

NATIONAL SECURITY GROUP INC

Form 10-K

March 17, 2017

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

---

FORM 10-K

---

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal Period Ended December 31, 2016

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 Incorporation or Organization)	(IRS Employer 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

---

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

None

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

Common Stock, par value \$1.00 per share	The NASDAQ Global Market (EXCHANGE)
------------------------------------------	-------------------------------------

---

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

Yes  No

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

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of the last business day of the registrant's most recently completed second fiscal quarter, based upon the bid price of these shares on NASDAQ on such date, was \$27,430,335

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock, as of the close of the period covered by this report.

---

Class	Outstanding March 17, 2017
-------	----------------------------

Common Stock \$1.00 par value	2,517,339 shares
-------------------------------	------------------

---

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

TABLE OF CONTENTS

	Page No.
PART I	
<u>Item 1. Business</u>	<u>3</u>
<u>Item 1A. Risk Factors</u>	<u>11</u>
<u>Item 1B. Unresolved Staff Comments</u>	<u>17</u>
<u>Item 2. Properties</u>	<u>17</u>
<u>Item 3. Legal Proceedings</u>	<u>17</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>17</u>
PART II	
<u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>17</u>
<u>Item 6. Selected Financial Data</u>	<u>19</u>
<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>19</u>
<u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>39</u>
<u>Item 8. Financial Statements and Supplementary Data</u>	<u>40</u>
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>82</u>
<u>Item 9A. Controls and Procedures</u>	<u>82</u>
<u>Item 9B. Other Information</u>	<u>82</u>
PART III	
<u>Item 10. Directors, Executive Officers and Corporate Governance</u>	<u>83</u>
<u>Item 11. Executive Compensation</u>	<u>83</u>
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>83</u>
<u>Item 13. Certain Relationships and Related Transactions and Director Independence</u>	<u>83</u>
<u>Item 14. Principal Accounting Fees and Services</u>	<u>83</u>
PART IV	
<u>Item 15. Exhibits and Financial Statement Schedules</u>	<u>84</u>
<u>Signature Page</u>	<u>85</u>

Certifications

DOCUMENTS INCORPORATED BY REFERENCE

Definitive proxy statement for the 2017 Annual Meeting of Stockholders to be held May 19, 2017 is incorporated by 1. reference into Part III of this report. The proxy statement will be filed no later than 120 days from December 31, 2016.

2. Current Report on Form 8-K for event occurring on February 28, 2017 is incorporated into Part IV of this report.

Table of Contents

PART I. Financial Information

Item 1. Business

Summary Description of The National Security Group, Inc.

The National Security Group, Inc. (the Company, NSG, we, us, our), an insurance holding company, was incorporated in Delaware on March 20, 1990. Our common stock is traded on the NASDAQ Global Market under the symbol NSEC.

Pursuant to regulations of the United States Securities and Exchange Commission (SEC), we are considered a “Smaller Reporting Company” as defined by SEC rules. We have elected to utilize an “a la carte” scaled disclosure which permits smaller reporting companies to elect to comply with scaled financial and non-financial disclosure requirements on an item by item basis. The most significant reporting difference permitted under the scaled disclosures, which we have utilized, is to include two years of audited financial statements.

The Company, through its three wholly owned subsidiaries, operates in two industry segments: property and casualty (P&C) insurance and life insurance.

The property and casualty subsidiaries of the Company, National Security Fire and Casualty (NSFC), and Omega One Insurance Company (Omega), primarily write personal lines dwelling coverage including dwelling fire and windstorm, homeowners and mobile homeowners lines of insurance in ten states. Property and casualty insurance is the most significant industry segment, accounting for 90.6% of total premium revenues.

The Company's life insurance subsidiary, National Security Insurance Company (NSIC), offers a basic line of life and health and accident insurance products in seven states.

The majority of our assets and investments are held in the insurance company subsidiaries.

The Company's website address is: [www.nationalsecuritygroup.com](http://www.nationalsecuritygroup.com). The “Investors” section of our website (<http://investors.nationalsecuritygroup.com/>) provides numerous resources for investors seeking additional information about us. Our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K are made available on our website soon after filing with the SEC. Additionally, stock trades by insiders as filed on Forms 3, 4, and 5 are posted to the website after filing with the SEC. The website also provides information regarding corporate governance, stock quotes and press releases. Investors are encouraged to visit our website for additional information about the Company.

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.

Table of Contents

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.

Industry Segment and Geographical Area Information

Property and Casualty Insurance Segment

The Company's property and casualty insurance business is conducted through 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. This segment will be referred to throughout this report as NSFC, property-casualty segment or P&C segment. NSFC is licensed to write property and casualty insurance in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia, and operates on a surplus lines basis in the state of Louisiana. Omega is licensed to write insurance in Alabama and Louisiana.

Table of Contents

The following table indicates allocation of direct premium written by state for the years ended December 31, 2016 and 2015:

State	Percent of Direct Written Premium			
	2016		2015	
Alabama	\$16,988,000	27.80 %	\$17,232,000	28.52 %
Arkansas	2,282,000	3.73 %	2,445,000	4.05 %
Georgia	7,931,000	12.98 %	7,205,000	11.92 %
Louisiana	6,804,000	11.13 %	7,188,000	11.90 %
Mississippi	10,938,000	17.90 %	10,852,000	17.96 %
Oklahoma	6,366,000	10.42 %	5,699,000	9.43 %
South Carolina	6,518,000	10.66 %	6,400,000	10.59 %
Tennessee	3,287,000	5.38 %	3,402,000	5.63 %
	\$61,114,000	100.00 %	\$60,423,000	100.00 %

In general, the property-casualty insurance business involves the transfer by the insured, to an insurance company of all or a portion of certain risks for the payment, by the insured, of a premium to the insurance company. A portion of such risks is often retained by the insured in the form of deductibles, which vary from policy to policy, but are typically in the range of \$500 to \$1,000 on NSFC and Omega's primary dwelling property and homeowners lines of business.

The premiums or payments to be made by the insured for insurance policies of the property and casualty subsidiaries are based upon expected costs of providing benefits, underwriting and administering the policies. In determining the premium to be charged, the property and casualty subsidiaries utilize data from past claims experience, modeled catastrophe losses and anticipated claims estimates along with catastrophe reinsurance cost, commissions, taxes and general expenses.

The operating results of the property-casualty insurance industry are subject to significant fluctuations from quarter-to-quarter and from year-to-year. These fluctuations are often due to the effect of competition on pricing, unpredictable losses incurred in connection with weather-related and other catastrophic events, general economic conditions and other factors, such as changes in tax laws and the regulatory environment.

The following table sets forth the premiums earned (net of reinsurance) and pretax income during the periods reported for the property and casualty insurance segment:

	Year Ended December 31,	
	2016	2015
Net premiums earned:		
Fire, allied lines and homeowners	\$55,031,000	\$53,252,000
Other	133,000	(90,000 )
Total net earned premium	\$55,164,000	\$53,162,000
Income before taxes	\$5,446,000	\$7,070,000

#### Property and Casualty Loss Reserves

Our property and casualty insurance subsidiaries are required to maintain reserves to cover their ultimate liability for losses and adjustment expenses. Our staff periodically conducts reviews throughout the year of projected loss development information in order to adjust estimates. The liability for loss and adjustment expense reserves consists of an estimated liability for the ultimate settlement of claims that have been reported as well as an estimate of loss and adjustment expenses for incurred claims that have not yet been reported (IBNR). IBNR estimates are based primarily on historical development patterns using quantitative data generated from statistical information and qualitative

analysis of legal developments, economic conditions and development caused by events deemed to be infrequent in occurrence. The reserves are based on an estimate made by management. Management estimates are based on an analysis of historical paid and incurred loss development patterns for the previous ten loss years. Prior year period-to-period loss development factors are applied to latest reported loss reserve estimates in order to estimate the ultimate

5

---



Table of Contents

incurred losses for each given loss year. The amount of loss reserves estimated in excess of current reported case losses are recorded as IBNR reserves.

In addition to loss and loss adjustment expense reserves for specific claims, both reported and unreported, we establish reserves for loss adjustment expenses that are not attributable to specific claims. These reserves consist of estimates for Defense and Cost Containment (DCC) and Adjusting and Other Expenses (AO). These reserves are established for the estimated expenses of internal claims staff and the cost of outside experts, such as attorneys representing our interest, in the final settlement of incurred claims that are still in process of settlement. We conduct annual and interim reviews over the course of each year in order to insure that no significant changes have occurred in our loss development that might adversely impact our loss reserving methodology.

The following loss reserve re-estimates table illustrates the change over time of the net reserves established for property-liability insurance claims and claims expense at the end of the last 10 calendar years. The first section shows the reserves as originally reported at the end of the stated year. The second section, reading down, shows retroactive re-estimates of the original recorded reserve as of the end of each successive year. These re-estimates are the result of the Company's expanded awareness of additional facts and circumstances that pertain to the unsettled claims. The third section, reading down, shows the cumulative amounts paid as of the end of successive years with respect to that year's reserve liability. The last section compares the latest re-estimated reserve to the reserve originally established and indicates whether the original reserve was adequate to cover the estimated costs of unsettled claims. The Loss Reserve Re-estimates table is cumulative, and therefore, ending balances should not be added since the amount at the end of each calendar year includes activity for both the current and prior years.

While the information in the table provides a historical perspective on the adequacy of unpaid losses and loss adjustment expenses established in previous years, it should not be assumed to be predictive of redundancies or deficiencies on current year unpaid losses in future periods. Company management believes that the reserves established at the end of 2016 are adequate. However, due to inherent uncertainties in the loss reserve estimation process, management cannot guarantee that current year reserve balances will prove to be adequate. Due to the relatively short tail nature of the property and casualty subsidiaries' claim liabilities, the Company does not discount loss reserves for the time value of money. Dollar amounts in the following table are in thousands.

Gross unpaid losses per	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Consolidated Balance Sheet	\$12,498	\$11,973	\$14,436	\$12,646	\$13,184	\$14,386	\$11,214	\$8,734	\$8,321	\$9,645	\$7,53
Ceded reserves	(1,783 )	(555 )	(2,421 )	(549 )	(1,329 )	(2,381 )	(1,229 )	(782 )	(839 )	(1,381 )	(1,184 )
Net unpaid losses	\$10,715	\$11,418	\$12,015	\$12,097	\$11,855	\$12,005	\$9,985	\$7,952	\$7,482	\$8,264	\$6,34
Cumulative net payments:											
1 year later	\$6,438	\$4,797	\$5,636	\$5,349	\$5,738	\$4,035	\$4,827	\$2,900	\$2,990	\$4,482	
2 years later	8,103	6,496	6,350	6,305	7,239	5,346	6,670	3,539	3,503		
3 years later	9,652	6,767	6,725	6,764	7,841	6,483	7,426	3,782			
4 years	10,094	6,976	6,980	7,244	8,382	7,001	7,496				

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

	later										
	5										
	years	10,360	7,202	7,295	7,701	8,419	7,001				
	later										
	6										
	years	10,662	7,213	7,390	7,725	8,433					
	later										
	7										
	years	10,810	7,156	7,406	7,743						
	later										
	8										
	years	10,015	7,164	7,509							
	later										
	9										
	years	10,022	7,264								
	later										
	10										
	years	10,022									
	later										
Net Liability	1										
re-estimated:	year	11,817	9,046	9,438	8,621	11,443	9,606	9,354	6,698	5,597	6,333
	later										
	2										
	years	11,061	8,739	7,916	8,869	11,064	8,439	9,360	5,185	4,559	
	later										
	3										
	years	11,121	7,739	8,179	9,033	9,725	8,500	8,483	4,348		
	later										
	4										
	years	10,792	7,792	8,514	8,418	9,178	7,661	7,700			
	later										
	5										
	years	11,089	8,010	7,855	8,064	8,854	7,091				
	later										
	6										
	years	11,413	7,636	7,641	8,092	8,453					
	later										
	7										
	years	11,175	7,577	7,707	7,762						
	later										
	8										
	years	10,236	7,390	7,528							
	later										
	9										
	years	10,038	7,274								
	later										
	10										
	years	10,022									
	later										
Net cumulative		\$693	\$4,144	\$4,487	\$4,335	\$3,402	\$4,914	\$2,285	\$3,604	\$2,923	\$1,931
redundancy											

(deficiency)

6

---

Table of Contents

Our reported results, financial position and liquidity could be affected by changes in key assumptions that determine our loss reserves. The table below illustrates the change to equity that would occur as a result of a change in loss reserves and reserves for loss adjustment expense:

Change in Loss and LAE Reserves	For The Years Ended December 31,			
	2016		2015	
	Adjusted		Adjusted	
	Loss and	% Change in Equity	Loss and	% Change in
	LAE		LAE	Equity
	Reserves		Reserves	
*Loss and LAE reserves are in thousands				
(10.0)%	\$ 6,778	1.57%	\$ 8,681	2.15%
(7.5)%	6,966	1.18%	8,922	1.61%
(5.0)%	7,154	0.78%	9,163	1.07%
(2.5)%	7,343	0.39%	9,404	0.54%
Reported	7,531	—%	9,645	—%
2.5%	7,719	(0.39)%	9,886	(0.54)%
5.0%	7,908	(0.78)%	10,127	(1.07)%
7.5%	8,096	(1.18)%	10,368	(1.61)%
10.0%	8,284	(1.57)%	10,610	(2.15)%

While our reserve estimates have had more significant variability in the past, we believe that the scenarios presented above are most reasonable as our methodology has become more seasoned, and we have maintained continuity of staff involved in the reserving process.

Life Insurance Segment

National Security Insurance Company (NSIC), a wholly owned subsidiary organized in 1947, conducts the Company's life insurance business. This segment will be referred to throughout this report as NSIC, Life Company, or Life segment. NSIC is licensed to write insurance in seven states: Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

The following table indicates NSIC's percentage of direct premiums collected by state for the two years ended December 31, 2016 and 2015:

State	Percentage of Total Direct Premiums					
	2016			2015		
Alabama	\$3,673,000	58.21	%	\$3,710,000	58.10	%
Florida	71,000	1.13	%	67,000	1.04	%
Georgia	1,308,000	20.73	%	1,338,000	20.95	%
Mississippi	643,000	10.19	%	659,000	10.32	%
South Carolina	413,000	6.55	%	413,000	6.47	%
Tennessee	27,000	0.42	%	16,000	0.25	%
Texas	175,000	2.77	%	183,000	2.87	%
	\$6,310,000	100.00	%	\$6,386,000	100.00	%

NSIC has two primary methods of distribution of insurance products: independent agents and home service (career) agents. The independent agent distribution method accounts for 66.4% of total premium revenue in the life insurance segment. Approximately 200 of the Company's independent agents produced new business during 2016. The home service distribution method of life insurance products accounts for 29.7% of total premium revenue in the life insurance segment. Home service life products consist of products marketed directly at the home or other premises of the insured by an employee agent. The Company employed five career agents and one regional manager as of December 31, 2016. The remaining 3.9% of premium revenue consists of the following: a book of business acquired

from a state guaranty association in 2000 (0.8%), premium generated through direct sales of school accident insurance (2.5%), and other miscellaneous business serviced directly through the home office (0.6%).

Table of Contents

NSIC's primary products are life insurance, primarily whole life, and health and accident insurance. NSIC does not sell annuities, interest sensitive whole life or universal life insurance products. Term life insurance policies provide death benefits if the insured's death occurs during the specific premium paying term of the policy. The policies generally do not provide a savings or investment element included as part of the policy premium. Whole-life insurance policies demand a higher premium than term life, but provide death benefits which are payable under effective policies regardless of the time of the insured's death and have a savings and investment element which may result in the accumulation of a cash surrender value. Our accident and health insurance policies provide coverage for losses sustained through sickness or accident and include individual hospitalization and accident policies, group supplementary health policies, and specialty products, such as cancer policies. Our line of health and accident products feature specified fixed benefits, so rapidly rising health care costs do not have as great an impact on our health and accident line as they do on comparable products offered by other companies.

The following table displays a schedule of 2016 life segment premium produced by product and distribution method:

Line of Business	Home Service Agent	Independent Agent	Other
Industrial	\$51,000	\$—	\$40,000
Ordinary	1,565,000	2,640,000	16,000
Group Life	—	10,000	59,000
A&H Group	—	104,000	153,000
A&H Other	233,000	1,335,000	28,000
Total Premium by Distribution Method	\$ 1,849,000	\$4,089,000	\$296,000

The following table sets forth certain information with respect to the development of the Life Company's business:

	Year ended December 31,	
	2016	2015
Life insurance in force at end of period:		
Ordinary-whole life	\$ 167,641,000	\$ 167,599,000
Term life	23,989,000	23,340,000
Industrial life	16,790,000	17,232,000
	\$208,420,000	\$208,171,000
Life insurance issued:		
Ordinary-whole life	\$24,407,000	\$23,000,000
	\$24,407,000	\$23,000,000
Net premiums earned:		
Life insurance	\$4,382,000	\$4,423,000
Accident and health insurance	1,852,000	1,877,000
	\$6,234,000	\$6,300,000

#### Life Insurance Segment Reserves

We engage Wakely Actuarial Services of Palm Harbor, Florida as consulting actuary to calculate our reserves for traditional life insurance products. The methodology used requires that the present value of future benefits to be paid under life insurance policies less the present value of future net premiums be calculated. The calculation uses assumptions including estimates of any adverse deviation, investment yields and changes in investment yields, mortality, maintenance expenses and any non-forfeiture options or termination benefits. The assumptions determine the level and sufficiency of reserves which are calculated and reviewed by our consulting actuary at the end of each quarter. The independent consulting actuary also reviews our estimates for other insurance products including claims reserves under accident and health contracts. Management believes that the reserve amounts reflected in the accompanying Consolidated Financial Statements are adequate.

#### Investments

A significant percentage of the total income for the Company is tied to the performance of its investments. Assets that will eventually be used to pay reserve liabilities and other policyholder obligations along with Company capital are invested to generate investment income while held by the Company. Our investment income is comprised primarily

8

---

## Table of Contents

of interest and dividend income on debt and equity securities and realized capital gains and losses generated by debt and equity securities. At December 31, 2016, cash and investments comprise 81% of total assets, and investment income (including realized gains) comprises 7.3% of total revenues evidencing the significant impact investments can have on financial results. Because the Company's insurance subsidiaries are regulated as to the types of investments they may make and the amount of funds they may maintain in any one type of investment, the Company has developed a conservative value oriented investment philosophy, in order to meet regulatory requirements. The Company's investment goals are to conserve capital resources and assets, obtain the necessary investment income threshold to meet reserves, and provide a reasonable return. Current yield from invested assets and capital appreciation of investments create this return.

### Marketing and Distribution

As mentioned earlier in this report, NSIC products are marketed through a field force of agents who are employees of the Life Company and through a network of independent agents. The Company's use of independent agents is expected to be more cost effective in the long term and has become our primary method of distribution over the past decade. In an effort to boost productivity and better educate agents on the products and services of NSIC, the Life Company marketing team travels throughout our service areas holding training sessions for agents.

NSFC and Omega products are marketed through a network of independent agents and brokers, who are independent contractors and generally maintain relationships with one or more competing insurance companies. NSFC employs field marketing representatives who visit in the offices of our independent agent force regularly to give the agents opportunities for feedback. Our NSFC marketing representatives also host training seminars throughout our service areas. The goal of these seminars is to educate the independent agent sales force about our products and services.

Agents receive compensation for their sales efforts. In the case of life insurance agents, compensation is paid in the form of sales commissions plus a servicing commission. Commissions paid by NSIC in 2016 averaged approximately 11.6% of premiums and are generally higher for new business production and decline each year at subsequent renewals. Commissions rates paid by NSFC in 2016 averaged approximately 15% of premiums on both new and renewal business. During 2016, one independent agent, accounted for more than 10% of total net earned premium of the property-casualty insurance subsidiaries. The net earned premium from this general agent totaled \$6,873,000 or 12.5% of total P&C segment net earned premium. NSFC also offers a "profit sharing bonus plan" to independent agents in order to promote better field underwriting and encourage retention of profitable business. This plan not only rewards our agents but also enhances profitability by giving the agent a vested interest in our success and also aids in maintaining price stability for all our customers as agents have a financial incentive to use good field underwriting practices when completing an application for insurance.

At December 31, 2016, NSIC employed five career agents and one regional manager. NSIC also had approximately 200 independent agents actively producing new business in seven states. At December 31, 2016, NSFC had contracts with approximately 1,700 independent agencies in eight states.

### Competition

In both of our insurance segments, we operate in a very competitive environment. There are numerous insurance companies competing in the various states in which we offer our products. Many of the companies with which we compete are much larger, have significantly larger volumes of business, offer much broader ranges of products and have more significant financial resources than we do. We compete directly with many of these companies, not only in the sale of products to consumers, but also in the recruitment and retention of qualified agents. We believe the main areas in which a smaller company, like us, can compete is in the areas of providing niche products in under-served areas of the insurance market at competitive prices while providing excellent service to our agents and policyholders during the entire insurance product life cycle from policy issuance to final payment of a claim. We pride ourselves on being accessible to our independent agent force and maintain a presence through the efforts of a field marketing staff



and easy access to home office staff. We believe we have made significant advancements in developing a competitive advantage, especially over the last decade. We also have longstanding relationships with many of our agents. We believe we compete effectively within the markets we serve and continue to evolve our processes and procedures in order to garner further competitive advantages.

NSFC's primary insurance products are dwelling fire and homeowners, including mobile homeowners. Dwelling fire and homeowners are collectively referred to as the dwelling property line of business. We focus on providing niche insurance products within the markets we serve. We are in the top twenty-five dwelling property insurance carriers in our two largest states, Alabama and Mississippi. However, due to the large concentration of business among the top five carriers, our total market share in the dwelling fire line of business is approximately 2.5% in Alabama and 1.5%

## Table of Contents

in Mississippi. In the homeowners line of business, our market share in both Alabama and Mississippi is less than 1%. The homeowners markets are even more concentrated with the top three homeowners carriers in both Alabama and Mississippi controlling nearly 50% of the market.

We have actively sought competitive advantages over the last decade in the area of technological advancement. Over the last thirteen years, we have replaced our primary policy administration systems in both our property and casualty and life insurance subsidiaries.

The property and casualty administration system is an internally developed end-to-end system that we believe enhances our ability to compete with larger carriers in the markets we serve. The system features a web based portal that allows our independent agents to rate, quote and issue policies directly in their office. The system streamlines the underwriting process with automation of many previous manual processes and enhances our agents' ability to provide excellent service to their clients. The system also enhances the efficiency of our underwriting process allowing for a more thorough evaluation of risks.

Our property and casualty claims administration system automates processes and workflows throughout the claims process and provides a single view of the activity that has occurred on a claim. The system also has an adjuster web portal, which allows adjusters to view policy limits, see reserve history and policy information, and view prior claims and loss history. Communications between adjusters and examiners are centralized on the web portal allowing for any messages to be viewed securely as part of the claims history. Computerized issuance of field checks by staff adjusters was also implemented enforcing reserve and policy limits while reducing the error rates of the previously used hand written checks issued in the field.

## Regulation

Our insurance subsidiaries are directly regulated by the insurance department in our state of domicile, Alabama. We are subject to the Alabama Insurance Holding Company System Regulatory Act and report to the Alabama Department of Insurance. Consequently, we are subject to periodic examination and regulation under Alabama Insurance Laws. We underwent our latest periodic regulatory examination which concluded in 2015 with no material issues noted and no financial adjustments made as a result of the examination.

Our insurance subsidiaries are also subject to licensing and supervision by the various governmental agencies in the jurisdictions in which we do business. The nature and extent of such regulation varies, but generally has its source in state statutes which bestow regulatory, supervisory and administrative authority to State Insurance Commissioners and their respective insurance departments. The regulations may require the Company to meet and maintain standards of solvency, comply with licensing requirements, periodically examine market conditions and financial activities and report on the condition of operations and finances. In addition, most of our insurance rates are subject to regulation and approval by regulatory authorities within the respective states in which we offer our products.

Our insurance subsidiaries are subject to various statutory restrictions and limitations relating to the payment of dividends or distributions to stockholders. The restrictions are generally based on certain levels of surplus, net income or operating income as determined by statutory accounting practices. Alabama law permits dividends in any year which, together with other dividends made within the preceding 12 months, do not exceed the greater of (1) 10% of statutory surplus as of the end of the preceding year or (2) for property and casualty insurers, statutory net income for the preceding year or for life companies, statutory net gain from operations for the preceding year. Dividends in excess of the restricted amounts are payable only after obtaining expressed regulatory approval. Future dividends from the insurance subsidiaries may be limited by business or regulatory considerations. The Company relies on the ability of the insurance subsidiaries to pay dividends to fund stockholder dividends and for payment of most operating expenses of the group, including interest and principal payments on debt. Further discussion of dividend payment capacity of subsidiaries can be found in Note 12 of the Consolidated Financial Statements included herein.

Our insurance subsidiaries are subject to risk based capital requirements adopted by the National Association of Insurance Commissioners (NAIC). These requirements direct our insurance companies to calculate and report information according to a risk based formula which attempts to measure statutory capital and surplus needs based on the risk in our product mix and investment portfolio. The formula is designed to allow state insurance regulators to identify companies that are potentially inadequately capitalized. Under the formula, the Company calculates Risk Based Capital (RBC) by taking into account certain risks inherent in an insurer's assets, including investments and an insurer's liabilities. Risk based capital rules provide for different levels of action depending on the ratio of a company's total adjusted capital to its "authorized control level" RBC. Based on calculations made by each of our insurance subsidiaries at December 31, 2016, each subsidiary exceeds any levels that would require regulatory actions.

## Table of Contents

### A.M. Best Rating

A.M. Best Company is a leading provider of insurance company financial strength ratings and insurance company issuer credit ratings. Best's financial strength ratings and issuer credit ratings provide an independent opinion based on comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. All of our insurance companies have been assigned ratings by A.M. Best Company (Best). On March 7, 2017, Best revised the outlook to stable from negative and 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 these ratings remained stable. Best also revised the outlook to stable from negative and affirmed the ICR of "bb" of the parent holding company, NSEC. For the latest ratings, you can access [www.ambest.com](http://www.ambest.com).

### Demotech Rating

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

### Employees

The Company itself has no management or operational employees. Instead, all human resource activities are within the subsidiary National Security Insurance Company. NSIC employed 84 staff members as of December 31, 2016, none of which were represented by a labor union. The Company and its property and casualty subsidiary have a Management Service Agreement ("Agreement") with National Security Insurance Company whereby the Company and the property and casualty subsidiaries reimburse NSIC for salaries and expenses of employees provided under the Agreement. Involved are employees in the areas of Underwriting, Customer Service, Policy Services, Accounting, Marketing, Administration, Document Management, Data Processing, Programming, Personnel, Claims, and Management. We consider our employee relations to be good.

### Additional information with respect to The National Security Group's Business

We maintain a website ([www.nationalsecuritygroup.com](http://www.nationalsecuritygroup.com)). The National Security Group, Inc.'s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to such reports that we file or furnish pursuant to Section 13(a) of the Securities Exchange Act of 1934 are available through our website, free of charge, as soon as reasonably practical upon having been electronically filed or furnished to the Securities and Exchange Commission. Our code of ethical conduct is also available on our website and in print to any stockholder who requests copies by contacting The National Security Group, Attn: Investor Relations, P. O. Box 703, Elba, AL 36323. Any of the materials we file with the SEC may also be read and copied at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the SEC's Public Reference Room may be obtained by calling the SEC at 1.800.SEC.0330. Our periodic reports filed with the SEC, which include Forms 3, 4 and 5, Form 10-K, Form 10-Q, Form 8-K and any amendments thereto may also be accessed free of charge from the SEC's website at [www.sec.gov](http://www.sec.gov).

### Item 1A. Risk Factors

As a "Smaller Reporting Company," we are not required to provide any disclosure under Item 1A. In providing these risk factors, we do not represent, and no inference should be drawn, that the disclosures so provided comply with all requirements of Item 1A if we were subject to them. Risk factors are events and uncertainties over which the Company has limited or no control and which can have a material adverse impact on our financial condition or results of operations. We are subject to a variety of risk factors. The following information sets forth our evaluation of the risk factors we deem to be most material. We work to actively manage these risks, but the reader should be cautioned that we are only able to mitigate the impact of most risk factors, not eliminate the risk. Also, there may be other risks which we do not presently deem material that may become material in the future.

### Underwriting and product pricing

The insurance subsidiaries maintain underwriting departments that seek to evaluate the risks associated with the issuance of an insurance policy. NSIC accepts standard risks and, to an extent, substandard risks. In the case of the property and casualty subsidiaries, the underwriting staff attempts to assess, in light of the type of insurance sought by an applicant, the risks associated with a prospective insured or insurance situation. The underwriting assessment may involve various components in the risk evaluation process including, but not limited to, potential liability or fire hazards, age of dwelling, loss history, credit history of insured, employment status, location of fire department, home value, home heat source, and general maintenance of the property. In general, the property and casualty subsidiaries specialize in writing nonstandard risks.

## Table of Contents

The nonstandard market in which the property and casualty subsidiaries operate reacts to general economic conditions in much the same way as the standard market. When insurers' profits and equity are strong, companies sometimes cut rates or do not seek increases. Also, underwriting rules are less restrictive. As profit and/or capital fall, companies may tighten underwriting rules and seek rate increases. Premiums in the nonstandard market are higher than the standard market because of the increased risk, which generally comprises more frequent claims. Lower valued dwellings and mobile homes often warrant higher premiums because of the nature of the risk. The costs of placing such nonstandard policies and making risk determinations are similar to those of the standard market. The added costs due to more frequent claims servicing are reflected in the generally higher premiums that are charged.

Our ability to maintain profitability is contingent upon our ability to actively manage our rates and our underwriting procedures. Premium rate inadequacy may not become apparent quickly, and we will incur lag-time to correct. If our rates or underwriting processes become inadequate, our results of operations and financial condition could be adversely impacted.

### Approval of rates

Most lines of business written by our property and casualty insurers are subject to prior approval of premium rates in the majority of the states in which we operate. The process of obtaining regulatory approval can be expensive and time consuming and can impair our ability to make necessary rate adjustments due to changes in loss experience, cost of reinsurance or other factors. If our requests to regulatory bodies for rate increases are not approved in an adequate or timely manner, our results of operations and financial condition may be adversely impacted.

### Maintenance of profit margins and potential for margin compression

Our maximum long-term average pretax profit margin on most of our insurance products is approximately five to six percent. In most states, we have limited ability to increase our margins beyond this level for higher risk, and we can incur significant delays in our ability to pass along higher cost that we may incur. Examples of this risk include:

Our catastrophe reinsurance cost is negotiated annually and effective January 1 of each year. The reinsurance market in which we operate is unregulated, and our reinsurance cost is based on negotiated rates that adjust annually. Due to increased frequency of storms over the past decade and cycles of limited reinsurance market capacity, we often experience rate increases in which we have limited ability to negotiate and often cannot include these increases in our rates until the new reinsurance agreement is negotiated. Due to increased cat loads in more storm prone areas, significant year over year increases in cat cost can often temporarily eliminate our profit margins in some areas and significantly compress our overall profit margins priced into our insurance coverages.

We have a geographic concentration in the Southeastern U.S. which is exposed to significant hurricane risk. We believe that we are often not adequately compensated for certain heavily exposed risk through a combination of limits on allowable margin and regulatory delays in obtaining rate increases. We often have to manage these exposures using alternatives to pricing, such as limits on new business production, to help us manage exposure concentrations and protect our capital position.

Due to increasing catastrophe reinsurance cost, we have incurred increases in our reinsurance retentions/deductibles over the past decade. Again, due to limits to profit margins, we are often not adequately compensated for the increased risk associated with these higher reinsurance retentions due to overall limits on margins in some of the states in which we operate.

### Reinsurance, risk of loss from catastrophic event and geographic concentration

Both insurance subsidiaries customarily reinsure with other insurers certain portions of the insurance risk. The primary purpose of such reinsurance arrangements is to enable the Company to limit its risk on individual policies, and in the case of property insurance, limit its risk in the event of a catastrophe in various geographic areas. A reinsurance arrangement does not discharge the issuing company from primary liability to the insured, and the issuing company is required to discharge its liability to the insured even if the reinsurer is unable to meet its obligations under

the reinsurance arrangements. Reinsurance, however, does make the reinsurer liable to the issuing company to the extent of any reinsurance in force at the time of the loss. Reinsurance arrangements also decrease premiums retained by the issuing company since that company pays the reinsuring company a portion of total premiums based upon the amount of liability reinsured. NSIC generally reinsures all risks in excess of \$50,000 with respect to any one insured. The property and casualty subsidiaries have catastrophe excess reinsurance, which provided protection in part with respect to aggregate property losses arising out of a single catastrophe, such as a hurricane.

During 2016, the property and casualty segment maintained a catastrophe contract, which covered losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeded the \$4 million company

## Table of Contents

retention stated in the contract, reinsurers would reimburse the company 100% of gross losses up to the upper limits of the reinsurance agreement, which was \$72.5 million in 2016 and 2015. Any losses above the \$72.5 million upper limit are the responsibility of our Company. The contract in place during 2016 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed. This reinsurance structure will remain unchanged in 2017.

The property and casualty subsidiaries utilize our actual in force policy data modeled applying two different industry accepted catastrophe models to structure catastrophe reinsurance and determine upper limits of catastrophe reinsurance agreements. Based on modeling results utilized in 2016 and 2015, the Company was reinsured at approximately a 250 year event level. While this estimate is subject to some uncertainty and model risk, the models indicate that we maintain catastrophe reinsurance upper limits to cover an event that has less than a 0.5% probability of occurring in a given year.

Our inability to procure reinsurance, primarily catastrophe reinsurance, could adversely impact our ability to maintain our level of premium revenue. The increased frequency of catastrophic events also increases our cost of reinsurance pressuring the profit margins of our insurance products. It is generally cost prohibitive to maintain deductibles below levels currently in place. Our current \$4 million catastrophe deductible will adversely impact underwriting results in years in which we incur losses from a major hurricane or tornado outbreak.

As described above, we maintain catastrophe reinsurance in amounts that provides protection to the Company's financial condition in all but the most remote likelihood of occurrences. Our most critical catastrophe risk is from hurricanes due to our proximity to the Atlantic Ocean and the Gulf of Mexico. Our results of operations are very likely to be materially impacted in the event of the landfall of a major hurricane striking the Northern Gulf Coast or Southern Atlantic Coast in Georgia or South Carolina where we maintain significant concentrations of business. We are also exposed to the risk of significant tornado activity in many of the states in which we operate. Our most significant catastrophic event risk is the risk of a loss in excess of the Company's upper catastrophe limit which could adversely impact the Company's financial condition if such an event occurs. We are also subject to assessments from windstorm underwriting pools in various states. These risks are often difficult to measure and in the event of a major catastrophe, could exceed the upper limits of our available reinsurance protection. We also face risk from a high frequency of catastrophe events. While these events may not reach the lower limits of our catastrophe reinsurance protection, a large number of smaller events can materially impact our results of operations.

Catastrophe modeling results play a major role in our decision making process regarding the upper limits of our catastrophe reinsurance protection. While the level of sophistication has increased significantly in recent years in the design of computer generated catastrophe modeling, there are risks inherent in the modeling process, and the process continues to evolve. We believe the chance of a catastrophe event exceeding the upper limits of our reinsurance protection is remote; however, with the unpredictability of natural disasters, we are unable to eliminate all risk of exceeding the upper limits of our reinsurance protection. Hurricane Katrina exceeded the upper limits of our coverage in 2005. We have since increased the upper limits of our coverage, but should a future event exceed the upper limits of our reinsurance coverage by a material amount, our financial condition could be adversely impacted.

### Climate change

Some scientific evidence supports that there have been and continue to be significant changes in climate including temperature, precipitation and wind resulting from various natural factors, processes, and human activities. Rising temperatures and changes in weather patterns could impact storm frequency and severity in our coverage areas. Increases in storm frequency and severity could negatively impact reinsurance costs impacting product pricing and the areas in which we offer our products. With respect to our property and casualty segment, climate change may impact the types of storms that impact our coverage areas as well as the frequency and severity of storms, thereby impacting reinsurance placement and rates. With respect to our life insurance segment, climate change may impact life



expectancies, thereby influencing mortality assumptions used in pricing assumptions and reserve calculations. Climate change could impact future product offerings, exclusions and/or policy limitations.

The Company may be impacted by domestic legislation and regulation related to climate change. Governmental mandates could impede our ability to make a profit with our current product offerings, limit the products we can offer and/or impact the geographic locations in which we offer our products. The impact of climate change cannot be quantified at this time.

## Table of Contents

### Reserve liabilities

NSIC maintains life insurance reserves for future policy benefits to meet future obligations under outstanding policies. These reserves are calculated to be sufficient to meet policy and contract obligations as they arise. Liabilities for future policy benefits are calculated using assumptions for interest, mortality, morbidity, expense and withdrawals determined at the time the policies were issued. As of December 31, 2016, the total reserves of NSIC (consisting of reserves for accident and health insurance) were approximately \$36,038,000. We believe, based on current available information, reserves for future policy benefits are adequate. However, we are currently in a period of persistent low interest rates, and should this period of low rates be sustained over the long term, it can impair our ability to make sufficient returns to cover future policy liabilities. Also, should actual mortality, morbidity, expense or withdrawal assumption differ materially from assumptions, our operating results could be negatively impacted.

The property and casualty subsidiaries are also required to maintain loss reserves (claim liabilities) for all lines of insurance. Such reserves are intended to cover the probable ultimate cost of settling all claims, including those incurred but not yet reported. The reserves of the property and casualty subsidiaries reflect estimates of the liability with respect to incurred claims and are determined by evaluating reported claims on an ongoing basis and by estimating liabilities for incurred but not reported claims. Such reserves include adjustment expenses to cover the cost of investigating losses and defending lawsuits. The establishment of accurate reserves is complicated by the fact that claims in some lines of insurance are settled many years after the policies have been issued, thus raising the possibility that inflation may have a significant effect on the amount of ultimate loss payment, especially when compared to initial loss estimates. The subsidiaries, however, attempt to restrict their writing to risks that settle within one to four years of issuance of the policy. As of December 31, 2016, the property and casualty subsidiaries had reserves for unpaid claims of approximately \$7,531,000, before subtracting unpaid claims due from reinsurers of \$1,184,000, leaving net unpaid claims of \$6,347,000. The reserves are not discounted for the time value of money. No changes were made in the assumptions used in estimating the reserves during the years ending December 31, 2016 or 2015. The Company believes, based on current available information, such reserves are adequate to provide for settlement of claims.

We incur the risk that we may experience excessive losses due to unanticipated claims frequency, severity or both that may not be factored into our loss reserve liabilities. Unexpected frequency and severity can be adversely impacted by outcomes of claims litigation; adverse jury verdicts related to claims settlements and adverse interpretations of insurance policy provisions which result in increased liabilities. We are also subject to the risk of unanticipated assessments from state underwriting associations or windstorm pools related to losses in excess of the associations or pool's ability to pay. Such costs are often allocated to companies operating in the jurisdiction of the association or windstorm pool, and the likelihood and amount of such assessments are difficult to predict. These events could adversely impact our historical loss reserving methodology and cause financial adjustments that could materially impact our financial condition and results of operations.

### Financial Ratings

The insurance subsidiaries are rated by the independent insurance rating agencies A.M. Best and Demotech. A downgrade in our ratings from either of these rating agencies could adversely impact our ability to maintain existing business or generate new business. See page 12 of this Form 10-K for additional information on our current financial ratings.

### Regulation

The insurance subsidiaries are each subject to regulation by the insurance departments of those states in which they are licensed to conduct business. Although the extent of regulation varies from state to state, the insurance laws of the various states generally establish supervisory departments having broad administrative powers with respect to, among other matters: the granting and revocation of licenses to transact business, the licensing of agents, the establishment of standards of financial solvency (including reserves to be maintained), the nature of investments and in most cases

premium rates, the approval of forms and policies, and the form and content of financial statements. The primary purpose of these regulations is the protection of policyholders. Compliance with regulations does not necessarily confer a benefit upon shareholders.

Many states in which the insurance subsidiaries operate, including Alabama, have laws requiring that insurers become members of guaranty associations. These associations guarantee that benefits due policyholders of insurance companies will continue to be provided even if the insurance company which wrote the business is financially unable to fulfill its obligations. To provide these benefits, the associations assess the insurance companies licensed in a state that write the line of insurance for which coverage is guaranteed. The amount of an insurer's assessment is generally based on the relationship between that company's premium volume in the state and the premium volume of all companies writing the particular line of insurance in the state. The Company has paid no material amounts to guaranty

## Table of Contents

associations over the past two years. These payments, when made, are principally related to association costs incurred due to the insolvency of various insurance companies. Future assessments depend on the number and magnitude of insurance company insolvencies, and such assessments are therefore difficult to predict.

Most states have enacted legislation or adopted administrative rules and regulations covering such matters as the acquisition of control of insurance companies, transactions between insurance companies and the persons controlling them. The National Association of Insurance Commissioners has recommended model legislation on these subjects, and all states where the Company's subsidiaries transact business have adopted, with some modifications, that model legislation. Among the matters regulated by such statutes are the payments of dividends. These regulations have a direct impact on the Company since its cash flow is substantially derived from dividends from its subsidiaries, and adverse operating results in the insurance subsidiaries or the development of significant additional obligations in the holding company could adversely impact liquidity at the holding company level. Statutory limitations of dividend payments by subsidiaries are disclosed in Note 12 of the accompanying Consolidated Financial Statements.

While most regulation is at the state level, the federal government has increasingly expressed an interest in regulating aspects of the insurance industry. All of these regulations at various levels of government increase the cost of conducting business through increased compliance expenses. Also, existing regulations are constantly evolving through administrative and court interpretations, and new regulations are often adopted. It is difficult to predict what impact changes in regulation may have on the Company in the future. Changes in regulations could occur that might adversely impact our ability to achieve acceptable levels of profitability and limit our growth.

### Competition

The insurance subsidiaries are engaged in a highly competitive business and compete with many insurance companies of substantially greater financial resources, including stock and mutual insurance companies. Mutual insurance companies return profits, if any, to policyholders rather than shareholders; therefore, mutual insurance companies may be able to charge lower net premiums than those charged by stock insurers. Accordingly, stock insurers must attempt to achieve competitive premium rates through greater volume, efficiency of operations and control of expenses.

NSIC primarily markets its life and health insurance products through the home service system and independent producers. Direct competition comes from home service companies and other insurance companies that utilize independent producers to sell insurance products, of which there are many. NSIC's life and health products also compete with products sold by ordinary life companies. NSIC writes policies primarily in Alabama, Georgia and Mississippi. The market share of the total life and health premiums written is small because of the number of insurers in this highly competitive field. The primary methods of competition in the field are service and price.

Because of the increased costs associated with a home service company, premium rates are generally higher than ordinary products; as a result, competition from these ordinary insurers must be met through service. Initial costs of distribution through independent agents are generally more than through home service distribution methods, but lower commissions are paid in years subsequent to the first year of the policy so costs decline rapidly as policies renew after the first year. The primary factor in controlling cost under the independent agent distribution method is maintaining a high persistency rate. The persistency rate is the rate at which new business is maintained in renewal periods subsequent to the first year. If a high persistency rate can be maintained, the overall costs of distribution are lowered due to lower commission rate payments on policies in force subsequent to the first year.

The property and casualty subsidiaries market their products through independent agents and brokers, concentrating primarily on dwelling fire and homeowners coverage. NSFC, though one of the larger writers of lower value dwelling fire insurance in Alabama, nevertheless faces a number of competitors in this niche market. Moreover, larger general line insurers also compete with NSFC. The market share in states other than Alabama is small. Price is the primary method of competition. Because the Company utilizes independent agents, commission rates and service to the agent

are also important factors in whether the independent agent agrees to offer NSFC products over those of its competitors. The Company primarily relies on an established independent agency force to market our insurance products. The loss of independent agents could adversely impact both the retention of existing business and production of new business.

Significant changes in the competitive environment in which we operate could materially impact our financial condition or results of operations.

## Table of Contents

### Inflation

The Company shares the same risks from inflation as other companies. Inflation causes operating expenses to increase and erodes the purchasing power of the Company's assets. A large portion of the Company's assets is invested in fixed maturity investments. The purchasing power of these investments will be less at maturity because of inflation. This is generally offset by the reserves that are a fixed liability and will be paid with cheaper dollars. Also, inflation tends to increase investment yields, which may reduce the impact of the increased operating expenses caused by inflation.

### Investment Risk and Liquidity

Our invested assets are managed by company personnel. The majority of these investments consist of fixed maturity securities. These securities are subject to price fluctuations due to changes in interest rates, and unfavorable changes could materially reduce the market value of the Company's investment portfolio and adversely impact our financial condition and results of operations. Fixed maturity investments are managed in light of anticipated liquidity needs and duration of liabilities. Should we experience a significant change in liquidity needs for any reason, we may be forced to sell fixed maturity securities at a loss to cover these liquidity needs. Changes in general economic conditions, the stock market and various other external factors could also adversely impact the value of our investments and consequently our results of operations and financial condition.

### Impact of economic and credit market conditions on our investments

Our investment portfolio is exposed to economic and financial market risks, including changes in interest rates, credit markets and prices of marketable equity and fixed-income securities. Events that unfolded in the latest recession had a material impact on the valuations of our investments. Economic and credit market conditions during the recession adversely affected the ability of some issuers of investment securities to repay their obligations and may further affect the values of investment securities. If the carrying value of our investments exceeds the fair value, and the decline in fair value is deemed to be other-than-temporary, we will be required to write down the value of our investments, which could adversely impact our results of operations and financial condition.

### Litigation

We are routinely involved in litigation related to our insurance products. Litigation can involve claims for damages in excess of stated policy limits and include damages for bad faith. Defense of these claims can often be expensive adding to our loss adjustment expenses, and adverse jury verdicts could materially impact our results of operations and financial position.

### Dependence of the Company on Dividends from Insurance Subsidiaries

The Company is an insurance holding company with no significant operations and limited outside sources of income. The primary asset of the Company is its stock in the insurance subsidiaries. The Company relies on dividends from the insurance subsidiaries in order to pay operating expenses, to service debt obligations and to provide liquidity for the payment of dividends to shareholders. The ability of the insurance subsidiaries to pay dividends is subject to regulatory restrictions discussed in detail in Note 12 of the Consolidated Financial Statements included herein. Should the insurance subsidiaries become subject to restrictions imposed by insurance regulations regarding the payment of dividends, the ability of the Company to pay expenses, meet debt service requirements and pay cash dividends to shareholders could be adversely impacted. Additionally, should business conditions deteriorate, we could be forced to further limit or suspend dividend payments in order to protect our capital position.

### Low common stock trading volume and liquidity limitations

We are a small public company with a large percentage of common stock outstanding owned by founding family members, employees, officers and directors. Consequently, our average daily trading volume is very low with no shares traded on some days and only a few hundred shares trading in a typical day. This low trading volume can lead to significant volatility in our share price and limit a shareholders ability to dispose of large quantities of stock in a short period of time.

Debt covenants

Should we become unable to remain current on interest payments on our long-term debt, under our debt covenants, we would be forced to suspend the payment of dividends to stockholders until interest payments are current.

Technology

Our insurance subsidiaries are dependent on computer technology and internet based platforms in the delivery of insurance products. Our ability to innovate and manage technological change is key to remaining competitive in the insurance industry. A breakdown in major systems or failure to maintain up-to-date technology could adversely impact

## Table of Contents

our ability to write new business and service existing policyholders, which would adversely impact our results of operations and financial condition. The occurrence of computer viruses, information security breaches, disasters, or unanticipated events could affect the data processing systems of the Company or its service providers which could damage the Company's business and adversely affect our financial condition and results of operations.

### Access to capital

We rely on debt and equity capital to operate. Due to a recent litigation settlement, our debt levels are higher than our historical norm. Adverse operating results, general market and economic conditions could impair our ability to raise new capital needed to support our operations.

### Key Personnel

As a small company within the insurance industry, we could be adversely impacted by the loss of key personnel. Our ability to remain competitive is contingent upon our ability to attract and retain qualified personnel in all aspects of our operations.

### Accounting Standards

Our financial statements are prepared based upon generally accepted accounting standards issued by the Financial Accounting Standards Board along with standards set by other regulatory organizations. We are required to adopt newly issued or revised accounting standards that are issued periodically. Future changes could impact accounting treatment applied to financial statements and could have a material adverse impact on the Company's results of operations and financial conditions. Potential changes in accounting standards that are currently expected to impact the Company are disclosed in the Consolidated Notes to Financial Statements included herein.

### Item 1B. Unresolved Staff Comments

As a smaller reporting company, the Company is not required to furnish the information required in Item 1B.

### Item 2. Properties

Our principal executive offices, owned by NSIC, are located at 661 East Davis Street, Elba, Alabama. The executive offices are shared by the insurance subsidiaries. The building was constructed in 1977 with an addition added in 2008. The executive offices total approximately 30,700 square feet. The Company believes this space to be adequate for our immediate needs.

The Company and its subsidiaries own certain real estate investment properties. The Company owns approximately 211 acres of real estate in Coffee County in Alabama. We also own, through our subsidiary NSFC, approximately 85 acres of undeveloped commercial real estate in Greenville, Alabama. We sell undeveloped lots from this development, and the development has no depreciable improvements.

Capitalized along with the Greenville property are site preparation costs, including clearing, filling and leveling of land. There are no improvements such as paving, parking lots or fencing that would be recorded as land improvements and depreciated over the appropriate useful life.

### Item 3. Legal Proceedings

The Company and its subsidiaries are named parties to litigation related to the conduct of their insurance operations. Further information regarding details of pending suits can be found in Note 16 to the Consolidated Financial Statements.

### Item 4. Mine Safety Disclosures

This section is not applicable.



Part II

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

The capital stock of the Company is traded in the NASDAQ Global Market. Quotations are furnished by the National Association of Security Dealers Automated Quotations System (NASDAQ). The trade symbol is NSEC.

Table of Contents

The following table sets forth the high and low sales prices per share, as reported by NASDAQ, during the period indicated:

	Stock Closing Prices			
	2016		2015	
	High	Low	High	Low
First Quarter	\$16.30	\$14.34	\$14.31	\$12.82
Second Quarter	\$18.40	\$14.98	\$16.32	\$13.85
Third Quarter	\$20.48	\$17.80	\$16.41	\$12.51
Fourth Quarter	\$18.49	\$17.00	\$15.16	\$13.12

## Shareholders

The number of shareholders of the Company's common stock was approximately 1,200, and the Company had 2,517,339 shares of common stock outstanding on March 17, 2017.

## Dividends

The following table sets forth quarterly dividend payment information for the Company for the periods indicated:

	Dividends Per Share	
	2016	2015
	First Quarter	\$0.045
Second Quarter	\$0.045	\$0.04
Third Quarter	\$0.045	\$0.04
Fourth Quarter	\$0.045	\$0.04

Discussion regarding dividend restrictions may be found on page 36 of the Managements' Discussion and Analysis as well as in Note 12 of the Consolidated Financial Statements.

The payment of shareholder dividends is subject to the discretion of our Board of Directors and is dependent upon many factors including our operating results, financial condition, capital requirements and general economic conditions. Total shareholder dividends paid in 2016 totaled \$452,000.

Future dividends are dependent on future earnings, the Company's financial condition and other factors evaluated periodically by management and the Board of Directors. The Company is an insurance holding company and depends upon the dividends from the insurance subsidiaries to pay operating expenses and to provide liquidity for the payment of shareholder dividends. The payment of shareholder dividends is subject to the profitability of the insurance subsidiaries and the ability of the insurance subsidiaries to pay dividends to the holding company. Dividends from the insurance subsidiaries are subject to approval of the regulator in the state of domicile, the Alabama Department of Insurance.

## Securities authorized for issuance under equity compensation plans

The Company currently only has one equity compensation plan which was approved by security holders at the 2009 Annual Shareholders Meeting. The following table sets forth securities authorized for issuance under the Company's equity compensations plans:

Plan category	Number of securities to be issued upon exercise of outstanding options,	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity

	warrants and rights (a)		compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	—	—	149,261
Equity compensation plans not approved by security holders	—	—	—
Total	—	—	149,261

Table of Contents

## Item 6. Selected Financial Data

Under smaller reporting company rules we are not required to disclose information required under Item 6. However, in order to provide information to our investors, we have elected to provide certain selected financial data.

## Five-Year Financial Information (dollars in thousands, except per share)

Selected Financial Data:	2016	2015	2014	2013	2012			
Net premiums earned	\$61,398	\$59,462	\$56,653	\$52,366	\$51,815			
Net investment income	3,892	3,462	3,823	3,746	4,191			
Net realized investment gains	998	503	100	4,439	2,790			
Other income	605	623	3,816	609	720			
Total revenues	\$66,893	\$64,050	\$64,392	\$61,160	\$59,516			
Net income (loss)	\$3,063	\$4,697	\$7,616	\$5,658	\$(6,671)			
Net income (loss) per share	\$1.22	\$1.87	\$3.04	\$2.28	\$(2.70)			
Total shareholders' equity				\$48,052	\$44,883	\$42,757	\$33,472	\$30,227
Book value per share				\$19.09	\$17.87	\$17.05	\$13.42	\$12.25
Dividends per share				\$0.18	\$0.16	\$0.120	\$0.100	\$0.325
Net change in unrealized capital gains (losses), net of tax				\$226	\$(2,128)	\$2,061	\$(2,801,000)	\$(101,000)
Total assets				\$148,579	\$147,841	\$144,865	\$133,980	\$135,716

Quarterly Information:	Premiums	Investment & Other Income	Realized Investment Gains (Losses)	Claims and Benefit Payments	Net Income (Loss)	Net Income (Loss) Per Share
2016						
First Quarter	\$ 15,165	\$ 1,145	\$ 7	\$ 9,047	\$941	\$ 0.37
Second Quarter	15,227	1,179	242	8,862	1,296	0.52
Third Quarter	15,675	1,157	287	10,082	930	0.37
Fourth Quarter	15,331	1,016	462	10,856	(104)	(0.04)
	\$ 61,398	\$ 4,497	\$ 998	\$ 38,847	\$ 3,063	\$ 1.22
2015						
First Quarter	\$14,706	\$1,132	\$142	\$8,262	\$1,308	\$0.52
Second Quarter	14,880	940	245	9,435	623	0.25
Third Quarter	15,104	868	130	8,170	1,616	0.64
Fourth Quarter	14,772	1,145	(14)	8,281	1,150	0.46
	\$59,462	\$4,085	\$503	\$34,148	\$4,697	\$1.87

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

## Overview

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 two year period ended December 31, 2016.

The National Security Group, Inc. operates in ten states with 48.0% of total premium revenue generated in the states of Alabama and Mississippi. The Company is made up of the following two segments:

Table of Contents

The Property and Casualty (P&C) segment is the most significant segment, accounting for 90.6% of gross earned premium in 2016. 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 9.4% of gross premium revenue in 2016. 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 is conducted through 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. The property and casualty segment consists of the consolidated operations of two subsidiaries, National Security Fire and Casualty Company and its wholly owned subsidiary, Omega One Insurance Company. There is no material differentiation between the products underwritten by NSFC and Omega as both underwrite primarily dwelling personal lines coverage. Due to Omega 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 profits 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.

The property and casualty segment can be impacted by severe storm activity resulting in incurred losses and loss adjustment expenses primarily from 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 document) 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.

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.

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

This discussion and analysis of the consolidated results of operations and financial condition of the Company should be read in conjunction with the Selected Financial Data and Consolidated Financial Statements and related notes

included in this Form 10-K. Please refer to our note regarding forward-looking statements on pages 4-5 of this report.

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

Table of Contents

## Overview-Year Ended December 31, 2016 compared to Year Ended December 31, 2015

## Summary:

For the year ended December 31, 2016, net income for the Company totaled \$3,063,000 or \$1.22 per share, compared to net income of \$4,697,000, \$1.87 per share, for the year ended December 31, 2015, a year over year decrease of \$1,634,000. Results for 2016 were negatively impacted by Hurricane Matthew which made landfall on the coast of South Carolina during early October 2016. On a gross basis, Hurricane Matthew added \$8,386,000 to P&C segment incurred losses and LAE (\$4,000,000 on a net basis). The P&C segment was not impacted by a hurricane during 2015. Pretax income from operations in 2016 totaled \$3,096,000 compared to \$5,844,000 in 2015. Pretax income from operations declined \$2,748,000 in 2016 primarily due to the increase in catastrophe claims in the P&C segment resulting from Hurricane Matthew.

Financial results for the year ended December 31, 2016 and 2015 were as follows:

Consolidated Financial Summary (dollars in thousands)	Year ended December 31,	
	2016	2015
Gross premiums written	\$67,424	\$66,809
Net premiums written	\$61,525	\$60,389
Net premiums earned	\$61,398	\$59,462
Net investment income	3,892	3,462
Net realized investment gains	998	503
Other income	605	623
Total Revenues	66,893	64,050
Policyholder benefits and settlement expenses	38,847	34,148
Amortization of deferred policy acquisition costs	3,506	3,510
Commissions	7,894	7,952
General and administrative expenses	8,996	8,615
Taxes, licenses and fees	2,204	2,086
Interest expense	1,352	1,392
Total Benefits, Losses and Expenses	62,799	57,703
Income Before Income Taxes	4,094	6,347
Income tax expense	1,031	1,650
Net Income	\$3,063	\$4,697
Income Per Common Share	\$1.22	\$1.87
Reconciliation of Net Income to non-GAAP Measurement		
Net income	\$3,063	\$4,697
Income tax expense	1,031	1,650
Realized investment gains, net	(998)	(503)
Pretax Income From Operations	\$3,096	\$5,844

## Premium Revenue:

For the year ended December 31, 2016, net premiums earned were up \$1,936,000 at \$61,398,000 compared to \$59,462,000 in 2015. The primary reasons for the increase were an 8.1% reduction in catastrophe reinsurance costs coupled with increases in gross earned premium. The increase in gross earned premium was due to growth in P&C segment premium revenue of 2.5% in 2016 compared to 2015.



Our primary management focus over the last four years has been rate adequacy/underwriting profitability, building balance sheet strength, capital growth and improved management of risk concentrations, particularly in our property and casualty segment. While this focus has been successful, these actions have led to rate increases in several states

Table of Contents

in which we operate and thus has reduced our written and earned premium growth rate. However, these efforts to improve profitability has led to four consecutive years of P&C segment underwriting profitability and the posting of a P&C underwriting profit in 2016 despite an increase in incurred losses from Hurricane Matthew. We have also increased consolidated shareholders equity at an annualized rate of 12.3% over the last four years. With our improved capital position generated by improved underwriting margins, we are implementing plans to increase our rate of top line growth; however, implementation of these plans to increase written premium will be deliberate as we do not intend to sacrifice long term underwriting profitability.

## Net Income:

For the year ended December 31, 2016, the Company had net income of \$3,063,000, \$1.22 per share, compared to net income of \$4,697,000, \$1.87 per share, for the same period in 2015, a decrease of \$1,634,000. The primary reason for the decline in 2016 year to date earnings compared to 2015 was the adverse impact of losses incurred from Hurricane Matthew, which reduced full year earnings by \$2,640,000.

## Pretax income from operations:

For the year ended December 31, 2016, pretax income from operations was \$3,096,000 compared to \$5,844,000 for the year ended December 31, 2015, a decrease of \$2,748,000. The primary reason for the decline in pretax income from operations in 2016 compared to pretax income from operations in 2015 was an increase in catastrophe related claims in the P&C segment from Hurricane Matthew. In addition to Hurricane Matthew, the P&C segment was impacted by numerous non-hurricane catastrophe events in 2016. In total, catastrophe losses, net of reinsurance recoveries, (including Hurricane Matthew) increased policyholder benefits and settlements expenses \$4,617,000 in 2016.

## P&amp;C segment combined ratio:

For the year ended December 31, 2016, the P&C segment had a GAAP combined ratio of 94.6%. Hurricane Matthew reported claims (on a net basis) coupled with non-hurricane cat event reported claims totaled \$9,742,000 and increased the P&C segment combined ratio 17.5 percentage points. In comparison, during 2015, the P&C segment had reported cat event claims totaling \$5,373,000 which added 10 percentage points to the prior year combined ratio. The most significant cat event in 2015 was an early October event in South Carolina which generated \$1,575,000 in incurred catastrophe losses.

As discussed above, management has made improved underwriting profitability a primary focus area over the past four years and we have seen the success of this undertaking in our results. Despite the negative impact of Hurricane Matthew in the P&C segment, 2016 was the fourth consecutive year the Company had a combined ratio below 100%. Efforts to continue improving processes, rate adequacy and ultimately underwriting profitability will continue to be a primary focus for management in the future.

## Overview - Balance Sheet highlights at December 31, 2016 compared to December 31, 2015

Selected Balance Sheet Highlights	December	
	31, 2016	31, 2015
(dollars in thousands)		
Invested Assets	\$ 113,156	\$ 112,557
Cash	\$ 7,368	\$ 6,763
Total Assets	\$ 148,579	\$ 147,841
Policy Liabilities	\$ 76,174	\$ 77,043
Total Debt	\$ 17,126	\$ 17,957
Accumulated Other Comprehensive Income	\$ 1,007	\$ 525
Shareholders' Equity	\$ 48,052	\$ 44,883

Book Value Per Share	\$ 19.09	\$ 17.87
----------------------	----------	----------

Invested Assets:

Invested assets as of December 31, 2016 were \$113,156,000 up \$599,000, or 0.5%, compared to \$112,557,000 as of December 31, 2015. Although invested assets had a slight increase in 2016 compared to 2015, growth of invested assets was adversely impacted by increased claim payments associated with Hurricane Matthew in the fourth quarter of 2016.

Table of Contents**Cash:**

The Company, primarily through its insurance subsidiaries, had \$7,368,000 in cash and cash equivalents at December 31, 2016, compared to \$6,763,000 at December 31, 2015. Cash remained relatively stable, up 8.9%, in 2016 compared to the same period in 2015.

**Total Assets:**

Total assets as of December 31, 2016 were \$148,579,000 compared to \$147,841,000 at December 31, 2015. While total assets increased year over year, 2016 total assets were negatively impacted by increased fourth quarter loss payments associated with Hurricane Matthew.

**Policy Liabilities:**

Policy liabilities were \$76,174,000 at December 31, 2016 compared to \$77,043,000 at December 31, 2015; a decrease of \$869,000 or 1.1%. The primary reason for the decrease in policy liabilities in 2016 compared to the same period last year was a \$2,114,000 decline in property and casualty loss reserves. Property and casualty loss reserves were down 21.9% in 2016 compared to 2015 primarily due to a lower year end claims inventory. While the property and casualty subsidiary did incur more claims in the fourth quarter of 2016 due to Hurricane Matthew, over 95% of Matthew claims were settled by December 31, 2016.

**Debt Outstanding:**

Total debt at December 31, 2016 was \$17,126,000 compared to \$17,957,000 at December 31, 2015. Debt was reduced \$831,000 during 2016 with the primary reason being the reduction of long term debt in our holding company. The improvement of balance sheet strength through reduction of debt continues to be a primary focus of management.

**Shareholders' Equity:**

Shareholders' equity as of December 31, 2016 was \$48,052,000 up \$3,169,000 compared to December 31, 2015 Shareholders' equity of \$44,883,000. Book value per share was \$19.09 at December 31, 2016, compared to \$17.87 per share at December 31, 2015, an increase of \$1.22. Despite the adverse impact of Hurricane Matthew, the Company had a 6.8% increase in book value per share and a 7.1% increase in Shareholders' Equity in 2016 compared to 2015. The primary factor contributing to the increase in Shareholders' equity was net income of \$3,063,000. In addition, new shares issued under our director compensation plan totaled \$76,000 in 2016. Furthermore, accumulated other comprehensive income increased \$482,000. The increase in accumulated other comprehensive income was driven by increases in market values of available-for-sale investment securities. Offsetting the increases in Shareholders' equity were dividends paid of \$452,000.

**Industry Segment Data**

Net earned premium revenues for The National Security Group's two operating segments (Life segment, Property and Casualty segment) are summarized as follows (amounts in thousands):

(dollars in thousands)	2016	%	2015	%
Life, accident and health insurance	\$6,234	10.2 %	\$6,300	10.6 %
Property and casualty insurance	55,164	89.8 %	53,162	89.4 %
	\$61,398	100.0%	\$59,462	100.0%

The property and casualty segment composed 89.8% of total net earned premium revenue in 2016 compared to 89.4% in 2015. The P&C segment is primarily composed of dwelling fire and homeowners lines of business. The life segment composed 10.2% of net earned premium revenue in 2016 compared to 10.6% in 2015 with revenue produced from life, accident and supplemental health insurance products. While reading this discussion regarding segment information, reference is made to Note 15 to the Consolidated Financial Statements which provides additional segment related information.

The following discussion outlines more specific information with regard to the individual operating segments of the Company along with non-insurance related information (primarily administration expenses and interest expense) associated with the insurance holding company.

Table of Contents

## Life and Accident and Health Insurance Operations:

From a revenue standpoint, our life segment is the smaller of our insurance segments contributing 10.2% of total insurance net earned premium revenue in 2016 and 10.6% in 2015. Premium revenues and operating income for the life segment for the year ended December 31, 2016 and 2015 are summarized below (amounts in thousands):

(dollars in thousands)	2016	2015
<b>REVENUE</b>		
Net premiums earned	\$6,234	\$6,300
Net investment income	2,122	1,913
Net realized investment gains	273	313
Other income	2	3
Total Revenues	\$8,631	\$8,529
<b>BENEFITS AND EXPENSES</b>		
Policyholder benefits paid or provided	\$5,285	\$4,687
Amortization of deferred policy acquisition costs	723	809
Commissions	310	380
General and administrative expenses	1,509	1,525
Insurance taxes, licenses and fees	199	180
Interest expense	78	61
Total Expenses	\$8,104	\$7,642
<b>INCOME BEFORE INCOME TAXES</b>	<b>\$527</b>	<b>\$887</b>

## Year Ended December 31, 2016 Compared to Year Ended December 31, 2015:

Net earned premium revenue in the life segment was \$6,234,000 at December 31, 2016 compared to \$6,300,000 at December 31, 2015; a decrease of 1.0%. The \$66,000 decrease in net earned premium revenue was primarily due to a decline in new business production in both the traditional life and supplemental accident and health insurance products offered in NSIC.

While NSIC composes only 10.2% of premium revenue, the segment makes up 39.5% of consolidated assets. The majority of these assets consist of fixed income investments. Net investment income was up \$209,000 or 10.9% at \$2,122,000 for the year ended December 31, 2016 compared to \$1,913,000 for the same period last year. An increase in life segment invested assets was the primary factor contributing to the increase in net investment income. US Market interest rates began to increase in late 2016 but the impact was marginal in generating additional investment income in 2016.

NSIC ended 2016 with net realized investment gains of \$273,000 compared to \$313,000 for the same period in 2015. Realized investment gains are highly dependent on several factors including market conditions, tax position and liquidity needs of the Company and can vary significantly from period to period. The primary source of realized investment gains in both 2016 and 2015, were gains from the sale of fixed income investments.

Claims were \$5,285,000 through December 31, 2016 compared to \$4,687,000 through December 31, 2015; an increase of \$598,000 or 12.8%. NSIC experienced an increase in both ordinary life and industrial life related claims in 2016 compared to the same period last year.

Deferred policy acquisition cost amortization and commission expenses decreased \$156,000 for the year ended December 31, 2016 at \$1,033,000 compared to \$1,189,000 for the same period in 2015; a decline of 13.1%. As a percent of net premiums earned, policy acquisition cost amortization and commission expense was 16.6% compared to 18.9% in 2015. A decline in the rate of new business production was the primary reason for the decline in policy acquisition costs.

General and administrative expenses were \$1,509,000 in 2016 compared to \$1,525,000 in 2015. Reduction of general and administrative expenses in NSIC has been a primary focus of management for the past three years. Historically, general and administrative expenses in our life segment have run higher than industry averages due to the small size of the subsidiary. This disadvantage, coupled with the persistent low interest rate environment, has eroded earnings in the life segment. In the second half of 2014, management began the process of implementing significant operational

Table of Contents

changes that included the consolidation of P&C and life segment operations. The consolidation process is now complete and we have completed employee cross training leaving operational areas more streamlined and more efficient. While the incremental improvement was less in 2016 compared to last year, the marginal year over year decline in general and administration expenses in the life insurance subsidiary is a direct result of this effort.

For the year ended December 31, 2016 and 2015, insurance taxes, licenses and fees were \$199,000 and \$180,000, respectively. As a percent of earned premium, insurance taxes, licenses and fees were comparable at 3.2% in 2016 and 2.9% in 2015.

For the year ended December 31, 2016, the life segment had pretax income of \$527,000 compared to a pretax income of \$887,000 for the same period in 2015. The increase in claims related expenses was the primary contributor to the decline in pretax income.

## Property &amp; Casualty Operations:

Property and casualty operations constitute our largest segment composing 89.8% and 89.4% of our total consolidated premium revenue in 2016 and 2015, respectively. Premium revenues and operating income for the P&C segment for the year ended December 31, 2016 and 2015 are summarized below:

(dollars in thousands)	2016	2015
<b>REVENUE</b>		
Net premiums earned	\$55,164	\$53,162
Net investment income	1,706	1,473
Net realized investment gains	725	190
Other income	603	620
Total Revenues	\$58,198	\$55,445
<b>BENEFITS AND EXPENSES</b>		
Policyholder benefits paid or provided	\$33,562	\$29,461
Amortization of deferred policy acquisition costs	2,783	2,701
Commissions	7,584	7,572
General and administrative expenses	6,818	6,735
Insurance taxes, licenses and fees	2,005	1,906
Total Expenses	\$52,752	\$48,375
<b>INCOME BEFORE INCOME TAXES</b>	<b>\$5,446</b>	<b>\$7,070</b>

## Year Ended December 31, 2016 Compared to Year Ended December 31, 2015:

Premium revenue in the P&C segment is primarily driven by our dwelling fire and homeowner lines of business. The following table provides premiums earned by line of business:

(dollars in thousands)	2016		2015		2016 Increase (Decrease) over 2015	
Line of Business	Premium Earned	% of NPE	Premium Earned	% of NPE		
Dwelling Fire/Allied Lines	\$37,399	67.8 %	\$35,718	67.2 %	4.7	%
Homeowners	23,595	42.8 %	23,800	44.8 %	(0.9)	%
Catastrophe Reinsurance Premium	(5,830 )	(10.6)%	(6,356 )	(12.0)%	(8.3)	%
Net Premium Earned	\$55,164	100.0 %	\$53,162	100.0 %	3.8	%

Property and casualty segment net premium earned for 2016 was \$55,164,000 compared to \$53,162,000 for the same period in 2015. The primary reason for the increase in 2016 compared to 2015 was a 4.7% increase in gross premium revenue in our dwelling fire program. A reduction in catastrophe reinsurance cost (ceded premium) of 8.3% also



contributed significantly to our 3.8% increase in net premium earned.

Table of Contents

The primary source of premium revenue growth in the P&C segment was in our non-coastal states; primarily the states of Oklahoma and Georgia. Premium revenue in Oklahoma increased 14.9% in 2016 with policy counts up 8.2%. An increase in new business production coupled with the implementation of increased rates during 2015 were the primary reasons for the increase in premium revenue in Oklahoma in 2016 compared to the same period last year. In addition, Georgia revenue increased 11.5% in 2016 with policy counts up 9.3% compared to December 31, 2015. Increased rates were implemented in Georgia during 2016 and, along with growth in policy count, lead to the increase in premium revenue in Georgia in 2016 compared to 2015. We expect to continue to look for opportunities to increase premium revenue in non-coastal and less hurricane prone regions of the states in which we operate in order to create more geographic diversification.

The reduction in catastrophe reinsurance cost also contributed to the improvement in underwriting margins in our property and casualty segment. The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. Our catastrophe retention remained unchanged at \$4 million in 2016 and we maintain catastrophe reinsurance coverage with an upper limit of \$72.5 million. Our catastrophe reinsurance also covers the cost of a second event up to the same \$72.5 million upper limit, again with a \$4 million retention. 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 and the primary models utilized indicate that the Company's upper limit of reinsurance is adequate to cover up to approximately a 250 year event (an event with an estimated probability of occurrence of 0.4% in a given year). It is noted, however, that hurricane models are subject to significant risks and uncertainties and are continuously evolving. Catastrophe models are only a tool to estimate the impact of catastrophe events. The Company also has risk associated with multiple smaller catastrophe events that individually may not exceed our \$4 million retention.

Under the catastrophe reinsurance program in 2016, the Company retained the first \$4,000,000 in losses from each event. Reinsurance coverage for 2016 was 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

Additional details regarding the structure of our 2016 catastrophe reinsurance program can be found in Note 10 to the Consolidated Financial Statements.

Net investment income totaled \$1,706,000 in 2016 compared to \$1,473,000 in 2015; an increase of \$233,000. The primary reason for the increase in net investment income in 2016 compared to 2015 was the change in value of our company owned life insurance (COLI). The change in value of the COLI decreased investment income \$34,000 in 2016 compared to a decrease to investment income of \$219,000 for the same period last year.

The P&C segment ended 2016 with realized capital gains of \$725,000 compared to realized capital gains totaling \$190,000 for the same period in 2015; an increase of \$535,000. The realized capital gains were primarily from sales of fixed income and equity 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 year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to year. The P&C segment was not impacted by the write-down of other-than-temporary impairments of fixed income or equity investments in 2016 or 2015.

Other income was \$603,000 in 2016 compared to \$620,000 for the same period in 2015; an \$17,000 decrease. 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 net earned premium other income was 1.1% 2016 compared to 1.2% in 2015.

Policyholder benefits and settlement expenses in the property and casualty segment were \$33,562,000 in 2016 compared to \$29,461,000 for the same period in 2015; an increase of \$4,101,000 or 13.9%. The P&C segment ended 2016 with a loss ratio of 60.2% compared to 54.8% for the same period in 2015. The primary reason for the increase in claims and the loss ratio in 2016 compared to 2015 was reported losses and loss adjustment expenses (LAE) from Hurricane Matthew in 2016.

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 year ended December 31, 2016 and 2015 (dollars in thousands):

For the year ended December 31, 2016			For the year ended December 31, 2015		
Cat Event	Reported Losses & LAE	Claim Count	Cat Event	Reported Losses & LAE	Claim Count
Cat 16 (Feb 22-24)	\$1,043	241	Cat 70 (Mar 25-26)	\$ 493	89
Cat 17 (Mar 5-11)	321	102	Cat 71 (Mar 31-Apr 1)	237	57
Cat 19 (Mar 13-14)	129	38	Cat 75 (Apr 18-21)	391	106
Cat 21 (Mar 23)	113	23	Cat 76 (Apr 24-28)	596	193
Cat 22 (Mar 30-Apr 1)	213	58	Cat 79 (May 6-13)	524	106
Cat 27 (Apr 25-28)	173	45	Cat 81 (May 23-28)	394	97
Cat 28 (Apr 29-May 3)	596	124	Cat 93 (Oct 2-6)	1,575	755
Cat 29 (May 7-10)	251	31	Cat 97 (Oct 24-26)	146	55
Cat 31 (May 16-19)	163	31	Cat 12 (Dec 23-24)	249	76
Cat 32 (May 26-28)	162	16	Cat 13 (Dec 26-27)	173	61
Cat 35 (Jun 16-18)	446	102			
Cat 40 (Jul 13-15)	345	93			
Cat 44 (Aug 11-13)	667	270			
Cat 46 (Aug 31-Sept 4)	374	126			
Cat 50 (Oct 6-9) GROSS	8,386	1,925			
Cat 53 (Nov 28-Dec 1)	538	104			
Misc cats less than \$100k	208	76	Misc cats less than \$100k	595	194
Total Before Reinsurance	\$14,128	3,405	Total Cat losses	\$ 5,373	1,789
Less: Reinsurance (Cat 50)	(4,386 )				
Total Net Cat losses	\$9,742				
Non-cat wind & hail	\$5,575	1,784	Non-cat wind & hail	\$ 5,615	1,923

During 2016, the P&C segment was impacted by 20 catastrophe events totaling \$14,128,000 (\$9,742,000 net of reinsurance recoveries) from 3,405 claims compared to reported losses and LAE from 22 cat events totaling \$5,373,000 from 1,789 claims in 2015. Claims reported from year to date 2016 cat events contributed 25.3 percentage points to the 2016 P&C segment loss ratio. In comparison, claims reported during 2015 from prior year cat events contributed 10.0 percentage points to the year to date 2015 P&C segment loss ratio.

During 2016, the P&C segment was negatively impacted by Hurricane Matthew (denoted as Cat 50 in the table above) which struck the Atlantic coast, during early October 2016, impacting our policyholders in Georgia and South Carolina. On a gross basis, Hurricane Matthew added \$8,386,000 to P&C segment incurred losses and LAE (\$4,000,000 on a net basis). The P&C segment was not impacted by a hurricane during 2015. The largest cat event impacting the P&C segment during 2015 was Cat 93 which totaled \$1,575,000 and produced 755 reported claims through December 31, 2015. This cat event primarily impacted our South Carolina policyholders and added 2.9 percentage points to the 2015 P&C segment loss ratio.

Non-catastrophe wind and hail claims reported in 2016 totaled \$5,575,000 compared to non-catastrophe wind and hail claims reported in 2015 totaling \$5,615,000; a decrease of \$40,000 or 0.7%. During 2016, the P&C segment had 1,784 non-cat wind and hail claims reported (an average of \$3,100 per claim) compared to 1,923 claims reported during 2015 (an average of \$2,900 per claim). Non-cat wind and hail claims reported during 2016 accounted for 16.6% of total P&C segment incurred losses and LAE in the current year. Non-cat wind and hail claims reported during 2015 accounted for 19.1% of total P&C segment incurred losses and LAE in 2015. The P&C segment has experienced a higher frequency of severe thunderstorm activity in 2016 and 2015. While most of these individual thunderstorms were isolated to small geographic areas, the frequency of these weather events contributed to a significant increase in

our reported non-cat wind and hail claims in both 2016 and 2015.

27

---

Table of Contents

In addition to the increase in reported losses and LAE from cat events, reported fire losses and LAE were also up in 2016 compared to the same period in 2015. Reported fire losses were up \$841,000 or 5.8% compared to fire losses reported during 2015. The P&C segment had 510 fire losses reported for the period ended December 31, 2016, totaling \$15,313,000 compared to 549 fire losses reported for the same period in 2015 totaling \$14,472,000. The average cost per claim was \$30,000 for fire losses reported in 2016 compared to \$26,400 for fire losses reported in 2015.

Deferred policy acquisition costs totaled \$2,783,000 in 2016 compared to \$2,701,000 in 2015. Deferred policy acquisition costs were comparable at 5.0% of net earned premium revenue for 2016 and 5.1% of net earned premium revenue for 2015. Deferred policy acquisition costs consist of amortization of previously capitalized distribution costs, primarily commissions.

Commission expense for 2016 was \$7,584,000 (13.7% of premium revenue) compared to \$7,572,000 (14.2% of premium revenue) for the same period in 2015. The primary reason for the \$12,000 increase in commission expense during 2016 compared to 2015 was a slight 1.1% increase in gross written premium.

General and administrative expenses in the property and casualty segment totaled \$6,818,000 in 2016 compared to \$6,735,000 in 2015; an increase of \$83,000 or 1.2%. The primary reason for the increase was a moderate increase in fees paid to consulting actuaries.

Insurance taxes, licenses and fees were \$2,005,000 through December 31, 2016 compared to \$1,906,000 for the same period in 2015. Insurance taxes, licenses and fees were 3.6% of premium revenue in 2016 and 2015.

The P&C segment ended 2016 with pretax income of \$5,446,000 compared to pretax income of \$7,070,000 for the same period in 2015. The \$1,624,000 decrease in pretax income was primarily due to the negative impact of claims incurred from Hurricane Matthew as discussed previously.

**Property & Casualty Combined Ratio:**

A measure used to analyze a property/casualty insurer's underwriting performance is the combined ratio based upon generally accepted accounting principles (GAAP). It is the sum of two ratios:

• The loss and loss expense ratio, which measures losses and loss adjustment expenses incurred as a percentage of premium revenue.

• The underwriting expense ratio, which measures underwriting expenses incurred (e.g., agents' commissions, premium taxes, and other administrative underwriting expenses) as a percentage of premium revenue.

The results of these ratios for the past two years were as follows:

	2016	2015
Loss and LAE Ratio	60.18%	54.78%
Underwriting Expense Ratio	34.41%	35.17%
Combined Ratio	94.59%	89.95%

Maintaining a combined ratio below 100%, which indicates that the company is making an underwriting profit, depends upon many factors including hurricane activity in the Gulf of Mexico and the southern Atlantic coast, strict underwriting of risks, catastrophe reinsurance costs, severe thunderstorm frequency and the ability to obtain adequate and timely premium rates. A major hurricane hitting the coast of Alabama, Georgia, South Carolina, Mississippi or Louisiana could cause the combined ratio to fluctuate materially from year to year. In addition, most of the states that we write business are prone to severe thunderstorm and tornado activity with significant variations in the level of activity from year to year. The property and casualty subsidiaries maintain catastrophe reinsurance to minimize the

effect of a major catastrophe; however, the geography of our coverage area, frequency of smaller catastrophe events and prohibitive cost of maintaining lower catastrophe deductibles and/or catastrophe aggregate coverage prevents us from further mitigating catastrophe risks.

During 2016, the P&C segment experienced an increase of 4.64 percentage points in the combined ratio compared to 2015. The primary reason for the increase was a \$4,699,000 increase in claims in 2016 compared to 2015. Reported claims from combined non-hurricane cat events and Hurricane Matthew increased the 2016 combined ratio by 17.5 percentage points. In 2015, claims from cat events increased the 2015 combined ratio by 10.0 percentage points. While catastrophe events are unpredictable and beyond management's control, management has sought to increase

Table of Contents

margins through efficiency measures and improved rate optimization. We believe that these efforts, while not eliminating volatility, will improve our ability to better absorb the impact of a major catastrophe or increased frequency of smaller catastrophe events. The impact of Hurricane Matthew, in 2016, further exhibits our ability to incur losses from a major catastrophe while maintaining a combined ratio below 100% and achieving underwriting profitability despite the negative impact. Management also continues to improve rate adequacy, reduce significant exposure concentrations and implement other risk management strategies in order to further improve underwriting profitability and reduce earnings volatility.

**Non-insurance Operations:**

The non-insurance operations of the Company consist of our parent company, The National Security Group, Inc. (NSG). The National Security Group has no material sources of revenue and relies on dividends and management service fees from our insurance subsidiaries to pay expenses. Dividends from subsidiaries are subject to insurance department approval and are subject to statutory restrictions. Subsidiary dividends are eliminated upon consolidation of the subsidiaries in the audited financial statements included herein and thus are not included in the table below. Revenues and expense for non-insurance operations for the year ended December 31, 2016 and 2015 are summarized as follows (amounts in thousands):

(dollars in thousands)	2016	2015
<b>REVENUE</b>		
Net investment income	\$64	\$76
Total Revenues	\$64	\$76
<b>EXPENSES</b>		
General and administrative expenses	\$669	\$355
Interest expense	1,274	1,331
Total Expenses	\$1,943	\$1,686
<b>INCOME (LOSS) BEFORE INCOME TAXES</b>	<b>\$(1,879)</b>	<b>\$(1,610)</b>

**Year Ended December 31, 2016 Compared to Year Ended December 31, 2015:**

Revenue for non-insurance operations primarily consists of interest on investments. General and administrative expenses totaled \$669,000 in 2016 compared to \$355,000 for the same period last year; an 88.5% increase. The expenses of NSG are primarily associated with the public listing of our stock, taxes and fees, and directors' fees. The most significant item impacting the increase in general expenses were increases in interest costs related to deferred compensation plans. Total interest expense associated with short-term and long-term borrowings of NSG was \$1,274,000 for the period ended December 31, 2016 and \$1,331,000 for the same period last year. The decline in interest expense is related to a reduction in debt outstanding.

**Investments:**

The life insurance and property/casualty subsidiaries primarily invest in highly liquid investment grade debt and equity securities. The types of assets in which the Company can invest are influenced by various state insurance laws which prescribe qualified investment assets. While working within the parameters of these regulatory requirements and further considering liquidity and capital needs, the Company considers investment quality, investment return, asset/liability matching and composition of the investment portfolio when making investment decisions.

At December 31, 2016, the Company's holdings in debt securities amounted to 83.7% of total investments and 63.7% of total assets. The Company utilizes the ratings of various Nationally Recognized Statistical Rating Organizations when classifying fixed maturity investments by quality rating.





Table of Contents

The following is a breakdown of the Company's fixed maturity investments by quality rating:

S&P or Equivalent Ratings	% of Total Bond Portfolio	
	2016	2015
AAA/AA+	39.15%	40.59%
AA	7.09%	8.37%
AA-	3.45%	3.06%
A+	3.61%	4.63%
A	4.68%	4.88%
A-	5.91%	4.98%
BBB+	9.26%	9.31%
BBB	13.49%	14.20%
BBB-	7.38%	6.66%
Below Investment Grade	5.98%	3.32%

There have been no material shifts in credit quality in the Company's fixed income portfolio. The slight increase in below investment grade securities has primarily been associated with our holdings in the energy sector. We have evaluated our current energy sector holdings for potential impairment, along with any other security with a market value of less than 80% of our amortized carrying value. Based on presently available information, we do not believe any below investment grade securities are other than temporarily impaired. Approximately 6% of our fixed income investments are in the energy sector with most of these securities currently carrying credit ratings of BBB- or below. Also, reductions in market value of these securities was the primary factor contributing to the increase in gross unrealized loss on corporate debt securities in the table that follows below. We currently have no fixed income investments in default.

The amortized cost and aggregate fair values of investments in securities at December 31, 2016 and December 31, 2015 are as follows (dollars in thousands):

December 31, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
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
Held-to-maturity securities:				
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

December 31, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	\$ 38,245	\$ 747	\$ 1,728	\$37,264
Mortgage backed securities	15,324	157	224	15,257
Private label asset backed securities	6,029	24	380	5,673
Obligations of states and political subdivisions	14,654	869	47	15,476
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	17,825	413	96	18,142
Total fixed maturities	92,077	2,210	2,475	91,812
Equity securities	2,420	2,590	113	4,897
Total	\$ 94,497	\$ 4,800	\$ 2,588	\$96,709
Held-to-maturity securities:				
Mortgage backed securities	\$ 2,395	\$ 62	\$ —	\$2,457
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	44	3	—	47
Total	\$ 2,439	\$ 65	\$ —	\$2,504

As shown in the tables above, the Company experienced a moderate increase in fixed income investments in 2016 compared to the portfolio composition at December 31, 2015. The increase in fixed income investments was driven by positive cash flow from operations which provided additional funds to invest.

A number of factors influence portfolio allocation within each of the insurance subsidiaries. Within the property and casualty subsidiaries, due to the relatively short term nature of segment liabilities, fixed income investments tend to be of shorter duration, typically inside of five years on average. Also due to higher levels of potential volatility of policy liabilities (severe weather related losses), a greater emphasis is placed upon overall liquidity of investments. In contrast, within the life insurance subsidiary, policy liabilities tend to be more stable and of significantly longer duration. In order to match the longer duration of liabilities, investments in the life insurance portfolio tend to have longer maturities and higher average book yields. Also, less emphasis is placed upon short term liquidity in the life subsidiary due to more predictable cash needs.

A downside of investing in longer duration securities in the life segment is that the portfolio is exposed to more significant price volatility as market interest rates change. This exposure to sudden interest rate changes can lead to declines in market value of fixed income securities in a rising interest rate environment. Management currently maintains the life insurance portfolio in the intermediate duration range of 6.0 to guard against the adverse impact of rising rates. However, due to the necessity of matching the duration of liabilities as closely as possible in order to pass regulatory cash flow testing, some volatility in market value of the portfolio in a rising rate environment cannot be avoided.

At December 31, 2016, 5.98% of total investments in the fixed income portfolio were classified as 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. Management has evaluated each security in a significant unrealized loss position. For the year ended December 31, 2016, the Company realized no other-than-temporary impairments related to fixed maturities or equity securities.

The amortized cost and aggregate fair value of debt securities at December 31, 2016, by contractual maturity, are as follows (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.

31

---

Table of Contents

	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	\$ 1,582	\$1,615
Due after one year through five years	15,047	15,006
Due after five years through ten years	34,497	34,444
Due after ten years	41,711	41,727
Total	\$ 92,837	\$92,792
Held-to-maturity securities:		
Due in one year or less	\$ 4	\$4
Due after one year through five years	26	27
Due after five years through ten years	80	87
Due after ten years	1,780	1,812
Total	\$ 1,890	\$1,930

As discussed earlier, the majority of our longer duration securities are investments made to match longer duration liabilities in the life segment or, are investments in mortgage backed securities, primarily government agency. Due to the amortizing nature and the ability to prepay mortgage backed securities, actual maturities tend to be significantly shorter than contractual maturities.

## Investment portfolio income

Investment returns with respect to the investment portfolio for the years ended December 31, 2016 and 2015 follows:

	Year Ended December 31,			
	2016	2015		
Net investment income	\$3,892	\$3,462		
Average current yield on investments	3.4	% 3.1	%	
Total return on investments	4.6	% 0.67	%	
Net realized gains on investments (before taxes)	\$998	\$503		
Change in accumulated net unrealized gains (before income taxes)	\$343	\$(3,225)		

Average current yield on investments increased to 3.5% due to a combination of decreased investment expenses and moderately higher yield on investments.

The total return on investments in 2016 increased significantly compared to 2015. Prior year total return was negatively impacted by a combination of interest rate driven declines in fixed income investments and declines in market value of our energy sector bond holdings. During 2016, market values of our energy sector bonds recovered leading to an increase in net unrealized capital gains. Also, realized capital gains were higher due to sales of both fixed income and equity investments.

Approximately 6% of our fixed income investments consist of bonds in the energy sector. We have evaluated each of these securities for potential impairment and, based on currently available information, believe that none of these securities are other than temporarily impaired. Our energy sector portfolio is diversified with our single largest bond holding in the sector having a par value of \$1,000,000, composing less than 1% of our total investments. We currently have no fixed income investments in default.

## Repurchase agreements

The Company's subsidiaries maintain repurchase agreements for cash held on deposit under which insurance regulations dictates that our policy requires 102% (100% minimum) of the fair value of the securities purchased to be maintained as collateral. The repurchase investments are limited to government securities that are highly liquid and therefore, the investment is reflected on the balance sheet as a cash equivalent. Due to a combination of the 102% collateral requirement and short term interest rates hovering near zero, we realize virtually no interest income from repurchase agreements/short term investments. However, repurchase agreements utilizing government agency securities do provide deposit protection for short term cash held in excess of FDIC deposit limits. The Company does not lend securities to any counterparty under repurchase agreements.

Table of Contents

## 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 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.

Virtually all invested assets of the Company are held in the insurance subsidiaries. As of December 31, 2016, 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	\$ 1,582	\$ 4	\$1,586	1.68	%
Maturity in 1-5 years	15,047	26	15,073	15.91	%
Maturity in 5-10 years	34,497	80	34,577	36.50	%
Maturity after 10 years	41,711	1,780	43,491	45.91	%
	\$ 92,837	\$ 1,890	\$94,727	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 would generate approximately a \$5,013,000, or 5.5%, decline in the market value of fixed income investments. Alternatively, a 100 basis point decrease in interest rates will generate approximately \$4,861,000, or 5.3%, 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 December 31, 2016, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$48,052,000, up \$3,169,000 compared to \$44,883,000 at December 31, 2015. Components of the change in equity were net income of \$3,063,000, increase in accumulated unrealized gains on investments of \$226,000, a net unrealized gain of \$256,000 related to interest rate swaps and cash dividends paid totaling \$452,000.

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 5.1% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.



Table of Contents

The Company, primarily through its insurance subsidiaries, had \$7,368,000 in cash and cash equivalents at December 31, 2016, compared to \$6,763,000 at December 31, 2015. Cash provided by operating activities increased cash by \$1,148,000 during the year ended December 31, 2016. The increase in cash provided by operations was primarily driven by net income from operations. For the year ended December 31, 2015, cash provided by operating activities totaled \$6,880,000. Operating cash flow generated in the property and casualty segment was the primary contributor to cash provided by operating activities in the prior year.

Net cash provided by investing activities totaled \$684,000 for the period ended December 31, 2016, compared to cash used of \$4,835,000 for the same period last year. The investment of cash generated from operations and reinvestment of maturing fixed income securities was the primary cash related investment activities during the year ended December 31, 2016. For the period ended December 31, 2015, cash used in investing activities totaled \$4,835,000 the reinvestment of maturities of fixed income securities and investment of cash from operations was the primary cash related investment activity during the period.

Net cash used in financing activities totaled \$1,227,000 for the period ended December 31, 2016, compared to \$1,708,000 for the same period last year. During the year ended December 31, 2016, the Company obtained a \$5,000,000 unsecured loan which was used to repay in full the \$5,143,000 promissory note associated with the Mobile Attic settlement. Under US tax laws the Mobile Attic plaintiff-financed settlement was not deductible until paid and, in anticipation of potentially lower corporate tax rates in the new US presidential administration, paying off the promissory note accelerated the ability to recognize the associated deferred tax benefit related to the settlement. During the year ended December 31, 2015, the Company repaid a \$500,000 long-term note and a \$700,000 short-term note payable. 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 was renewed in February of 2016. During the year ended December 31, 2016, the Company drew down and repaid amounts from both short-term and long-term lines of credit. Between the two lines of credit, \$1,700,000 was available at December 31, 2016.

The Company had a total of \$15,326,000 of long-term debt outstanding as of December 31, 2016, compared to \$17,100,000 at December 31, 2015, 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, \$246,000 and \$258,000, respectively.

The following table reflects the anticipated cash flows associated with our short- and long-term contractual obligations and commitments as of December 31, 2016 (dollars in thousands):

	Payments due by period				
	Total	Less than 1 year	Years 1 through 3	Years 4 through 5	More than 5 years
Contractual Obligations					
Notes payable	\$1,800	\$1,800	\$—	\$—	\$—
Debt obligations <sup>1</sup>	\$15,326	\$—	\$3,200	\$—	\$12,126
Interest on debt obligations <sup>1</sup>	\$12,913	\$1,185	\$2,871	\$1,154	\$7,703
Property and casualty claim reserves <sup>2</sup>	\$7,531	\$6,597	\$859	\$68	\$7
Future life insurance obligations <sup>3</sup>	\$70,900	\$4,486	\$12,019	\$6,989	\$47,406

<sup>1</sup> Long-term debt, consisting of two separate issues of trust preferred securities, a line of credit and the long-term portion of an installment note is assumed to be settled at contractual maturity. Interest on long-term debt is calculated using the interest rates in effect at December 31, 2016 for each issue. Interest on long-term debt is accrued and settled quarterly on the trust preferred securities, monthly on the

line of credit and annually on the installment note. Therefore, the timing and amount of interest payments may vary from the calculated value included in the table above. These calculations do not take into account any potential prepayments. For additional information regarding long-term debt and interest on long-term debt, please see Note 8, Notes Payable and Long-term Debt, in the notes to Consolidated Financial Statements.

<sup>2</sup> The anticipated payout of property and casualty claim reserves, which includes loss and loss adjustment expenses, are based upon historical payout patterns. Both the timing and amount of these payments may vary from the payment indicated. For additional details on payout patterns please see Note 9.

<sup>3</sup> Future life insurance obligations consist primarily of estimated future contingent benefit payments and surrender benefits on policies inforce at December 31, 2016. These estimated payments are computed using assumptions for future mortality, morbidity and persistency. In contrast to this table, the majority of NSIC's obligations is recorded on the balance sheet at the current account values and do not incorporate an expectation of future market growth, interest crediting or future deposits. Therefore, the estimated future life insurance obligations presented in this table significantly exceed the liabilities recorded in the Company's consolidated balance sheet. Due to the significance of the assumptions used, the actual amount and timing of such payments may differ significantly from the estimated amounts. Management believes that current assets, future premiums and investment income will be sufficient to fund all future life insurance obligations.

Contractual obligations reflected in the table above include the issuance of \$9,101,000 in subordinated debentures completed on December 15, 2005. The subordinated debentures mature December 15, 2035. It is anticipated that

Table of Contents

principal payments will not be made before maturity. Also included in long-term debt is the issuance of \$3,025,000 in subordinated debentures on June 21, 2007. This issue matures June 15, 2037 and may be prepaid at any time. Also reflected in the table above is a \$5,000,000 unsecured loan obtained in December 2016. Associated with this loan are \$1,800,000 in short-term notes payable and \$3,200,000 in long-term debt. The unsecured loan matures in November 2019.

In estimating the time interval for payment of property and casualty claim reserves, the Company utilized historical payment patterns. By the nature of the insurance contracts under which these liabilities exist, there can be no certainty that actual payments will fall in the periods indicated above. However, management believes that current liquidity and capital resources are sufficient to pay these obligations as they come due. Also, due to the relatively short-tail nature of the majority of the Company's property and casualty claim liabilities, management can conclude with a reasonable level of confidence that historical patterns indicate that approximately 97.3% of claim liabilities at the end of a given year are settled within the following two year period. See Note 9 for additional details on payout patterns.

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 three 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 2016 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 previous adverse impacts on regulatory surplus, will likely lead to dividend payments to NSG substantially below the above referenced regulatory maximums. The Company received \$1,750,000 in

dividends from its subsidiaries during the year ended December 31, 2016.

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

Table of Contents

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.

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.

**Statutory Risk-Based Capital of Insurance Subsidiaries**

The NAIC has adopted Risk-Based Capital (RBC) requirements for life/health and property/casualty insurance companies to evaluate the adequacy of statutory capital and surplus in relation to investment and insurance risks such as asset quality, mortality and morbidity, asset and liability matching, benefit and loss reserve adequacy, and other business factors. State insurance regulators will use the RBC formula as an early warning tool to identify, for the purpose of initiating regulatory action, insurance companies that potentially are inadequately capitalized. In addition, the formula defines minimum capital standards that will supplement the current system of low fixed minimum capital and surplus requirements on a state-by-state basis. Regulatory compliance is determined by a ratio of the Company's regulatory total adjusted capital, as defined by the NAIC, to its authorized control level RBC, as defined by the NAIC. Companies below specific trigger points or ratios are classified within levels, each of which requires corrective action.

The levels and ratios are as follows:

	Ratio of Total Adjusted Capital to Authorized Control Level RBC (Less Than or Equal to)
Regulatory Event	
Company action level	2.0
Regulatory action level	1.5
Authorized control level	1.0
Mandatory control level	0.7

The ratios of Total Adjusted Capital to Authorized Control Level RBC for The National Security Group's life/health and property/casualty insurance subsidiaries are all in excess of 5 to 1 at December 31, 2016.

National Security Insurance Company (life insurer) has regulatory adjusted capital of \$15.1 million and \$13.9 million at December 31, 2016 and 2015, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 15.2 and 17.9 at December 31, 2016 and 2015, respectively. Accordingly, National Security Insurance Company exceeds the minimum RBC requirements.

National Security Fire & Casualty Company (property/casualty insurer) has regulatory adjusted capital of \$35.2 million and \$34.5 million at December 31, 2016 and 2015, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 5.1 and 5.2 at December 31, 2016 and 2015, respectively. Accordingly, National Security Fire & Casualty Company exceeds the minimum RBC requirements.

Omega One Insurance Company (property/casualty insurer), which began writing business in late 1995, has regulatory adjusted capital of \$10.7 million at December 31, 2016 and 2015, and a ratio of regulatory total adjusted capital to authorized control level RBC of 43.7 and 37.8 at December 31, 2016 and 2015, respectively. Accordingly, Omega One Insurance Company exceeds the minimum RBC requirements.

**Application of Critical Accounting Policies**

Our Consolidated Financial Statements are based upon the development and application of accounting policies that require management to make significant estimates and assumptions. Accounting policies may be based on (including but not limited to) GAAP authoritative literature, statutory authoritative literature, regulations and industry standards. The Company's financial results would be directly impacted by changes in assumptions and judgments used to select and apply our accounting policies. It is management's opinion that the following are some of the more critical judgment areas in regards to the application of our accounting policies and their effect on our financial condition and results of operations.

Reinsurance

Deferred Policy Acquisition Costs

Income Taxes

Fair Values of Financial Instruments

Table of Contents

Claim Liabilities  
Recognition of Revenue  
Contingencies

Reinsurance

Risk management involves ceding risks to reinsurers for policies underwritten based on contractual agreements. The reinsurance purchased helps provide protection by individual loss or catastrophic event when claims exceed specified amounts. Although the reinsurance protects our Company in the event a loss exceeds retention limits specified in a particular reinsurance agreement; ultimate responsibility for claim settlement rests with our Company if any reinsurer defaults on payments due. We record an asset for reinsurance recoverable in the financial statements for amounts due from reinsurers and monitor the balances due by reinsurer to ensure the asset is ultimately going to be collectible. If we discover an amount due may not be received, we remove the balance and charge it to an allowance for doubtful accounts or charge it off to expense based on the information available at the time.

When a claim is made under a policy we have reinsured, we initially pay the full amount owed to the policyholder or claimant. Subsequently, we initiate the process to recover any amounts due from reinsurers in accordance with the terms of the applicable reinsurance contract.

Reinsurance is maintained by the life and accident and health segment for losses that exceed \$50,000 for any one insured.

During 2016, the property and casualty segment maintained a catastrophe contract, which covered losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeded the \$4 million company retention stated in the contract, reinsurers would reimburse the company 100% of gross losses up to the upper limits of the reinsurance agreement, which was \$72.5 million in 2016 and 2015. Any losses above the \$72.5 million upper limit are the responsibility of our Company. The contract in place during 2016 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed.

The property and casualty subsidiaries utilize our actual in force policy data modeled utilizing two different industry accepted catastrophe models to structure catastrophe reinsurance and determine upper limits of catastrophe reinsurance agreements. Based on modeling results utilized in 2016 and 2015, the Company was reinsured at approximately a 250 year event level. While this estimate is subject to some uncertainty and model risk, the models indicate that we maintain catastrophe reinsurance upper limits to cover an event that has less than a 0.5% probability of occurring in a given year.

At December 31, 2016, the estimated reinsurance recoverable recorded was \$1,780,000 compared to \$1,660,000 for the same period last year. The Company does not anticipate any issues with collection of the recorded amount. In 2016, catastrophe reinsurance premiums ceded totaled \$5,185,000 compared to \$5,477,000 ceded in 2015. Catastrophe reinsurance premiums are based on a premium calculation applying the agreed upon rate to the earned premium of the covered lines of business. The decline in ceded premium in 2016 is attributable to a 5% decline in the rate applied. In addition to catastrophe reinsurance, the Company placed reinstatement premium protection (RPP) reinsurance during 2016 and 2015 totaling \$734,000 and \$789,000, respectively.

The reinsurance related amounts recorded have been estimated based upon management's interpretation of the related reinsurance treaty. Areas in which judgment has been used regarding said estimates include: assessing the financial viability and credit quality of each reinsurer as well as the ability of each reinsurer to pay amounts owed.

There is a possibility that the actual amounts recovered from reinsurers could be materially less than the estimates recorded. This possibility could result in a material adverse impact on our financial condition and results of

operations. Reinsurers may dispute claims under reinsurance treaties, such as the calculated amount of reinsurance recoverable. Management does not anticipate any issues with recoverability of reinsurance balances based on current evaluations of collectability. For more information regarding reinsurance, see the Notes to our Consolidated Financial Statements.

#### Deferred Policy Acquisition Costs

Deferred policy acquisition costs (DAC) are those costs incurred in connection with acquiring new business or renewing existing business. DAC is primarily comprised of commissions, premium taxes, and underwriting costs associated with issuing new policies. In accordance with generally accepted accounting principles, these costs are not expensed in their entirety at policy inception; rather, they are recorded as an asset and amortized over the lives of the policies.



## Table of Contents

A reduction in DAC is recognized if the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums and projected investment income. Management reviews DAC calculations throughout the year to establish and assess their recoverability. Changes in management's assumptions, estimates or judgment with respect to calculating DAC could materially impact our financial statements and financial condition. Changes in loss ratios, projected investment income, premium rates or overall expense levels could negatively impact the recoverability of DAC.

At December 31, 2016 and 2015, the Company recorded \$8,351,000 and \$8,485,000, respectively, as an asset for DAC in the Consolidated Financial Statements. We do not foresee any issues related to recoverability of these capitalized costs. For more information regarding deferred policy acquisition costs, see Note 1 to our Consolidated Financial Statements.

### Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Deferred income taxes arise from the recognition of temporary differences between financial statement carrying amounts and the tax bases of the Company's assets and liabilities and operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or are settled. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. The effect of a change in tax rates is recognized in the period the new rate is enacted.

At December 31, 2016, there is no evidence to suggest to management that any deferred tax asset is unrealizable. For more information regarding deferred income taxes, see Note 7 to our Consolidated Financial Statements.

The Company evaluates all tax positions taken on its U.S. federal income tax return. No material uncertainties exist for any tax positions taken by the Company.

### Fair Values of Financial Instruments

Investments are recorded at fair value based upon quoted prices when available. Quoted prices are available for most investment debt and equity securities included in the financial statements. Further discussion of fair value methodology is discussed in Note 5 to the Consolidated Financial Statements. Periodically, the carrying values of an individual investment may become temporarily impaired because of time value, volatility, credit quality and existing market conditions. Management evaluates investments to determine whether the impairment is other-than-temporary. Evaluation criteria include credit quality of security, severity of decrease between cost and market value, length of time of the impairment and likelihood that the impairment will reverse in the near future. This evaluation requires significant assumptions, estimates and judgments by management. If the impairment is determined to be other-than-temporary, the investment is written down to the current fair value and a realized loss is recorded on the income statement. We have very limited exposure to less liquid and difficult to value investments.

### Claim Liabilities

Property and casualty loss reserves are maintained to cover the estimated unpaid liability for losses and loss adjustment expenses with respect to reported and unreported incurred claims. Loss reserves are an estimation based on actuarial projection techniques common in the insurance industry. Reserves are management's expectations of what the settlement and administration of claims will cost. Management estimate of reserves are based on historical settlement patterns, estimated salvage and subrogation, and an appraisal of the related facts and circumstances. Management's reserve estimates are reviewed by consulting actuaries to determine their adequacy and reasonableness. The reserve analysis performed by management is reviewed by the actuaries during the third quarter each year with a final comprehensive review performed at year-end.

At December 31, 2016 and 2015, the recorded liability for loss and loss adjustment expense was \$7,531,000 and \$9,645,000, respectively, a \$2,114,000 decrease. The decrease in claim and claim adjustment expense reserves is primarily due to a reduction in non-catastrophe reported claims in the fourth quarter of 2016 compared to last year. We believe the estimate of unpaid losses and loss adjustment expenses to be sufficient based on currently available information and a review of our historical reserving practices. For more information regarding loss and loss adjustment expense, see Note 9 to our Consolidated Financial Statements.

#### Recognition of Revenue

Life insurance premiums are recognized as revenues when due. Property and casualty insurance premiums include direct writings plus reinsurance assumed less reinsurance ceded and are recognized on a pro-rata basis over the

Table of Contents

terms of the policies. Unearned premiums represent that portion of direct premiums written that are applicable to the unexpired terms of policy contracts in force and is reported as a liability. Prepaid reinsurance premiums represent the unexpired portion of premiums ceded to reinsurers and are reported as an asset.

Contingencies

Liabilities for loss contingencies arising from, but not limited to, litigation, claims, assessments, fines and penalties are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated. Significant attorney fees are estimated and recorded when incurred. Additional details with respect to contingencies are disclosed in Note 16 to the accompanying Consolidated Financial Statements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Under smaller reporting company rules we are not required to disclose information required under Item 7A. 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 \$4,943,000. 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 December 31, 2016 value, the fair value of the Company's common stock investments would decrease by approximately \$494,000.

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 8. Financial Statements and Supplementary Data  
Index to Financial Statements

Consolidated Financial Statements:

Report of Independent Registered Public Accounting Firm 41

Consolidated Balance Sheets – December 31, 2016 and 2015 42

Consolidated Statements of Income – Years Ended December 31, 2016 and 2015 43

Consolidated Statements of Comprehensive Income – Years Ended December 31, 2016 and 2015 44

Consolidated Statements of Changes in Shareholders’ Equity – Years Ended December 31, 2016 and 2015 45

Consolidated Statements of Cash Flows – Years Ended December 31, 2016 and 2015 46

Notes to Consolidated Financial Statements – December 31, 2016 47

Financial Statement Schedules:

Schedule I. Summary of Investments Other Than Investments in Related Parties – December 31, 2016 and 2015 78

Schedule II. Condensed Financial Information of Registrant – December 31, 2016 and 2015 79

Schedule III. Supplementary Insurance Information – December 31, 2016 and 2015 81

Schedule IV. Reinsurance – Years Ended December 31, 2016 and 2015 81

Schedule V. Valuation and Qualifying Accounts – Years Ended December 31, 2016 and 2015 82

All other Schedules are not required under related instructions or are not applicable and therefore have been omitted.

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of The National Security Group, Inc. as of December 31, 2016 and 2015 and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the years then ended. The National Security Group, Inc.'s management is responsible for these financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The National Security Group, Inc. as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the financial statement schedules listed in the accompanying index appearing under Item 8, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ Warren  
Averett, LLC

Birmingham,  
Alabama  
March 17, 2017

Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED BALANCE SHEETS (In thousands)

	December 31, 2016	December 31, 2015
<b>ASSETS</b>		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2016 - \$1,930; 2015 - \$2,504)	\$ 1,890	\$ 2,439
Fixed maturities available-for-sale, at estimated fair value (cost: 2016 - \$92,837; 2015 - \$92,077)	92,792	91,812
Equity securities available-for-sale, at estimated fair value (cost: 2016 - \$2,343; 2015 - \$2,420)	4,943	4,897
Trading securities	107	107
Receivable for securities sold	499	—
Mortgage loans on real estate, at cost	174	202
Investment real estate, at book value	3,221	3,291
Policy loans	1,708	1,655
Company owned life insurance	4,864	4,898
Other invested assets	2,958	3,256
Total Investments	113,156	112,557
Cash and cash equivalents	7,368	6,763
Accrued investment income	776	797
Policy receivables and agents' balances, net	11,434	11,296
Reinsurance recoverable	1,780	1,660
Deferred policy acquisition costs	8,351	8,485
Property and equipment, net	1,880	1,946
Accrued income tax recoverable	941	—
Deferred income tax asset, net	2,402	3,824
Other assets	491	513
Total Assets	\$ 148,579	\$ 147,841
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Property and casualty benefit and loss reserves	\$ 7,531	\$ 9,645
Accident and health benefit and loss reserves	3,405	3,197
Life and annuity benefit and loss reserves	32,633	31,962
Unearned premiums	29,968	29,852
Policy and contract claims	1,008	826
Other policyholder funds	1,629	1,561
Short-term notes payable and current portion of long-term debt	1,800	857
Long-term debt	15,326	17,100
Accrued income taxes	—	101
Other liabilities	7,227	7,857
Total Liabilities	100,527	102,958
Contingencies		
Shareholders' equity		
Common stock	2,517	2,512
Additional paid-in capital	5,412	5,341
Accumulated other comprehensive income	1,007	525

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

Retained earnings	39,116	36,505
Total Shareholders' Equity	48,052	44,883
Total Liabilities and Shareholders' Equity	\$ 148,579	\$ 147,841

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

42

---



Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

	Year ended December 31,	
	2016	2015
REVENUES		
Net premiums earned	\$61,398	\$59,462
Net investment income	3,892	3,462
Net realized investment gains	998	503
Other income	605	623
Total Revenues	66,893	64,050
BENEFITS, LOSSES AND EXPENSES		
Policyholder benefits and settlement expenses	38,847	34,148
Amortization of deferred policy acquisition costs	3,506	3,510
Commissions	7,894	7,952
General and administrative expenses	8,996	8,615
Taxes, licenses and fees	2,204	2,086
Interest expense	1,352	1,392
Total Benefits, Losses and Expenses	62,799	57,703
Income Before Income Taxes	4,094	6,347
INCOME TAX EXPENSE (BENEFIT)		
Current	(142	) 1,127
Deferred	1,173	523
	1,031	1,650
Net Income	\$3,063	\$4,697
INCOME PER COMMON SHARE BASIC AND DILUTED	\$1.22	\$1.87
DIVIDENDS DECLARED PER SHARE	\$0.18	\$0.16

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

Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	Year ended December 31,	
	2016	2015
Net income	\$3,063	\$4,697
Other comprehensive income (loss), net of tax		
Changes in:		
Unrealized gains (losses) on securities, net of reclassification adjustment of \$549 and \$354 for 2016 and 2015, respectively	226	(2,128 )
Unrealized gain (loss) on interest rate swap	256	(119 )
Other comprehensive income (loss), net of tax	482	(2,247 )
Comprehensive income	\$3,545	\$2,450

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

Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(In thousands)

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital
Balance at December 31, 2014	\$42,757	\$32,210	\$ 2,772	\$ 2,508	\$ 5,267
Comprehensive income:					
Net income for 2015	4,697	4,697			
Other comprehensive loss (net of tax)	(2,247 )		(2,247 )		
Common stock issued	78			4	74
Cash dividends	(402 )	(402 )			
Balance at December 31, 2015	\$44,883	\$36,505	\$ 525	\$ 2,512	\$ 5,341
Net income for 2016	3,063	3,063			
Other comprehensive income (net of tax)	482		482		
Common stock issued	76			5	71
Cash dividends	(452 )	(452 )			
Balance at December 31, 2016	\$48,052	\$39,116	\$ 1,007	\$ 2,517	\$ 5,412

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

Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (In thousands)

	Year ended	
	December 31,	
	2016	2015
Cash Flows from Operating Activities		
Net income	\$3,063	\$4,697
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense and amortization/accretion, net	303	299
Decrease in cash surrender value of company owned life insurance	34	219
Net realized gains on investments	(998 )	(503 )
Deferred income taxes	1,173	523
Amortization of deferred policy acquisition costs	3,506	3,510
Changes in assets and liabilities:		
Change in receivable for securities sold	(499 )	—
Change in accrued investment income	21	—
Change in reinsurance recoverable	(120 )	(721 )
Policy acquisition costs deferred	(3,372 )	(3,403 )
Change in accrued income taxes	(1,042 )	(386 )
Change in net policy liabilities and claims	(1,082 )	2,522
Change in other assets/liabilities, net	152	112
Other, net	9	11
Net cash provided by operating activities	1,148	6,880
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(26,832)	(30,968)
Trading securities and short-term investments	—	(88 )
Property and equipment	(94 )	(138 )
Proceeds from sale or maturities of:		
Held-to-maturity securities	572	689
Available-for-sale securities	27,034	23,296
Real estate held for investment	38	444
Property and equipment	—	5
Other invested assets, net	(34 )	1,925
Net cash provided by (used in) investing activities	684	(4,835 )
Cash Flows from Financing Activities		
Change in other policyholder funds	68	51
Proceeds from long-term debt	3,900	—
Repayments of long-term debt	(5,686 )	(1,357 )
Change in short-term notes payable	943	—
Dividends paid	(452 )	(402 )
Net cash used in financing activities	(1,227 )	(1,708 )
Net change in cash and cash equivalents	605	337
Cash and cash equivalents, beginning of year	6,763	6,426
Cash and cash equivalents, end of period	\$7,368	\$6,763

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



Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying 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 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 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.

Description of Business

NSIC is licensed in the states of Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas and was organized in 1947 to provide life and burial insurance policies to the home service market. Business is now produced by both company and independent agents. Primary products include ordinary life, accident and health, supplemental hospital, and cancer insurance products.

NSFC is licensed in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia. In addition, NSFC operates on a surplus lines basis in Louisiana. NSFC operates in various property and casualty lines, the most significant of which are: dwelling fire and extended coverage, homeowners and mobile homeowners.

Omega is licensed in the states of Alabama and Louisiana. Omega currently has no insurance policies in-force.

The Company is incorporated under the laws of the State of Delaware. Its common stock is traded on the NASDAQ Global Market under the ticker symbol NSEC. Pursuant to the regulations of the United States Securities and Exchange Commission (SEC), the Company is considered a "Smaller Reporting Company" as defined by SEC Rule 12b-2 of the Exchange Act. The Company has elected to comply with the scaled disclosure requirements of Regulation S-K and only two years of financial statements are included 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these 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.

Concentration of Risk

The Company's property and casualty subsidiaries, composing 91% of consolidated direct written premium, produced business during 2016 in eight states. However, 57% of property and casualty segment direct written premium is generated in the states of Alabama, Mississippi and Louisiana, subjecting the Company to significant geographic concentration. Consequently, adverse weather conditions or changes in the legal, regulatory or economic environment could adversely impact the Company.

The Company's life, accident and health insurance subsidiary, composing approximately 9% of consolidated direct written premium, is licensed in seven states. However, over 79% of life segment direct premium is generated in the states of Alabama and Georgia. Consequently, changes in the legal, regulatory or economic environment in these states could adversely impact the Company.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

For the year ended December 31, 2016, one agency individually produced greater than 5% of the Company's direct written premium.

Investments

The Company's securities are classified as follows:

**Securities Held-to-Maturity.** Bonds, notes and redeemable preferred stock for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.

**Securities Available-for-Sale.** Bonds, notes, common stock and non-redeemable preferred stock, not classified as either held-to-maturity or trading, are reported at fair value and adjusted for other-than-temporary declines in fair value.

**Trading Securities.** Mutual funds (primarily) are reported at fair value.

Unrealized gains and losses on investments, net of tax, on securities available-for-sale are reflected directly in shareholders' equity as a component of accumulated other comprehensive income (loss), and accordingly, have no effect on operating results until realized.

Changes in fair value of trading securities are recognized in net income.

Realized gains and losses on the sale of investments available-for-sale are determined using the specific-identification method and include write downs on available-for-sale investments considered to have other-than-temporary declines in market value.

When a fixed maturity security has a decline in value, where fair value is below amortized cost, an other-than-temporary impairment (OTTI) is triggered in circumstances where:

- the Company has the intent to sell the security
- it is more likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis
- the Company does not expect to recover the entire amortized cost basis of the security

If the Company intends to sell the security or if it is more-likely-than-not the Company will be required to sell the security before recovery, an OTTI is recognized as a realized loss in the income statement equal to the difference between the security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more-likely-than-not that the Company will be required to sell the security before recovery, the OTTI is separated into an amount representing the credit loss, which is recognized as a realized loss in the statement of operations, and the amount related to all other factors, which is recognized in other comprehensive income.

When an equity security has a decline in value, where fair value is below cost, that is deemed to be other-than-temporary, the Company reduces the book value of the security to its current fair value, recognizing the decline as a realized loss in the statement of income. Any future increases in the market value of investments written down are reflected as changes in unrealized gains as part of accumulated other comprehensive income within shareholders' equity.



Interest on fixed income securities is credited to income as it accrues on the principal amounts outstanding adjusted for amortization of premiums and accretion of discounts computed utilizing the effective interest rate method. Premiums and discounts on mortgage backed securities amortize or accrete using anticipated prepayments with changes in anticipated prepayments accounted for prospectively. The model used to determine anticipated prepayment assumptions for mortgage backed securities uses separate home sale, refinancing, curtailment and pay-off assumptions derived from a variety of industry sources. Mortgage backed security valuations are subject to prospective adjustments in yield due to changes in prepayment assumptions. The utilization of the prospective method will result in a recalculated effective yield that will equate the carrying amount of the investment to the present value of the projected future cash flows. The recalculated yield is used to accrue income on investments for subsequent periods.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Mortgage loans and policy loans are stated at the unpaid principal balance of such loans, net of any related allowance for loan losses.

Investment real estate is reported at cost, less allowances for depreciation computed on the straight-line basis. Investment real estate consists primarily of undeveloped commercial real estate.

Other investments consist primarily of investments in notes and equity investments in limited liability companies. The Company has no influence or control over the operating or financial policies of the limited liability companies, and consequently, these investments are accounted for using the cost method.

The Company owns life insurance (COLI) contracts on certain management and supervisory employees each having a face amount of approximately \$2,000,000 (including cash surrender value at the time of payment). The Company's original investment in company owned life insurance was \$5,000,000. The primary purpose of the program is to offset future employee benefit expenses through earnings on the cash value of the policies. The Company is the owner and principal beneficiary of these policies. The life insurance contracts are carried at their current cash surrender value. Cash surrender value at December 31, 2016 and December 31, 2015 was \$4,864,000 and \$4,898,000, respectively. Changes in cash surrender values are included in income in the current period. The change in surrender value included in earnings for the periods ended December 31, 2016 and 2015 was a decline of \$34,000 and \$219,000, respectively. Death proceeds from the contracts are recorded when the proceeds become payable under the terms of the policy and proceeds in excess of cash surrender value are recognized as a gain on company owned life insurance.

Cash and short-term investments are carried at cost, which approximates market value.

Investments with other-than-temporary impairment in value are written down to estimated realizable values and losses recognized as a component of investments gains and losses in the Consolidated Statement of Income. The fair value of the investment becomes its new cost basis.

Fair Values of Financial Instruments

The Company uses the following methods and assumptions to estimate fair values:

Investments

Fixed income security fair values are based on quoted market prices when available. If not available, fair values are based on values obtained from investment brokers and independent pricing services.

Equity security fair values are based on quoted market prices.

Multiple observable inputs are not available for some of our investments, primarily private placements and limited partnerships. Management values these investments either using non-binding broker quotes or pricing models that utilize market based assumptions that have limited observable inputs. These investments compose less than 1% of total assets.

Receivables and reinsurance recoverable - The carrying amounts reported approximate fair value.

Interest rate swaps - The estimated fair value of the interest rate swaps is based on valuations received from financial institution counterparties.

Trust preferred securities obligations and line of credit obligations - The carrying amounts reported for these instruments are equal to the principal balance outstanding and approximate their fair value.

Policy Receivables

Receivable balances are reported at unpaid balances, less a provision for credit losses.

Accounts Receivable

Accounts receivable are reported at net realizable value. Management determines the allowance for doubtful accounts based on historical losses and current economic conditions. On a continuing basis, management analyzes delinquent

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

receivables, and once these receivables are determined to be uncollectible, they are written off through a charge against an existing allowance account or against earnings.

Property and Equipment

Property and equipment is carried at cost less accumulated depreciation and includes expenditures that substantially increase the useful lives of existing property and equipment. Significant costs incurred for internally developed software are capitalized and amortized over estimated useful lives of 3 years. Maintenance, repairs, and minor renovations are charged to expense as incurred. Upon sale or retirement of property and equipment, the costs and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations. The Company provides for depreciation of property and equipment using the straight-line method designed to amortize costs over estimated useful lives. Estimated useful lives range up to 40 years for buildings and from 3-10 years for electronic data processing equipment and furniture and fixtures. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Statement of Cash Flows

For purposes of reporting cash flows, cash includes cash-on-hand, demand deposits with banks and overnight investments consisting primarily of repurchase agreements.

Premium Revenue

Life insurance premiums are recognized as revenues when due. Property and casualty insurance premiums include direct writings plus reinsurance assumed less reinsurance ceded and are recognized on a pro-rata basis over the terms of the policies. Unearned premiums represent that portion of direct premiums written that are applicable to the unexpired terms of policy contracts in force and is reported as a liability. Prepaid reinsurance premiums represent the unexpired portion of premiums ceded to reinsurers and are reported as an asset.

Deferred Policy Acquisition Costs

The costs of acquiring new insurance business are deferred and amortized over the lives of the policies. Deferred costs include commissions, premium taxes, other agency compensation and expenses, and other underwriting expenses directly related to the level of new business produced.

Acquisition costs relating to life contracts are amortized over the premium paying period of the contracts, or the first renewal period of term policies, if earlier. Assumptions utilized in amortization are consistent with those utilized in computing policy liabilities.

The method of computing the deferred policy acquisition costs for property and casualty policies limits the amount deferred to a percentage of related unearned premiums.

Policy Liabilities

The liability for future life insurance policy benefits is computed using a net level premium method including the following assumptions:

Years of Issue	Interest Rate
1947 - 1968	4%
1969 - 1978	6% graded to 5%

1979 - 2003	7% graded to 6%
2004 - 2012	5.25%
2013 - 2016	4.25%

Mortality assumptions include various percentages of the 1955-60 and 1965-70 Select and Ultimate Basic Male Mortality Table. Withdrawal assumptions are based on the Company's experience.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Claim Liabilities

The liability for unpaid claims represents the estimated liability for claims reported plus claims incurred but not yet reported and the related loss adjustment expenses. The liabilities for claims and related adjustment expenses are determined using case-basis evaluations and statistical analysis and represent estimates of the ultimate net cost of all losses incurred through December 31 of each year. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in the period in which they are determined.

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 2,515,459 at December 31, 2016 and 2,510,504 at December 31, 2015. The Company did not have any dilutive securities as of December 31, 2016 and 2015.

Reinsurance

The Company's insurance operations re-insure certain risks in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. See Note 10 for additional information regarding the Company's reinsurance practices.

Income Taxes

The Company files a consolidated U.S. federal income tax return that includes the holding company and its subsidiaries. The Company is currently subject to a statutory rate of 34%. Tax related interest and penalties are reported as components of income tax expense.

The Company uses the asset and liability method of accounting for income taxes. Deferred income taxes arise from the recognition of temporary differences between financial statement carrying amounts and the tax bases of the Company's assets and liabilities and capital or operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. The effect of a change in tax rates is recognized in the period the new rate is enacted.

The Company evaluates all tax positions taken on its U.S. federal income tax return. No material uncertainties exist for any tax positions taken by the Company.

Contingencies

Liabilities for loss contingencies arising from, but not limited to, litigation, claims, assessments, fines and penalties are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated. Significant attorney fees are estimated and recorded when incurred.

Reclassifications

Certain 2015 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2016 presentation.

Advertising

The Company expenses advertising costs as incurred.

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 December 31, 2016, the net amount exceeding FDIC insured limits was \$11,169,000 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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

losses, are composed of balances due from independent agents. At December 31, 2016, the single largest balance due from one agent totaled \$561,000.

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 December 31, 2016 and December 31, 2015, 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 December 31, 2016, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Change in Accounting Principle:

Effective January 1, 2016, the Company elected to change its method of presentation relating to placement fees associated with the issuance of trust preferred securities in accordance with FASB ASU 2015-03. Prior to 2016, the Company's policy was to present these fees in Other Assets on the balance sheet, net of accumulated amortization. Beginning in 2016, the Company has presented these fees as a direct reduction in the related note payable.

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 are still in the process of evaluating the impact, if any, the guidance may have on its consolidated financial statements.

Presentation of Financial Statements - Going Concern

In August 2014, the FASB issued guidance on determining when and how to disclose going concern uncertainties in the financial statements, and requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued. The updated guidance is effective for annual periods ending after December 15, 2016 and interim periods thereafter. Early adoption is permitted. The Company does not expect the adoption to have a material impact on its financial position, results of operations or disclosures.

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.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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.

Recently Adopted Accounting Standards

Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

In January 2015, the FASB issued guidance that eliminates from GAAP the concept of extraordinary items. The Company adopted this standard on January 1, 2016. This guidance did not have a material effect on results of operations or financial position.

Amendments to the Consolidation Analysis

In February 2015, the FASB issued additional guidance regarding the consolidation of certain legal entities. The guidance modifies the evaluation of whether or not limited partnerships and similar legal entities are variable interest entities (VIEs) and the consolidation analysis of entities involved with VIEs, particularly those that have fee arrangements and related party relationships. The Company adopted this standard on January 1, 2016. This guidance did not have a material effect on results of operations or financial position.

Interest - Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs.

In April 2015, the FASB issued guidance to simplify the presentation of debt issuance costs. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability. The Company adopted this standard retrospectively on January 1, 2016,

which resulted in the reclassification of \$258,000 of unamortized debt issuance costs related to Company borrowings from other assets to long-term debt within our consolidated balance sheet as of December 31, 2015. The adoption also resulted in the reclassification of \$12,000 from general expenses to interest expense for the twelve months ended December 31, 2015.

#### Disclosure about Short-Duration Contracts

In May 2015, the FASB issued guidance that enhances disclosure about short-duration insurance liabilities to help users understand the nature, amount, timing and uncertainty of future cash flows related to insurance liabilities and the effect of those cash flows on the statement of comprehensive income. The Company adopted this standard on

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

January 1, 2016. Required disclosures will be included in the notes to consolidated financial statements included in the Company's 2016 Annual Report on Form 10-K and in interim reports beginning in 2017.

Simplifying the Accounting for Measurement-Period Adjustments

In September 2015, the FASB issued guidance that requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The acquirer must record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The guidance requires an entity to present on the face of the income statement or to disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The Company adopted this standard on January 1, 2016. This guidance did not have a material effect on results of operations or financial position.

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 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 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.

NOTE 3 – STATUTORY ACCOUNTING PRACTICES

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which vary in certain respects from reporting practices prescribed or permitted by insurance regulatory authorities. The significant differences for statutory reporting include: (a) acquisition costs of acquiring new business are charged to operations as incurred, (b) life policy liabilities are established utilizing interest and mortality factors specified by regulatory authorities, (c) the Asset Valuation Reserve (AVR) and the Interest

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Maintenance Reserve (IMR) are recorded as liabilities in the life subsidiary, and (d) non-admitted assets (primarily furniture and equipment, agents' debit balances and prepaid expenses) are charged directly to surplus.

Statutory net gains (losses) from operations and capital and surplus, excluding intercompany transactions, are summarized as follows:

	2016	2015
NSIC - including realized capital gains of \$313 and \$313, respectively	\$1,488	\$1,488
NSFC - including realized capital gains (losses) of \$254 and 166, respectively	\$2,060	\$2,988
Omega - including realized capital gains of \$471 and \$24, respectively	\$225	\$771
Statutory risk-based adjusted capital:		
NSIC - including AVR of \$1,037 and \$820, respectively	\$13,872	\$13,872
NSFC - including investment in Omega of \$7,222 and \$7,189, respectively	\$35,242	\$34,446
Omega	\$10,719	\$10,689

The above amounts exclude allocation of direct expenses of the Company. NSIC, NSFC and Omega are in compliance with statutory restrictions with regard to minimum amounts of surplus and capital.

## NOTE 4 – INVESTMENTS

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

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 ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2015 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$ 38,245	\$ 747	\$ 1,728	\$37,264
Mortgage backed securities	15,324	157	224	15,257
Private label asset backed securities	6,029	24	380	5,673
Obligations of states and political subdivisions	14,654	869	47	15,476
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	17,825	413	96	18,142
Total fixed maturities	92,077	2,210	2,475	91,812
Equity securities	2,420	2,590	113	4,897
Total	\$ 94,497	\$ 4,800	\$ 2,588	\$96,709

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2015 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$ 2,395	\$ 62	\$	—\$2,457
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	44	3	—	47
Total	\$ 2,439	\$ 65	\$	—\$2,504

The amortized cost and aggregate fair value of debt securities at December 31, 2016, 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	\$ 1,582	\$1,615
Due after one year through five years	15,047	15,006
Due after five years through ten years	34,497	34,444
Due after ten years	41,711	41,727
Total	\$ 92,837	\$92,792
Held-to-maturity securities:		
Due in one year or less	\$ 4	\$4
Due after one year through five years	26	27
Due after five years through ten years	80	87
Due after ten years	1,780	1,812
Total	\$ 1,890	\$1,930





Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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.

A summary of securities available-for-sale with unrealized losses as of December 31, 2015, 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, 2015	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	\$ 18,205	\$ 821	\$ 3,783	\$ 907	\$ 21,988	\$ 1,728	44
Mortgage backed securities	9,069	161	675	63	9,744	224	20
Private label asset backed securities	4,962	379	84	1	5,046	380	10
Obligations of state and political subdivisions	1,920	36	331	11	2,251	47	5
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	6,131	70	1,452	26	7,583	96	12
Equity securities	—	—	1,173	113	1,173	113	1
	\$ 40,287	\$ 1,467	\$ 7,498	\$ 1,121	\$ 47,785	\$ 2,588	92

There were no securities held-to-maturity with unrealized losses as of December 31, 2015.

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

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 5.98% 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 year ended December 31, 2016 and year ended December 31, 2015, the Company realized no other-than-temporary impairments. 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. At December 31, 2015, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$252,000. The second largest loss position was in the bond portfolio and totaled \$211,000. The third largest loss position was in the bond portfolio and totaled \$186,000.

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

	Year ended	
	December 31, 2016	2015
Fixed maturities	\$3,686	\$3,464
Equity securities	104	121
Mortgage loans on real estate	14	14
Investment real estate	7	8
Policy loans	128	121
Company owned life insurance change in surrender value	(34 )	(219 )
Other	161	145
	4,066	3,654
Less: Investment expenses	174	192
Net investment income	\$3,892	\$3,462

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

Year ended  
December

	31, 2016	2015
Fixed maturities	\$409	\$536
Equity securities	422	—
Other, principally real estate	167	(33 )
Net realized investment gains	\$998	\$503

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

	December 31, 31, 2016	December 31, 2015
Net change in unrealized appreciation on available-for-sale securities before deferred tax	\$ 343	\$ (3,225 )
Deferred income tax	(117 )	1,097
Net change in unrealized appreciation on available-for-sale securities	\$ 226	\$ (2,128 )

## NOTE 5 – 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.

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.

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## Assets/Liabilities Measured at Fair Value on a Recurring Basis

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
<b>Financial Assets</b>				
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
<b>Total Financial Assets</b>	<b>\$97,842</b>	<b>\$22,310</b>	<b>\$74,274</b>	<b>\$1,258</b>
<b>Financial Liabilities</b>				
Interest rate swap	\$(1,030)	\$—	\$—	\$(1,030)
<b>Total Financial Liabilities</b>	<b>\$(1,030)</b>	<b>\$—</b>	<b>\$—</b>	<b>\$(1,030)</b>

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 December 31, 2016, Level 3 fair value measurements of assets include \$1,258,000 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 December 31, 2016, Level 3 fair value measurements of liabilities include \$1,030,000 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

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 8.

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

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2015 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
<b>Financial Assets</b>				
Fixed maturities available-for-sale				
Corporate debt securities	\$37,264	\$—	\$37,264	\$—
Mortgage backed securities	15,257	—	15,257	—
Private label asset backed securities	5,673	—	5,673	—
Obligations of states and political subdivisions	15,476	—	15,476	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,142	18,142	—	—
Trading securities	107	107	—	—
Equity securities available-for-sale	4,897	3,724	—	1,173
<b>Total Financial Assets</b>	<b>\$96,816</b>	<b>\$21,973</b>	<b>\$73,670</b>	<b>\$1,173</b>
<b>Financial Liabilities</b>				
Interest rate swap	\$(1,419)	\$—	\$—	\$(1,419)

Total Financial Liabilities	\$(1,419)	\$—	\$—	\$(1,419)
-----------------------------	-----------	-----	-----	-----------

61

---

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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, 2015 (in thousands):

For the year ended December 31, 2015	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$ 1,116	\$(1,238)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	57	(181 )
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$ 1,173	\$(1,419)
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, 2015:	\$ —	\$—

For the year ended December 31, 2015, 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 Company does not hold or issue derivatives that are not designated as hedging instruments. See Note 8 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.

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The carrying amount and estimated fair value of the Company's financial instruments as of December 31, 2016 and December 31, 2015 are as follows (in thousands):

	December 31, 2016		December 31, 2015	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related instruments				
Held-to-maturity securities	\$1,890	\$ 1,930	\$2,439	\$ 2,504
Mortgage loans	174	174	202	202
Policy loans	1,708	1,708	1,655	1,655
Company owned life insurance	4,864	4,864	4,898	4,898
Other invested assets	2,958	2,958	3,256	3,256
Liabilities and related instruments				
Other policyholder funds	1,629	1,629	1,561	1,561
Short-term notes payable and current portion of long-term debt	1,800	1,800	857	857
Long-term debt	15,326	15,326	17,100	17,100

## NOTE 6 – PROPERTY AND EQUIPMENT

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

	December 31, 2016	December 31, 2015
Building and improvements	\$ 3,348	\$ 3,350
Electronic data processing equipment	1,548	1,631
Furniture and fixtures	515	529
	5,411	5,510
Less accumulated depreciation	3,531	3,564
Property and equipment, net	\$ 1,880	\$ 1,946

Depreciation expense for the year ended December 31, 2016 was \$159,000 (\$168,000 for the year ended December 31, 2015).

## NOTE 7 – 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 \$2,402,000 at December 31, 2016 and \$3,824,000 at December 31, 2015.



Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

	As of December 31, 2016	As of December 31, 2015
General expenses	\$ 1,685	\$ 1,569
Unearned premiums	2,046	2,039
Claims liabilities	746	730
Litigation settlement	—	1,748
AMT credit	1,230	816
Impairment on real estate owned	187	187
Unrealized loss on interest rate swaps	350	483
Deferred tax assets	6,244	7,572
Depreciation	(135 )	(111 )
Deferred policy acquisition costs	(2,839 )	(2,885 )
Unrealized gains on securities available-for-sale	(868 )	(752 )
Deferred tax liabilities	(3,842 )	(3,748 )
Net deferred tax asset	\$ 2,402	\$ 3,824

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

	Year ended December 31,	
	2016	2015
Deferred policy acquisition costs	\$(46 )	\$(36 )
Unearned premiums	(7 )	(78 )
General expenses	(116 )	(198 )
Depreciation	24	—
Claims liabilities	(16 )	119
Litigation settlement	1,748	292
AMT credit	(414 )	424
Deferred income tax expense	\$ 1,173	\$ 523

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:

	Year ended December 31,	
	2016	2015
Federal income tax rate applied to pre-tax income/loss	34.0 %	34.0 %
Dividends received deduction and tax-exempt interest	(1.9 )%	(1.6 )%
Company owned life insurance	0.3 %	1.2 %
Small life deduction	(8.6 )%	(6.6 )%
Other, net	1.4 %	(1.0 )%
Effective federal income tax rate	25.2 %	26.0 %





Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Under pre-1984 life insurance company tax laws, a portion of NSIC's gain from operations was not subject to current income taxation, but was accumulated for tax purposes in a memorandum account designated "policyholders' surplus". The aggregate balance in this account, \$2,520,000 at December 31, 2016, would be taxed at current rates only if distributed to shareholders or if the account exceeded a prescribed minimum. The Deficit Reduction Act of 1984 eliminated additions to policyholders' surplus for 1984 and thereafter. Deferred taxes have not been provided on amounts designated as policyholders' surplus. The deferred income tax liability not recognized is approximately \$857,000 at December 31, 2016.

## NOTE 8 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of December 31, 2016 and December 31, 2015 (dollars in thousands):

	December 31, 2016	December 31, 2015
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.	\$ 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.	—	—
Current portion of installment note payable due November 2015 with variable interest rate equal to the WSJ prime rate plus 1%. Unsecured.	—	857
	\$ 1,800	\$ 857
Long-term debt consisted of the following as of December 31, 2016 and December 31, 2015 (dollars in thousands):		
	December 31, 2016	December 31, 2015
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.	\$ —	\$ 700
Long-term portion of installment note with variable interest rate equal to the WSJ prime rate plus 1% and adjustable each November; maturity November 2021. Interest payable annually with principal payable in equal annual installments. Unsecured.	—	4,286
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	—
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 \$178,000 in debt issuance cost (\$187,000 in 2015); maturity December 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured.	9,101	9,092
	3,025	3,022

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; applied to the outstanding principal; net of \$68,000 in debt issuance cost (\$71,000 in 2015); maturity June 15, 2037. Interest payments due quarterly. All may be redeemed at any time following the fifth anniversary of issuance. Unsecured.

\$ 15,326 \$ 17,100

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Annual maturities of all outstanding debt for the next five years and beyond are as follows (dollars in thousands):

2017	2018	2019	2020	2021	Thereafter
\$1,800	\$800	\$2,400	\$ —	\$ —	\$12,126

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 \$145,000 (liability) and \$885,000 (liability), respectively, for a total liability of \$1,030,000 at December 31, 2016 (\$1,419,000 at December 31, 2015). The swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of \$256,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements at December 31, 2016. A net valuation loss of \$119,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2015.

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 December 31, 2016, the Company has securities on deposit with fair market values of \$1,466,000 and cash of \$231,000 (all of which is posted as collateral). At December 31, 2015, the Company had securities on deposit with fair market values of \$1,482,000 and cash of \$130,000 (all of which is posted as collateral). See Note 5 for additional information about the interest rate swaps.

**NOTE 9 – 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.

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

	Year ended December 31,	
	2016	2015
Summary of claims and claim adjustment expense reserves		
Balance, beginning of year	\$9,645	\$8,321
Less reinsurance recoverable on unpaid losses	1,380	839
Net balances at beginning of year	8,265	7,482
Net losses:		
Provision for claims and claim adjustment expenses for claims arising in current year	35,659	30,900
Estimated claims and claim adjustment expenses for claims arising in prior years	(1,460 )	(962 )
Total increases	34,199	29,938
Claims and claim adjustment expense payments for claims arising in:		
Current year	31,265	25,339
Prior years	4,852	3,816
Total payments	36,117	29,155
Net balance at end of year	6,347	8,265
Plus reinsurance recoverable on unpaid losses	1,184	1,380
Claims and claim adjustment expense reserves at end of year	\$7,531	\$9,645

The decrease in claim and claim adjustment expense reserves is primarily due to a reduction in non-catastrophe reported claims in the fourth quarter of 2016 compared to last year. The Company did experience an overall increase in claims in 2016 versus 2015, primarily due to claims associated with Hurricane Matthew which occurred in October of 2016. However, over 95% of reported claims from Hurricane Matthew were paid at December 31, 2016. The estimate for claims arising in prior years was reduced \$1,460,000 in 2016 (reduced \$962,000 in 2015) due to favorable loss development during the year on claims arising in prior years.

The Company has a geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather, explosions and fires, and the incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophe losses are restricted to small geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. The Company generally seeks to reduce its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance. At December 31, 2016, the Company's estimate of unpaid losses and adjustment expenses for claims incurred in prior years related to catastrophes that exceeded our retention totaled \$462,000 before reinsurance (\$856,000 in 2015). Because the Company has exhausted its catastrophe coverage limits available for Hurricane Katrina any additional development will not be covered by reinsurance.

The claim development table that follows present incurred and cumulative paid claims and adjustment expense by accident year. Information presented is undiscounted and net of reinsurance (dollars in thousands).



Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## Homeowners, Dwelling Fire and Other Liability

For the Years Ended December 31,											IBNR Reserve	Cumulative Number of Reported Claims
2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2016		
Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance												
Unaudited												
2007	\$29,056	\$27,990	\$27,636	\$27,415	\$27,356	\$27,343	\$27,341	\$27,422	\$27,433	\$27,333	\$ —	5,927
2008	40,544	38,807	38,639	38,912	39,327	39,069	39,420	39,180	39,117	(56 )	13,609	
2009		31,425	30,236	30,442	30,432	30,484	30,362	30,306	30,280	—	7,989	
2010			30,610	29,918	29,805	29,718	29,687	29,672	29,641	1	5,884	
2011				35,203	33,957	34,233	34,711	34,806	34,650	23	8,121	
2012					29,959	30,190	30,402	30,091	29,948	69	5,188	
2013						27,436	27,147	27,076	27,023	174	5,191	
2014							25,929	26,422	26,290	328	4,734	
2015								31,484	30,861	694	5,826	
2016									36,287	2,386	4,909	
									Total	\$311,430		

Cumulative Paid Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance  
Unaudited

2007	\$24,545	\$27,178	\$27,195	\$27,250	\$27,300	\$27,286	\$27,283	\$27,222	\$27,223	\$27,323
2008	34,664	37,986	38,312	38,498	38,617	38,935	39,090	39,105	39,108	
2009		25,245	29,281	29,869	29,847	30,004	30,265	30,274	30,280	
2010			26,064	29,201	29,404	29,507	29,639	29,640	29,640	
2011				31,488	33,080	33,484	34,167	34,622	34,621	
2012					26,162	29,135	29,614	29,765	29,834	
2013						24,157	26,114	26,487	26,661	
2014							22,844	25,461	25,800	
2015								25,923	30,066	
2016									31,893	
									Total	\$305,226
										88
										\$6,292

The cumulative number of reported claims presented above is reported on a per claimant basis.

## Average Annual Percentage Payout of Incurred Claims by Age

## Unaudited

Years	1	2	3	4	5	6	7	8	9	10
	87.6%	9.7%	1.1%	0.6%	0.6%	0.3%	0.1%	(0.1)%	(0.1)%	0.2%

The tables presented above represent homeowners, dwelling fire and other liability lines of business. The Company combined the data for these lines of business because the policy coverage and payout pattern for homeowners and

68

---



Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

dwelling fire are not materially different. Also, other liability is combined with dwelling fire because liability coverage is only sold as an additional coverage offered only with the dwelling fire policy. The Company offers no stand alone liability products.

Management periodically estimates the liability for claims that have been reported but not paid and for claims incurred but not reported (IBNR). Management utilizes expected losses along with historical data analysis of paid and incurred loss development patterns over the past ten years to aide in establishing the claims liability. Management also separately evaluates any recent large events in establishing claim reserves. The Company also engages a consulting actuary to review managements' estimates of claim liabilities each year. There has been no material change in reserving methodology in 2016 compared to prior years.

As shown in the table above depicting average annual payout of incurred claims, 87.6% of claims are settled within twelve months of the date of loss and cumulatively, 97.3% of claims are settled within two years of the date of loss. While reserve for reported but unpaid and incurred but not reported claims can ultimately prove to be excessive or deficient, the short duration of the Company's claim liabilities serves to lesson the uncertainty compared to longer tail lines of insurance. The Company has no material exposure to difficult to estimate long tail liabilities such as toxic waste cleanup, asbestos related illness or other environmental remediation exposures.

Reconciliation of the Disclosure of Incurred and Paid Claims Development to the Liability  
for Unpaid Claims and Claim Adjustment Expenses

	December 31, 2016
Net outstanding liabilities	
Homeowners' insurance	\$ 1,972
Dwelling fire insurance	2,938
Other Liability insurance	1,382
Other short-duration insurance lines	55
Liabilities for unpaid claims and claim adjustment expenses, net of reinsurance	6,347
Reinsurance recoverable on unpaid claims	
Homeowners' insurance	889
Dwelling fire insurance	295
Other Liability insurance	—
Other short-duration insurance lines	—
Total reinsurance recoverable on unpaid claims	1,184
Insurance lines other than short-duration	—
Unallocated claims adjustment expenses	—
Other	—
Total gross liability for unpaid claims and claim adjustment expense	\$ 7,531

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 tend to be of short duration with claims typically settled in three years or less and the reserve

69

---

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

for unpaid claims totaled \$391,000 at December 31, 2016. These claims are a component of policy and contract claims which totaled \$1,008,000 at December 31, 2016.

Cumulative incurred and paid claims over the last three years, along with annual percentage payouts related to accident and health claims, is as follows (dollars in thousands):

For the Years Ended December 31,				IBNR	Cumulative
2014	2015	2016		Reserves	Number of
Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance Unaudited				Dec. 31, 2016	Reported Claims
2014	\$742	\$903	\$835	\$	—1,299
2015		765	813	—	1,120
2016			960	341	947
Cumulative Paid Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance Unaudited					
2014	\$539	\$808	\$836		
2015		568	724		
2016			657		
Average Annual Percentage Payout of Incurred Claims by Age Unaudited					
Years 1	2	3			
	67.6%	25.3%	7.2%		

## NOTE 10 – 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, 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.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 December 31, 2016, the largest reinsurance recoverable of a single reinsurer was \$332,000 (\$12,000 at December 31, 2015). Amounts reported as ceded incurred losses in 2016 were related to Hurricane Matthew as well as development of losses from prior year catastrophes. Amounts reported as ceded incurred losses in 2015 were related to the development of losses from prior year catastrophes.

NOTE 11 – 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 years ended December 31, 2016 and 2015 amounted to \$196,000 and \$201,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limitations.

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 years ended December 31, 2016 and 2015 amounted to approximately \$245,000 and \$68,000, 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 other benefits to such employees. There were \$250,000 costs incurred during the years ended December 31, 2016 and 2015 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.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

The Company is dependent on dividends from its insurance subsidiaries to fund operations and for the payment of shareholder dividends. Dividend payments from the insurance subsidiaries are subject to regulatory review/approval and statutory limitations. The statutory limitations are outlined as follows:

The amount of dividends paid from NSIC to the Company in any year may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2016, NSIC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to \$1,642,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. At December 31, 2016, NSFC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to \$3,524,000.

The payment of any subsidiary dividend requires prior notice to the regulatory authorities who may disallow the dividend if, in their judgment, payment of the dividend would have an adverse effect on the surplus of the subsidiary. Additionally, there are other considerations that can limit the payment of dividends to amounts less than statutory limits. Some of these considerations include potential adverse impact on regulatory capital ratios and impact on ratings issued by rating agencies such as A.M. Best.

At December 31, 2016, securities with market values of \$3,026,000 (\$3,642,000 at December 31, 2015) were deposited with various states pursuant to statutory requirements.

NOTE 13 – SHAREHOLDERS' EQUITY

During the years ended December 31, 2016 and year ended December 31, 2015, changes in shareholders' equity consisted of net income of \$3,063,000 and \$4,697,000, respectively; dividends paid of \$452,000 in 2016 and \$402,000 in 2015; increases in accumulated other comprehensive income, net of applicable taxes, of \$482,000 in 2016 and decreases in accumulated other comprehensive income, net of applicable taxes, of \$2,247,000 in 2015. 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.



Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The table below provides information regarding the Company's preferred and common stock as of December 31, 2016 and December 31, 2015:

	December 31, 2016			December 31, 2015		
	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	2,517,339	2,517,339	3,000,000	2,512,425	2,512,425

On May 20, 2016, 4,914 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

## NOTE 14 – 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):

	Year ended	
	December 31, 2016	2015
Gains and Losses on Cash Flow Hedges		
Balance at beginning of period	\$(935 )	\$(816 )
Other comprehensive loss for period:		
Other comprehensive loss before reclassifications	256	(119 )
Amounts reclassified from accumulated other comprehensive income	—	—
Net current period other comprehensive loss	256	(119 )
Balance at end of period	\$(679 )	\$(935 )
Unrealized Gains and Losses on Available-for-Sale Securities		
Balance at beginning of period	\$1,460	\$3,588
Other comprehensive income for period:		
Other comprehensive income (loss) before reclassifications	775	(1,774 )
Amounts reclassified from accumulated other comprehensive income	(549 )	(354 )
Net current period other comprehensive income (loss)	226	(2,128 )
Balance at end of period	\$1,686	\$1,460
Total Accumulated Other Comprehensive Income at end of period	\$1,007	\$525

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the amounts reclassified out of AOCI for the year ended December 31, 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	\$ 832	Net realized investment gains
	832	Total before tax
	(283 )	Tax (expense) or benefit
	\$ 549	Net of Tax

The following table presents the amounts reclassified out of AOCI for the year ended December 31, 2015 (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	\$ 536	Net realized investment gains
	536	Total before tax
	(182 )	Tax (expense) or benefit
	\$ 354	Net of Tax

## NOTE 15 – 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 December 31, 2016 and at December 31, 2015 are summarized below (dollars in thousands):

	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
December 31, 2016	\$148,579	\$ 82,647	\$ 58,689	\$ 7,243
December 31, 2015	\$147,841	\$ 84,435	\$ 57,067	\$ 6,339

74

---

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Premium revenues and operating income by business segment for the years ended December 31, 2016 and 2015 are summarized below (dollars in thousands):

Year ended December 31, 2016	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
<b>REVENUE</b>				
Net premiums earned	\$61,398	\$ 55,164	\$ 6,234	\$ —
Net investment income	3,892	1,706	2,122	64
Net realized investment gains (losses)	998	725	273	—
Other income	605	603	2	—
	66,893	58,198	8,631	64
<b>BENEFITS AND EXPENSES</b>				
Policyholder benefits paid	38,847	33,562	5,285	—
Amortization of deferred policy acquisition costs	3,506	2,783	723	—
Commissions	7,894	7,584	310	—
General and administrative expenses	8,996	6,818	1,509	669
Taxes, licenses and fees	2,204	2,005	199	—
Interest expense	1,352	—	78	1,274
	62,799	52,752	8,104	1,943
Income (Loss) Before Income Taxes	\$4,094	\$ 5,446	\$ 527	\$ (1,879 )

Year ended December 31, 2015	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
<b>REVENUE</b>				
Net premiums earned	\$59,462	\$ 53,162	\$ 6,300	\$ —
Net investment income	3,462	1,473	1,913	76
Net realized investment gains	503	190	313	—
Other income	623	620	3	—
	64,050	55,445	8,529	76
<b>BENEFITS AND EXPENSES</b>				
Policyholder benefits paid	34,148	29,461	4,687	—
Amortization of deferred policy acquisition costs	3,510	2,701	809	—
Commissions	7,952	7,572	380	—
General and administrative expenses	8,615	6,735	1,525	355
Taxes, licenses and fees	2,086	1,906	180	—
Interest expense	1,392	—	61	1,331
	57,703	48,375	7,642	1,686
Income (Loss) Before Income Taxes	\$6,347	\$ 7,070	\$ 887	\$ (1,610 )



Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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 years ended December 31, 2016 and 2015, respectively:

	Year ended	
	December 31,	
	2016	2015
Life, accident and health operations premiums written:		
Traditional life insurance	\$4,459	\$4,519
Accident and health insurance	1,851	1,867
Gross life, accident and health	6,310	6,386
Reinsurance premium ceded	(69 )	(64 )
Net life, accident and health premiums written	\$6,241	\$6,322
Property and Casualty operations premiums written:		
Dwelling fire & extended coverage	\$35,783	\$34,737
Homeowners (Including mobile homeowners)	23,250	23,698
Other liability	2,081	1,988
Gross property and casualty	61,114	60,423
Reinsurance premium ceded	(5,830 )	(6,356 )
Net property and casualty written	\$55,284	\$54,067
Consolidated gross premiums written	\$67,424	\$66,809
Reinsurance premium ceded	(5,899 )	(6,420 )
Consolidated net premiums written	\$61,525	\$60,389

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 years ended December 31, 2016 and 2015, respectively:

	Year ended	
	December 31,	
	2016	2015
Life, accident and health operations premiums earned:		
Traditional life insurance	\$4,451	\$4,487
Accident and health insurance	1,852	1,877
Gross life, accident and health	6,303	6,364
Reinsurance premium ceded	(69 )	(64 )
Net life, accident and health premiums earned	\$6,234	\$6,300
Property and Casualty operations premiums earned:		
Dwelling fire & extended coverage	\$35,367	\$33,789
Homeowners (Including mobile homeowners)	23,595	23,800
Other liability	2,032	1,929
Gross property and casualty	60,994	59,518
Reinsurance premium ceded	(5,830 )	(6,356 )
Net property and casualty earned	\$55,164	\$53,162
Consolidated gross premiums earned	\$67,297	\$65,882
Reinsurance premium ceded	(5,899 )	(6,420 )
Consolidated net premiums earned	\$61,398	\$59,462



Table of Contents

THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 16 – 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 17 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the year ended December 31, 2016 was \$1,360,000 (\$1,376,000 in 2015). Cash paid for income taxes during the year ended December 31, 2016 was \$750,000 (\$1,546,000 in 2015).

During the year ended December 31, 2016, 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 18 – SUBSEQUENT EVENTS

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



Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
FINANCIAL STATEMENT SCHEDULES

## Schedule I. Summary of Investments Other Than Investments in Related Parties

THE NATIONAL SECURITY GROUP, INC.  
(dollars in thousands)

	December 31, 2016			December 31, 2015		
	Cost	Fair Value	Amount per the Balance Sheet	Cost	Fair Value	Amount per the Balance Sheet
Securities Held-to-Maturity:						
United States government	\$27	\$29	\$27	\$44	\$47	\$44
Mortgage backed securities	1,863	1,901	1,863	2,395	2,457	2,395
Total Securities Held-to-Maturity	1,890	1,930	1,890	2,439	2,504	2,439
Securities Available-for-Sale:						
Equity Securities:						
Banks and insurance companies	1,363	1,991	1,991	1,363	1,767	1,767
Industrial and all other	980	2,952	2,952	1,057	3,130	3,130
Total equity securities	2,343	4,943	4,943	2,420	4,897	4,897
Debt Securities:						
United States government	18,618	18,518	18,518	17,825	18,142	18,142
States, municipalities and political subdivisions	14,806	15,166	15,166	14,654	15,476	15,476
Mortgage backed securities	10,970	10,931	10,931	15,324	15,257	15,257
Private label asset backed securities	7,910	7,774	7,774	6,029	5,673	5,673
Industrial and Miscellaneous	40,533	40,403	40,403	38,245	37,264	37,264
Total Debt Securities	92,837	92,792	92,792	92,077	91,812	91,812
Total Available-for-Sale	95,180	97,735	97,735	94,497	96,709	96,709
Total Securities	97,070	99,665	99,625	96,936	99,213	99,148
Trading securities	107	107	107	107	107	107
Mortgage loans on real estate	174	174	174	202	202	202
Investment real estate	3,221	3,221	3,221	3,291	3,291	3,291
Policy loans	1,708	1,708	1,708	1,655	1,655	1,655
Company owned life insurance	4,315	4,864	4,864	4,315	4,898	4,898
Other invested assets	3,457	3,457	3,457	3,256	3,256	3,256
Total investments	\$110,052	\$113,196	\$113,156	\$109,762	\$112,622	\$112,557

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
FINANCIAL STATEMENT SCHEDULESSchedule II. Condensed Financial Information of Registrant  
THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)

## BALANCE SHEETS

(dollars in thousands)

	December 31,	
	2016	2015
Assets		
Fixed maturities available-for-sale, at estimated fair value	\$1,466	\$1,482
Investment real estate, at book value	356	356
Cash	1,690	991
Investment in subsidiaries (equity method) eliminated upon consolidation	61,108	58,986
Deferred income tax asset	1,826	3,435
Other assets	2,058	957
Total Assets	\$68,504	\$66,207
Liabilities and Shareholders' Equity		
Liabilities		
Accrued general expenses	\$2,296	\$1,948
Interest rate swaps	1,030	1,419
Short-term notes payable	1,800	857
Long-term debt	15,326	17,100
Total Liabilities	20,452	21,324
Total Shareholders' Equity	48,052	44,883
Total Liabilities and Shareholders' Equity	\$68,504	\$66,207

## THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)

## STATEMENTS OF INCOME

(dollars in thousands)

	Years Ended	
	December 31,	
	2016	2015
Income		
Dividends (eliminated upon consolidation)	\$1,750	\$2,000
Holding company management service fees	1,011	1,001
Other income	64	75
	2,825	3,076
Expenses		
State taxes	43	43
Interest	1,274	1,331
Other expenses	626	312
	1,943	1,686
Income before income taxes and equity in undistributed earnings of subsidiaries	882	1,390
Income tax expense (benefit)	(274 )	422
Income before equity in undistributed earnings of subsidiaries	1,156	968
Equity in undistributed earnings of subsidiaries	1,907	3,729
Net income	\$3,063	\$4,697



Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
FINANCIAL STATEMENT SCHEDULESTHE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)  
STATEMENTS OF CASH FLOWS  
(dollars in thousands)

	Years Ended December 31,	
	2016	2015
Cash Flows from Operating Activities:		
Net income	\$3,063	\$4,697
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Equity in undistributed earnings of subsidiaries	(1,907 )	(3,729 )
Deferred income tax expense	1,481	1,701
Other, net	(643 )	(190 )
Net cash provided by operating activities	1,994	2,479
Cash Flows from Investing Activities:		
Net sales (purchases) of investments	—	—
Net cash provided by investing activities	—	—
Cash Flows from Financing Activities:		
Net (repayments) proceeds from debt	(843 )	(1,357 )
Cash dividends	(452 )	(402 )
Net cash used in financing activities	(1,295 )	(1,759 )
Net change in cash and cash equivalents	699	720
Cash and cash equivalents, at beginning of year	991	271
Cash and cash equivalents, at end of year	\$1,690	\$991

## Notes to Condensed Financial Information of Registrant

## Note 1 - Basis of Presentation

Pursuant to the rules and regulations of the Securities and Exchange Commission, the Condensed Financial Information of the Registrant does not include all of the information and notes normally included with financial statements prepared in accordance with generally accepted accounting principles. It is, therefore, suggested that this Condensed Financial Information be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Registrant's Annual Report as referenced in Form 10-K, Part II, Item 8, page 41.

## Note 2 - Cash Dividends and Asset Transfers from Insurance Subsidiaries

In 2016, cash dividends of \$1,750,000 were paid to the Registrant by its subsidiaries (\$2,000,000 in 2015).

Table of ContentsTHE NATIONAL SECURITY GROUP, INC.  
FINANCIAL STATEMENT SCHEDULESSchedule III. Supplementary Insurance Information  
THE NATIONAL SECURITY GROUP, INC.

(dollars in thousands)		Deferred Acquisition Costs	Future Policy Benefits	Unearned Premiums	Unpaid Losses	
At December 31, 2016:						
Life and accident and health insurance		\$ 4,907	\$ 36,038	\$ 13	\$ 1,008	
Property and casualty insurance		3,444	—	29,955	7,531	
Total		\$ 8,351	\$ 36,038	\$ 29,968	\$ 8,539	
At December 31, 2015:						
Life and accident and health insurance		\$ 5,035	\$ 35,159	\$ 14	\$ 826	
Property and casualty insurance		3,450	—	29,838	9,645	
Total		\$ 8,485	\$ 35,159	\$ 29,852	\$ 10,471	
	Premium Revenue	Net Investment Income	Other Income	Benefits, Claims, Losses and Settlement Expenses	Commissions, Amortization of Policy Acquisition Costs	General Expenses, Taxes, Licenses and Fees
For the year ended December 31, 2016:						
Life and accident and health insurance	\$ 6,234	\$ 2,122	\$ 2	\$ 5,285	\$ 1,033	\$ 1,708
Property and casualty insurance	55,164	1,706	603	33,562	10,367	8,823
Other	—	64	—	—	—	669
Total	\$ 61,398	\$ 3,892	\$ 605	\$ 38,847	\$ 11,400	\$ 11,200
For the year ended December 31, 2015:						
Life and accident and health insurance	\$ 6,300	\$ 1,913	\$ 3	\$ 4,687	\$ 1,189	\$ 1,705
Property and casualty insurance	53,162	1,473	620	29,461	10,273	8,641
Other	—	76	—	—	—	355
Total	\$ 59,462	\$ 3,462	\$ 623	\$ 34,148	\$ 11,462	\$ 10,701

Note: Investment income and other operating expenses are reported separately by segment and not allocated.

Schedule IV. Reinsurance  
THE NATIONAL SECURITY GROUP, INC.

(dollars in thousands)	Gross Amount	Ceded to Other Companies	Assumed from Other Companies	Net Amount	Percentage of Amount Assumed to Net
For the year ended December 31, 2016					
Life insurance in force	\$ 208,420	\$ 9,825	\$	—\$198,595	—%
Premiums:					
Life insurance and accident and health insurance	\$ 6,303	\$ 69	\$	—\$6,234	—%
Property and casualty insurance	60,994	5,830	—	55,164	—%
Total premiums	\$ 67,297	\$ 5,899	\$	—\$61,398	—%
For the year ended December 31, 2015					
Life insurance in force	\$ 208,172	\$ 9,318	\$	—\$198,854	—%
Premiums:					
Life insurance and accident and health insurance	\$ 6,364	\$ 64	\$	—\$6,300	—%

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

Property and casualty insurance	59,518	6,356	—	53,162	—%
Total premiums	\$65,882	\$ 6,420	\$	—\$59,462	—%

81

---

Table of Contents

## Schedule V. Valuation and Qualifying Accounts

The National Security Group, Inc.

Years ended December 31, 2016 and 2015

(dollars in thousands)

	2016	2015
Balance, January 1 Allowance for Doubtful Accounts	\$ 6	\$ 9
Additions	2	2
Deletions	1	5
Balance, December 31 Allowance for Doubtful Accounts	\$ 7	\$ 6

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure  
None

## Item 9A. Controls and Procedures

Company management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this annual report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

## Management's Report on Internal Control over Financial Reporting

Management of The National Security Group, Inc. is responsible for establishing and maintaining effective internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP).

The Company's internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO-2013) and the smaller reporting company guidance - COSO for Smaller Reporting Companies released in 2007. Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2016.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

Item 9B. Other Information

None

82

---



Table of Contents

Part III

Item 10. Directors, Executive Officers and Corporate Governance

Executive Officers

JACK E. BRUNSON (60) has served as a director since 1999 and as President of NSFC since 1997. He also serves on the Boards of Directors of NSFC and Omega. He joined the Company in 1982. Mr. Brunson is a Chartered Property and Casualty Underwriter.

W. L. BRUNSON, JR. (58) has served as a director since 1999 and as President and Chief Executive Officer of the Company since 2000. He also holds the position of President of NSIC. He joined the Company in 1983. Mr. Brunson is also a director of NSFC, NATSCO, NSIC, and Omega. Mr. Brunson is a member of the Alabama State Bar.

BRIAN R. MCLEOD (48) currently serves as Vice President of Finance & Operations, CFO and Treasurer of the Company. From 1992-2002 he served as Controller. He joined the Company in 1992. Mr. McLeod is a Director of NSIC, NSFC, Omega and NATSCO. Mr. McLeod is also a member of the Board of Directors for Trinity Bank, a community bank in Dothan, Alabama. Mr. McLeod is a Certified Public Accountant.

The information contained in The National Security Group's definitive proxy statement for the 2017 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 7, 2017 with respect to directors and executive officers of the Company as well as Corporate Governance, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2017 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 7, 2017 with respect to Audit Committee and Audit Committee financial expert, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2017 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 7, 2017 with respect to information on the beneficial ownership reporting for directors and executive officers, is incorporated herein by reference in response to this item.

Item 11. Executive Compensation

The information contained in The National Security Group's definitive proxy statement for the 2017 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 7, 2017, with respect to executive compensation and transactions, is incorporated herein by reference in response to this item.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information contained in The National Security Group's definitive proxy statement for the 2017 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 7, 2017, with respect to security ownership of certain beneficial owners and management is incorporated herein by reference in response to this item.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information contained in The National Security Group's definitive proxy statement for the 2017 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 7, 2017, with respect to certain relationships and related transactions, is incorporated herein by reference in response to this item.

Item 14. Principal Accounting Fees and Services

The information contained in The National Security Group's definitive proxy statement for the 2017 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 7, 2017, with respect to principal accountant fees and services, is incorporated herein by reference in response to this item.

Table of Contents

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this report:

1. Consolidated financial statements, notes thereto and related information of The National Security Group, Inc. (the "Company") are included in Item 8 of Part II of this report:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets - December 31, 2016 and 2015

Consolidated Statements of Income (Loss) - Years ended December 31, 2016 and 2015

Consolidated Statements of Comprehensive Income - Years ended December 31, 2016 and 2015

Consolidated Statements of Shareholders' Equity - Years ended December 31, 2016 and 2015

Consolidated Statements of Cash Flows - Years ended December 31, 2016 and 2015

Consolidated Notes to the Financial Statements

2. Additional financial statement schedules and report of independent registered accounting firm are furnished herewith pursuant to the requirements of Form 10-K:

The National Security Group, Inc.

Schedule I Summary of Investments Other Than Investments in Related Parties

Schedule II Condensed Financial Information of the Registrant

Schedule III Supplementary Insurance Information

Schedule IV Reinsurance

Schedule V Valuation and Qualifying Accounts

3. Exhibits filed as part of this Form 10-K:

11. Computation of Earnings Per Share filed Herewith, See Note 1 to Consolidated Financial Statements.

14. Code of Ethics, See Additional Information in Part 1, Item 1 of This Report

21.1 Subsidiaries of the Registrant

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
October 19, 2016	October 19, 2016	Press release announcing estimated losses from Hurricane Matthew.
October 21, 2016	October 24, 2016	Press release announcing quarterly dividend.
November 11, 2016	November 11, 2016	Press release announcing financial results for the period ended September 30, 2016.



Table of Contents

SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

THE NATIONAL SECURITY GROUP, INC.

/s/ Brian R. McLeod	/s/ William L. Brunson, Jr.
Brian R. McLeod	William L. Brunson, Jr.
Chief Financial Officer and Treasurer	President, Chief Executive Officer and Director

Date: March 17, 2017

POWER OF ATTORNEY

Know all by these present, that the undersigned hereby constitutes and appoints Brian R. McLeod, with full power of substitution and/or revocation, the undersigned's true and lawful attorney-in-fact: to execute for and on behalf of the undersigned, in the undersigned's capacity as a director of National Security Group, inc. (the "Company"), any and all forms (including, without limitation Form 10-K) required or desired to be executed by or on behalf of the Company pursuant to section 13 or 15(D) of the Securities Exchange Act of 1934, as amended, after said form has been approved by the Company's audit committee; to do and perform any and all acts for and on behalf of the undersigned which may be necessary or desirable to complete and execute any such Form and timely file such Form with the appropriate governmental authority (including, without limitation, the United States Securities and Exchange Commission) and any stock exchange or similar authority; and take any other action of any type whatsoever in connection with the foregoing which, in the opinion of such attorney-in-fact, may be of benefit to, in the best interest of, or legally required by, the undersigned, it being understood that the documents executed by any such attorney-in-fact on behalf of the undersigned pursuant to this Power of Attorney shall be in such form and shall contain such terms and conditions as such attorney-in-fact may approve in such attorney-in-fact's discretion.

The undersigned hereby grants to each such attorney-in-fact full power and authority to do and perform any and every act and thing whatsoever requisite, necessary, or proper to be done in the exercise of any of the rights and powers herein granted, as fully to all intents and purposes as the undersigned might or could do if personally present, with full power of substitution or revocation, hereby ratifying and confirming all that such attorney-in-fact, or such attorney-in-fact's substitute or substitutes, shall lawfully do or cause to be done by virtue of this Power of Attorney and the rights and powers herein granted. The undersigned acknowledges that the foregoing attorneys-in-fact, and each of them, in serving in such capacity at the request of the undersigned, are not assuming, nor is the Company assuming, any of the undersigned's responsibilities to comply with section 13 or 15(D) of the Securities Exchange Act of 1934, as amended.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in their capacity as a Director of The National Security Group, Inc. on March 17, 2017:

SIGNATURE

/s/ Winfield Baird	/s/ Mickey L. Murdock
/s/ Fleming Brooks	/s/ Frank B. O'Neil
/s/ Jack E. Brunson	/s/ Donald Pittman
/s/ William L. Brunson, Jr.	/s/ Paul C. Wesch
/s/ Fred D. Clark, Jr.	/s/ L. Brunson White
/s/ Brian R. McLeod	/s/ Walter P. Wilkerson

