

NATIONAL SECURITY GROUP INC

Form 10-Q

August 11, 2017

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For Quarterly Period Ended June 30, 2017

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____.

Commission File Number 0-18649

The National Security Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware 63-1020300
(State or Other Jurisdiction of (IRS Employer
Incorporation or Organization) Identification No.)

661 East Davis Street 36323
Elba, Alabama
(Address of principal executive offices) (Zip-Code)

Registrant's Telephone Number including Area Code (334) 897-2273

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 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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in rule 12b-2 of the Act). (Check One) : Large accelerated filer Accelerated filer 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

As of August 11, 2017, there were 2,522,312 shares, \$1.00 par value, of the registrant's common stock outstanding.

1

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

	Page No.
Item 1. Financial Statements	
Condensed Consolidated Balance Sheets	<u>4</u>
Condensed Consolidated Statements of Operations	<u>5</u>
Condensed Consolidated Statements of Comprehensive Income (Loss)	<u>6</u>
Condensed Consolidated Statements of Changes in Shareholders' Equity	<u>7</u>
Condensed Consolidated Statements of Cash Flows	<u>8</u>
Notes to Condensed Consolidated Financial Statements	<u>9</u>
Review Report of Independent Registered Public Accounting Firm	<u>31</u>
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>32</u>
Item 3. Quantitative and Qualitative Disclosures about Market Risk	<u>46</u>
Item 4. Controls and Procedures	<u>47</u>

PART II. OTHER INFORMATION

Item 1. Legal Proceedings	<u>47</u>
Item 1A. Risk Factors	<u>47</u>
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	<u>47</u>
Item 3. Defaults Upon Senior Securities	<u>47</u>
Item 4. Mine Safety Disclosures	<u>47</u>
Item 5. Other Information	<u>47</u>
Item 6. Exhibits	<u>48</u>
SIGNATURE	<u>49</u>

Table of Contents

Cautionary Statement Regarding Forward-Looking Statements

Any statement contained in this report which is not a historical fact, or which might otherwise be considered an opinion or projection concerning the Company or its business, whether expressed or implied, is meant as and should be considered a forward-looking statement as that term is defined in the Private Securities Litigation Reform Act of 1995. The following report contains forward-looking statements that are not strictly historical and that involve risks and uncertainties. Such statements include any statements containing the words “expect,” “plan,” “estimate,” “anticipate” or other words of a similar nature. Management cautions investors about forward-looking statements. Forward-looking statements involve certain evaluation criteria, such as risks, uncertainties, estimates, and/or assumptions made by individuals informed of the Company and industries in which we operate. Any variation in the preceding evaluation criteria could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These risks and uncertainties include, without limitation, the following:

The insurance industry is highly competitive and the Company encounters significant competition in all lines of business from other insurance companies. Many of the competing companies have more abundant financial resources than the Company.

Insurance is a highly regulated industry. It is possible that legislation may be enacted which would have an adverse effect on the Company's business.

The Company is subject to regulation by state governments for each of the states in which it conducts business.

The Company cannot predict the subject of any future regulatory initiative(s) or its (their) impact on the Company's business. Company insurance rates are also subject to approval by state insurance departments in each of these states. We are often limited in the level of rate increases we can obtain.

The Company is rated by various insurance rating agencies. If a rating is downgraded from its current level by one of these agencies, sales of the Company's products and stock price could be adversely impacted.

The Company's financial results are adversely affected by increases in policy claims received by the Company. While a manageable risk, this fluctuation is often unpredictable.

The Company's investments are subject to a variety of risks. Investments are subject to defaults and changes in market value. Market value can be affected by changes in interest rates, market performance and the economy.

The Company mitigates risk associated with life policies through implementing effective underwriting and reinsurance strategies. These factors mitigate, not eliminate, risk related to mortality and morbidity exposure. The Company has established reserves for claims and future policy benefits based on amounts determined by independent actuaries. There is no assurance that these estimated reserves will prove to be sufficient or that the Company will not incur claims exceeding reserves, which could result in operating losses and loss of capital.

The Company mitigates risk associated with property and casualty policies through implementing effective underwriting and reinsurance strategies. The Company obtains reinsurance which increases underwriting capacity and limits the risk associated with policy claims. The Company is subject to credit risk with regard to reinsurers as reinsurance does not alleviate the Company's liability to its insured's for the ceded risks. The Company utilizes a third-party to develop a reinsurance treaty with reinsurers who are reliable and financially stable. However, there is no guarantee that booked reinsurance recoverable will actually be recovered. A reinsurer's insolvency or inability to make payments due could have a material adverse impact on the financial condition of the Company.

The Company's ability to continue to pay dividends to shareholders is contingent upon profitability and capital adequacy of the insurance subsidiaries. The insurance subsidiaries operate under regulatory restrictions that could limit the ability to fund future dividend payments of the Company. An adverse event or series of events could materially impact the ability of the insurance subsidiaries to fund future dividends, and consequently, the Board of Directors would have to suspend the declaration of dividends to shareholders.

The Company is subject to the risk of adverse settlements or judgments resulting from litigation of contested claims. It is difficult to predict or quantify the expected results of litigation because the outcome depends on decisions of the court and jury that are based on facts and legal arguments presented at the trial.

Table of Contents

PART I. Financial Information

Item 1. Financial Statements

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

	June 30, 2017	December 31, 2016
	(UNAUDITED)	
ASSETS		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2017 - \$1,789; 2016 - \$1,930)	\$ 1,741	\$ 1,890
Fixed maturities available-for-sale, at estimated fair value (cost: 2017 - \$91,466; 2016 - \$92,837)	92,649	92,792
Equity securities available-for-sale, at estimated fair value (cost: 2017 - \$2,044; 2016 - \$2,343)	4,699	4,943
Trading securities	107	107
Receivable for securities sold	—	499
Mortgage loans on real estate, at cost	164	174
Investment real estate, at book value	3,221	3,221
Policy loans	1,747	1,708
Company owned life insurance	4,920	4,864
Other invested assets	2,790	2,958
Total Investments	112,038	113,156
Cash and cash equivalents	8,005	7,368
Accrued investment income	733	776
Policy receivables and agents' balances, net	13,032	11,434
Reinsurance recoverable	506	1,780
Deferred policy acquisition costs	8,518	8,351
Property and equipment, net	1,852	1,880
Accrued income tax recoverable	1,839	941
Deferred income tax asset, net	2,145	2,402
Other assets	934	491
Total Assets	\$ 149,602	\$ 148,579
LIABILITIES AND SHAREHOLDERS' EQUITY		
Property and casualty benefit and loss reserves	\$ 7,603	\$ 7,531
Accident and health benefit and loss reserves	3,385	3,405
Life and annuity benefit and loss reserves	32,945	32,633
Unearned premiums	32,474	29,968
Policy and contract claims	833	1,008
Other policyholder funds	1,669	1,629
Short-term notes payable and current portion of long-term debt	1,300	1,800
Long-term debt	15,332	15,326
Other liabilities	6,544	7,227
Total Liabilities	102,085	100,527
Contingencies		
Shareholders' equity		
Common stock	2,522	2,517
Additional paid-in capital	5,483	5,412

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Accumulated other comprehensive income	1,963	1,007
Retained earnings	37,549	39,116
Total Shareholders' Equity	47,517	48,052
Total Liabilities and Shareholders' Equity	\$ 149,602	\$ 148,579

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In thousands, except per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
REVENUES				
Net premiums earned	\$15,331	\$15,227	\$30,371	\$30,392
Net investment income	930	1,029	1,856	2,020
Net realized investment gains	77	242	237	249
Other income	145	150	297	304
Total Revenues	16,483	16,648	32,761	32,965
BENEFITS, LOSSES AND EXPENSES				
Policyholder benefits and settlement expenses	12,581	8,862	23,727	17,909
Amortization of deferred policy acquisition costs	819	906	1,764	1,693
Commissions	1,758	2,117	3,851	4,225
General and administrative expenses	2,215	2,158	4,012	4,287
Taxes, licenses and fees	517	574	1,206	1,174
Interest expense	326	333	649	678
Total Benefits, Losses and Expenses	18,216	14,950	35,209	29,966
Income (Loss) Before Income Taxes	(1,733)	1,698	(2,448)	2,999
INCOME TAX EXPENSE (BENEFIT)				
Current	(572)	399	(897)	620
Deferred	(162)	3	(236)	142
	(734)	402	(1,133)	762
Net Income (Loss)	\$(999)	\$1,296	\$(1,315)	\$2,237
INCOME (LOSS) PER COMMON SHARE BASIC AND DILUTED	\$(0.39)	\$0.52	\$(0.52)	\$0.89
DIVIDENDS DECLARED PER SHARE	\$0.05	\$0.045	\$0.10	\$0.09

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)
(In thousands)

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Net income (loss)	\$(999)	\$1,296	\$(1,315)	\$2,237
Other comprehensive income (loss), net of tax				
Changes in:				
Unrealized gains on securities, net of reclassification adjustment of \$155 and \$172 for 2017 and 2016, respectively	502	1,130	846	2,288
Unrealized gain (loss) on interest rate swap	40	21	110	(81)
Other comprehensive income, net of tax	542	1,151	956	2,207
Comprehensive income (loss)	\$(457)	\$2,447	\$(359)	\$4,444

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)
(In thousands)

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital
Balance at December 31, 2016 (AUDITED)	\$48,052	\$39,116	\$ 1,007	\$ 2,517	\$ 5,412
Net loss for June 30, 2017	(1,315)	(1,315)	—	—	—
Other comprehensive income (net of tax)	956	—	956	—	—
Common stock issued	76	—	—	5	71
Cash dividends	(252)	(252)	—	—	—
Balance at June 30, 2017	\$47,517	\$37,549	\$ 1,963	\$ 2,522	\$ 5,483

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

	Six months ended June 30,	
	2017	2016
Cash Flows from Operating Activities		
Net income (loss)	\$(1,315)	\$2,237
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation expense and amortization/accretion, net	265	154
Decrease in cash surrender value of company owned life insurance	(56)	(53)
Net realized gains on investments	(237)	(249)
Deferred income taxes	(236)	142
Amortization of deferred policy acquisition costs	1,764	1,693
Changes in assets and liabilities:		
Change in receivable for securities sold	499	—
Change in accrued investment income	43	(6)
Change in reinsurance recoverable	1,274	1,116
Policy acquisition costs deferred	(1,931)	(1,898)
Change in accrued income taxes	(898)	(30)
Change in net policy liabilities and claims	1,090	(1,319)
Change in other assets/liabilities, net	(715)	(436)
Other, net	6	8
Net cash provided by (used in) operating activities	(447)	1,359
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(8,467)	(14,278)
Property and equipment	(51)	(84)
Proceeds from sale or maturities of:		
Held-to-maturity securities	139	213
Available-for-sale securities	10,202	10,317
Property and equipment	2	—
Other invested assets, net	(29)	(29)
Net cash provided by (used in) investing activities	1,796	(3,861)
Cash Flows from Financing Activities		
Change in other policyholder funds	40	28
Change in short-term notes payable	(500)	—
Dividends paid	(252)	(226)
Net cash used in financing activities	(712)	(198)
Net change in cash and cash equivalents	637	(2,700)
Cash and cash equivalents, beginning of year	7,368	6,763
Cash and cash equivalents, end of period	\$8,005	\$4,063

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary, Omega One Insurance Company (Omega). The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). In the opinion of management, all adjustments, consisting of normal and recurring items, necessary for the fair presentation of the condensed consolidated financial statements have been included. All significant intercompany transactions and accounts have been eliminated. The financial information presented herein should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2016, which includes information and disclosures not presented herein.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these condensed consolidated financial statements are reserves for future life insurance policy benefits, liabilities for losses and loss adjustment expenses, reinsurance recoverable associated with loss and loss adjustment expense liabilities, deferred policy acquisition costs, deferred income tax assets and liabilities, assessments of other-than-temporary impairments on investments and accruals for contingencies. Actual results could differ from these estimates.

Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,518,520 at June 30, 2017 and 2,513,559 at June 30, 2016. The Company did not have any dilutive securities as of June 30, 2017 and 2016.

Reclassifications

Certain 2016 amounts have been reclassified from the prior year condensed consolidated financial statements to conform to the 2017 presentation.

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts subject to FDIC insured limits of \$250,000 per entity. At June 30, 2017, the net amount exceeding FDIC insured limits was \$5,928,000 at two financial institutions. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of financial institutions on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit

losses, are composed of balances due from independent agents. At June 30, 2017, the single largest balance due from one agent totaled \$1,142,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At June 30, 2017 and December 31, 2016, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At June 30, 2017, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Accounting Changes Not Yet Adopted

Revenue from Contracts with Customers

In May 2014, the Financial Accounting Standards Board (FASB) issued guidance on a comprehensive new revenue recognition standard. This standard will not impact accounting for insurance contracts, leases, financial instruments and guarantees. For those contracts that are impacted by the new guidance, the guidance will require an entity to recognize revenue upon the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to, in exchange for those goods or services. The guidance requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. In August 2015, the FASB issued a deferral of the effective date by one year. This guidance is effective retrospectively for fiscal years beginning after December 15, 2017 and interim periods within those years. Early adoption of this standard is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. Although insurance contracts are specifically scoped out of this new guidance, the Company has minor services that may be subject to the new revenue recognition guidance and does not expect the guidance to have a material impact on its condensed consolidated financial statements.

Recognition and Measurement of Financial Assets and Financial Liabilities

In January 2016, the FASB issued guidance that requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The guidance requires entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset. The guidance eliminates the requirement for public companies to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. This guidance is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Leases

In February 2016, the FASB issued guidance that requires lessees (for capital and operating leases) to recognize the lease liability and right-of-use asset at the commencement date of the lease. This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those years. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Contingent Put and Call Options in Debt Instruments

In March 2016, the FASB issued guidance that clarifies the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. This guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within those years. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Financial Instruments - Credit Losses

In June 2016, the FASB issued guidance that replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. This guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within those years. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Classification of Certain Cash Receipts and Cash Payments

In August 2016, the FASB issued guidance that clarifies how certain cash receipts and cash payments shall be presented and classified in the statement of cash flows. This guidance addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The guidance is effective for annual and interim reporting periods beginning after December 15, 2017. The Company does not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Receivables - Nonrefundable Fees and Other Costs

In March 2017, the FASB issued guidance that shortens the amortization period for certain callable debt securities held at a premium and requires the premium to be amortized to the earliest call date. The guidance is effective for fiscal years beginning after December 15, 2018 and interim reporting periods within those fiscal years. The Company does not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

Compensation - Stock Compensation

In May 2017, the FASB issued guidance to provide clarity and reduce diversity in practice as well as cost and complexity when there is a change in the terms or conditions of a share-based payment award. The guidance is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company does not expect adoption of this guidance to have a significant impact on our financial position, results of operations or cash flows.

Recently Adopted Accounting Standards

None

NOTE 2 – VARIABLE INTEREST ENTITIES

The Company holds a passive interest in a limited partnership that is considered to be a Variable Interest Entity (VIE) under the provisions of ASC 810 Consolidation. The Company is not the primary beneficiary of the entity and is not required to consolidate under ASC 810. The entity is a private placement investment fund formed for the purpose of investing in private equity investments. The Company owns less than 1% of the limited partnership. The carrying value of the investment totals \$228,000 and is included as a component of Other Invested Assets in the accompanying consolidated balance sheets.

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, \$9,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$9,279,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 7, are reported in the accompanying condensed consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$279,000 and are included in Other Assets in the accompanying consolidated balance sheets.

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, \$3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with

the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$3,093,000 unsecured junior subordinated deferrable interest debentures. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$2,995,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the Trust. The Subordinated Debentures, disclosed in Note 7, are reported in the accompanying condensed consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$93,000 and are included in Other Assets in the accompanying consolidated balance sheets.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

NOTE 3 – INVESTMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of June 30, 2017 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$ 39,520	\$ 1,200	\$ 722	\$39,998
Mortgage backed securities	10,238	134	191	10,181
Private label asset backed securities	9,962	281	18	10,225
Obligations of states and political subdivisions	13,268	498	74	13,692
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,478	267	192	18,553
Total fixed maturities	91,466	2,380	1,197	92,649
Equity securities	2,044	2,655	—	4,699
Total	\$ 93,510	\$ 5,035	\$ 1,197	\$97,348

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of June 30, 2017 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$ 1,736	\$ 48	\$ —	—\$1,784
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	5	—	—	5
Total	\$ 1,741	\$ 48	\$ —	—\$1,789

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2016 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$ 40,533	\$ 748	\$ 878	\$40,403
Mortgage backed securities	10,970	134	173	10,931
Private label asset backed securities	7,910	29	165	7,774
Obligations of states and political subdivisions	14,806	507	147	15,166
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,618	208	308	18,518
Total fixed maturities	92,837	1,626	1,671	92,792
Equity securities	2,343	2,628	28	4,943
Total	\$ 95,180	\$ 4,254	\$ 1,699	\$97,735

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2016 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$ 1,863	\$ 38	\$	—\$1,901
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	27	2	—	29
Total	\$ 1,890	\$ 40	\$	—\$1,930

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

The amortized cost and aggregate fair value of debt securities at June 30, 2017, by contractual maturity, are presented in the following table (dollars in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in Thousands)	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	\$ 1,240	\$ 1,254
Due after one year through five years	15,766	15,881
Due after five years through ten years	32,905	33,456
Due after ten years	41,555	42,058
Total	\$ 91,466	\$ 92,649
Held-to-maturity securities:		
Due in one year or less	\$ 13	\$ 13
Due after one year through five years	1	1
Due after five years through ten years	70	76
Due after ten years	1,657	1,699
Total	\$ 1,741	\$ 1,789

A summary of securities available-for-sale with unrealized losses as of June 30, 2017, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows (dollars in thousands):

	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
June 30, 2017							
Fixed maturities							
Corporate debt securities	\$ 8,639	\$ 225	\$ 3,571	\$ 497	\$ 12,210	\$ 722	23
Mortgage backed securities	5,545	86	752	105	6,297	191	15
Private label asset backed securities	947	18	—	—	947	18	1
Obligations of state and political subdivisions	3,330	66	496	8	3,826	74	9
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	8,548	155	1,316	37	9,864	192	13
	\$ 27,009	\$ 550	\$ 6,135	\$ 647	\$ 33,144	\$ 1,197	61

There were no securities held-to-maturity with unrealized losses as of June 30, 2017.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

A summary of securities available-for-sale with unrealized losses as of December 31, 2016, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows (dollars in thousands):

December 31, 2016	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
Fixed maturities							
Corporate debt securities	\$ 14,036	\$ 396	\$ 2,594	\$ 482	\$ 16,630	\$ 878	33
Mortgage backed securities	4,235	84	847	89	5,082	173	16
Private label asset backed securities	1,774	53	3,261	112	5,035	165	11
Obligations of state and political subdivisions	4,154	147	—	—	4,154	147	9
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	11,421	294	291	14	11,712	308	16
Equity securities	—	—	1,258	28	1,258	28	1
	\$ 35,620	\$ 974	\$ 8,251	\$ 725	\$ 43,871	\$ 1,699	86

There were no securities held-to-maturity with unrealized losses as of December 31, 2016.

The Company conducts periodic reviews to identify and evaluate securities in an unrealized loss position in order to identify other-than-temporary impairments. For securities in an unrealized loss position, the Company assesses whether the Company has the intent to sell the security or more-likely-than-not will be required to sell the security before the anticipated recovery. If either of these conditions is met, the Company is required to recognize an other-than-temporary impairment with the entire unrealized loss reported in earnings. For securities in an unrealized loss position that do not meet these conditions, the Company assesses whether the impairment of a security is other-than-temporary. If the impairment is determined to be other-than-temporary, the Company is required to separate the other-than-temporary impairments into two components: the amount representing the credit loss and the amount related to all other factors. The credit loss is the portion of the amortized book value in excess of the net present value of the projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. The credit loss component of other-than-temporary impairments is reported in earnings, whereas the amount relating to factors other than credit losses are recorded in other comprehensive income, net of taxes.

Management has evaluated each security in a significant unrealized loss position. The Company has no material exposure to sub-prime mortgage loans and approximately 6.44% of the fixed income investment portfolio is rated below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, Management evaluated financial information on each company and where available, reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the securities in an accumulated loss position in the portfolio were temporary impairments.

For the six months ended June 30, 2017 and year ended December 31, 2016, the Company realized no other-than-temporary impairments. At June 30, 2017, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$327,000. The second largest loss position was in the bond portfolio and totaled \$86,000. The third largest loss position was in the bond portfolio and totaled \$77,000. At December 31, 2016, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$340,000. The second largest loss position was in the bond portfolio and totaled \$85,000. The third largest loss position was in the bond portfolio and totaled \$66,000.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Major categories of investment income are summarized as follows (dollars in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Fixed maturities	\$841	\$948	\$1,658	\$1,849
Equity securities	24	26	48	54
Mortgage loans on real estate	3	6	5	7
Investment real estate	—	2	2	4
Policy loans	33	32	66	64
Company owned life insurance change in surrender value	14	19	57	53
Other	42	26	87	75
	957	1,059	1,923	2,106
Less: Investment expenses	27	30	67	86
Net investment income	\$930	\$1,029	\$1,856	\$2,020

Major categories of realized investment gains and losses are summarized as follows (dollars in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Fixed maturities	\$75	\$243	\$235	\$260
Other, principally real estate	2	(1)	2	(11)
Net realized investment gains	\$77	\$242	\$237	\$249

An analysis of the net change in unrealized appreciation on available-for-sale securities follows (dollars in thousands):

	June 30, December 31,	
	2017	2016
Net change in unrealized appreciation on available-for-sale securities before deferred tax	\$1,282	\$ 343
Deferred income tax	(436)	(117)
Net change in unrealized appreciation on available-for-sale securities	\$846	\$ 226

NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Our available-for-sale securities consists of fixed maturity and equity securities which are recorded at fair value in the accompanying consolidated balance sheets. The change in the fair value of these investments, unless deemed to be other-than-temporarily impaired, is recorded as a component of other comprehensive income.

We are permitted to elect to measure financial instruments and certain other items at fair value, with the change in fair value recorded in earnings. We elected not to measure any eligible items using the fair value option.

Accounting standards define fair value as the price that would be received to sell an asset or would be paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework

to make the measurement of fair value more consistent and comparable. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets.

The Company categorizes assets and liabilities carried at their fair value based upon a fair value hierarchy:

Level 1 – Quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Level 1 assets and liabilities consist of money market fund deposits and certain of our marketable debt and equity instruments, including equity instruments offsetting deferred compensation, that are traded in an active market with sufficient volume and frequency of transactions.

Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 2 assets include certain of our marketable debt and equity instruments with quoted market prices that are traded in less active markets or priced using a quoted market price for similar instruments. Level 2 assets also include marketable equity instruments with security-specific restrictions that would transfer to the buyer, marketable debt instruments priced using indicator prices which represent non-binding market consensus prices that can be corroborated by observable market quotes, as well as derivative contracts and debt instruments priced using inputs that are observable in the market or can be derived principally from or corroborated by observable market data. Marketable debt instruments in this category generally include commercial paper, bank time deposits, repurchase agreements for fixed-income instruments, and a majority of floating-rate notes, corporate bonds, and municipal bonds.

Level 3 - Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

Level 3 assets and liabilities include marketable debt instruments, non-marketable equity investments, derivative contracts, and company issued debt whose values are determined using inputs that are both unobservable and significant to the values of the instruments being measured. Level 3 assets also include marketable debt instruments that are priced using indicator prices that we were unable to corroborate with observable market quotes.

Marketable debt instruments in this category generally include asset-backed securities and certain floating-rate notes, corporate bonds, and municipal bonds.

Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2017 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	\$39,998	\$—	\$39,998	\$—
Mortgage backed securities	10,181	—	10,181	—
Private label asset backed securities	10,225	—	10,225	—
Obligations of states and political subdivisions	13,692	—	13,692	—

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,553	18,553	—	—
Trading securities	107	107	—	—
Equity securities available-for-sale	4,699	3,657	—	1,042
Total Financial Assets	\$97,455	\$22,317	\$74,096	\$1,042
Financial Liabilities				
Interest rate swap	\$(864)	\$—	\$—	\$(864)
Total Financial Liabilities	\$(864)	\$—	\$—	\$(864)

16

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

The methods and assumptions the Company uses to estimate the fair value of assets and liabilities measured at fair value on a recurring basis are summarized below.

Fixed maturities available-for-sale — The fair values of the Company’s public fixed maturity securities are generally based on prices obtained from independent pricing services. Consistent with the fair value hierarchy described above, securities with validated quotes from pricing services are generally reflected within Level 2, as they are primarily based on observable pricing for similar assets and/or other market observable inputs.

Trading securities — Trading securities consist primarily of mutual funds whose fair values are determined consistent with similar instruments described above under “Fixed Maturities” and below under “Equity Securities.”

Equity securities — Equity securities consist principally of investments in common and preferred stock of publicly traded companies and privately traded securities. The fair values of our publicly traded equity securities are based on quoted market prices in active markets for identical assets and are classified within Level 1 in the fair value hierarchy.

Estimated fair values for our privately traded equity securities require a substantial level of judgment. Privately traded equity securities are classified within Level 3.

Interest rate swaps — Interest rate swaps are recorded at fair value either as assets, within other assets or as liabilities, within other liabilities. The fair values of our interest rate swaps are provided by a third-party broker and are classified within Level 3.

As of June 30, 2017, Level 3 fair value measurements of assets include \$1,042,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of June 30, 2017, Level 3 fair value measurements of liabilities include \$864,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party broker who utilizes financial modeling tools and assumptions on interest and other factors. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 7.

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the six months ended June 30, 2017 (in thousands):

For the six months ended June 30, 2017	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$ 1,258	\$(1,030)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	83	166
Purchases:	46	—

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Sales:	(345)	—
Issuances:	—		—
Settlements:	—		—
Transfers in/(out) of Level 3	—		—
Ending balance	\$ 1,042		\$(864)
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of June 30, 2017:	\$ —		\$—

For the six months ended June 30, 2017, there were no assets or liabilities measured at fair values on a nonrecurring basis.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2016 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	\$40,403	\$—	\$40,403	\$—
Mortgage backed securities	10,931	—	10,931	—
Private label asset backed securities	7,774	—	7,774	—
Obligations of states and political subdivisions	15,166	—	15,166	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,518	18,518	—	—
Trading securities	107	107	—	—
Equity securities available-for-sale	4,943	3,685	—	1,258
Total Financial Assets	\$97,842	\$22,310	\$74,274	\$1,258
Financial Liabilities				
Interest rate swap	\$(1,030)	\$—	\$—	\$(1,030)
Total Financial Liabilities	\$(1,030)	\$—	\$—	\$(1,030)

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2016 (in thousands):

For the year ended December 31, 2016	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$ 1,173	\$(1,419)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	85	389
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$ 1,258	\$(1,030)
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of December 31, 2016:	\$ —	\$—

For the year ended December 31, 2016, there were no assets or liabilities measured at fair values on a nonrecurring basis.

The Company is exposed to certain risks in the normal course of its business operations. The primary risk that is managed through the use of derivatives is interest rate risk on floating rate borrowings. This risk is managed through the use of interest rate swap agreements which are designated as cash flow hedges. For cash flow hedges, the effective portion of the gain or loss on the interest rate swap is included as a component of other comprehensive income and reclassified into earnings in the same period during which the hedged transaction is recognized in earnings. The

18

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Company does not hold or issue derivatives that are not designated as hedging instruments. See Note 7 for additional information about the interest rate swap agreements.

The following methods and assumptions were used to estimate fair value of each class of financial instrument for which it is practical to estimate that value:

Cash and cash equivalents — the carrying amount is a reasonable estimate of fair value.

Fixed maturities held-to-maturity — the carrying amount is amortized cost; the fair values of the Company's public fixed maturity securities that are classified as held-to-maturity are generally based on prices obtained from independent pricing services.

Mortgage loans — the carrying amount is a reasonable estimate of fair value due to the restrictive nature and limited marketability of the mortgage notes.

Policy loans — the carrying amount is a reasonable estimate of fair value.

Company owned life insurance — the carrying amount is a reasonable estimate of fair value.

Other invested assets — the carrying amount is a reasonable estimate of fair value.

Other policyholder funds — the carrying amount is a reasonable estimate of fair value.

Debt — the carrying amount is a reasonable estimate of fair value.

The carrying amount and estimated fair value of the Company's financial instruments as of June 30, 2017 and December 31, 2016 are as follows (in thousands):

	June 30, 2017		December 31, 2016	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related instruments				
Held-to-maturity securities	\$1,741	\$ 1,789	\$1,890	\$ 1,930
Mortgage loans	164	164	174	174
Policy loans	1,747	1,747	1,708	1,708
Company owned life insurance	4,920	4,920	4,864	4,864
Other invested assets	2,790	2,790	2,958	2,958
Liabilities and related instruments				
Other policyholder funds	1,669	1,669	1,629	1,629
Short-term notes payable and current portion of long-term debt	1,300	1,300	1,800	1,800
Long-term debt	15,332	15,332	15,326	15,326

NOTE 5 – PROPERTY AND EQUIPMENT

Major categories of property and equipment are summarized as follows (dollars in thousands):

	June 30, December 31,	
	2017	2016
Building and improvements	\$ 3,379	\$ 3,348
Electronic data processing equipment	1,559	1,548
Furniture and fixtures	508	515
	5,446	5,411
Less accumulated depreciation	3,594	3,531
Property and equipment, net	\$ 1,852	\$ 1,880

Depreciation expense for the six months ended June 30, 2017 was \$79,000 (\$159,000 for the year ended December 31, 2016).

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

NOTE 6 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2011. Tax returns have been filed through the year 2015.

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax assets. The Company recognized net deferred tax asset positions of \$2,145,000 at June 30, 2017 and \$2,402,000 at December 31, 2016.

The tax effect of significant differences representing deferred tax assets and liabilities are as follows (dollars in thousands):

	As of June 30, 2017	As of December 31, 2016
General expenses	\$1,655	\$ 1,685
Unearned premiums	2,209	2,046
Claims liabilities	855	746
AMT credit	1,277	1,230
Impairment on real estate owned	187	187
Unrealized loss on interest rate swaps	294	350
Deferred tax assets	6,477	6,244
Depreciation	(131)	(135)
Deferred policy acquisition costs	(2,896)	(2,839)
Unrealized gains on securities available-for-sale	(1,305)	(868)
Deferred tax liabilities	(4,332)	(3,842)
Net deferred tax asset	\$2,145	\$ 2,402

The appropriate income tax effects of changes in temporary differences are as follows (dollars in thousands):

	Six months ended June 30,	
	2017	2016
Deferred policy acquisition costs	\$57	\$69
Unearned premiums	(163)	(154)
General expenses	30	25
Depreciation	(4)	4
Claims liabilities	(109)	(75)
AMT credit	(47)	273

Deferred income tax expense (benefit) \$(236) \$142

20

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Total income tax expense (benefit) varies from amounts computed by applying current federal income tax rates to income or loss before income taxes. The reasons for these differences and the approximate tax effects are as follows:

	Six months ended June 30,	
	2017	2016
Federal income tax rate applied to pre-tax income/loss	34.0 %	34.0 %
Dividends received deduction and tax-exempt interest	1.4 %	(1.5)%
Company owned life insurance	0.8 %	(0.6)%
Small life deduction	11.5 %	(5.4)%
Other, net	(1.4)%	(1.1)%
Effective federal income tax rate	46.3 %	25.4 %

NOTE 7 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of June 30, 2017 and December 31, 2016 (dollars in thousands):

	June 30, 2017	December 31, 2016
Current portion of installment note payable \$1,000,000 due March 2017 with \$800,000 due November 2017 with variable interest rate equal to the WSJ prime rate plus 0.5%. Unsecured.	\$ 800	\$ 1,800
Line of credit, \$1,000,000 available, with variable interest rate equal to the WSJ prime rate, subject to a 4.5% floor; maturity September 2017. Interest payments due monthly. Secured.	—	—
Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 5.0% floor; maturity March 2018. Interest payments due quarterly. Unsecured.	500	—
	\$ 1,300	\$ 1,800

Long-term debt consisted of the following as of June 30, 2017 and December 31, 2016 (dollars in thousands):

	June 30, 2017	December 31, 2016
Promissory note with variable interest rate equal to the WSJ prime rate plus 0.5%; maturity November 2019. Annual installment payments beginning November 2017 with final balloon payment due November 30, 2019. Unsecured.	\$ 3,200	\$ 3,200
Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-Month LIBOR plus 3.75% applied to the outstanding principal; net of \$173,000 in debt issuance cost (\$178,000 in 2016); maturity December 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured.	9,106	9,101
Subordinated debentures issued on June 21, 2007 with a floating interest rate equal to the 3-Month LIBOR plus 3.40% applied to the outstanding principal; net of \$66,000 in debt issuance	3,026	3,025

cost (\$68,000 in 2016); maturity June 15, 2037. Interest payments due quarterly. All may be redeemed at any time following the fifth anniversary of issuance. Unsecured.

\$15,332 \$ 15,326

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

The Company has entered into various swap agreements related to the trust preferred securities. On March 19, 2009, the Company entered into a forward swap effective September 17, 2012, with a notional amount of \$3,000,000 and designated the swap as a hedge against changes in cash flows attributable to changes in the benchmark interest rate (LIBOR) associated with the subordinated debentures issued June 21, 2007. Quarterly, commencing September 17, 2012, under the terms of the forward swap, the Company will pay interest at a fixed rate of 7.02% until March 15, 2019. On May 26, 2010, the Company entered into a forward swap with a notional amount of \$9,000,000 effective December 15, 2015, which hedges against changes in cash flows following the termination of the fixed rate period. Quarterly, commencing March 16, 2016 under the terms of the forward swap, the Company pays interest at a fixed rate of 8.49% until March 15, 2020.

The swaps entered into in 2009 and 2010 have fair values of \$110,000 (liability) and \$754,000 (liability), respectively, for a total liability of \$864,000 at June 30, 2017 (\$1,030,000 at December 31, 2016). The swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of \$110,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements at June 30, 2017. A net valuation gain of \$256,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2016.

We use dollar offset at the hedge's inception and for each reporting period thereafter to assess whether the derivative used in a hedging transaction is expected to be, and has been, effective in offsetting changes in the fair value of the hedged item. Since inception, no portion of the hedged item has been deemed ineffective. For all hedges, we discontinue hedge accounting if it is determined that a derivative is not expected to be, or has ceased to be, effective as a hedge.

The Company's interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. At June 30, 2017, the Company has securities on deposit with fair market values of \$1,465,000 (all of which is posted as collateral). At December 31, 2016, the Company had securities on deposit with fair market values of \$1,466,000 and cash of \$231,000 (all of which is posted as collateral). See Note 4 for additional information about the interest rate swaps.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

NOTE 8 – POLICY AND CLAIM RESERVES

The Company regularly updates its reserve estimates as new information becomes available and events occur that may impact the resolution of unsettled claims. Reserve estimation can be an inherently uncertain process and reserves estimates can be revised up or down depending on changes in circumstances. Changes in prior years' reserve estimates are reflected in the results of operations in the year such changes are determined.

The following table is a reconciliation of beginning and ending property and casualty reserve balances for claims and claim adjustment expense (dollars in thousands):

	Six months ended June 30,	
	2017	2016
Summary of claims and claim adjustment expense reserves		
Balance, beginning of year	\$7,531	\$9,645
Less reinsurance recoverable on unpaid losses	1,184	1,380
Net balances at beginning of year	6,347	8,265
Net losses:		
Provision for claims and claim adjustment expenses for claims arising in current year	22,667	17,105
Estimated claims and claim adjustment expenses for claims arising in prior years	(1,202)	(1,391)
Total increases	21,465	15,714
Claims and claim adjustment expense payments for claims arising in:		
Current year	18,033	13,154
Prior years	2,532	4,245
Total payments	20,565	17,399
Net balance at end of period	7,247	6,580
Plus reinsurance recoverable on unpaid losses	356	427
Claims and claim adjustment expense reserves at end of period	\$7,603	\$7,007

The increase in claim and claim adjustment expense reserves before reinsurance recoverable is primarily due to the increase in catastrophe losses during the period. The estimate for claims arising in prior years was reduced \$1,202,000 in 2017 (reduced \$1,391,000 in 2016) due to favorable loss development during the year on claims arising in prior years.

Accident and Health Claim Reserves

The Company, through its life insurance subsidiary, underwrites a limited number of short duration accident and health contracts. These claims are typically settled in three years or less and the reserve for unpaid claims totaled \$306,000 at June 30, 2017 (\$391,000 at December 31, 2016). These claims are a component of policy and contract claims which totaled \$833,000 at June 30, 2017 (\$1,008,000 at December 31, 2016).

NOTE 9 – REINSURANCE

The Company's insurance operations utilize reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term coverage. Property and casualty reinsurance is placed on an excess of loss basis to cover losses from catastrophe events. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of re-insurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurance companies and monitor concentrations of credit risk arising from similar geographic regions, activities,

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

or economic characteristics of the companies to minimize their exposure to significant losses from reinsurance insolvencies.

In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other individually significant large loss events that cause unfavorable underwriting results by re-insuring certain levels of risk in various areas of exposure with reinsurance companies. NSFC maintains a catastrophe reinsurance agreement to cover losses from catastrophic events, primarily hurricanes.

Under the catastrophe reinsurance program, the Company retains the first \$4,000,000 in losses from each catastrophe event. Catastrophe reinsurance coverage is maintained in three layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	100% of \$13,500,000 in excess of \$4,000,000 retention
Second Layer	100% of \$25,000,000 in excess of \$17,500,000
Third Layer	100% of \$30,000,000 in excess of \$42,500,000

Each reinsurance layer covers events occurring from January 1 through December 31 of the contract year. All significant reinsurance companies under the program carry A.M. Best ratings of A- (Excellent) or higher, or equivalent ratings.

The Company's catastrophe reinsurance contract allows for one reinstatement. The Company maintains reinstatement premium protection (RPP) to cover reinstatement premiums incurred. The RPP further reduces risk from a major catastrophe and serves to strengthen the Company's capital position by reducing the modeled 100 year event net cost.

Amounts recoverable from re-insurers are estimated in a manner consistent with the claim liability associated with the underlying insurance policies. Amounts paid for prospective reinsurance contracts are reported as prepaid reinsurance premiums and amortized over the remaining contract period.

In the normal course of business, NSIC seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid by ceding reinsurance to reinsurance companies under excess coverage contracts. NSIC retains a maximum of \$50,000 of coverage per individual life. The cost of reinsurance is amortized over the contract period of the reinsurance.

At June 30, 2017, the largest reinsurance recoverable of a single reinsurer was \$321,000 (\$332,000 at December 31, 2016). Amounts reported as ceded incurred losses were related to development of losses from prior year catastrophes.

NOTE 10 – EMPLOYEE BENEFIT PLANS

The Company and its subsidiaries have an established retirement savings plan (401K Plan). All full-time employees are eligible to participate, and all employer contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for the six months ended June 30, 2017 and 2016 amounted to \$99,000 and \$113,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limits.

In January 2006, the Company established a non-qualified plan under which directors are allowed to defer all or a portion of directors' fees into various investment options. The supplemental executive retirement plan (SERP) became effective March 1, 2008 and covers named executive officers, with the Company contributing 15% of executive compensation to the plan. Contributions to the plan are fully vested upon the earlier of death, disability, change in control, or ten years of participation in the plan. Costs for amounts credited to the non-qualified deferred compensation plans for the six months ended June 30, 2017 and 2016 amounted to approximately \$143,000 and \$107,000, respectively.

The Company and its subsidiaries established an Employee Stock Ownership Plan (ESOP) in January 2010, to enable its eligible employees to acquire a proprietary interest in the Company's common stock and to provide retirement and

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

other benefits to such employees. There were \$268,000 costs incurred during the six months ended June 30, 2017 and \$150,000 costs incurred during the six months ended June 30, 2016 related to ESOP plan contributions. All contributions were made in cash for purchase of Company shares in the open market. The Company has not allocated shares directly to the plan and the plan has no debt.

NOTE 11 – SHAREHOLDERS' EQUITY

During the six months ended June 30, 2017 and year ended December 31, 2016, changes in shareholders' equity consisted of net loss of \$1,315,000 and net income of \$3,063,000, respectively; dividends paid of \$252,000 in 2017 and \$452,000 in 2016; increases in accumulated other comprehensive income, net of applicable taxes, of \$956,000 in 2017 and increases in accumulated other comprehensive income, net of applicable taxes, of \$482,000 in 2016. Other comprehensive gains and loss consisted of accumulated unrealized gains and losses on securities available-for-sale and unrealized loss on interest rate swaps.

Preferred Stock

Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference.

Common Stock

The holders of the Class A Common Stock will have one-twentieth of one vote per share, and the holders of the common stock will have one vote per share. There is currently no Class A Common Stock issued or outstanding.

In the event of any liquidation, dissolution or distribution of the assets of the Company remaining after the payments to the holders of the Preferred Stock of the full preferential amounts to which they may be entitled as provided in the resolution or resolutions creating any series thereof, the remaining assets of the Company shall be divided and distributed among the holders of both classes of common stock, except as may otherwise be provided in any such resolution or resolutions.

The table below provides information regarding the Company's preferred and common stock as of June 30, 2017 and December 31, 2016:

	June 30, 2017			December 31, 2016		
	Authorized	Issued	Outstanding	Authorized	Issued	Outstanding
Preferred Stock, \$1 par value	500,000	—	—	500,000	—	—
Class A Common Stock, \$1 par value	2,000,000	—	—	2,000,000	—	—
Common Stock, \$1 par value	3,000,000	2,522,312	2,522,312	3,000,000	2,517,339	2,517,339

On May 19, 2017, 4,973 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

NOTE 12 – ACCUMULATED OTHER COMPREHENSIVE INCOME

Accumulated other comprehensive income (loss) ("AOCI") includes certain items that are reported directly within a separate component of shareholders' equity. The following table presents changes in AOCI balances (dollars in thousands):

	Six months ended June 30,	
	2017	2016
Gains and Losses on Cash Flow Hedges		
Balance at beginning of period	\$(679)	\$(935)
Other comprehensive loss for period:		
Other comprehensive gain (loss) before reclassifications	110	(81)
Amounts reclassified from accumulated other comprehensive income	—	—
Net current period other comprehensive income (loss)	110	(81)
Balance at end of period	\$(569)	\$(1,016)
Unrealized Gains and Losses on Available-for-Sale Securities		
Balance at beginning of period	\$1,686	\$1,460
Other comprehensive income for period:		
Other comprehensive income before reclassifications	1,001	2,460
Amounts reclassified from accumulated other comprehensive income	(155)	(172)
Net current period other comprehensive income	846	2,288
Balance at end of period	\$2,532	\$3,748
Total Accumulated Other Comprehensive Income at end of period	\$1,963	\$2,732

The following table presents the amounts reclassified out of AOCI for the six months ended June 30, 2017 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	\$ 235	Net realized investment gains
	235	Total before tax
	(80)	Tax (expense) or benefit
	\$ 155	Net of Tax

The following table presents the amounts reclassified out of AOCI for the six months ended June 30, 2016 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	\$ 260 260 (88) \$ 172	Net realized investment gains Total before tax Tax (expense) or benefit Net of Tax

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

NOTE 13 – SEGMENTS

The Company's property and casualty insurance operations comprise one business segment. The property and casualty insurance segment primarily underwrites home insurance coverage with primary lines of business consisting of dwelling fire and extended coverage, homeowners (including mobile homeowners) and other liability.

Management organizes the business utilizing a niche strategy focusing on lower valued dwellings. Our chief decision makers (Chief Executive Officer, Chief Financial Officer and President) review results and operating plans making decisions on resource allocations on a company-wide basis. The Company's products are primarily produced through independent agents within the states in which we operate.

The Company's life and accident and health operations comprise the second business segment. The life and accident and health insurance segment consists of two lines of business: traditional life insurance and accident and health insurance.

Total assets by industry segment at June 30, 2017 and at December 31, 2016 are summarized below (dollars in thousands):

	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
June 30, 2017	\$ 149,602	\$ 82,703	\$ 59,955	\$ 6,944
December 31, 2016	\$ 148,579	\$ 82,647	\$ 58,689	\$ 7,243

Premium revenues and operating income by business segment for the three and six months ended June 30, 2017 and 2016 are summarized below (dollars in thousands):

Three months ended June 30, 2017	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	\$ 15,331	\$ 13,749	\$ 1,582	\$ —
Net investment income	930	386	527	17
Net realized investment gains (losses)	77	60	17	—
Other income	145	145	—	—
	16,483	14,340	2,126	17
BENEFITS AND EXPENSES				
Policyholder benefits paid	12,581	11,274	1,307	—
Amortization of deferred policy acquisition costs	819	695	124	—
Commissions	1,758	1,689	69	—
General and administrative expenses	2,215	1,602	339	274

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Taxes, licenses and fees	517	475	42	—
Interest expense	326	—	20	306
	18,216	15,735	1,901	580
Income (Loss) Before Income Taxes	\$(1,733)	\$(1,395)	\$ 225	\$ (563)

27

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Three months ended June 30, 2016	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	\$15,227	\$ 13,646	\$ 1,581	\$ —
Net investment income	1,029	455	559	15
Net realized investment gains	242	185	57	—
Other income	150	150	—	—
	16,648	14,436	2,197	15
BENEFITS AND EXPENSES				
Policyholder benefits paid	8,862	7,577	1,285	—
Amortization of deferred policy acquisition costs	906	695	211	—
Commissions	2,117	2,020	97	—
General and administrative expenses	2,158	1,704	310	144
Taxes, licenses and fees	574	529	45	—
Interest expense	333	—	20	313
	14,950	12,525	1,968	457
Income (Loss) Before Income Taxes	\$1,698	\$ 1,911	\$ 229	\$ (442)
Six months ended June 30, 2017	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	\$30,371	\$ 27,238	\$ 3,133	\$ —
Net investment income	1,856	778	1,046	32
Net realized investment gains (losses)	237	60	177	—
Other income	297	295	2	—
	32,761	28,371	4,358	32
BENEFITS AND EXPENSES				
Policyholder benefits paid	23,727	21,192	2,535	—
Amortization of deferred policy acquisition costs	1,764	1,389	375	—
Commissions	3,851	3,713	138	—
General and administrative expenses	4,012	2,877	618	517
Taxes, licenses and fees	1,206	1,067	139	—
Interest expense	649	—	39	610
	35,209	30,238	3,844	1,127
Income (Loss) Before Income Taxes	\$(2,448)	\$(1,867)	\$ 514	\$(1,095)

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

Six months ended June 30, 2016	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	\$30,392	\$ 27,247	\$ 3,145	\$ —
Net investment income	2,020	908	1,080	32
Net realized investment gains	249	185	64	—
Other income	304	303	1	—
	32,965	28,643	4,290	32
BENEFITS AND EXPENSES				
Policyholder benefits paid	17,909	15,439	2,470	—
Amortization of deferred policy acquisition costs	1,693	1,391	302	—
Commissions	4,225	4,036	189	—
General and administrative expenses	4,287	3,125	815	347
Taxes, licenses and fees	1,174	1,064	110	—
Interest expense	678	—	38	640
	29,966	25,055	3,924	987
Income (Loss) Before Income Taxes	\$2,999	\$ 3,588	\$ 366	\$ (955)

The following table presents the Company's gross and net premiums written for the property and casualty segment and the life and accident and health segment for the three and six months ended June 30, 2017 and 2016, respectively:

	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Life, accident and health operations premiums written:				
Traditional life insurance	\$1,093	\$1,124	\$2,238	\$2,243
Accident and health insurance	406	409	829	827
Gross life, accident and health	1,499	1,533	3,067	3,070
Reinsurance premium ceded	(14)	(23)	(43)	(48)
Net life, accident and health premiums written	\$1,485	\$1,510	\$3,024	\$3,022
Property and Casualty operations premiums written:				
Dwelling fire & extended coverage	\$10,040	\$9,716	\$19,471	\$18,908
Homeowners (Including mobile homeowners)	6,409	6,674	12,036	12,386
Other liability	590	570	1,133	1,093
Gross property and casualty	17,039	16,960	32,640	32,387
Reinsurance premium ceded	(1,707)	(1,697)	(2,809)	(2,699)
Net property and casualty written	\$15,332	\$15,263	\$29,831	\$29,688
Consolidated gross premiums written	\$18,538	\$18,493	\$35,707	\$35,457
Reinsurance premium ceded	(1,721)	(1,720)	(2,852)	(2,747)
Consolidated net premiums written	\$16,817	\$16,773	\$32,855	\$32,710

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2016 AMOUNTS)

The following table presents the Company's gross and net premiums earned for the property and casualty segment and the life and accident and health segment for the three and six months ended June 30, 2017 and 2016, respectively:

	Three months ended		Six months ended	
	June 30, 2017	2016	June 30, 2017	2016
Life, accident and health operations premiums earned:				
Traditional life insurance	\$1,188	\$1,194	\$2,346	\$2,367
Accident and health insurance	408	410	830	826
Gross life, accident and health	1,596	1,604	3,176	3,193
Reinsurance premium ceded	(14)	(23)	(43)	(48)
Net life, accident and health premiums earned	\$1,582	\$1,581	\$3,133	\$3,145
Property and Casualty operations premiums earned:				
Dwelling fire & extended coverage	\$9,032	\$8,807	\$17,848	\$17,469
Homeowners (Including mobile homeowners)	5,744	5,881	11,464	11,787
Other liability	527	503	1,040	996
Gross property and casualty	15,303	15,191	30,352	30,252
Reinsurance premium ceded	(1,554)	(1,545)	(3,114)	(3,005)
Net property and casualty earned	\$13,749	\$13,646	\$27,238	\$27,247
Consolidated gross premiums earned	\$16,899	\$16,795	\$33,528	\$33,445
Reinsurance premium ceded	(1,568)	(1,568)	(3,157)	(3,053)
Consolidated net premiums earned	\$15,331	\$15,227	\$30,371	\$30,392

NOTE 14 – CONTINGENCIES

The Company and its subsidiaries continue to be named individually as parties to litigation related to the conduct of their insurance operations. These suits involve alleged breaches of contracts, torts, including bad faith and fraud claims based on alleged wrongful or fraudulent acts of the Company's subsidiaries, and other miscellaneous causes of action.

The Company's property & casualty subsidiaries are defending a limited number of matters filed in the aftermath of Hurricane Ike in Texas. These actions include individual lawsuits with allegations of underpayment of hurricane-related claims.

The various suits seek a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief. The Company has reserves set up on litigated claims and the reserves are included in benefit and loss reserves.

NOTE 15 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the six months ended June 30, 2017 was \$546,000 (\$561,000 in 2016). There was no cash paid for income taxes during the six months ended June 30, 2017 (\$650,000 in 2016).

During the six months ended June 30, 2017, non-cash changes in equity included \$5,000 in common stock issued to Directors in lieu of cash compensation along with a corresponding \$71,000 increase in additional paid-in capital.

NOTE 16 – SUBSEQUENT EVENTS

Management has evaluated subsequent events and their potential effects on these condensed consolidated financial statements through the filing date of this Form 10-Q.

30

Table of Contents

REVIEW OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
The National Security Group, Inc.

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. as of June 30, 2017, and the related condensed consolidated statements of income and comprehensive income (loss) for the three-month and six-month periods ended June 30, 2017 and 2016 and the condensed consolidated statement of changes in shareholders' equity for the six-month period ended June 30, 2017 and the statement of cash flows for the six-month periods ended June 30, 2017 and 2016. These condensed consolidated financial statements are the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the consolidated financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying condensed consolidated financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The National Security Group, Inc. as of December 31, 2016, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 17, 2017, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2016, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Warren
Averett, LLC

Birmingham,
Alabama
August 11, 2017

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) and its subsidiaries. We are a “smaller reporting company” under Securities and Exchange Commission (SEC) regulations and therefore qualify for the scaled disclosure of smaller reporting companies. In general, the same information is required to be disclosed in the management discussion and analysis by smaller reporting companies except that the discussion need only cover the latest two year period and disclosures relating to contractual obligations are not required. In accordance with the scaled disclosure requirements, this discussion covers the three month and six month periods ended June 30, 2017 and 2016.

This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part 1, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2016.

Information in this discussion is presented in whole dollars rounded to the nearest thousand. Tabular amounts are presented in thousands.

The National Security Group, Inc. operates in ten states with 47.4% of total premium revenue generated in the states of Alabama and Mississippi. The Company is made up of the following two segments:

The Property and Casualty (P&C) segment is the most significant segment, accounting for 90.5% of gross earned premium in 2017. The P&C segment has insurance in-force in the states of Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, and Tennessee.

The Life segment accounted for 9.5% of gross premium revenue in 2017. The Life segment is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

The Company's P&C segment consists of the consolidated operations of two subsidiaries, National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992. There is no material differentiation between the products underwritten by NSFC and Omega as both underwrite primarily dwelling personal lines coverage. Due to Omega currently producing no direct written premium and the fact that Omega is a wholly owned subsidiary of NSFC authorized to underwrite similar lines of business, all references to NSFC or P&C segment in the remainder of this management discussion and analysis will include the insurance operations of both NSFC and Omega.

Life segment business is conducted through National Security Insurance Company (NSIC), a wholly owned subsidiary of the Company organized in 1947. All references to NSIC or life segment in the remainder of this management discussion and analysis will refer to the combined life, accident and health insurance operations.

Our income is principally derived from net underwriting profit generated by the P&C segment and investment income. Net underwriting profit is principally derived from earned premiums received less claims paid, sales commissions to agents, costs of underwriting and insurance taxes and fees. Investment income includes interest and dividend income and gains and losses on investment holdings.

All of the insurance subsidiaries are Alabama domiciled insurance companies; therefore, the Alabama Department of Insurance is the primary insurance regulator. However, each subsidiary is subject to regulation by the respective

insurance regulators of each state in which it is licensed to transact business. Insurance rates charged by each of the insurance subsidiaries are typically reviewed and approved by each insurance department for the respective state in which the rates will apply.

All of our insurance companies have been assigned ratings by A.M. Best Co (Best). On March 7, 2017, Best affirmed the financial strength rating (FSR) of B++ (Good) and the issuer credit rating (ICR) of "bbb" of NSFC. In addition, Best affirmed the FSR of B+(Good) and ICR of "bbb-" of Omega and NSIC. The outlook for all of these ratings is stable. Best also affirmed the ICR of "bb" of the parent holding company, NSEC, with a stable outlook.

Table of Contents

The property and casualty subsidiaries have been assigned a Financial Stability Rating by Demotech, Inc. On November 22, 2016, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

The property and casualty segment can be impacted by severe storm activity resulting in incurred losses and loss adjustment expenses primarily from hurricane, tornado, wind and hail related damage. These storm systems or other natural disasters are classified as catastrophes (referred to as "cat events" or "catastrophe events" throughout the remainder of this discussion) by Property Claim Service (PCS) when these events cause \$25 million or more in industry wide direct insured losses and affect a significant number of policyholders and insurers.

Overview-Three and Six Months Ended June 30, 2017 compared to Three and Six Months Ended June 30, 2016

Summary:

For the three months ended June 30, 2017, the Company had a net loss of \$999,000, \$0.39 per share, compared to net income of \$1,296,000, \$0.52 per share, for the three months ended June 30, 2016. The pretax loss from operations in second quarter of 2017 totaled \$1,810,000 compared to pretax income from operations of \$1,456,000 in the second quarter of 2016. Results for the second quarter of 2017 were negatively impacted by an increased frequency of severe thunderstorm activity which generated widespread wind, hail and tornado damage to insured property across the Southeastern United States. This increased frequency of severe thunderstorm activity led to a \$3,621,000 increase in quarterly P&C segment catastrophe losses, compared to second quarter 2016. Total catastrophe related losses in the second quarter of 2017 were \$5,657,000 compared to \$2,036,000 in the second quarter of 2016.

For the six months ended June 30, 2017, the Company had a net loss of \$1,315,000, \$0.52 per share, compared to net income of \$2,237,000, \$0.89 per share, for the six months ended June 30, 2016, a period over period decrease of \$3,552,000. The year to date pretax loss from operations in 2017 totaled \$2,685,000 compared to pretax income from operations of \$2,750,000 in 2016. Results for 2017 were negatively impacted by an increased frequency of severe thunderstorm activity which generated widespread wind, hail and tornado damage to insured property across the Southeastern United States throughout the six month period. This increased frequency of severe thunderstorm activity led to a \$5,695,000 increase in P&C segment catastrophe losses, compared to 2016. Year to date catastrophe related losses in 2017 were \$9,178,000 compared to \$3,483,000 in 2016. Partially offsetting the increase in P&C segment storm losses was a decline in non-cat wind and hail losses of \$319,000 and a \$79,000 reduction in fire losses in 2017 compared to the same period last year.

Table of Contents

Financial results for the three and six months ended June 30, 2017 and 2016 were as follows:

Consolidated Financial Summary (dollars in thousands)	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Gross premiums written	\$18,538	\$18,493	\$35,707	\$35,457
Net premiums written	\$16,817	\$16,773	\$32,855	\$32,710
Net premiums earned	\$15,331	\$15,227	\$30,371	\$30,392
Net investment income	930	1,029	1,856	2,020
Net realized investment gains	77	242	237	249
Other income	145	150	297	304
Total Revenues	16,483	16,648	32,761	32,965
Policyholder benefits and settlement expenses	12,581	8,862	23,727	17,909
Amortization of deferred policy acquisition costs	819	906	1,764	1,693
Commissions	1,758	2,117	3,851	4,225
General and administrative expenses	2,215	2,158	4,012	4,287
Taxes, licenses and fees	517	574	1,206	1,174
Interest expense	326	333	649	678
Total Benefits, Losses and Expenses	18,216	14,950	35,209	29,966
Income (Loss) Before Income Taxes	(1,733)	1,698	(2,448)	2,999
Income tax expense (benefit)	(734)	402	(1,133)	762
Net Income (Loss)	\$(999)	\$1,296	\$(1,315)	\$2,237
Income (Loss) Per Common Share	\$(0.39)	\$0.52	\$(0.52)	\$0.89
Reconciliation of Net Income (Loss) to non-GAAP Measurement				
Net income (loss)	\$(999)	\$1,296	\$(1,315)	\$2,237
Income tax expense (benefit)	(734)	402	(1,133)	762
Realized investment gains, net	(77)	(242)	(237)	(249)
Pretax Income (Loss) From Operations	\$(1,810)	\$1,456	\$(2,685)	\$2,750

Three month period ended June 30, 2017 compared to three month period ended June 30, 2016

Premium Revenue:

For the quarter ended June 30, 2017, net premiums earned were up \$104,000 at \$15,331,000 compared to \$15,227,000 in the second quarter of 2016. The slight increase in net premium earned was due to a 0.7% increase in gross premium earned in the P&C segment which was partially offset by a 0.6% increase in ceded premium in the P&C segment. Net premium earned was up 0.1% in the life segment for the second quarter of 2017 compared to the same period last year.

Net Income (Loss):

For the three months ended June 30, 2017, the Company had a net loss of \$999,000, \$0.39 per share, compared to net income of \$1,296,000, \$0.52 per share, for the same period in 2016, a decrease of \$2,295,000. As discussed in the summary above, an increase in second quarter storm losses in the P&C segment was the primary factor contributing to the decline in net income.

Pretax Income (Loss) from Operations:

For the quarter ended June 30, 2017, pretax loss from operations was \$1,810,000 compared to pretax income of \$1,456,000 for the quarter ended June 30, 2016, a decrease of \$3,266,000. Losses from storm related catastrophe events totaled \$5,657,000 in the second quarter of 2017 compared to \$2,036,000 for the same period last year. The

single largest catastrophe event in the second quarter of 2017 was an early April severe thunderstorm event that

34

Table of Contents

generated \$768,000 in storm losses. In comparison, the single largest catastrophe event in the second quarter of 2016 was a late April severe thunderstorm event that totaled \$546,000.

P&C Segment Combined Ratio:

The P&C segment ended the second quarter of 2017 with a combined ratio of 113.3% with catastrophe losses totaling \$5,657,000 and increasing the combined ratio by 40.7 percentage points. In comparison, second quarter 2016 cat events added \$2,036,000 to prior year policyholder benefits and settlement expenses. The P&C segment ended the second quarter of 2016 with a combined ratio of 90.8% with catastrophe losses contributing 14.8 percentage points to the combined ratio.

Six month period ended June 30, 2017 compared to six month period ended June 30, 2016

Premium Revenue:

For the six month period ended June 30, 2017, net premiums earned were down \$21,000 at \$30,371,000 compared to \$30,392,000 for the same period in 2016. The slight decrease in net premium earned was due to a minimal increase in gross premium earned in the P&C segment which was offset by a 3.6% increase in ceded premium in the P&C segment. In addition, net earned premium in the life segment was down 0.4% in 2017 compared to the same period in 2016.

Net Income (Loss):

For the six month period ended June 30, 2017, the Company had a net loss of \$1,315,000, \$0.52 per share, compared to net income of \$2,237,000, \$0.89 per share, for the same period in 2016, a decrease of \$3,552,000. An increased frequency of catastrophe losses related to widespread thunderstorm activity, which has persisted in the first six months of 2017, was the primary factor contributing to the decline in year to date net income. We have incurred catastrophe losses from twenty-one cat events in 2017 compared to losses from thirteen cat events in 2016.

Pretax Income (Loss) from Operations:

For the six month period ended June 30, 2017, pretax loss from operations was \$2,685,000 compared to pretax income of \$2,750,000 for the period ended June 30, 2016, a decrease of \$5,435,000. Losses from severe thunderstorm related catastrophe events totaled \$9,178,000 in 2017 compared to \$3,483,000 for the same period last year. The single largest catastrophe event in 2017 was a January severe thunderstorm event that heavily impacted Georgia along with several other states and generated \$2,125,000 in insured losses. In comparison, the single largest catastrophe event in 2016 was a February severe thunderstorm event that totaled \$1,054,000 and primarily impacted the state of Louisiana.

P&C Segment Combined Ratio:

The P&C segment ended the first six months of 2017 with a combined ratio of 109.8% with catastrophe losses totaling \$9,178,000 and increasing the combined ratio by 33.3 percentage points. In comparison, 2016 cat events added \$3,483,000 to prior year policyholder benefits and settlement expenses. The P&C segment ended the first six months of 2016 with a combined ratio of 90.9% with catastrophe losses contributing 12.6 percentage points to the combined ratio.

Overview - Balance Sheet highlights at June 30, 2017 compared to December 31, 2016

Selected Balance Sheet Highlights	June 30, 2017	December 31, 2016
(dollars in thousands)	(UNAUDITED)	
Invested Assets	\$ 112,038	\$ 113,156
Cash	\$ 8,005	\$ 7,368
Total Assets	\$ 149,602	\$ 148,579
Policy Liabilities	\$ 78,909	\$ 76,174

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Total Debt	\$ 16,632	\$17,126
Accumulated Other Comprehensive Income	\$ 1,963	\$1,007
Shareholders' Equity	\$ 47,517	\$48,052
Book Value Per Share	\$ 18.84	\$19.09

35

Table of Contents

Invested Assets:

Invested assets as of June 30, 2017 were \$112,038,000 down \$1,118,000, or 1.0%, compared to \$113,156,000 as of December 31, 2016. Growth of invested assets was adversely impacted by increased claim payments associated with losses from catastrophe events in 2017, a decline in cash flow from operations and the maintenance of higher levels of liquidity due to the increase in P&C segment insurance claims throughout the first half of 2017.

Cash:

The Company, primarily through its insurance subsidiaries, had \$8,005,000 in cash and cash equivalents at June 30, 2017 compared to \$7,368,000 at December 31, 2016. The moderate increase in cash was due to an increase in cash flow provided from investments and delays in the reinvestment of invested assets due to increased storm activity in the second quarter of 2017.

Total Assets:

Total assets as of June 30, 2017 were \$149,602,000 compared to \$148,579,000 at December 31, 2016. While total assets increased in 2017, growth was negatively impacted by increased loss payments associated with the higher frequency of catastrophe events.

Policy Liabilities:

Policy liabilities were \$78,909,000 at June 30, 2017 compared to \$76,174,000 at December 31, 2016; an increase of \$2,735,000 or 3.6%. The primary reason for the increase in policy liabilities in 2017 compared to 2016 was a \$2,506,000 increase in unearned premiums. Due to the timing of insurance renewals across our entire book of P&C segment business, unearned premium tends to peak around mid year which is the primary factor contributing to the increase in unearned premium at June 30, 2017 compared to December 31, 2016.

Debt Outstanding:

Total debt at June 30, 2017 was \$16,632,000 compared to \$17,126,000 at December 31, 2016. Debt was reduced \$494,000 during the first half of 2017 due to a reduction in short term debt. The improvement of balance sheet strength through reduction of debt continues to be a primary focus of management.

Shareholders' Equity:

Shareholders' equity as of June 30, 2017 was \$47,517,000 down \$535,000 compared to December 31, 2016 Shareholders' equity of \$48,052,000. Book value per share was \$18.84 at June 30, 2017, compared to \$19.09 per share at December 31, 2016, a decrease of \$0.25. Despite the adverse impact of multiple catastrophe events in 2017, the Company had only a 1.3% decrease in book value per share and a 1.1% decrease in Shareholders' Equity during the first six months of 2017. The primary factor contributing to the decrease in Shareholders' equity was a net loss of \$1,315,000. In addition, Shareholders' equity was also reduced by dividends paid of \$252,000. Offsetting the decreases was an increase in accumulated other comprehensive income of \$956,000. The increase in accumulated other comprehensive income was driven by increases in market values of available-for-sale investment securities.

Table of Contents

Three month period ended June 30, 2017 compared to three month period ended June 30, 2016

Premium Revenue:

The table below provides earned premium revenue by segment for the three months ended June 30, 2017 and 2016:

(dollars in thousands)	Three months ended June 30,		Percent	
	2017	2016	increase (decrease)	
Life, accident and health operations premiums earned:				
Traditional life insurance	\$1,188	\$1,194	(0.5)%
Accident and health insurance	408	410	(0.5)%
Gross life, accident and health	1,596	1,604	(0.5)%
Reinsurance premium ceded	(14) (23) (39.1)%
Net life, accident and health premiums earned	\$1,582	\$1,581	0.1	%
Property and Casualty operations premiums earned:				
Dwelling fire & extended coverage	\$9,032	\$8,807	2.6	%
Homeowners (Including mobile homeowners)	5,744	5,881	(2.3)%
Other liability	527	503	4.8	%
Gross property and casualty	15,303	15,191	0.7	%
Reinsurance premium ceded	(1,554) (1,545) 0.6	%
Net property and casualty premiums earned	\$13,749	\$13,646	0.8	%
Consolidated gross premiums earned	\$16,899	\$16,795	0.6	%
Reinsurance premium ceded	(1,568) (1,568) —	%
Consolidated net premiums earned	\$15,331	\$15,227	0.7	%

Consolidated net premium earned was up 0.7% for the quarter ended June 30, 2017, at \$15,331,000 compared to \$15,227,000 for the quarter ended June 30, 2016. The slight increase in net premium earned was due to a 0.7% increase in gross premium earned in the P&C segment which was partially offset by a 0.6% increase in ceded premium in the P&C segment. Net premium earned was up 0.1% in the life segment for the second quarter of 2017 compared to the same period last year.

Investment Income:

For the three months ended June 30, 2017, net investment income was \$930,000 compared to \$1,029,000 for the same period in 2016; a decrease of \$99,000 or 9.6%. The primary reason for the decline was a \$69,000 decrease in investment income in the P&C segment in second quarter 2017 compared to second quarter 2016. While investment yields have increased moderately in 2017, overall reinvestment rates for fixed income securities continue to be below the rates obtained on maturing investments which puts moderate downward pressure on our book yield on our investment portfolio.

Realized Investment Gains and Losses:

Realized investment gains, for the three months ended June 30, 2017, were \$77,000 compared to \$242,000 for the same period in 2016. The largest portion of the \$165,000 decrease was attributable to the P&C segment in the second quarter of 2017. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and therefore can vary significantly from quarter to quarter and year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to

year.

Other Income:

Other income was comparable at \$145,000 for the three months ended June 30, 2017, compared to \$150,000 for the same period in 2016; a decrease of \$5,000. Other income consists primarily of fees related to the issuance of our property insurance policies as well as other miscellaneous income. As a percent of total revenue, other income was 0.9% in second quarter 2017 and 2016.

37

Table of Contents

Policyholder Benefits:

Policyholder claims were \$12,581,000 for the three months ended June 30, 2017, compared to \$8,862,000 for the three months ended June 30, 2016; an increase of \$3,719,000 or 42.0%. Claims as a percentage of premium earned was 82.1% in the second quarter of 2017 compared to 58.2% in the second quarter of 2016. A significant increase in the frequency of catastrophe losses generated from increased severe thunderstorm activity throughout the first half of 2017 was the primary factor contributing to the increase in policyholder benefits in the second quarter of 2017.

The table below provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the three months ended June 30, 2017 and 2016 (dollars in thousands). (Note: this table includes both reported claims from catastrophe events incurred in the second quarter and development of first quarter catastrophe events from claims reported in the second quarter of each year):

For the three months ended June 30, 2017			For the three months ended June 30, 2016		
Cat Event	Reported Losses & LAE	Claim Count	Cat Event	Reported Losses & LAE	Claim Count
Cat 11 (Jan 1-3)	\$ 24	2	Cat 16 (Feb 22-24)	\$ 56	6
Cat 13 (Jan 18-22)	91	15	Cat 17 (Mar 5-11)	50	9
Cat 19 (Feb 28-Mar 2)	217	54	Cat 22 (Mar 30-Apr 1)	204	55
Cat 20 (Mar 6-9)	22	8	Cat 27 (Apr 25-28)	199	48
Cat 21 (Mar 21-22)	173	37	Cat 28 (Apr 29-May 3)	546	109
Cat 22 (Mar 26-28)	414	72	Cat 29 (May 7-10)	202	24
Cat 24 (Apr 2-3)	768	150	Cat 31 (May 16-19)	140	30
Cat 25 (Apr 4-6)	612	152	Cat 32 (May 26-28)	144	13
Cat 28 (Apr 21-25)	407	63	Cat 35 (Jun 16-18)	353	92
Cat 30 (Apr 28-May 1)	762	169			
Cat 31 (May 3-5)	483	97			
Cat 32 (May 8-11)	255	47			
Cat 33 (May 15-18)	284	48			
Cat 34 (May 27-28)	596	77			
Cat 38 (June 2-4)	147	41			
T.S. Cindy (June 21-25)	362	90			
Misc cats less than \$100k	40	3	Misc cats less than \$100k	142	31
Total Cat losses	\$ 5,657	1,125	Total Cat losses	\$ 2,036	417
Non-cat wind & hail	\$ 1,787	427	Non-cat wind & hail	\$ 1,824	489

During the second quarter of 2017, the P&C segment was impacted by 13 catastrophe events and development on eight catastrophe events from first quarter of 2017 totaling \$5,657,000 from 1,125 claims. Net of tax, these losses reduced second quarter net income by \$3,734,000 or \$1.48 per share. Second quarter 2017 catastrophe events and first quarter 2017 cat event development contributed 40.7 percentage points to the second quarter P&C combined ratio. In comparison, the P&C segment was impacted by seven catastrophe events and development on six catastrophe events from first quarter of 2016 totaling \$2,036,000 from 417 claims. Net of tax, these losses reduced second quarter 2016 net income by \$1,344,000 or \$0.53 per share. Second quarter 2016 catastrophe events and first quarter 2016 cat event development contributed 14.8 percentage points to the second quarter 2016 P&C combined ratio.

In the second quarter of 2017, our catastrophe losses were above normal driven by a high frequency of isolated severe thunderstorm events across the Southeastern U.S. While the claims incurred from second quarter 2017 cat events were widespread across our coverage area, incurred losses from these second quarter cat events heavily impacted Alabama

and Oklahoma. Incurred losses from cat events impacting Alabama made up approximately 30% of all losses incurred from cat events in the second quarter of 2017. Furthermore, incurred losses from second quarter cat events impacting Oklahoma made up an additional 20% of all claims incurred from cat events in the second quarter of 2017.

Table of Contents

In comparison, Oklahoma made up approximately 28% of all losses incurred from cat events in the second quarter 2016 while Alabama made up approximately 16% of all losses incurred from second quarter 2016 cat events.

Non-catastrophe wind and hail claims reported in the second quarter of 2017 totaled \$1,787,000 compared to non-catastrophe wind and hail claims reported in the second quarter of 2016 totaling \$1,824,000; a decrease of \$37,000 or 2.0%. During the three months ended June 30, 2017, the P&C segment had 427 non-cat wind and hail claims reported (an average of \$4,200 per claim) compared to 489 claims reported during the three months ended June 30, 2016 (an average of \$3,700 per claim). Non-cat wind and hail claims reported during the second quarter of 2017 accounted for 15.9% of total P&C segment incurred losses in the current year. Non-cat wind and hail claims reported during the second quarter of 2016 accounted for 24.1% of total P&C segment incurred losses in 2016.

In addition to overall policyholder benefit payments being up in the property and casualty segment due to a higher frequency of cat event losses, fire losses reported in the second quarter of 2017 were also up \$431,000 or 14.6% compared to fire losses reported during the second quarter of 2016. The P&C segment had 122 fire losses reported in the second quarter of 2017 totaling \$3,385,000 compared to 113 claims reported in the second quarter of 2016 totaling \$2,954,000. The average cost per claim was \$27,700 for fire losses reported in the second quarter of 2017 compared to \$26,100 for fire losses reported in the second quarter of 2016.

Policy Acquisition Cost (Commissions and Amortization of Deferred Acquisition Cost):

For the three months ended June 30, 2017, policy acquisition costs were \$2,577,000 compared to \$3,023,000 for the same period in 2016; a decrease of \$446,000 or 14.8%. Policy acquisition costs consist of amortization of previously capitalized distribution costs and current commission payments to agents. The primary reason for the decline was a reduction in estimated contingent commissions in the P&C segment in the second quarter of 2017 compared to the second quarter of 2016. With the significant increase in storm losses in 2017 compared to last year, it is our expectation that full year contingent commission payments to our agents will be down in 2017. As a percentage of premium revenue, policy acquisition costs were 16.8% in the second quarter of 2017 compared to 19.9% for the same period in 2016.

General Expenses:

General and administrative expenses were comparable at \$2,215,000 in the second quarter of 2017 compared to \$2,158,000 in the second quarter of 2016; a \$57,000 or 2.6% increase. As a percent of net premium, general and administrative expenses were 14.4% in second quarter 2017 compared to 14.2% in second quarter 2016.

Taxes, Licenses and Fees:

Insurance taxes, licenses and fees were \$517,000 for the three months ended June 30, 2017, compared to \$574,000 for the same period in 2016. As a percentage of net premiums earned, insurance taxes, licenses and fees were 3.4% for the three months ended June 30, 2017 compared to 3.8% for the three months ended June 30, 2016.

Interest Expense:

Interest expense for the second quarter of 2017 was \$326,000 compared to \$333,000 for the same period in 2016. A reduction in total debt outstanding over the past twelve months was the primary factor contributing to the \$7,000 decrease.

Income Taxes:

For the three month period ended June 30, 2017, the Company had a pretax loss of \$1,733,000 compared to pretax income of \$1,698,000 for the same period in 2016. The \$734,000 tax benefit for the second quarter of 2017 consisted of current tax benefit of \$572,000 and deferred tax benefit of \$162,000. Tax expense for the second quarter of 2016 consisted of current tax expense of \$399,000 and deferred tax expense of \$3,000.

Net Income (Loss):

The Company ended the second quarter of 2017 with a net loss of \$999,000 compared to net income of \$1,296,000 for the same period in 2016. As discussed in detail above, the primary reason for the second quarter 2017 net loss compared to second quarter 2016 net income was an increase in storm related losses.

Table of Contents

Six month period ended June 30, 2017 compared to six month period ended June 30, 2016:

Premium Revenue:

The table below provides earned premium revenue by segment for the six months ended June 30, 2017 and 2016:

(dollars in thousands)	Six months ended		Percent	
	June 30, 2017	2016	increase (decrease)	
Life, accident and health operations premiums earned:				
Traditional life insurance	\$2,346	\$2,367	(0.9)%
Accident and health insurance	830	826	0.5	%
Gross life, accident and health	3,176	3,193	(0.5)%
Reinsurance premium ceded	(43)	(48)	(10.4)%
Net life, accident and health premiums earned	\$3,133	\$3,145	(0.4)%
Property and Casualty operations premiums earned:				
Dwelling fire & extended coverage	\$17,848	\$17,469	2.2	%
Homeowners (Including mobile homeowners)	11,464	11,787	(2.7)%
Other liability	1,040	996	4.4	%
Gross property and casualty	30,352	30,252	0.3	%
Reinsurance premium ceded	(3,114)	(3,005)	3.6	%
Net property and casualty premiums earned	\$27,238	\$27,247	—	%
Consolidated gross premiums earned	\$33,528	\$33,445	0.2	%
Reinsurance premium ceded	(3,157)	(3,053)	3.4	%
Consolidated net premiums earned	\$30,371	\$30,392	(0.1)%

Consolidated net premium earned was down 0.1% for the year ended June 30, 2017, at \$30,371,000 compared to \$30,392,000 for the year ended June 30, 2016; a slight decline of \$21,000. The decrease in net premium earned was due to a 0.4% decrease in net premium earned in the life segment coupled with a \$9,000 decrease in net premium earned in the P&C segment. A 3.6% increase in catastrophe reinsurance cost in the P&C segment also contributed to the decline in net premium earned in the P&C segment. The increase in catastrophe reinsurance cost was due to a 5.5% catastrophe reinsurance rate increase in our 2017 calendar year contract renewal.

An increased focus on rate adequacy in our P&C segment over the past four years has decreased our rate of growth in gross premium earned. This focus on rate adequacy has resulted in rate increases across most states and lines of business in which we operate. However, as more of our programs in various states are reaching rate adequacy, we will likely be able to implement moderate rate reductions in some of our programs in 2017 which we expect to improve our gross written premium growth. In addition, it should be noted that we are experiencing some increases in competitive pressures in our markets but we will not be overly aggressive in chasing market share at rates that are inadequate to maintain long term underwriting profitability. While our 2017 results to date have been disappointing, we believe that our focus on rate adequacy mitigated the impact on our underwriting results and was a primary factor in maintaining our strong capital position despite the increased frequency of 2017 catastrophe losses.

The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. With our 2017 catastrophe contract placement, our catastrophe retention remained unchanged from last year at \$4 million and, also unchanged from last year, we maintain catastrophe reinsurance covering incurred claims of a single catastrophe event up to \$72.5 million. Our catastrophe reinsurance has a reinstatement provision for one event and

covers the cost of a second event up to the same \$72.5 million upper limit. In our reinsurance structure, management attempts to limit the impact on pretax earnings of a single modeled 100 year cat event to no more than \$4 million (net of reinsurance). It is noted, however, that hurricane models are subject to significant risk and are only a tool to estimate the impact of catastrophe events. The Company also has risk associated with multiple smaller catastrophe events, such as those experienced in 2017, that individually may not exceed our \$4 million retention and would not be covered under our catastrophe reinsurance contract. While 2017 has a high frequency of catastrophe related losses, no single event approached the upper limit of our \$4 million retention under our catastrophe reinsurance coverage.

Table of Contents

Under the catastrophe reinsurance program in 2017, the Company retains the first \$4,000,000 in losses from each event. Reinsurance coverage is maintained in three layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	100% of \$13,500,000 in excess of \$4,000,000 retention
Second Layer	100% of \$25,000,000 in excess of \$17,500,000
Third Layer	100% of \$30,000,000 in excess of \$42,500,000

Investment Income:

For the six months ended June 30, 2017, net investment income was \$1,856,000 compared to \$2,020,000 for the same period in 2016; an decrease of \$164,000. The primary reason for the decrease in net investment income in the first six months of 2017 compared to the same period in 2016 was a decline in interest income primarily related to fixed income investments.

Realized Investment Gains and Losses:

For the six months ended June 30, 2017, the Company had net realized capital gains totaling \$237,000 compared to \$249,000 for the same period in 2016. The \$12,000 change was primarily associated with sales of fixed income investments. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and therefore can vary significantly from quarter to quarter and year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to year.

Other Income:

Other income was \$297,000 for the six months ended June 30, 2017, compared to \$304,000 for the same period in 2016; a decrease of \$7,000. Other income consists primarily of fees related to the issuance of our property insurance policies as well as other miscellaneous income. As a percentage of total revenue, other income was 0.9% in 2017 and 2016.

Policyholder Benefits:

Policyholder claims were \$23,727,000 for the six months ended June 30, 2017, compared to \$17,909,000 for the six months ended June 30, 2016; an increase of \$5,818,000 or 32.5%. Claims as a percentage of premium earned was 78.1% in the first half of 2017 compared to 58.9% in the first half of 2016. Policyholder benefits were up due to an increase in P&C segment claims in the first six months of 2017 compared to the same period in 2016. The increase in P&C segment claims were from a \$5,695,000 increase in reported catastrophe event losses. However, offsetting the increase in cat losses were a decline in reported non-cat wind and hail claims totaling \$319,000 and a decline in reported fire claims totaling \$79,000 in the P&C segment.

Table of Contents

The table below provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the six months ended June 30, 2017 and 2016 (dollars in thousands):

For the six months ended June 30, 2017			For the six months ended June 30, 2016		
Cat event	Reported Losses & LAE	Claim Count	Cat event	Reported Losses & LAE	Claim Count
Cat 11 (Jan 1-3)	\$ 801	180	Cat 16 (Feb 22-24)	\$ 1,054	239
Cat 13 (Jan 18-22)	2,125	367	Cat 17 (Mar 5-11)	329	101
Cat 19 (Feb 28-Mar 2)	547	142	Cat 22 (Mar 30-Apr 1)	204	55
Cat 20 (Mar 6-9)	128	43	Cat 27 (Apr 25-28)	199	48
Cat 21 (Mar 21-22)	288	69	Cat 28 (Apr 29-May 3)	546	109
Cat 22 (Mar 26-28)	414	72	Cat 29 (May 7-10)	202	24
Cat 24 (Apr 2-3)	768	150	Cat 31 (May 16-19)	140	30
Cat 25 (Apr 4-6)	612	152	Cat 32 (May 26-28)	144	13
Cat 28 (Apr 21-25)	407	63	Cat 35 (Jun 16-18)	353	92
Cat 30 (Apr 28-May 1)	762	169			
Cat 31 (May 3-5)	483	97			
Cat 32 (May 8-11)	255	47			
Cat 33 (May 15-18)	284	48			
Cat 34 (May 27-28)	596	77			
Cat 38 (June 2-4)	147	41			
T.S. Cindy (June 21-25)	362	90			
Misc cats less than \$100k	199	49	Misc cats less than \$100k	312	91
Total Cat losses	\$ 9,178	1,856	Total Cat losses	\$ 3,483	802
Non-cat wind & hail	\$ 2,940	727	Non-cat wind & hail	\$ 3,259	975

During the first six months of 2017, the P&C segment was impacted by 21 catastrophe events producing 1,856 policyholder claims totaling \$9,178,000. Net of tax, these losses reduced 2017 net income by \$6,057,000 or \$2.41 per share. In comparison, the P&C segment was impacted by 13 catastrophe events from 802 claims totaling \$3,483,000. Net of tax, 2016 catastrophe losses reduced net income for the six month period ended June 30, 2016 by \$2,299,000 or \$0.91 per share.

During the current year, Alabama and Georgia were the primary source of the reported cat claims, while Louisiana and Oklahoma were the primary source of the reported cat event claims during 2016. The 2017 cat event claims reported from Alabama and Georgia accounted for 26.3% of all reported cat event claims in 2017. In 2016, the cat event claims reported in Louisiana and Oklahoma accounted for 39.0% of all reported cat event claims.

Non-catastrophe wind and hail claims reported in the first half of 2017 totaled \$2,940,000 compared to non-catastrophe wind and hail claims reported in the first half of 2016 totaling \$3,259,000; a decrease of \$319,000 or 9.8%. During the first six months of 2017, the P&C segment had 727 non-cat wind and hail claims reported (an average of \$4,000 per claim) compared to 975 claims reported during the first six months of 2016 (an average of \$3,300 per claim). Non-cat wind and hail claims reported during the first half of 2017 accounted for 13.9% of total P&C segment incurred losses and LAE in the current year. Non-cat wind and hail claims reported during the first half of 2016 accounted for 21.1% of total P&C segment incurred losses and LAE in 2016.

Year to date policyholder benefit payments were up in the property and casualty segment due to an increase in frequency of reported losses from catastrophe events; however, reported fire losses were down slightly in 2017 compared to 2016. Reported fire losses were down \$79,000 or 1.1% in 2017 compared to fire losses reported during

the first half of 2016. The P&C segment had 257 fire losses reported for the period ended June 30, 2017, totaling \$6,906,000 compared to 242 fire claims reported for the same period in 2016 totaling \$6,985,000. The average cost per claim was \$26,900 for fire losses reported in 2017 compared to \$28,900 for fire losses reported in 2016.

Table of Contents

Policy Acquisition Cost (Commissions and Amortization of Deferred Acquisition Cost):

For the six months ended June 30, 2017, policy acquisition costs were \$5,615,000 compared to \$5,918,000 for the same period in 2016; a decrease of \$303,000. Policy acquisition costs consist of amortization of previously capitalized distribution costs and current commission payments to agents. As a percentage of premium revenue, policy acquisition costs were 18.5% in the first half of 2017 compared to 19.5% for the same period in 2016. Policy acquisition cost are down due to a reduction in our estimate of 2017 contingent commission payments to agents due to underwriting losses generated by increased catastrophe losses in the P&C segment.

General Expenses:

Year to date general and administrative expenses totaled \$4,012,000 in 2017 compared to \$4,287,000 in 2016; a 6.4% decrease. The primary reason for the \$275,000 decrease in general and administrative expenses in 2017 compared to 2016 was an decrease in actuarial fees paid associated with rate filings in the P&C segment.

Taxes, Licenses and Fees:

Insurance taxes, licenses and fees were comparable at \$1,206,000 for the six months ended June 30, 2017, compared to \$1,174,000 for the same period in 2016. As a percentage of net premiums earned, insurance taxes, licenses and fees were 4.0% for the six months ended June 30, 2017 compared to 3.9% for the six months ended June 30, 2016.

Interest Expense:

Interest expense for the first half of 2017 was \$649,000 compared to \$678,000 for the same period in 2016; a decrease of 4.3%. The primary reason for the \$29,000 decrease was due to a reduction in debt outstanding.

Income Taxes:

For the six month period ended June 30, 2017, the Company had a pretax loss of \$2,448,000 compared to pretax income of \$2,999,000 for the same period in 2016. The \$1,133,000 tax benefit for the first half 2017 consisted of current tax benefit of \$897,000 and deferred tax benefit of \$236,000. Tax expense of \$762,000 for the first half of 2016 consisted of current tax expense of \$620,000 and deferred tax expense of \$142,000.

Net Income (Loss):

The Company ended the first half of 2017 with a net loss of \$1,315,000 compared to net income of \$2,237,000 for the same period in 2016. The primary factor contributing to the \$3,552,000 decrease in net income was a \$5,695,000 increase in reported losses from cat events in 2017 compared to 2016.

Liquidity and Capital Resources:

Due to regulatory restrictions, the majority of the Company's cash is required to be invested in investment-grade securities to provide protection for policyholders. The liabilities of the property and casualty insurance subsidiaries are of various terms, and therefore, those subsidiaries invest in securities with various effective maturities spread over periods usually not exceeding 10 years with an average portfolio duration typically of less than 5 years. The liabilities of the life insurance subsidiary are typically of a longer duration, and therefore, a higher percentage of securities in the life insurance subsidiary are invested for periods exceeding 10 years.

The liquidity requirements for the Company are primarily met by funds generated from operations of the life insurance and property/casualty insurance subsidiaries. All operations and virtually all investments are maintained by the insurance subsidiaries. Premium and investment income as well as maturities and sales of invested assets provide the primary sources of cash for both the life and property/casualty businesses, while applications of cash are applied by both businesses to the payment of policy benefits, the cost of acquiring new business (principally commissions), operating expenses, purchases of new investments, and in the case of life insurance, policy loans.

Table of Contents

Virtually all invested assets of the Company are held in the insurance subsidiaries. As of June 30, 2017, the contractual maturity schedule for all bonds and notes held by the Company, stated at amortized cost, was as follows (dollars in thousands):

Maturity	Available- for-Sale	Held-to-Maturity	Total	Percentage of Total	
Maturity in less than 1 year	\$ 1,240	\$ 13	\$1,253	1.34	%
Maturity in 1-5 years	15,766	1	15,767	16.92	%
Maturity in 5-10 years	32,905	70	32,975	35.38	%
Maturity after 10 years	41,555	1,657	43,212	46.36	%
	\$ 91,466	\$ 1,741	\$93,207	100.00	%

It should be noted that the above table represents maturities based on stated/contractual maturity. Due to call and prepayment features inherent in some debt securities and principal pay-downs on mortgage backed securities, actual repayment, or effective maturities, will differ from stated maturities. The Company routinely evaluates the impact of changing interest rates on the projected maturities of bonds in the portfolio and actively manages the portfolio in order to minimize the impact of interest rate risk. However, due to other factors, both regulatory and those associated with good investment management practices associated with asset/liability matching, we do have exposure to changes in market values of securities due to changes in interest rates. Currently, a 100 basis point immediate increase in interest rates (represented by a parallel shift in the yield curve) would generate approximately a \$5,271,000, or 5.8%, decline in the market value of fixed income investments. Alternatively, a 100 basis point decrease in interest rates will generate approximately \$5,445,000, or 6.0%, increase in market value of fixed income investments. Management has attempted, to the extent possible, to reduce risk in a rising rate environment. However, due to asset liability matching requirements, particularly in the life subsidiary portfolio, interest rate risk can not be eliminated and exposure to market volatility can cause some variability in our accumulated other comprehensive income, total shareholders' equity and book value per share.

At June 30, 2017, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$47,517,000, down \$535,000 compared to \$48,052,000 at December 31, 2016. Components of the change in equity were a net loss of \$1,315,000, increase in accumulated unrealized gains on investments of \$846,000, a net unrealized gain of \$110,000 related to interest rate swaps and cash dividends paid totaling \$252,000.

As discussed above, changing interest rates can have a significant impact on the market value of fixed income securities. Fixed income securities classified as available-for-sale increase the liquidity resources of the Company as they can be sold at any time to pay claims or meet other Company obligations. However, these securities are required to be carried at market value with net of tax accumulated unrealized gains and losses directly impacting shareholder's equity. While the increase in interest rates causes near term declines in the value of fixed income securities, we are able to reap the benefit of reinvesting at higher rates as current fixed income investments are called, amortized (mortgage backed securities) or reach contractual maturity. Over the next twelve months, based on cash flow projection modeling that considers such factors as anticipated principal payments on mortgage backed securities, likelihood of call provisions being enacted and regular contractual maturities, we expect approximately 4% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.

The Company, primarily through its insurance subsidiaries, had \$8,005,000 in cash and cash equivalents at June 30, 2017, compared to \$4,063,000 at June 30, 2016. Cash used by operating activities decreased cash by \$447,000 during the six months ended June 30, 2017. The decrease in cash from operating activities was primarily related to the net loss for the period generated by increased catastrophe losses in the P&C segment. For the six months ended June 30, 2016, cash provided by operating activities totaled \$1,359,000 and was primarily driven by an increase in recovery of reinsurance balances receivable.

Net cash provided by investing activities totaled \$1,796,000 for the period ended June 30, 2017, compared to cash used of \$3,861,000 for the same period last year. Cash provided by investing activities was utilized to offset reduced cash from operations due to increased storm activity and to reduce debt during the six months ended June 30, 2017. Also, the decrease in cash from operations adversely impacted investment growth during the period. For the six months ended June 30, 2016, cash used in investing activities totaled \$3,861,000. The investment of cash held at December 31, 2015 and reinvestment of fixed income securities were the primary cash related investment activities during the period.

Table of Contents

Net cash used in financing activities totaled \$712,000 for the six months ended June 30, 2017, compared to \$198,000 for the same period last year. During the six months ended June 30, 2017, the Company repaid \$1,000,000 in long-term debt and drew down \$500,000 from an operating line of credit. The Company maintains a \$1,000,000 operating line of credit which matures in September 2017, as well as a \$700,000 line of credit which matures in March of 2018. Between the two lines of credit, \$1,200,000 was available at June 30, 2017.

The Company had a total of \$15,332,000 of long-term debt outstanding as of June 30, 2017, compared to \$15,326,000 at December 31, 2016, which includes \$12,372,000 in trust preferred securities issued by the Company in addition to the installment note. Current year and prior year amounts were reduced by the unamortized portion of the placement fees associated with the issuance of the trust preferred securities, \$240,000 and \$246,000, respectively.

The ability of the Company to meet its commitments for timely payment of claims and other expenses depends, in addition to current cash flow, on the liquidity of its investments. The Company has relatively little exposure to below investment grade fixed income investments, which might be especially subject to liquidity problems due to thinly traded markets.

The Company's liquidity requirements are primarily met by funds provided from operations of the insurance subsidiaries. The Company receives funds from its subsidiaries through payment of dividends, management fees, reimbursements for federal income taxes and reimbursement of expenses incurred at the corporate level for the subsidiaries. These funds are used to pay stockholder dividends, principal and interest on debt, corporate administrative expenses, federal income taxes, and for funding investments in the subsidiaries. The Company maintains minimal liquidity in order to maximize liquidity within the insurance subsidiaries in order to support ongoing insurance operations. The Company has no separate source of revenue other than dividends and fees from the insurance subsidiaries. Also, dividends from the insurance subsidiaries are subject to regulatory restrictions and, therefore, are limited depending on capital levels and earnings of the subsidiaries.

Our P&C segment is the primary source of dividends to the holding company. Consideration of insurance subsidiary growth opportunities, regulatory capital adequacy, rating agency impact and holding company debt reduction, among other items, are factors that influence our subsidiary dividend requirements. While we have made significant progress over the past four years, strengthening capital levels in the insurance subsidiaries and reduction of debt remains a top priority.

Dividends paid from the insurance subsidiaries are subject to regulatory restrictions and prior approval of the Alabama Department of Insurance. As disclosed in Note 12 to the audited Consolidated Financial Statements included in our 2016 Annual Report on Form 10-K, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company during 2017 is statutorily limited to \$1,642,000 in the life insurance subsidiary and \$3,524,000 in the property/casualty insurance subsidiary. Dividends are limited to the greater of net income (operating income for life subsidiary) or 10% of statutory capital, and regulators consider dividends paid within the preceding twelve months when calculating the available dividend capacity. Therefore, all of the above referenced dividend capacity will not be available for consideration of payment until dividends paid in the preceding twelve months have been considered on a rolling basis. The Company also has to continuously evaluate other factors such as subsidiary operating performance, subsidiary capital requirements and potential impact by rating agencies in making decisions on how much capital can be released from insurance subsidiaries for payment of dividends to NSG. These factors are considered along with the goal of growing year over year statutory surplus in the subsidiaries, and these considerations along with potential adverse impacts on regulatory surplus, will likely lead to dividend payments to NSG substantially below the above referenced regulatory maximums. The Company received \$500,000 dividends from its subsidiaries during the six months ended June 30, 2017.

The Company's subsidiaries require cash in order to fund policy acquisition costs, claims, other policy benefits, interest expense, general expenses, and dividends to the Company. Premium and investment income, as well as maturities, calls, and sales of invested assets, provide the primary sources of cash for both subsidiaries. A significant portion of the Company's investment portfolio, which is held by the insurance subsidiaries, consists of readily marketable securities, which can be sold for cash.

The Company continues to monitor liquidity and subsidiary capital closely. Improved underwriting results stemming from the discontinuation of unprofitable lines of business, favorable tropical weather patterns, streamlining of products offered combined with enhancements to the Company's rate development process and improvements in the Company's catastrophe reinsurance structure have reduced the pressure on subsidiary capital levels. However, continuing to strengthen subsidiary capital continues to be a top priority for management.

Table of Contents

Except as discussed above, the Company is unaware of any known trends, events, or uncertainties reasonably likely to have a material effect on its liquidity, capital resources, or operations. Additionally, the Company has not been made aware of any recommendations of regulatory authorities, which if implemented, would have such an effect.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Under smaller reporting company rules we are not required to disclose information required under Item 3. However, in order to provide information to our investors, we have elected to provide information related to market risk.

The Company's primary objectives in managing its investment portfolio are to maximize investment income and total investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including changes in interest rates, overall market conditions, underwriting results, regulatory requirements and tax position. Investment decisions are made by management and reviewed by the Board of Directors. Market risk represents the potential for loss due to adverse changes in fair value of securities. The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk and default risk. The primary risk related to the Company's equity portfolio is equity price risk.

Since the Company's assets and liabilities are largely monetary in nature, the Company's financial position and earnings are subject to risks resulting from changes in interest rates at varying maturities, changes in spreads over U.S. Treasuries on new investment opportunities and changes in the yield curve and equity pricing risks.

The Company is exposed to equity price risk on its equity securities. The Company holds common stock with a fair value of \$4,669,000. Our portfolio has historically been highly correlated to the S&P 500 with regard to market risk. Based on an evaluation of the historical risk measure of our portfolio relative to the S&P 500, if the market value of the S&P 500 Index decreased 10% from its June 30, 2017 value, the fair value of the Company's common stock investments would decrease by approximately \$470,000.

Certain fixed interest rate market risk sensitive instruments may not give rise to incremental income or loss during the period illustrated but may be subject to changes in fair values. Note 5 in the consolidated financial statements present additional disclosures concerning fair values of Financial Assets and Financial Liabilities and are incorporated by reference herein.

The Company limits the extent of its market risk by purchasing securities that are backed by entities considered to be financially stable, the majority of the assets are issued by U.S. government sponsored entities or corporate entities with debt considered to be "investment grade". Also, the majority of all of the subsidiaries' CMO's are Planned Amortization Class (PAC) bonds. PAC bonds are typically the lowest risk CMO's, and provide greater cash flow predictability. Such securities with reduced risk typically have a lower yield, but higher liquidity, than higher-risk mortgage backed bonds. To reduce the risk of losing principal should prepayments exceed expectations, the Company generally does not purchase mortgage backed securities at significant premiums over par value.

The Company's investment approach in the equity markets is based primarily on a fundamental analysis of value. This approach requires the investment committee to invest in well managed, primarily dividend paying companies, which have a low debt to capital ratio, above average return on capital for a sustained period of time, and low volatility rating (beta) relative to the market. The dividends provide a steady cash flow to help pay current claim liabilities, and it has been the Company's experience that by following this investment strategy, long term investment results have been superior to those offered by bonds, while keeping the risk of loss of capital to a minimum relative to the overall equity market.

As for shifts in investment allocations, the Company has used improved cash flows from insurance operations to increase allocations to corporate and US Government bonds.

Table of Contents

Item 4. Controls and Procedures

Our management carried out an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as of June 30, 2017. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There has not been any change in our internal control over financial reporting in connection with the evaluation required by Rule 13A-15(d) under the Exchange Act that occurred during the six month period ended June 30, 2017, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

Please refer to Note 13 to the condensed consolidated financial statements included herein, and the 2016 Annual Report filed on Form 10-K.

Item 1A. Risk Factors

There has been no material change in risk factors previously disclosed under Item 1A. of the Company's Annual Report for 2016 on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

None

Item 5. Other Information

None

Table of Contents

Item 6. Exhibits

a. Exhibits

- 31.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCHXBRL Taxonomy Extension Schema Document
- 101.CALXBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LABXBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

b. During the last fiscal quarter of the period covered by this Report, the Company filed the following Current Reports on Form 8-K:

Date of Report	Date Filed	Description
April 14, 2017	April 14, 2017	Press release, dated April 14, 2017, issued by The National Security Group, Inc.
April 21, 2017	April 21, 2017	Press release, dated April 21, 2017, issued by The National Security Group, Inc.
May 12, 2017	May 12, 2017	Press release, dated May 12, 2017, issued by The National Security Group, Inc.
May 19, 2017	May 19, 2017	Item 7.01, 9.01 - investor presentation
May 22, 2017	May 22, 2017	Item 5.07 - announcement of annual meeting voting results

Table of Contents

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed by the undersigned duly authorized officer, on its behalf and in the capacity indicated.

The National Security Group, Inc.

/s/ Brian R. McLeod

Brian R. McLeod

Chief Financial Officer and Treasurer

/s/ William L. Brunson, Jr.

William L. Brunson, Jr.

President, Chief Executive Officer and Director

Date: August 11, 2017