fort Worth, Texas	76102
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (817) 348-1600

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, par value $.18 per share – 18,611,982 shares outstanding as of November 7, 2016.

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

INDEX TO FINANCIAL STATEMENTS

Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Balance Sheets

($ in thousands, except par value)

	September 30, 2016 (unaudited)	December 31, 2015
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value (cost: $597,890 in 2016 and $538,629 in 2015)	$600,791	$531,325
Equity securities, available-for-sale, at fair value (cost: $30,309 in 2016 and $24,951 in 2015)	48,836	47,504
Total investments	649,627	578,829
Cash and cash equivalents	69,921	114,446
Restricted cash	11,156	8,522
Ceded unearned premiums	81,256	65,094
Premiums receivable	95,497	83,376
Accounts receivable	2,133	2,005
Receivable for securities	685	10,424
Reinsurance recoverable	133,479	114,287
Deferred policy acquisition costs	20,701	20,366
Goodwill	44,695	44,695
Intangible assets, net	13,108	14,959
Deferred federal income taxes, net	972	3,360
Federal income tax recoverable	-	1,779
Prepaid expenses	1,948	3,213
Other assets	13,905	10,192
Total assets	$1,139,083	$1,075,547
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Revolving credit facility payable	$30,000	$30,000
Subordinated debt securities (less unamortized debt issuance cost of $1,014 in 2016 and $1,053 in 2015)	55,688	55,649
Reserves for unpaid losses and loss adjustment expenses	455,000	450,878
Unearned premiums	248,304	216,407
Reinsurance balances payable	49,803	33,741
Pension liability	1,987	2,496
Payable for securities	3,955	1,097

Federal income tax payable	1,001	-
Accounts payable and other accrued expenses	22,407	23,253
Total liabilities	$868,145	$813,521
Commitments and Contingencies (Note 17)		
Stockholders' equity:		
Common stock, $.18 par value, authorized 33,333,333; issued 20,872,831 shares in 2016 and 2015	3,757	3,757
Additional paid-in capital	123,263	123,480
Retained earnings	151,689	141,501
Accumulated other comprehensive income	11,489	7,418
Treasury stock (2,229,441 shares in 2016 and 1,775,512 in 2015), at cost	(19,260)	(14,130)
Total stockholders' equity	270,938	262,026
	$1,139,083	$1,075,547

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

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Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

($ in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Gross premiums written	$147,065	$132,141	$419,549	$390,708
Ceded premiums written	(51,380)	(42,217)	(140,995)	(116,105)
Net premiums written	95,685	89,924	278,554	274,603
Change in unearned premiums	(4,890)	(1,518)	(15,734)	(11,025)
Net premiums earned	90,795	88,406	262,820	263,578
Investment income, net of expenses	4,070	3,495	11,943	10,051
Net realized gains (losses)	1,105	(335)	(1,299)	3,688
Finance charges	1,036	1,619	3,825	4,400
Commission and fees	546	60	1,278	(41)
Other income	66	439	131	655
Total revenues	97,618	93,684	278,698	282,331
Losses and loss adjustment expenses	62,337	56,005	176,234	171,820
Other operating expenses	26,344	26,458	82,563	78,818
Interest expense	1,144	769	3,398	3,043
Amortization of intangible assets	617	617	1,851	1,851
Total expenses	90,442	83,849	264,046	255,532
Income before tax	7,176	9,835	14,652	26,799
Income tax expense	2,128	3,137	4,464	8,382
Net income	5,048	6,698	10,188	18,417
Net income per share:				
Basic	$0.27	$0.35	$0.54	$0.96
Diluted	$0.27	$0.35	$0.54	$0.95

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

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Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(Unaudited)

($ in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$5,048	$6,698	$10,188	$18,417
Other comprehensive income (loss):				
Change in net actuarial gain	28	26	85	78
Tax effect on change in net actuarial gain	(10)	(9)	(30)	(27)
Unrealized holding gains (losses) arising during the period	2,039	(10,821)	7,767	(7,858)
Tax effect on unrealized holding gains (losses) arising during the period	(714)	3,787	(2,718)	2,750
Reclassification adjustment for gains included in net income	(1,105)	(28)	(1,589)	(5,881)
Tax effect on reclassification adjustment for gains included in net income	387	10	556	2,058
Other comprehensive income (loss), net of tax	625	(7,035)	4,071	(8,880)
Comprehensive income (loss)	$5,673	$(337)	$14,259	$9,537

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

Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Stockholders' Equity

(Unaudited)

($ in thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Common Stock				
Balance, beginning of period	$3,757	$3,757	$3,757	$3,757
Balance, end of period	3,757	3,757	3,757	3,757
Additional Paid-In Capital				
Balance, beginning of period	123,650	123,618	123,480	123,194
Equity based compensation	(249)	(11)	(21)	526
Shares issued under employee benefit plans	(138)	(1)	(196)	(114)
Balance, end of period	123,263	123,606	123,263	123,606
Retained Earnings				
Balance, beginning of period	146,641	131,357	141,501	119,638
Net income	5,048	6,698	10,188	18,417
Balance, end of period	151,689	138,055	151,689	138,055
Accumulated Other Comprehensive Income				
Balance, beginning of period	10,864	15,956	7,418	17,801
Additional minimum pension liability, net of tax	18	17	55	51
Unrealized holding gains (losses) arising during period, net of tax	1,325	(7,034)	5,049	(5,108)
Reclassification adjustment for gains included in net income, net of tax	(718)	(18)	(1,033)	(3,823)
Balance, end of period	11,489	8,921	11,489	8,921
Treasury Stock				
Balance, beginning of period	(18,817)	(12,376)	(14,130)	(12,353)
Acquisition of treasury stock	(1,047)	(1,180)	(5,792)	(1,910)
Shares issued under employee benefit plans	604	9	662	716
Balance, end of period	(19,260)	(13,547)	(19,260)	(13,547)
Total Stockholders' Equity	$270,938	$260,792	$270,938	$260,792

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

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Hallmark Financial Services, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

($ in thousands)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	$ 10,188	$ 18,417
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	2,927	2,346
Deferred federal income taxes	196	(1,311)
Net realized losses (gains)	1,299	(3,688)
Share-based payment compensation	(21)	526
Change in ceded unearned premiums	(16,162)	(10,739)
Change in premiums receivable	(12,121)	(15,874)
Change in accounts receivable	(128)	900
Change in deferred policy acquisition costs	(335)	(364)
Change in unpaid losses and loss adjustment expenses	4,122	36,248
Change in unearned premiums	31,897	21,764
Change in reinsurance recoverable	(19,192)	(6,623)
Change in reinsurance balances payable	16,062	6,429
Change in current federal income tax payable (recoverable)	2,780	(446)
Change in all other liabilities	468	(3,561)
Change in all other assets	3,552	(923)
Net cash provided by operating activities	25,532	43,101
Cash flows from investing activities:		
Purchases of property and equipment	(3,658)	(2,569)
Net transfers into restricted cash	(2,634)	(6,611)
Purchases of investment securities	(167,062)	(167,677)
Maturities, sales and redemptions of investment securities	110,407	98,344
Net cash used in investing activities	(62,947)	(78,513)
Cash flows from financing activities:		
Payment of contingent consideration	(1,784)	(1,216)
Proceeds from exercise of employee stock options	466	602
Purchase of treasury shares	(5,792)	(1,910)

Net cash used in financing activities	(7,110)	(2,524)
Decrease in cash and cash equivalents	(44,525)	(37,936)
Cash and cash equivalents at beginning of period	114,446	130,985
Cash and cash equivalents at end of period	$69,921	$93,049
Supplemental cash flow information:		
Interest paid	$3,143	$3,043
Income taxes paid	$1,488	$10,139
Supplemental schedule of non-cash investing activities:		
Change in receivable for securities related to investment disposals that settled after the balance sheet date	$9,739	$1,422
Change in payable for securities related to investment purchases that settled after the balance sheet date	$2,858	$(2,948)

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

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Hallmark Financial Services, Inc. and Subsidiaries

Notes to Consolidated Financial Statements (Unaudited)

1. General

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

We pursue our business activities primarily through subsidiaries whose operations are organized into product-specific operating units that are supported by our insurance company subsidiaries. Our MGA Commercial Products operating unit offers commercial insurance products and services in the excess and surplus lines market. Our Specialty Commercial operating unit offers general aviation and satellite launch insurance products and services, low and middle market commercial umbrella and primary/excess liability insurance, medical professional liability insurance products and services, and primary/excess commercial property coverages for both catastrophe and non-catastrophe exposures. Our Standard Commercial P&C operating unit offers industry-specific commercial insurance products and services in the standard market. Our Workers Compensation operating unit specializes in small and middle market workers compensation business. Effective July 1, 2015, this operating unit no longer markets or retains any risk on new or renewal policies. Our Specialty Personal Lines operating unit offers non-standard personal automobile and renters insurance products and services. Our insurance company subsidiaries supporting these operating units are American Hallmark Insurance Company of Texas ("AHIC"), Hallmark Insurance Company ("HIC"), Hallmark Specialty Insurance Company ("HSIC"), Hallmark County Mutual Insurance Company, Hallmark National Insurance Company and Texas Builders Insurance Company.

These operating units are segregated into three reportable industry segments for financial accounting purposes. The Specialty Commercial Segment includes our MGA Commercial Products operating unit and our Specialty Commercial operating unit. The Standard Commercial Segment includes our Standard Commercial P&C operating unit and our Workers Compensation operating unit. The Personal Segment consists solely of our Specialty Personal Lines operating unit.

2. Basis of Presentation

Our unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and include our accounts and the accounts of our subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial reporting. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2015 included in our Annual Report on Form 10-K filed with the SEC.

The interim financial data as of September 30, 2016 and 2015 is unaudited. However, in the opinion of management, the interim data includes all adjustments, consisting of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results of operations for the period ended September 30, 2016 are not necessarily indicative of the operating results to be expected for the full year.

Business Combinations

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

Income Taxes

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

Use of Estimates in the Preparation of the Financial Statements

Our preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect our reported amounts of assets and liabilities and our disclosure of contingent assets and liabilities at the date of our consolidated financial statements, as well as our reported amounts of revenues and expenses during the reporting period. Refer to "Critical Accounting Estimates and Judgments" under Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2015 for information on accounting policies that we consider critical in preparing our consolidated financial statements. Actual results could differ materially from those estimates.

Fair Value of Financial Instruments

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

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

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

Revolving Credit Facility Payable: A revolving credit facility with Frost Bank had a carried value of $30.0 million and a fair value of $30.2 million as of September 30, 2016. The fair value is based on discounted cash flows using a discount rate derived from LIBOR spot rates plus a market spread resulting in discount rates ranging between 3.3% to 3.7% for each future payment date. This revolving credit facility would be included in Level 3 of the fair value hierarchy if it was reported at fair value.

Subordinated Debt Securities: Our trust preferred securities have a carried value of $55.7 million and a fair value of $39.7 million as of September 30, 2016. The fair value of our trust preferred securities is based on discounted cash flows using a current yield to maturity of 8.0%, which is based on similar issues to discount future cash flows. Our trust preferred securities would be included in Level 3 of the fair value hierarchy if they were reported at fair value.

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

Variable Interest Entities

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

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

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

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

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued guidance which revises the criteria for revenue recognition. Insurance contracts are excluded from the scope of the new guidance. Under the guidance, the transaction price is attributed to underlying performance obligations in the contract and revenue is recognized as the entity satisfies the performance obligations and transfers control of a good or service to the customer. Incremental costs of obtaining a contract may be capitalized to the extent the entity expects to recover those costs. The guidance is effective for reporting periods beginning after December 15, 2017 and is to be applied retrospectively. We are in the process of evaluating the impact of adoption, which is not expected to be material to our results of operations or financial position.

In February 2015, the FASB issued ASU 2015-02, "Amendments to the Consolidation Analysis" (Topic 810). ASU 2015-02 changes the analysis that a reporting entity must perform to determine whether entities should be consolidated if they are deemed variable interest entities. It is effective for annual reporting periods, and interim periods within those years, beginning after December 15, 2015. We have adopted this standard as of the effective date, and the adoption did not impact our financial statements.

In May 2015, the FASB issued guidance which requires additional disclosures about short-duration contracts for products in effect for typically a year or less. The disclosures will focus on the liability for unpaid claims and claim adjustment expenses. This guidance is effective for annual periods beginning after December 15, 2015 and interim periods within annual periods beginning after December 15, 2016. We are in the process of evaluating the impact of the adoption, which is not expected to be material to our results of operations or financial position.

In April 2015, the FASB issued ASU 2015-03, “Simplifying the Presentation of Debt Issuance Costs,” which amends the guidance in Accounting Standards Codification Topic 835-30 “Interest-Imputation of Interest.” ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. For public business entities, the guidance was effective for annual and interim periods beginning after December 15, 2015. We adopted this guidance effective January 1, 2016 and adjusted our prior period balances to reflect the adoption of this guidance.

3. Acquisitions, Dispositions and Business Combinations

During the third quarter of 2015 we paid $1.2 million to the sellers of the subsidiaries comprising our Workers Compensation operating unit pursuant to the terms of the acquisition agreement. The sellers disputed the calculation of the amount paid and, pursuant to the terms of the acquisition agreement, an independent actuary was engaged to resolve this matter. In accordance with the report of the independent actuary, we accrued during the second quarter of 2016 and paid during the third quarter of 2016 an additional $1.8 million to the sellers.

On June 30, 2015, Redpoint Comp Holdings LLC (“Purchaser”) acquired exclusive renewal rights to our current in-force Texas workers compensation policies, together with certain physical assets associated with the administration of such in-force policies. In consideration for such renewal rights and physical assets, Purchaser assumed certain office lease obligations and offered employment to certain of our employees associated with the Workers Compensation operating unit. Purchaser also agreed to administer the run-off of all of our current workers compensation policies and claims for a period of three years. In connection with the transaction, we made a one-time payment to the Purchaser of $83,000. We also agreed not to compete in the workers compensation line of insurance in the State of Texas (with certain exceptions) until after the assumed office lease obligations expire on October 31, 2017. We recorded a gain of $0.2 million during the second quarter of 2015 in connection with the transaction.

On September 15, 2015, we executed Amendment No. 1 to the sale agreement with the Purchaser. Pursuant to the Amendment, the Purchaser agreed to pay us $115,000 and administer the run-off of all of our workers compensation policies and claims in perpetuity or through final conclusion (rather than for three years as contemplated by the original agreement) in consideration of us assigning to Purchaser the commission on all unearned premiums on such policies as of July 1, 2015. We recorded an additional gain of $0.4 million during the third quarter of 2015 as a result of this Amendment No.1.

4. Fair Value

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

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

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

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

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

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

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

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

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

The following table presents for each of the fair value hierarchy levels, our assets that are measured at fair value on a recurring basis at September 30, 2016 and December 31, 2015 (in thousands):

	As of September 30, 2016			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	$ -	$ 72,072	$ -	$ 72,072
Corporate bonds	-	207,701	-	207,701
Collateralized corporate bank loans	-	86,435	-	86,435
Municipal bonds	-	161,258	8,222	169,480
Mortgage-backed	-	65,103	-	65,103
Total debt securities	-	592,569	8,222	600,791
Total equity securities	48,571	-	265	48,836
Total debt and equity securities	$ 48,571	$ 592,569	$ 8,487	$ 649,627

	As of December 31, 2015			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	Total
U.S. Treasury securities and obligations of U.S. Government	$ -	$ 76,269	$ -	$ 76,269
Corporate bonds	-	121,709	-	121,709
Collateralized corporate bank loans	-	81,596	-	81,596
Municipal bonds	-	178,281	14,087	192,368
Mortgage-backed	-	59,383	-	59,383
Total debt securities	-	517,238	14,087	531,325

Total equity securities	47,504	-	-	47,504
Total debt and equity securities	$47,504	$ 517,238	$ 14,087	$578,829

Due to significant unobservable inputs into the valuation model for certain municipal bonds in illiquid markets, as of September 30, 2016 and December 31, 2015, and one equity security as of September 30, 2016, we classified these investments as Level 3 in the fair value hierarchy. We used an income approach in order to derive an estimated fair value of the municipal bonds classified as Level 3, which included inputs such as expected holding period, benchmark swap rate, benchmark discount rate and a discount rate premium for illiquidity. Changes in the unobservable inputs in the fair value measurement of these municipal bonds or equity security could result in a significant change in the fair value measurement.

The following table summarizes the changes in fair value for all financial assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2016 and 2015 (in thousands):

Beginning balance as of January 1, 2016	$14,087
Sales	-
Settlements	(6,025)
Purchases	-
Issuances	-
Total realized/unrealized gains included in net income	-
Net gains included in other comprehensive income	160
Transfers into Level 3	265
Transfers out of Level 3	-
Ending balance as of September 30, 2016	$8,487
Beginning balance as of January 1, 2015	$14,598
Sales	-
Settlements	(370)
Purchases	-
Issuances	-
Total realized/unrealized gains included in net income	-
Net losses included in other comprehensive income	(380)
Transfers into Level 3	-
Transfers out of Level 3	