

NATIONAL SECURITY GROUP INC
Form 10-Q
August 13, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For Quarterly Period Ended June 30, 2018

or

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

For the transition period from _____ to _____.

Commission File Number 0-18649

The National Security Group, Inc.
(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

As of August 13, 2018, there were 2,527,136 shares, \$1.00 par value, of the registrant's common stock outstanding.

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THE NATIONAL SECURITY GROUP, INC.

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Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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

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

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

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

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

The Company's ability to continue to pay dividends to shareholders is contingent upon profitability and capital adequacy of the insurance subsidiaries. The insurance subsidiaries operate under regulatory restrictions that could

limit the ability to fund future dividend payments of the Company. An adverse event or series of events could materially impact the ability of the insurance subsidiaries to fund future dividends, and consequently, the Board of Directors would have to suspend the declaration of dividends to shareholders.

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

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PART I. Financial Information

Item 1. Financial Statements

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

| | June 30, 2018 (UNAUDITED) | December 31, 2017 |
|---|---------------------------------|----------------------|
| ASSETS | | |
| Investments | | |
| Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2018 - \$1,512; 2017 - \$1,645) | \$ 1,523 | \$ 1,616 |
| Fixed maturities available-for-sale, at estimated fair value (cost: 2018 - \$98,514; 2017 - \$94,467) | 97,036 | 95,758 |
| Equity securities, at estimated fair value (cost: 2018 - \$1,842; 2017 - \$1,842) | 4,140 | 4,509 |
| Trading securities | 107 | 107 |
| Mortgage loans on real estate, at cost | 160 | 162 |
| Investment real estate, at book value | 2,945 | 3,221 |
| Policy loans | 1,851 | 1,810 |
| Company owned life insurance | 4,838 | 4,974 |
| Other invested assets | 2,346 | 2,574 |
| Total Investments | 114,946 | 114,731 |
| Cash and cash equivalents | 4,543 | 6,644 |
| Accrued investment income | 808 | 768 |
| Policy receivables and agents' balances, net | 12,870 | 11,653 |
| Reinsurance recoverable | 278 | 366 |
| Deferred policy acquisition costs | 8,140 | 8,124 |
| Property and equipment, net | 1,712 | 1,781 |
| Income tax recoverable | 711 | 393 |
| Deferred income tax asset, net | 1,405 | 1,487 |
| Other assets | 886 | 491 |
| Total Assets | \$ 146,299 | \$ 146,438 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Property and casualty benefit and loss reserves | \$ 6,847 | \$ 7,075 |
| Accident and health benefit and loss reserves | 3,583 | 3,595 |
| Life and annuity benefit and loss reserves | 33,538 | 33,283 |
| Unearned premiums | 32,080 | 30,112 |
| Policy and contract claims | 942 | 903 |
| Other policyholder funds | 1,708 | 1,706 |
| Short-term notes payable and current portion of long-term debt | 800 | 1,300 |
| Long-term debt | 14,345 | 14,339 |
| Other liabilities | 6,059 | 6,500 |
| Total Liabilities | 99,902 | 98,813 |
| Contingencies | | |
| Shareholders' equity | | |
| Common stock | 2,527 | 2,522 |
| Additional paid-in capital | 5,554 | 5,483 |
| Accumulated other comprehensive income (loss) | (1,441) |) 2,646 |
| Retained earnings | 39,757 | 36,974 |

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| | | |
|--|------------|------------|
| Total Shareholders' Equity | 46,397 | 47,625 |
| Total Liabilities and Shareholders' Equity | \$ 146,299 | \$ 146,438 |

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

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THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In thousands, except per share amounts)

| | Three months ended June 30, | | Six months ended June 30, | |
|---|-----------------------------------|-----------|------------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| REVENUES | | | | |
| Net premiums earned | \$15,260 | \$15,331 | \$30,319 | \$30,371 |
| Net investment income | 998 | 930 | 1,779 | 1,856 |
| Net realized investment gains (losses) | (203) | 77 | (328) | 237 |
| Other income | 148 | 145 | 309 | 297 |
| Total Revenues | 16,203 | 16,483 | 32,079 | 32,761 |
| BENEFITS, LOSSES AND EXPENSES | | | | |
| Policyholder benefits and settlement expenses | 9,772 | 12,581 | 19,199 | 23,727 |
| Amortization of deferred policy acquisition costs | 787 | 819 | 1,590 | 1,764 |
| Commissions | 1,732 | 1,758 | 3,792 | 3,851 |
| General and administrative expenses | 2,668 | 2,215 | 4,671 | 4,012 |
| Taxes, licenses and fees | 349 | 517 | 998 | 1,206 |
| Interest expense | 309 | 326 | 611 | 649 |
| Total Benefits, Losses and Expenses | 15,617 | 18,216 | 30,861 | 35,209 |
| Income (Loss) Before Income Taxes | 586 | (1,733) | 1,218 | (2,448) |
| INCOME TAX EXPENSE (BENEFIT) | | | | |
| Current | 216 | (572) | (318) | (897) |
| Deferred | (87) | (162) | 608 | (236) |
| | 129 | (734) | 290 | (1,133) |
| Net Income (Loss) | \$457 | \$(999) | \$928 | \$(1,315) |
| INCOME (LOSS) PER COMMON SHARE BASIC AND DILUTED | \$0.18 | \$(0.39) | \$0.37 | \$(0.52) |
| DIVIDENDS DECLARED PER SHARE | \$0.05 | \$0.05 | \$0.10 | \$0.10 |

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

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THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS (UNAUDITED)

(In thousands)

| | Three months ended June 30, | | Six months ended June 30, | |
|---|-----------------------------------|---------|------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Net income (loss) | \$457 | \$(999) | \$928 | \$(1,315) |
| Other comprehensive income (loss), net of tax Changes in: | | | | |
| Unrealized gains (losses) on securities, net of reclassification adjustment of \$102 and \$155 for 2018 and 2017, respectively | (811) | 502 | (2,187) | 846 |
| Unrealized gain on interest rate swap | 75 | 40 | 207 | 110 |
| Other comprehensive income (loss), net of tax | (736) | 542 | (1,980) | 956 |
| Comprehensive income (loss) | \$(279) | \$(457) | \$(1,052) | \$(359) |

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

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THE NATIONAL SECURITY GROUP, INC.

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

| | Total | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Common Stock | Additional Paid-in Capital |
|---|----------|-------------------|---|--------------|----------------------------|
| Balance at December 31, 2017 | \$47,625 | \$36,974 | \$ 2,646 | \$ 2,522 | \$ 5,483 |
| Cumulative effect of change in accounting principle | — | 2,107 | (2,107) | — | — |
| Comprehensive income (loss): | | | | | |
| Net income for June 30, 2018 | 928 | 928 | — | — | — |
| Other comprehensive loss (net of tax) | (1,980) | — | (1,980) | — | — |
| Common stock issued | 76 | — | — | 5 | 71 |
| Cash dividends | (252) | (252) | — | — | — |
| Balance at June 30, 2018 | \$46,397 | \$39,757 | \$ (1,441) | \$ 2,527 | \$ 5,554 |

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

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THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

| | Six months ended June 30, | |
|---|------------------------------|-----------|
| | 2018 | 2017 |
| Cash Flows from Operating Activities | | |
| Net income (loss) | \$928 | \$(1,315) |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation expense and amortization/accretion, net | 169 | 265 |
| (Increase) decrease in cash surrender value of company owned life insurance | 136 | (56) |
| Net realized gains (losses) on investments | 328 | (237) |
| Deferred income taxes | 608 | (236) |
| Amortization of deferred policy acquisition costs | 1,590 | 1,764 |
| Changes in assets and liabilities: | | |
| Change in receivable for securities sold | — | 499 |
| Change in accrued investment income | (40) | 43 |
| Change in reinsurance recoverable | 88 | 1,274 |
| Policy acquisition costs deferred | (1,606) | (1,931) |
| Change in accrued income taxes | (318) | (898) |
| Change in net policy liabilities and claims | 800 | 1,090 |
| Change in other assets/liabilities, net | (270) | (715) |
| Other, net | 5 | 6 |
| Net cash provided by (used in) operating activities | 2,418 | (447) |
| Cash Flows from Investing Activities | | |
| Purchase of: | | |
| Available-for-sale securities | (10,579) | (8,467) |
| Property and equipment | (8) | (51) |
| Proceeds from sale or maturities of: | | |
| Held-to-maturity securities | 99 | 139 |
| Available-for-sale securities | 6,570 | 10,202 |
| Real estate held for investment | 188 | — |
| Property and equipment | — | 2 |
| Other invested assets, net | (39) | (29) |
| Net cash provided by (used in) investing activities | (3,769) | 1,796 |
| Cash Flows from Financing Activities | | |
| Change in other policyholder funds | 2 | 40 |
| Change in short-term notes payable | (500) | (500) |
| Dividends paid | (252) | (252) |
| Net cash used in financing activities | (750) | (712) |
| Net change in cash and cash equivalents | (2,101) | 637 |
| Cash and cash equivalents, beginning of year | 6,644 | 7,368 |
| Cash and cash equivalents, end of period | \$4,543 | \$8,005 |

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

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2017 AMOUNTS)

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, 2017, which includes information and disclosures not presented herein.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the 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.

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 2,523,484 at June 30, 2018 and 2,518,520 at June 30, 2017. The Company did not have any dilutive securities as of June 30, 2018 and 2017.

Reclassifications

Certain 2017 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2018 presentation.

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts subject to FDIC insured limits of \$250,000 per entity. At June 30, 2018, the net amount exceeding FDIC insured limits was \$2,903,000 at three financial institutions. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of financial institutions on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At June 30, 2018, the single largest balance due from one agent totaled \$963,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet its obligation could result in losses to the insurance subsidiaries. Allowances for losses on reinsurance recoverables are established if amounts are believed to be uncollectible. At June 30, 2018 and December 31, 2017, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At June 30, 2018, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2017 AMOUNTS)

Accounting Changes Not Yet Adopted

Improvements to Nonemployee Share-Based Payment Accounting

In June 2018, the Financial Accounting Standards Board (FASB) issued guidance to simplify the accounting for nonemployee share-based payment awards. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. The Company does not make any material share-based payments and does not expect the adoption to have a material impact on its financial position or results of operations.

Recognition and Measurement of Financial Assets and Financial Liabilities

In February 2018, the FASB issued guidance to address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The guidance is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years beginning after June 15, 2018. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Leases

In February 2016, the FASB issued guidance that requires lessees (for capital and operating leases) to recognize the lease liability and right-of-use asset at the commencement date of the lease. Additional transition guidance was issued in 2018. 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.

Receivables - Nonrefundable Fees and Other Costs

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

Derivatives and Hedging

In August 2017, the FASB issued guidance that amends and simplifies hedge accounting guidance in order to enable entities to better portray the economic results of their risk management activities. The guidance is effective for fiscal

years beginning after December 15, 2018, including interim periods within those periods. Early adoption is permitted. The Company is currently evaluating the impact of the standard on its consolidated financial statements and related disclosures.

Recently Adopted Accounting Standards

Income Statement - Reporting Comprehensive Income

In February 2018, the Financial Accounting Standards Board (FASB) issued guidance that allows a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. The guidance eliminates the stranded tax effects resulting from the Tax Cuts and Jobs Act and

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2017 AMOUNTS)

improves the usefulness of information reported to financial statement users. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those periods. Early adoption is permitted. The Company adopted this guidance as of December 31, 2017. The adoption of this guidance resulted in a \$435,000 reclassification to accumulated other comprehensive income from retained earnings related to stranded tax effects resulting from the Tax Cuts and Jobs Act.

Revenue from Contracts with Customers

In May 2014, 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. Insurance contracts are specifically scoped out of this new guidance.

The Company does not have policy fees or any material services that may be subject to the new revenue recognition guidance. The Company adopted this guidance as of January 1, 2018. The adoption of this guidance did not have an impact on its condensed consolidated financial statements.

Recognition and Measurement of Financial Assets and Financial Liabilities

In January 2016, the FASB issued guidance that requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The guidance requires entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset. The guidance eliminates the requirement for public companies to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. This guidance is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company adopted this guidance as of January 1, 2018. The adoption of this guidance resulted in a \$2,107,000 reclassification to retained earnings from accumulated other comprehensive income related to accumulated unrealized gains on equity securities as well as recognition of a \$292,000 loss, net of tax, related to the change in value of equity securities.

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 adopted this guidance as of January 1, 2018. The adoption of this guidance did not have a significant impact on our financial position, results of operations or cash flows.

Compensation - Stock Compensation

In May 2017, the FASB issued guidance to provide clarity and reduce diversity in practice as well as cost and complexity when there is a change in the terms or conditions of a share-based payment award. The guidance is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company adopted this guidance as of January 1, 2018. The adoption of this guidance did not have a significant impact on our financial position, results of operations or cash flows.

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

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THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2017 AMOUNTS)

investing in private equity investments. The Company owns less than 1% of the limited partnership. The carrying value of the investment totals \$132,000 and is included as a component of Other Invested Assets in the accompanying consolidated balance sheets.

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

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, \$3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$3,093,000 unsecured junior subordinated deferrable interest debentures. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$2,995,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the Trust. The Subordinated Debentures, disclosed in Note 7, are reported in the accompanying condensed consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$93,000 and are included in Other Assets in the accompanying condensed consolidated balance sheets.

NOTE 3 – INVESTMENTS

Our investment in available-for-sale securities, which are reported at fair value, includes fixed maturity securities and prior to January 1, 2018, equity securities. Net unrealized gains or losses on equity securities prior to January 1, 2018, and on fixed maturities are reported after-tax as a component of other comprehensive income. As of January 1, 2018, changes in fair value of equity securities are recognized through net income.

The amortized cost and aggregate fair values of investments in available-for-sale securities as of June 30, 2018 are as follows (dollars in thousands):

| Available-for-sale securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Corporate debt securities | \$ 39,440 | \$ 439 | \$ 1,118 | \$38,761 |
| Mortgage backed securities | 13,773 | 89 | 576 | 13,286 |
| Private label asset backed securities | 14,007 | 205 | 24 | 14,188 |

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| | | | | |
|---|-----------|--------|----------|----------|
| Obligations of states and political subdivisions | 11,954 | 201 | 144 | 12,011 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 19,340 | 34 | 584 | 18,790 |
| Total | \$ 98,514 | \$ 968 | \$ 2,446 | \$97,036 |

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The amortized cost and aggregate fair values of investments in held-to-maturity securities as of June 30, 2018 are as follows (dollars in thousands):

| Held-to-maturity securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|------------------------------|----------------|------------------------|-------------------------|------------|
| Mortgage backed securities | \$ 1,523 | \$ 12 | \$ 23 | \$1,512 |
| Total | \$ 1,523 | \$ 12 | \$ 23 | \$1,512 |

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2017 are as follows (dollars in thousands):

| Available-for-sale securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|----------------|------------------------|-------------------------|------------|
| Corporate debt securities | \$ 39,127 | \$ 1,103 | \$ 321 | \$39,909 |
| Mortgage backed securities | 12,892 | 177 | 274 | 12,795 |
| Private label asset backed securities | 10,128 | 382 | — | 10,510 |
| Obligations of states and political subdivisions | 13,758 | 389 | 54 | 14,093 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 18,562 | 206 | 317 | 18,451 |
| Total fixed maturities | 94,467 | 2,257 | 966 | 95,758 |
| Equity securities | 1,842 | 2,667 | — | 4,509 |
| Total | \$ 96,309 | \$ 4,924 | \$ 966 | \$ 100,267 |

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2017 are as follows (dollars in thousands):

| Held-to-maturity securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|----------------|------------------------|-------------------------|------------|
| Mortgage backed securities | \$ 1,615 | \$ 29 | \$ — | —\$1,644 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 1 | — | — | 1 |
| Total | \$ 1,616 | \$ 29 | \$ — | —\$1,645 |

The amortized cost and aggregate fair value of debt securities at June 30, 2018, by contractual maturity, are presented in the following table (dollars in thousands). Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

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| (Dollars in Thousands) | Amortized Cost | Fair Value |
|--|----------------|------------|
| Available-for-sale securities: | | |
| Due in one year or less | \$ 1,093 | \$ 1,100 |
| Due after one year through five years | 17,858 | 17,806 |
| Due after five years through ten years | 27,667 | 27,317 |
| Due after ten years | 51,896 | 50,813 |
| Total | \$ 98,514 | \$ 97,036 |
| Held-to-maturity securities: | | |
| Due in one year or less | \$ — | \$ — |
| Due after one year through five years | 4 | 5 |
| Due after five years through ten years | 48 | 50 |
| Due after ten years | 1,471 | 1,457 |
| Total | \$ 1,523 | \$ 1,512 |

A summary of securities available-for-sale with unrealized losses as of June 30, 2018, 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):

| June 30, 2018 | 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 | \$ 19,523 | \$ 676 | \$ 7,400 | \$ 442 | \$ 26,923 | \$ 1,118 | 47 |
| Mortgage backed securities | 6,380 | 164 | 4,869 | 412 | 11,249 | 576 | 25 |
| Private asset backed securities | 4,381 | 24 | — | — | 4,381 | 24 | 5 |
| Obligations of state and political subdivisions | 4,366 | 62 | 2,516 | 82 | 6,882 | 144 | 14 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 8,691 | 198 | 7,677 | 386 | 16,368 | 584 | 24 |
| | \$ 43,341 | \$ 1,124 | \$ 22,462 | \$ 1,322 | \$ 65,803 | \$ 2,446 | 115 |

A summary of securities held-to-maturity with unrealized losses as of June 30, 2018 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:

| June 30, 2018 | 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: | | | | | | | |
| Mortgage backed securities | \$ 1,091 | \$ 23 | \$ — | \$ — | \$ 1,091 | \$ 23 | 1 |
| | \$ 1,091 | \$ 23 | \$ — | \$ — | \$ 1,091 | \$ 23 | 1 |

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A summary of securities available-for-sale with unrealized losses as of December 31, 2017, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows (dollars in thousands):

| December 31, 2017 | Less than 12 months | | 12 months or longer | | Total | | |
|---|---------------------|-------------------------|---------------------|-------------------------|------------|-------------------------|-------------------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Total Securities in a Loss Position |
| Fixed maturities | | | | | | | |
| Corporate debt securities | \$6,567 | \$ 166 | \$5,607 | \$ 155 | \$12,174 | \$ 321 | 20 |
| Mortgage backed securities | 5,872 | 124 | 2,281 | 150 | 8,153 | 274 | 17 |
| Obligations of state and political subdivisions | 2,176 | 7 | 2,574 | 47 | 4,750 | 54 | 9 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 4,878 | 111 | 6,667 | 206 | 11,545 | 317 | 18 |
| | \$19,493 | \$ 408 | \$17,129 | \$ 558 | \$36,622 | \$ 966 | 64 |

There were no equity securities or securities held-to-maturity with unrealized losses as of December 31, 2017.

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

Management has evaluated each security in a significant unrealized loss position in both the debt and equity investment portfolios. The Company has no material exposure to sub-prime mortgage loans and approximately 5.79% of the fixed income investment portfolio is rated below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, Management evaluated financial information on each company and where available, reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the securities in an accumulated loss position in the portfolio were temporary impairments.

For the six months ended June 30, 2018 and year ended December 31, 2017, the Company realized no other-than-temporary impairments. At June 30, 2018, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$103,000. The second largest loss position was in the bond portfolio and totaled \$98,000.

The third largest loss position was in the bond portfolio and totaled \$96,000. At December 31, 2017, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$75,000. The second largest loss position was in the bond portfolio and totaled \$60,000. The third largest loss position was in the bond portfolio and totaled \$53,000.

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|-------|---------------------------|---------|
| | 2018 | 2017 | 2018 | 2017 |
| Fixed maturities | \$963 | \$841 | \$1,854 | \$1,658 |
| Equity securities | 20 | 24 | 40 | 48 |
| Mortgage loans on real estate | 2 | 3 | 4 | 5 |
| Investment real estate | — | — | 1 | 2 |
| Policy loans | 35 | 33 | 70 | 66 |
| Company owned life insurance change in surrender value | 3 | 14 | (136 |) 57 |
| Other | 7 | 42 | 15 | 87 |
| | 1,030 | 957 | 1,848 | 1,923 |
| Less: Investment expenses | 32 | 27 | 69 | 67 |
| Net investment income | \$998 | \$930 | \$1,779 | \$1,856 |

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|-----------------------------|------|---------------------------|-------|
| | 2018 | 2017 | 2018 | 2017 |
| Fixed maturities | \$48 | \$75 | \$129 | \$235 |
| Change in fair value of equity securities | (163 |) — | (369 |) — |
| Other, principally real estate | (88 |) 2 | (88 |) 2 |
| Net realized investment gains (losses) | \$(203) | \$77 | \$(328) | \$237 |

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

| | June 30, 2018 | December 31, 2017 |
|--|---------------|-------------------|
| Net change in unrealized gains (losses) on available-for-sale securities before deferred tax | \$(2,768) | \$ 1,402 |
| Deferred income tax | 581 | (476 |
| Net change in unrealized gains (losses) on available-for-sale securities | \$(2,187) | \$ 926 |

NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

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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 with 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.

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Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2018 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

| Description | Fair Value Measurements at Reporting Date Using | | | |
|---|---|-----------------|-----------------|-----------------|
| | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets | | | | |
| Fixed maturities available-for-sale | | | | |
| Corporate debt securities | \$38,761 | \$— | \$38,761 | \$— |
| Mortgage backed securities | 13,286 | — | 13,286 | — |
| Private label asset backed securities | 14,188 | — | 14,188 | — |
| Obligations of states and political subdivisions | 12,011 | — | 12,011 | — |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 18,790 | 18,790 | — | — |
| Trading securities | 107 | 107 | — | — |
| Equity securities | 4,140 | 3,084 | — | 1,056 |
| Total Financial Assets | \$101,283 | \$21,981 | \$78,246 | \$1,056 |
| Financial Liabilities | | | | |
| Interest rate swap | \$(346) | \$— | \$— | \$(346) |
| Total Financial Liabilities | \$(346) | \$— | \$— | \$(346) |

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

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

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

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

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

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

As of June 30, 2018, Level 3 fair value measurements of assets include \$1,056,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of June 30, 2018, Level 3 fair value measurements of liabilities include \$346,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party that utilizes financial modeling tools and assumptions on interest and other factors. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 7.

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The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the six months ended June 30, 2018 (in thousands):

| | Equity Securities | Interest Rate Swap |
|---|-------------------|--------------------|
| For the six months ended June 30, 2018 | | |
| Beginning balance | \$ 1,073 | \$(608) |
| Total gains or losses (realized and unrealized): | | |
| Included in earnings | (17) | — |
| Included in other comprehensive income | — | 262 |
| Purchases: | — | — |
| Sales: | — | — |
| Issuances: | — | — |
| Settlements: | — | — |
| Transfers in/(out) of Level 3 | — | — |
| Ending balance | \$ 1,056 | \$(346) |
| The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of June 30, 2018: | \$— | \$— |

For the six months ended June 30, 2018, 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, 2017 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

| Description | Fair Value Measurements at Reporting Date Using | | | |
|---|---|----------|----------|----------|
| | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets | | | | |
| Fixed maturities available-for-sale | | | | |
| Corporate debt securities | \$39,909 | \$— | \$39,909 | \$— |
| Mortgage backed securities | 12,795 | — | 12,795 | — |
| Private label asset backed securities | 10,510 | — | 10,510 | — |
| Obligations of states and political subdivisions | 14,093 | — | 14,093 | — |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 18,451 | 18,451 | — | — |
| Trading securities | 107 | 107 | — | — |
| Equity securities available-for-sale | 4,509 | 3,436 | — | 1,073 |
| Total Financial Assets | \$100,374 | \$21,994 | \$77,307 | \$1,073 |
| Financial Liabilities | | | | |
| Interest rate swap | \$(608) | \$— | \$— | \$(608) |
| Total Financial Liabilities | \$(608) | \$— | \$— | \$(608) |

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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, 2017 (in thousands):
For the year ended December 31, 2017