

NATIONAL SECURITY GROUP INC  
Form 10-Q  
November 14, 2013  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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(Mark One)

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

For Quarterly Period Ended September 30, 2013

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

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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 (Zip-Code)  
(Address of principal executive offices)  
Registrant's Telephone Number including Area Code (334) 897-2273

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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 Novemer 14, 2013, there were 2,494,480 shares, \$1.00 par value, of the registrant's common stock outstanding.

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1

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Table of Contents

THE NATIONAL SECURITY GROUP, INC.

INDEX

PART I. FINANCIAL INFORMATION

|   | Page No.  |
|---|-----------|
| Item 1. Financial Statements  |           |
| Condensed Consolidated Balance Sheets   | <u>4</u>  |
| Condensed Consolidated Statements of Income (Loss) (Unaudited)                                | <u>5</u>  |
| Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited)                  | <u>6</u>  |
| Condensed Consolidated Statements of Shareholders' Equity (Unaudited)                         | <u>7</u>  |
| Condensed Consolidated Statements of Cash Flows (Unaudited)                                   | <u>8</u>  |
| Notes to Condensed Consolidated Financial Statements (Unaudited)                              | <u>9</u>  |
| Review Report of Independent Registered Public Accounting Firm                                | <u>36</u> |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations | <u>37</u> |
| Item 3. Quantitative and Qualitative Disclosures about Market Risk                            | <u>49</u> |
| Item 4. Controls and Procedures   | <u>50</u> |

PART II. OTHER INFORMATION

|   |           |
|---|-----------|
| Item 1. Legal Proceedings   | <u>50</u> |
| Item 1A. Risk Factors   | <u>50</u> |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | <u>50</u> |
| Item 3. Defaults Upon Senior Securities                             | <u>50</u> |
| Item 4. Mine Safety Disclosures                                     | <u>50</u> |
| Item 5. Other Information   | <u>50</u> |
| Item 6. Exhibits  | <u>51</u> |

|            |           |
|------------|-----------|
| SIGNATURES | <u>52</u> |
|------------|-----------|

Table of Contents

Cautionary Statement Regarding Forward-Looking Statements

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

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

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

The Company is subject to regulation by state governments for each of the states in which it conducts business. The Company cannot predict the subject of any future regulatory initiative(s) or its (their) impact on the Company's business.

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

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

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

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

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

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

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

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

Table of Contents

## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

|   | September 30,<br>2013 | December 31,<br>2012 |
|---|-----------------------|----------------------|
|   | (UNAUDITED)           |                      |
| <b>ASSETS</b>   |                       |                      |
| Investments   |                       |                      |
| Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2013 - \$931; 2012 - \$1,609) | \$878                 | \$1,502              |
| Fixed maturities available-for-sale, at estimated fair value (cost: 2013 - \$76,265; 2012 - \$71,678)     | 77,602                | 76,294               |
| Equity securities available-for-sale, at estimated fair value (cost: 2013 - \$2,465; 2012 - \$3,191)      | 4,375                 | 5,132                |
| Trading securities  | 19                    | 40                   |
| Mortgage loans on real estate, at cost  | 378                   | 383                  |
| Investment real estate, at book value   | 4,218                 | 5,757                |
| Policy loans  | 1,417                 | 1,317                |
| Company owned life insurance  | 5,831                 | 5,931                |
| Other invested assets   | 3,602                 | 3,777                |
| Total Investments   | 98,320                | 100,133              |
| Cash  | 5,596                 | 6,779                |
| Accrued investment income   | 830                   | 788                  |
| Policy receivables and agents' balances, net  | 11,114                | 9,006                |
| Reinsurance recoverable   | 1,348                 | 1,541                |
| Deferred policy acquisition costs   | 9,042                 | 9,097                |
| Property and equipment, net   | 2,161                 | 2,392                |
| Deferred income tax asset   | 5,405                 | 4,997                |
| Other assets  | 1,113                 | 983                  |
| Total Assets  | \$134,929             | \$135,716            |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                       |                      |
| Property and casualty benefit and loss reserves   | \$9,248               | \$11,214             |
| Accident and health benefit and loss reserves   | 2,545                 | 2,341                |
| Life and annuity benefit and loss reserves  | 30,300                | 30,041               |
| Unearned premiums   | 28,946                | 25,777               |
| Policy and contract claims  | 654                   | 995                  |
| Other policyholder funds  | 1,439                 | 1,417                |
| Short-term notes payable and current portion of long-term debt  | 1,167                 | 1,292                |
| Long-term debt  | 21,705                | 25,339               |
| Accrued income taxes  | 654                   | 296                  |
| Other liabilities   | 5,973                 | 6,777                |
| Total Liabilities   | 102,631               | 105,489              |
| Contingencies   |                       |                      |
| Shareholders' equity  |                       |                      |
| Common stock  | 2,494                 | 2,467                |
| Additional paid-in capital  | 5,147                 | 4,951                |

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|  |           |           |
|--|-----------|-----------|
| Accumulated other comprehensive income     | 1,464     | 3,325     |
| Retained earnings                          | 23,193    | 19,484    |
| Total Shareholders' Equity                 | 32,298    | 30,227    |
| Total Liabilities and Shareholders' Equity | \$134,929 | \$135,716 |

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

4

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Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS) (UNAUDITED)

(In thousands, except per share amounts)

|   | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |           |
|---|-------------------------------------|----------|------------------------------------|-----------|
|   | 2013                                | 2012     | 2013                               | 2012      |
| <b>REVENUES</b>                                   |                                     |          |                                    |           |
| Net premiums earned                               | \$13,191                            | \$12,904 | \$39,163                           | \$38,933  |
| Net investment income                             | 1,046                               | 1,140    | 2,858                              | 3,341     |
| Net realized investment gains                     | 3,297                               | 1,703    | 4,354                              | 2,774     |
| Other income                                      | 163                                 | 258      | 480                                | 648       |
| Total Revenues                                    | 17,697                              | 16,005   | 46,855                             | 45,696    |
| <b>EXPENSES</b>                                   |                                     |          |                                    |           |
| Policyholder benefits and settlement expenses     | 7,112                               | 11,564   | 24,923                             | 27,385    |
| Amortization of deferred policy acquisition costs | 894                                 | 1,056    | 2,759                              | 2,787     |
| Commissions                                       | 1,800                               | 1,949    | 5,268                              | 5,923     |
| General and administrative expenses               | 2,156                               | 1,954    | 6,199                              | 6,277     |
| Litigation settlement and defense costs           | —                                   | 76       | —                                  | 13,335    |
| Taxes, licenses and fees                          | 438                                 | 452      | 1,398                              | 1,382     |
| Interest expense                                  | 434                                 | 311      | 1,311                              | 891       |
| Total Expenses                                    | 12,834                              | 17,362   | 41,858                             | 57,980    |
| Income (Loss) Before Income Taxes                 | 4,863                               | (1,357)  | ) 4,997                            | (12,284)  |
| <b>INCOME TAX EXPENSE (BENEFIT)</b>               |                                     |          |                                    |           |
| Current   | 332                                 | 410      | 552                                | 583       |
| Deferred  | 1,192                               | (1,140)  | ) 550                              | (5,465)   |
|   | 1,524                               | (730)    | ) 1,102                            | (4,882)   |
| Net Income (Loss)                                 | \$3,339                             | \$(627)  | ) \$3,895                          | \$(7,402) |
| INCOME (LOSS) PER COMMON SHARE                    | \$1.35                              | \$(0.25) | ) \$1.57                           | \$(3.00)  |
| DIVIDENDS DECLARED PER SHARE                      | \$0.025                             | \$0.10   | \$0.075                            | \$0.30    |

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



Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

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

|   | Three months ended<br>September 30, |         | Nine months ended<br>September 30, |           |
|---|-------------------------------------|---------|------------------------------------|-----------|
|   | 2013                                | 2012    | 2013                               | 2012      |
| Net income (loss)   | \$3,339                             | \$(627) | ) \$3,895                          | \$(7,402) |
| Other comprehensive loss, net of tax  |                                     |         |                                    |           |
| Changes in:   |                                     |         |                                    |           |
| Unrealized losses on securities, net of reclassification adjustment of \$2,176 and \$1,127 for the three months ended 2013 and 2012, respectively and \$2,874 and \$1,831 for the nine months ended 2013 and 2012, respectively | (229)                               | ) (147) | ) (2,185)                          | ) (71)    |
| Unrealized gain (loss) on interest rate swap  | (30)                                | ) (80)  | ) 324                              | (239)     |
| Other comprehensive loss, net of tax  | (259)                               | ) (227) | ) (1,861)                          | ) (310)   |
| Comprehensive income (loss)   | \$3,080                             | \$(854) | ) \$2,034                          | \$(7,712) |

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (UNAUDITED)

Nine months ended September 30, 2013 (In thousands)

|   | Total    | Retained Earnings | Accumulated Other Comprehensive Income | Common Stock | Additional Paid-in Capital |
|---|----------|-------------------|--|--------------|----------------------------|
| Balance at December 31, 2012                            | \$30,227 | \$19,484          | \$3,325                                | \$2,467      | \$4,951                    |
| Net income for the nine months ended September 30, 2013 | 3,895    | 3,895             |  |              |                            |
| Other comprehensive loss (net of tax)                   | (1,861 ) |                   | (1,861 )                               |              |                            |
| Common stock issued                                     | 27       |                   |  | 27           |                            |
| Additional paid-in capital                              | 196      |                   |  |              | 196                        |
| Cash dividends  | (186 )   | (186 )            |  |              |                            |
| Balance at September 30, 2013 (UNAUDITED):              | \$32,298 | \$23,193          | \$1,464                                | \$2,494      | \$5,147                    |

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

Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) (In thousands)

|  | Nine months ended<br>September 30 |            |
|--|-----------------------------------|------------|
|  | 2013                              | 2012       |
| Cash Flows from Operating Activities   |                                   |            |
| Net income (loss)  | \$3,895                           | \$(7,402 ) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                                   |            |
| Depreciation expense and amortization/accretion, net   | 563                               | 465        |
| Increase in cash surrender value of company owned life insurance                                   | 100                               | (284 )     |
| Net realized gains on investments  | (4,354 )                          | (2,774 )   |
| Deferred income taxes  | 550                               | (5,465 )   |
| Amortization of deferred policy acquisition costs  | 2,759                             | 2,787      |
| Changes in assets and liabilities:   |                                   |            |
| Change in accrued investment income  | (42 )                             | (112 )     |
| Change in reinsurance recoverable  | 193                               | 1,026      |
| Policy acquisition costs deferred  | (2,704 )                          | (2,836 )   |
| Change in accrued income taxes/recoverable   | 358                               | 2,021      |
| Change in net policy liabilities and claims  | (791 )                            | 78         |
| Change in other assets/liabilities, net  | (310 )                            | (813 )     |
| Other, net   | 235                               | (510 )     |
| Net cash provided by (used in) operating activities  | 452                               | (13,819 )  |
| Cash Flows from Investing Activities   |                                   |            |
| Purchase of:   |                                   |            |
| Available-for-sale securities  | (13,553 )                         | (25,221 )  |
| Trading securities and short-term investments  | —                                 | (40 )      |
| Real estate held for investment  | —                                 | (32 )      |
| Property and equipment   | (67 )                             | (311 )     |
| Proceeds from sale or maturities of:   |                                   |            |
| Held-to-maturity securities  | 623                               | 1,581      |
| Available-for-sale securities  | 10,485                            | 27,778     |
| Trading securities and short-term investments  | —                                 | 83         |
| Real estate held for investment  | 4,847                             | —          |
| Property and equipment   | 7                                 | 9          |
| Other invested assets, net   | (54 )                             | 16         |
| Net cash provided by investing activities  | 2,288                             | 3,863      |
| Cash Flows from Financing Activities   |                                   |            |
| Change in other policyholder funds   | 22                                | 28         |
| Change in long-term debt   | (3,634 )                          | 12,534     |
| Change in short-term notes payable   | (125 )                            | (360 )     |
| Dividends paid   | (186 )                            | (740 )     |
| Net cash provided by (used in) financing activities  | (3,923 )                          | 11,462     |
| Net change in cash and cash equivalents  | (1,183 )                          | 1,506      |
| Cash and cash equivalents, beginning of year   | 6,779                             | 3,393      |
| Cash and cash equivalents, end of period   | \$5,596                           | \$4,899    |

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



Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary - Omega One Insurance Company (Omega). In the opinion of Management, the unaudited financial statements presented herein include all accruals necessary to present fairly the Company's financial position at September 30, 2013, and the results of operations, cash flows and changes in shareholders' equity for the interim periods ended September 30, 2013 and 2012, in conformity with accounting principles generally accepted in the United States. All significant intercompany transactions and accounts have been eliminated. The condensed consolidated financial statements of the Company presented herein have not been audited by independent auditors, except for the Consolidated Balance Sheet at December 31, 2012. Financial statements and notes to condensed consolidated financial statements included in this Form 10-Q report should be read in conjunction with the Company's 2012 Form 10-K report, as certain notes and other pertinent information have been abbreviated or omitted in this report. Financial results for the three-month and nine-month period ended September 30, 2013 are not necessarily indicative of future results.

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, Missouri, and Texas. NSFC operates in various property and casualty lines, the most significant of which are: dwelling property fire and extended coverage, homeowners and mobile homeowners.

Omega is licensed in the states of Alabama and Louisiana. Omega operates in the property and casualty homeowners line of business.

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 generally accepted accounting principles 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 policy benefits, liabilities for losses and loss adjustment expenses, reinsurance recoverable asset on associated 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 those estimates.

#### 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.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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. Trading securities are classified as such on the balance sheet and 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 operations. 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 are amortized or accreted 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.

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

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



Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 investee 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. 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 September 30, 2013 and December 31, 2012 was \$5,831,000 and \$5,931,000, respectively. Changes in cash surrender values are included in investment income in the current period. The change in surrender value included in earnings for the three-month periods ended September 30, 2013 and 2012 was an increase of \$48,000 and \$113,000, respectively. The change in surrender value included in earnings for the nine-month periods ended September 30, 2013 and 2012 was a decline of \$100,000 and an increase of \$284,000, respectively. Death proceeds from the contracts are recorded when the proceeds become payable under the terms of the policy. There were no proceeds received from the COLI during 2013 or 2012.

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 in the determination of operating results. 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 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.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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.

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 policies 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.

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 2,476,302 in 2013 and 2,466,600 in 2012.

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 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 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.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 2012 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2013 presentation.

Advertising

The Company expenses advertising costs as incurred. Advertising costs charged to expense were \$24,000 for the three months ended September 30, 2013 (\$21,000 for the three months ended September 30, 2012). Advertising costs charged to expense were \$108,000 for the nine months ended September 30, 2013 (\$81,000 for the nine months ended September 30, 2012). Advertising cost consists primarily of agent convention expense and print media.

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts. Through December 31, 2012, these balances were insured by the FDIC with no balance limits. On January 1, 2013, \$250,000 per account balance limits were reinstated. At September 30, 2013, the net amount exceeding FDIC insured limits was \$3,070,000 at one financial institution. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of the financial institution 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 September 30, 2013, the single largest balance due from one agent totaled \$960,000.

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 September 30, 2013 and December 31, 2012, 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 September 30, 2013, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Accounting Changes Not Yet Adopted

Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists

In July 2013, the FASB issued guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss ("NOL") carryforward, a similar tax loss, or a tax credit carryforward exists. This guidance applies to all entities with unrecognized tax benefits that also have tax loss or tax credit carryforwards in the same tax jurisdiction as of the reporting date. The Company will adopt this standard in December 2013. The Company anticipates that adoption of the standard will not have a material impact on its Consolidated Financial Statements.

Recently Adopted Accounting Standards

Disclosures about Offsetting Assets and Liabilities for Financial Instruments and Derivative Instruments

In December 2011, the FASB issued guidance requiring expanded disclosures, including both gross and net information, for financial instruments and derivative instruments that are either offset in the reporting entity's financial statements or those that are subject to an enforceable master netting arrangement or similar agreement. The Company adopted the new guidance on January 1, 2013 and applied it retrospectively. The guidance impacts disclosures only and will have no impact on the Company's results of operations or financial position. The Company does not have any derivative instruments subject to master netting arrangements at September 30, 2013.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

In February 2013, the FASB issued an accounting standards update that requires additional disclosures for reclassification adjustments from accumulated other comprehensive income (AOCI). These additional disclosures include changes in AOCI balances by component and significant items reclassified out of AOCI. These disclosures must be presented either on the face of the affected financial statement or in the notes to the financial statements. The disclosures are effective beginning in the first quarter of 2013 and are to be provided on a prospective basis. These disclosures are presented in Note 12.

**Intangibles-Goodwill and Other**

In July 2012, the FASB issued guidance related to impairment of indefinite-lived intangible assets other than goodwill. The new guidance allows an entity to first make a qualitative assessment of whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount before applying the quantitative impairment test. An entity is required to perform the quantitative test only if it determines that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. The Company adopted this guidance January 1, 2013. No interim testing was required as of September 30, 2013, and we do not expect a material effect on results of operations or financial position following annual testing.

**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 FIN 46(R). The Company is not the primary beneficiary of the entity and is not required to consolidate under FIN 46(R). 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 \$325,000 and is included as a component of Other Invested Assets in the accompanying condensed 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 condensed 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.



Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 3 – INVESTMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of September 30, 2013 are as follows:

| Available-for-sale securities:   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Corporate debt securities  | \$34,841          | \$1,778                      | \$507                         | \$36,112      |
| Trust preferred securities   | 538               | 10                           | —                             | 548           |
| Mortgage backed securities   | 8,007             | 90                           | 466                           | 7,631         |
| Private label mortgage backed securities   | 5,690             | 158                          | 2                             | 5,846         |
| Obligations of states and political subdivisions   | 17,034            | 685                          | 226                           | 17,493        |
| U.S. Treasury securities and obligations of U.S.<br>Government corporations and agencies | 10,155            | 165                          | 348                           | 9,972         |
| Total fixed maturities   | 76,265            | 2,886                        | 1,549                         | 77,602        |
| Equity securities  | 2,465             | 2,334                        | 424                           | 4,375         |
| Total  | \$78,730          | \$5,220                      | \$1,973                       | \$81,977      |

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of September 30, 2013 are as follows:

| Held-to-maturity securities:   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Mortgage backed securities   | \$764             | \$47                         | \$—                           | \$811         |
| Obligations of states and political subdivisions   | —                 | —                            | —                             | —             |
| U.S. Treasury securities and obligations of U.S.<br>Government corporations and agencies | 114               | 6                            | —                             | 120           |
| Total  | \$878             | \$53                         | \$—                           | \$931         |

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2012 are as follows:

| Available-for-sale securities:   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Corporate debt securities  | \$31,387          | \$2,430                      | \$80                          | \$33,737      |
| Trust preferred securities   | 537               | 50                           | —                             | 587           |
| Mortgage backed securities   | 8,595             | 175                          | 85                            | 8,685         |
| Private label mortgage backed securities   | 7,679             | 294                          | 9                             | 7,964         |
| Obligations of states and political subdivisions   | 16,160            | 1,359                        | 3                             | 17,516        |
| U.S. Treasury securities and obligations of U.S.<br>Government corporations and agencies | 7,320             | 487                          | 2                             | 7,805         |
| Total fixed maturities   | 71,678            | 4,795                        | 179                           | 76,294        |
| Equity securities  | 3,191             | 2,398                        | 457                           | 5,132         |
| Total  | \$74,869          | \$7,193                      | \$636                         | \$81,426      |



Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2012 are as follows:

| Held-to-maturity securities:  | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|----------------|------------------------|-------------------------|------------|
| Mortgage backed securities  | \$1,194        | \$91                   | \$—                     | \$1,285    |
| Obligations of states and political subdivisions                                      | 145            | 2                      | —                       | 147        |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 163            | 14                     | —                       | 177        |
| Total   | \$1,502        | \$107                  | \$—                     | \$1,609    |

The amortized cost and aggregate fair value of debt securities at September 30, 2013, by contractual maturity, are presented in the following table. 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                | \$1,155                | \$1,185    |
| Due after one year through five years  | 15,140                 | 16,257     |
| Due after five years through ten years | 26,309                 | 26,726     |
| Due after ten years                    | 33,661                 | 33,434     |
| Total                                  | \$76,265               | \$77,602   |
| Held-to-maturity securities:           |                        |            |
| Due in one year or less                | \$—                    | \$—        |
| Due after one year through five years  | 271                    | 285        |
| Due after five years through ten years | 195                    | 207        |
| Due after ten years                    | 412                    | 439        |
| Total                                  | \$878                  | \$931      |

A summary of securities available-for-sale with unrealized losses as of September 30, 2013, 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:

| September 30, 2013                              | 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                       | \$10,133            | \$404                   | \$1,561             | \$103                   | \$11,694   | \$507                   | 25                                  |
| Mortgage backed securities                      | 3,250               | 337                     | 1,879               | 129                     | 5,129      | 466                     | 17                                  |
| Private label mortgage backed securities        | 178                 | 2                       | —                   | —                       | 178        | 2                       | 1                                   |
| Obligations of state and political subdivisions | 2,855               | 192                     | 322                 | 34                      | 3,177      | 226                     | 8                                   |

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|   |          |         |         |       |          |         |    |
|---|----------|---------|---------|-------|----------|---------|----|
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 5,150    | 259     | 409     | 89    | 5,559    | 348     | 11 |
| Equity securities   | —        | —       | 862     | 424   | 862      | 424     | 1  |
|   | \$21,566 | \$1,194 | \$5,033 | \$779 | \$26,599 | \$1,973 | 63 |

16

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Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

A summary of securities available-for-sale with unrealized losses as of December 31, 2012, 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:

| December 31, 2012   | 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   | \$2,226             | \$31                    | \$963               | \$49                    | \$3,189    | \$80                    | 7                                   |
| Mortgage backed securities  | 2,904               | 77                      | 165                 | 8                       | 3,069      | 85                      | 8                                   |
| Private label mortgage backed securities  | 206                 | 8                       | 65                  | 1                       | 271        | 9                       | 2                                   |
| Obligations of state and political subdivisions                                       | 356                 | 3                       | —                   | —                       | 356        | 3                       | 1                                   |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 495                 | 2                       | —                   | —                       | 495        | 2                       | 1                                   |
| Equity securities   | —                   | —                       | 829                 | 457                     | 829        | 457                     | 1                                   |
|   | \$6,187             | \$121                   | \$2,022             | \$515                   | \$8,209    | \$636                   | 20                                  |

There were no securities held-to-maturity with unrealized losses as of September 30, 2013 and December 31, 2012.

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

Management has evaluated each security in a significant unrealized loss position. The Company has no material exposure to sub-prime mortgage loans and less than 3.7% 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 nine months ended September 30, 2013, the Company realized no additional other-than-temporary impairments. The single largest accumulated loss not realized as an impairment was in the equity portfolio and totaled \$424,000. The second largest loss position was in the bond portfolio and totaled \$110,000. The third largest loss position was in the bond portfolio and totaled \$92,000.

For the year ended December 31, 2012, the Company realized \$87,000 in other-than-temporary impairments. The single largest accumulated loss not realized as an impairment was in the equity portfolio and totaled \$457,000. The

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

second largest loss position was in the bond portfolio and totaled \$39,000. The third largest loss position was in the bond portfolio and totaled \$27,000.

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

|  | Three months ended |         | Nine months ended |         |
|--|--------------------|---------|-------------------|---------|
|  | September 30,      |         | September 30,     |         |
|  | 2013               | 2012    | 2013              | 2012    |
| Fixed maturities                                       | \$846              | \$860   | \$2,486           | \$2,621 |
| Equity securities                                      | 34                 | 44      | 107               | 156     |
| Mortgage loans on real estate                          | 5                  | 6       | 17                | 20      |
| Investment real estate                                 | 42                 | 31      | 123               | 52      |
| Policy loans   | 27                 | 24      | 77                | 70      |
| Company owned life insurance change in surrender value | 48                 | 113     | (100              | ) 284   |
| Other, principally short-term investments              | 98                 | 115     | 306               | 293     |
|  | 1,100              | 1,193   | 3,016             | 3,496   |
| Less: Investment expenses                              | 54                 | 53      | 158               | 155     |
| Net investment income                                  | \$1,046            | \$1,140 | \$2,858           | \$3,341 |

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

|                                  | Three months ended |         | Nine months ended |         |
|----------------------------------|--------------------|---------|-------------------|---------|
|                                  | September 30,      |         | September 30,     |         |
|                                  | 2013               | 2012    | 2013              | 2012    |
| Fixed maturities                 | \$(16              | ) \$376 | \$110             | \$503   |
| Equity securities                | (1                 | ) 1,528 | 928               | 2,263   |
| Trading securities               | —                  | (1      | ) —               | 1       |
| Other, principally real estate   | 3,314              | (200    | ) 3,316           | 7       |
| Other-than-temporary impairments | —                  | —       | —                 | —       |
| Net realized investment gains    | \$3,297            | \$1,703 | \$4,354           | \$2,774 |

Other, principally real estate gain above reflects the third quarter sale of investment real estate with a carrying value of \$1,300,000.

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

|  | September 30, 2013 | December 31, 2012 |
|--|--------------------|-------------------|
|  | (UNAUDITED)        |                   |
| Net change in unrealized appreciation on available-for-sale securities before deferred tax | \$3,310            | \$(153            |
| Deferred income tax  | (1,125             | ) 52              |
| Net change in unrealized appreciation on available-for-sale securities                     | \$2,185            | \$(101            |





Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

Accounting standards define fair value as the price that would be received to sell an asset or would be paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework to make the measurement of fair value more consistent and comparable. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets.

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

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

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 of our floating-rate notes, corporate bonds, and municipal bonds.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

Financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2013 are summarized in the following table by the type of inputs applicable to the fair value measurements (unaudited) (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   | \$36,112  | \$—             | \$36,112        | \$—            |
| Trust preferred securities  | 548   | —               | 548             | —              |
| Mortgage backed securities  | 7,631   | —               | 7,631           | —              |
| Private label mortgage backed securities  | 5,846   | —               | 5,846           | —              |
| Obligations of states and political subdivisions                                      | 17,493  | —               | 17,493          | —              |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 9,972   | 9,972           | —               | —              |
| Trading securities  | 19  | 19              | —               | —              |
| Equity securities available-for-sale  | 4,375   | 3,513           | —               | 862            |
| <b>Total Financial Assets</b>   | <b>\$81,996</b>                                 | <b>\$13,504</b> | <b>\$67,630</b> | <b>\$862</b>   |
| <b>Financial Liabilities</b>  |   |                 |                 |                |
| Interest rate swap  | \$1,031   | \$—             | \$—             | \$1,031        |
| <b>Total Financial Liabilities</b>  | <b>\$1,031</b>                                  | <b>\$—</b>      | <b>\$—</b>      | <b>\$1,031</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 September 30, 2013, Level 3 fair value measurements of assets include \$862,000 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 September 30, 2013, Level 3 fair value measurements of liabilities include \$1,031,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party broker. 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.

20

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Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 nine months ended September 30, 2013 (in thousands):

| For the nine months ended September 30, 2013 (unaudited)   | Equity Securities<br>Available-for-Sale | Interest Rate Swap |
|--|---|--------------------|
| Beginning balance  | \$829                                   | \$(1,521)          |
| Total gains or losses (realized and unrealized):   |   |                    |
| Included in earnings   | —                                       | —                  |
| Included in other comprehensive income   | 33                                      | 490                |
| Purchases:   | —                                       | —                  |
| Sales:   | —                                       | —                  |
| Issuances:   | —                                       | —                  |
| Settlements:   | —                                       | —                  |
| Transfers in/(out) of Level 3  | —                                       | —                  |
| Ending balance   | \$862                                   | \$(1,031)          |
| 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 September 30, 2013: | \$—                                     | \$—                |

For the nine months ended September 30, 2013, 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, 2012 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   | \$33,737  | \$—             | \$33,737        | \$—            |
| Trust preferred securities  | 587   | —               | 587             | —              |
| Mortgage backed securities  | 8,685   | —               | 8,685           | —              |
| Private label mortgage backed securities  | 7,964   | —               | 7,964           | —              |
| Obligations of states and political subdivisions                                      | 17,516  | —               | 17,516          | —              |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 7,805   | 7,805           | —               | —              |
| Trading securities  | 40  | 40              | —               | —              |
| Equity securities available-for-sale  | 5,132   | 4,303           | —               | 829            |
| <b>Total Financial Assets</b>   | <b>\$81,466</b>                                 | <b>\$12,148</b> | <b>\$68,489</b> | <b>\$829</b>   |
| <b>Financial Liabilities</b>  |   |                 |                 |                |
| Interest rate swap  | \$1,521   | \$—             | \$—             | \$1,521        |
| <b>Total Financial Liabilities</b>  | <b>\$1,521</b>                                  | <b>\$—</b>      | <b>\$—</b>      | <b>\$1,521</b> |



Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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, 2012 (in thousands):

| For the year ended December 31, 2012  | Equity Securities<br>Available-for-Sale | Interest Rate Swap |
|---|---|--------------------|
| Beginning balance   | \$642                                   | \$(1,196 )         |
| Total gains or losses (realized and unrealized):  |   |                    |
| Included in earnings  | —                                       | —                  |
| Included in other comprehensive income  | 44                                      | (325 )             |
| Purchases:  | 143                                     | —                  |
| Sales:  | —                                       | —                  |
| Issuances:  | —                                       | —                  |
| Settlements:  | —                                       | —                  |
| Transfers in/(out) of Level 3   | —                                       | —                  |
| Ending balance  | \$829                                   | \$(1,521 )         |
| 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, 2012: | \$—                                     | \$—                |

For the year ended December 31, 2012, 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 7 for additional information about the interest rate swap agreements.

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

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

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 Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The carrying amount and estimate fair value of the Company's financial instruments as of September 30, 2013 and December 31, 2012 are as follows (in thousands):

|  | September 30, 2013<br>(UNAUDITED) |                         | December 31, 2012 |                         |
|--|-----------------------------------|-------------------------|-------------------|-------------------------|
|  | Carrying<br>Value                 | Estimated<br>Fair Value | Carrying<br>Value | Estimated<br>Fair Value |
| Assets and related instruments                                 |                                   |                         |                   |                         |
| Mortgage loans   | \$378                             | \$378                   | \$383             | \$383                   |
| Policy loans   | 1,417                             | 1,417                   | 1,317             | 1,317                   |
| Company owned life insurance                                   | 5,831                             | 5,831                   | 5,931             | 5,931                   |
| Other invested assets  | 3,602                             | 3,602                   | 3,777             | 3,777                   |
| Liabilities and related instruments                            |                                   |                         |                   |                         |
| Other policyholder funds                                       | 1,439                             | 1,439                   | 1,417             | 1,417                   |
| Short-term notes payable and current portion of long-term debt | 1,167                             | 1,167                   | 1,292             | 1,292                   |
| Long-term debt   | 21,705                            | 21,705                  | 25,339            | 25,339                  |

## NOTE 5 – PROPERTY AND EQUIPMENT

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

|                                      | September 30, 2013<br>(UNAUDITED) |         | December 31, 2012 |         |
|--------------------------------------|-----------------------------------|---------|-------------------|---------|
|                                      | Building and improvements         | \$3,185 |                   | \$3,185 |
| Electronic data processing equipment | 1,832                             |         | 1,814             |         |
| Furniture and fixtures               | 891                               |         | 912               |         |
|                                      | 5,908                             |         | 5,911             |         |
| Less accumulated depreciation        | 3,747                             |         | 3,519             |         |
|                                      | \$2,161                           |         | \$2,392           |         |

Depreciation expense for the nine months ended September 30, 2013 was \$298,000 (\$433,000 for the year ended December 31, 2012).

## NOTE 6 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company incurred income tax related penalties and interest of \$5,000 during the nine-month period ended September 30, 2013 and incurred no income tax related interest and penalties during 2012. 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 2009. Tax returns have been filed through the year 2012.

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 \$5,405,000 at

September 30, 2013 and \$4,997,000 at December 31, 2012.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

|  | September 30, 2013<br>(UNAUDITED) | December 31, 2012 |        |
|--|-----------------------------------|-------------------|--------|
| General expenses                                     | \$ 1,283                          | \$ 1,211          |        |
| Unearned premiums                                    | 1,967                             | 1,751             |        |
| Claims liabilities                                   | 520                               | 243               |        |
| Litigation settlement                                | 3,570                             | 3,570             |        |
| AMT credit   | 246                               | 246               |        |
| NOL carryforward                                     | 1,649                             | 2,711             |        |
| Other-than-temporary impairments on securities owned | 68                                | 164               |        |
| Unrealized loss on interest rate swaps               | 351                               | 518               |        |
| Deferred tax assets                                  | 9,654                             | 10,414            |        |
| Trading securities                                   | —                                 | (1                | )      |
| Depreciation   | (71                               | )                 | (94    |
| Deferred policy acquisition costs                    | (3,074                            | )                 | (3,093 |
| Unrealized gains on securities available-for-sale    | (1,104                            | )                 | (2,229 |
| Deferred tax liabilities                             | (4,249                            | )                 | (5,417 |
| Net deferred tax asset                               | \$ 5,405                          | \$ 4,997          |        |

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

|                                   | Nine months ended<br>September 30, |      |           |
|-----------------------------------|------------------------------------|------|-----------|
|                                   | 2013                               | 2012 |           |
|                                   | (UNAUDITED)                        |      |           |
| Deferred policy acquisition costs | \$(19                              | )    | \$ 16     |
| Other-than-temporary impairments  | 96                                 | )    | 27        |
| Trading securities                | (1                                 | )    | 1         |
| Unearned premiums                 | (216                               | )    | (152      |
| General expenses                  | (72                                | )    | (81       |
| Depreciation                      | (23                                | )    | (38       |
| Claim liabilities                 | (277                               | )    | 11        |
| Litigation settlement             | —                                  | )    | (3,145    |
| AMT credit                        | —                                  | )    | (246      |
| NOL carryforward                  | 1,062                              | )    | (1,858    |
| Deferred income tax benefit       | \$ 550                             | )    | \$ (5,465 |

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Total income tax (benefit) expense 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:

|  | Nine months ended |         |      |    |
|--|-------------------|---------|------|----|
|  | September 30,     |         |      |    |
|  | 2013              | 2012    |      |    |
| Federal income tax rate applied to pre-tax income/loss | 34.0              | % (34.0 | )%   |    |
| Dividends received deduction and tax-exempt interest   | (1.9              | )%      | (1.1 | )% |
| Company owned life insurance                           | 0.7               | % (0.8  | )%   |    |
| Small life deduction                                   | (5.2              | )%      | (3.9 | )% |
| Life reserve tax adjustment                            | (6.6              | )%      | —    | %  |
| Other, net   | 1.1               | % 0.1   |      | %  |
| Effective federal income tax rate                      | 22.1              | % (39.7 | )%   |    |

## NOTE 7 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of September 30, 2013 and December 31, 2012:

|  | (Dollars in thousands) |         |
|--|------------------------|---------|
|  | 2013                   | 2012    |
|  | (UNAUDITED)            |         |
| Line of credit with variable interest rate equal to the Wall Street Journal (WSJ) prime rate, subject to a 5.0% floor; maturity February 2014. Interest payments due quarterly. Unsecured. | \$—                    | \$125   |
| Current portion of installment note payable due November 2013 with variable interest rate equal to the WSJ prime rate plus 1%; Unsecured   | 1,167                  | 1,167   |
|  | \$1,167                | \$1,292 |

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Long-term debt consisted of the following as of September 30, 2013 and December 31, 2012:

|  | (Dollars in thousands) |          |
|--|------------------------|----------|
|  | 2013                   | 2012     |
|  | (UNAUDITED)            |          |
| Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 4.5% floor; maturity September 2017. Interest payments due monthly. Secured.  | \$—                    | \$3,634  |
| 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. Next principal installment on long term portion due November 2014. Unsecured.   | 9,333                  | 9,333    |
| 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; maturity December 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured. | 9,279                  | 9,279    |
| 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; maturity June 15, 2037. Interest payments due quarterly. All may be redeemed at any time following the fifth anniversary of issuance. Unsecured.   | 3,093                  | 3,093    |
|  | \$21,705               | \$25,339 |

The subordinated debentures (debentures) have the same maturities and other applicable terms and features as the associated trust preferred securities (TPS). Payment of interest may be deferred for up to 20 consecutive quarters; however, stockholder dividends cannot be paid during any extended interest payment period or any time the debentures are in default. All have stated maturities of thirty years. None of the TPS securities require the Company to maintain minimum financial covenants. The Company has guaranteed that amounts paid to the Trusts will be remitted to the holders of the associated TPS. This guarantee, when taken together with the obligations of the Company under the debentures, the Indentures pursuant to which the debentures were issued, and the related trust agreement (including obligations to pay related trust fees, expenses, debt and other obligations with respect to the TPS), provides a full and unconditional guarantee of amounts due the Trusts. The amount guaranteed is not expected to at any time exceed the obligations of the TPS, and no additional liability has been recorded related to the guarantee.

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. Commencing September 17, 2012, under the terms of the forward swap, the Company receives interest at the three-month LIBOR rate plus 3.4% and pay interest at the fixed rate of 7.02%. This forward swap will effectively fix the interest rate on \$3,000,000 in debt until September of 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 will hedge 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 will pay interest at a fixed rate of 8.49% until March 15, 2020.

The swaps entered into in 2009 and 2010 have fair values of \$319,000 (liability) and \$712,000 (liability), respectively, for a total liability of \$1,031,000 at September 30, 2013 (\$1,521,000 at December 31, 2012). The swap liability is reported as a component of other liabilities on the condensed consolidated balance sheets. A net valuation gain of \$324,000 is included in accumulated other comprehensive income related to the swap agreements for the current period. A net valuation loss of \$214,000 was included in accumulated other comprehensive income related to the swap at December 31, 2012.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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. The Company has securities on deposit with fair market values of \$1,474,000 (all of which is posted as collateral). At December 31, 2012, the Company had securities on deposit with fair market values of \$1,557,000, all of which is posted as collateral. See Note 4 for additional information about the interest rate swaps.

In January 2013, the Company renewed an unsecured line of credit for \$700,000, with an interest rate of 5%, to be made available for general corporate purposes. As of September 30, 2013, there were no funds drawn on this line (\$125,000 at December 31, 2012).

In July 2012, the Company executed a promissory note in the amount of \$13,000,000 payable to the Bagley Family Revocable Trust with an interest rate of WSJ prime plus 1% (4.25% at September 30, 2013 and December 31, 2012). The purpose of this promissory note is to finance the settlement obligation related to the Mobile Attic litigation. As of September 30, 2013 and December 31, 2012, a total of \$10,500,000 was outstanding with principal payments due in equal annual installments of \$1,167,000 payable each November beginning in 2013. Installment payments due within 12 months of the balance sheet date are classified as current portion of long term debt. The promissory note allows for the Company to defer payments in years in which its P&C subsidiaries incur substantial catastrophe losses thus allowing capital management flexibility in the P&C subsidiaries. Under the terms of the promissory note, annual debt service payments on the note must equal or exceed any payment of dividends to shareholders in the preceding twelve months.

In September 2012, the Company obtained a secured line of credit in the amount of \$4,000,000 with an interest rate equal to the WSJ prime but subject to a floor of 4.5% (4.5% at December 31, 2012). In August of 2013, the Company sold substantially all timber property securing the credit line and paid the \$4,000,000 principal balance outstanding. The line remains available but, due to the sale of substantially all collateral securing the line of credit, as of September 30, 2013, the line was reduced to \$500,000 and there were no funds drawn on this line (\$3,634,000 at December 31, 2012).

NOTE 8 – 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 both a quota-share and excess of loss basis. 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 (UNAUDITED)

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

| Layer        | Reinsurers' Limits of Liability                |
|--------------|--|
| First Layer  | 100% of \$6,000,000 in excess of \$4,000,000   |
| Second Layer | 100% of \$7,500,000 in excess of \$10,000,000  |
| Third Layer  | 100% of \$25,000,000 in excess of \$17,500,000 |
| Fourth Layer | 100% of \$30,000,000 in excess of \$42,500,000 |

Each reinsurance layer covers events occurring from January 1-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 September 30, 2013, the largest reinsurance recoverable of a single reinsurer was \$69,000 (\$295,000 at December 31, 2012). Amounts reported as ceded incurred losses in both 2013 and 2012 were related to the development of losses from prior year catastrophes.

The effect of reinsurance on premiums written and earned in the property and casualty segment is as follows (dollars in thousands):

|         | Three months ended September 30, 2013 |          | Three months ended September 30, 2012 |          |
|---------|---------------------------------------|----------|---------------------------------------|----------|
|         | Written                               | Earned   | Written                               | Earned   |
| Direct  | \$14,304                              | \$13,528 | \$13,890                              | \$13,311 |
| Assumed | —                                     | —        | —                                     | —        |
| Ceded   | (2,081                                | ) (2,082 | ) (2,064                              | ) (2,068 |
| Net     | \$12,223                              | \$11,446 | \$11,826                              | \$11,243 |
|         | Nine months ended September 30, 2013  |          | Nine months ended September 30, 2012  |          |
|         | Written                               | Earned   | Written                               | Earned   |
| Direct  | \$43,403                              | \$40,423 | \$42,181                              | \$39,928 |
| Assumed | —                                     | —        | —                                     | —        |
| Ceded   | (6,401                                | ) (6,413 | ) (6,135                              | ) (6,127 |

|     |          |          |          |          |
|-----|----------|----------|----------|----------|
| Net | \$37,002 | \$34,010 | \$36,046 | \$33,801 |
|-----|----------|----------|----------|----------|

28

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Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The effect of reinsurance on premiums written and earned in the life segment is as follows (dollars in thousands):

|         | Three months ended September 30, 2013 |         | Three months ended September 30, 2012 |         |
|---------|---------------------------------------|---------|---------------------------------------|---------|
|         | Written                               | Earned  | Written                               | Earned  |
| Direct  | \$1,788                               | \$1,767 | \$1,719                               | \$1,684 |
| Assumed | —                                     | —       | —                                     | —       |
| Ceded   | (22                                   | ) (22   | ) (23                                 | ) (23   |
| Net     | \$1,766                               | \$1,745 | \$1,696                               | \$1,661 |
|         | Nine months ended September 30, 2013  |         | Nine months ended September 30, 2012  |         |
|         | Written                               | Earned  | Written                               | Earned  |
| Direct  | \$5,071                               | \$5,205 | \$5,131                               | \$5,190 |
| Assumed | —                                     | —       | —                                     | —       |
| Ceded   | (52                                   | ) (52   | ) (58                                 | ) (58   |
| Net     | \$5,019                               | \$5,153 | \$5,073                               | \$5,132 |

## NOTE 9 – 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 three months ended September 30, 2013 and 2012 amounted to \$47,000 and \$47,000, respectively. Company matching contributions for the nine months ended September 30, 2013 and 2012 amounted to \$144,000 and \$149,000, 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 of the non-qualified deferred compensation plans for the three months ended September 30, 2013 and 2012 amounted to approximately \$64,000 and \$44,000, respectively. Costs for amounts credited of the non-qualified deferred compensation plans for the nine months ended September 30, 2013 and 2012 amounted to approximately \$178,000 and \$131,000, 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. The Company incurred \$50,000 in costs related to the ESOP during the first nine months of 2013. No costs were incurred during the first nine months of 2012 related to the ESOP.

NOTE 10 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

The Company is dependent on dividends from its insurance subsidiaries to fund operations and 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:

29

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Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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, 2012, NSIC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to \$1,034,000.

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, 2012, NSFC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to \$2,468,000.

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.

At September 30, 2013, securities with market values of \$3,548,000 (\$3,785,000 at December 31, 2012) were deposited with various states pursuant to statutory requirements.

NOTE 11 – SHAREHOLDERS' EQUITY

During the nine months ended September 30, 2013, and year ended December 31, 2012, changes in shareholders' equity consisted of a net income of \$3,895,000 and net loss of \$6,671,000, respectively; dividends paid of \$186,000 in 2013 and \$802,000 in 2012; changes in accumulated other comprehensive loss, net of applicable taxes, of \$1,861,000 in 2013 and \$315,000 in 2012. Other comprehensive loss consists of accumulated unrealized gains and losses on securities and unrealized gains and losses on interest rate swaps.

Preferred Stock

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

Common Stock

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

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

The table below provides information regarding the Company's preferred and common stock as of September 30, 2013 and December 31, 2012:

September 30, 2013

December 31, 2012

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|                                     | 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  | 2,494,480 | 2,494,480   | 3,000,000  | 2,466,600 | 2,466,600   |

On June 28, 2013, 27,880 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 12 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The balance of and changes in each component of accumulated other comprehensive income (loss) (“AOCI”) for the nine months ended September 30, 2013, net of income taxes, are as follows (dollars in thousands):

|   | Gains and Losses on<br>Cash Flow Hedges | Unrealized Gains and<br>Losses on<br>Available-for-Sale<br>Securities | Total    |
|---|---|---|----------|
| Beginning balance   | \$(1,003                                | ) \$4,328   | \$3,325  |
| Other comprehensive income<br>before reclassifications                  | 324                                     | (705  | ) (381   |
| Amounts reclassified from<br>accumulated other comprehensive—<br>income |   | (1,480  | ) (1,480 |
| Net current period other<br>comprehensive income                        | 324                                     | (2,185  | ) (1,861 |
| Ending balance  | \$(679                                  | ) \$2,143   | \$1,464  |

The following table presents the amounts reclassified out of AOCI for the nine months ended September 30, 2013 (dollars in thousands):

| Details about Accumulated Other<br>Comprehensive Income Components | Amounts Reclassified from<br>Accumulated Other Comprehensive<br>Income | Affected Line Item in the Statement<br>Where Net Income is Presented |
|--|--|--|
| Unrealized Gains and Losses on<br>Available-for-Sale Securities    | \$4,354  | Net realized investment gains  |
|  | 4,354  | Total before tax   |
|  | (1,480   | ) Tax (expense) or benefit   |
|  | \$2,874  | Net of Tax   |

## NOTE 13 – SEGMENTS

The Company’s property and casualty insurance operations comprise one business segment. The property and casualty insurance segment consists of seven lines of business: dwelling fire and extended coverage, homeowners (including mobile homeowners), ocean marine, other liability, private passenger auto liability, commercial auto liability and auto physical damage. Management organizes the business utilizing a niche strategy focusing on lower valued dwellings. Our chief decision makers (President, Chief Financial Officer and Chief Executive Officer) review results and operating plans making decisions on resource allocations on a company-wide basis. The Company’s products are primarily produced through 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.





Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Premium revenues and operating income by industry segment for the three and nine months ended September 30, 2013 and 2012 are summarized below (dollars in thousands):

| Three months ended September 30, 2013             | Total    | P&C Insurance<br>Operations | Life Insurance<br>Operations | Non-Insurance<br>Operations |
|---|----------|-----------------------------|------------------------------|-----------------------------|
| <b>REVENUE</b>                                    |          |                             |                              |                             |
| Net premiums earned                               | \$13,191 | \$11,446                    | \$1,745                      | \$—                         |
| Net investment income                             | 1,046    | 474                         | 553                          | 19                          |
| Net realized investment gains                     | 3,297    | 8                           | (19                          | ) 3,308                     |
| Other income                                      | 163      | 152                         | 11                           | —                           |
|   | 17,697   | 12,080                      | 2,290                        | 3,327                       |
| <b>BENEFITS AND EXPENSES</b>                      |          |                             |                              |                             |
| Policyholder benefits paid                        | 7,112    | 5,845                       | 1,267                        | —                           |
| Amortization of deferred policy acquisition costs | 894      | 639                         | 255                          | —                           |
| Commissions                                       | 1,800    | 1,704                       | 96                           | —                           |
| General and administrative expenses               | 2,156    | 1,444                       | 582                          | 130                         |
| Taxes, licenses and fees                          | 438      | 385                         | 53                           | —                           |
| Interest expense                                  | 434      | —                           | 34                           | 400                         |
|   | 12,834   | 10,017                      | 2,287                        | 530                         |
| Income (Loss) Before Income Taxes                 | \$4,863  | \$2,063                     | \$3                          | \$2,797                     |
| <br>  |          |                             |                              |                             |
| Three months ended September 30, 2012             | Total    | P&C Insurance<br>Operations | Life Insurance<br>Operations | Non-Insurance<br>Operations |
| <b>REVENUE</b>                                    |          |                             |                              |                             |
| Net premiums earned                               | \$12,904 | \$11,243                    | \$1,661                      | \$—                         |
| Net investment income                             | 1,140    | 560                         | 541                          | 39                          |
| Net realized investment gains                     | 1,703    | 875                         | 829                          | (1                          |
| Other income                                      | 258      | 172                         | —                            | 86                          |
|   | 16,005   | 12,850                      | 3,031                        | 124                         |
| <b>BENEFITS AND EXPENSES</b>                      |          |                             |                              |                             |
| Policyholder benefits paid                        | 11,564   | 10,302                      | 1,262                        | —                           |
| Amortization of deferred policy acquisition costs | 1,056    | 685                         | 371                          | —                           |
| Commissions                                       | 1,949    | 1,865                       | 84                           | —                           |
| General and administrative expenses               | 1,954    | 1,415                       | 436                          | 103                         |
| Litigation settlement and defense costs           | 76       | —                           | —                            | 76                          |
| Taxes, licenses and fees                          | 452      | 393                         | 59                           | —                           |
| Interest expense                                  | 311      | —                           | 35                           | 276                         |
|   | 17,362   | 14,660                      | 2,247                        | 455                         |
| Income (Loss) Before Income Taxes                 | \$(1,357 | ) \$(1,810                  | ) \$784                      | \$(331                      |

Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

| Nine months ended September 30, 2013              | Total    | P&C Insurance<br>Operations | Life Insurance<br>Operations | Non-Insurance<br>Operations |
|---|----------|-----------------------------|------------------------------|-----------------------------|
| <b>REVENUE</b>                                    |          |                             |                              |                             |
| Net premiums earned                               | \$39,163 | \$34,010                    | \$5,153                      | \$—                         |
| Net investment income                             | 2,858    | 1,170                       | 1,631                        | 57                          |
| Net realized investment gains                     | 4,354    | 1,038                       | 8                            | 3,308                       |
| Other income                                      | 480      | 467                         | 13                           | —                           |
|   | 46,855   | 36,685                      | 6,805                        | 3,365                       |
| <b>BENEFITS AND EXPENSES</b>                      |          |                             |                              |                             |
| Policyholder benefits paid                        | 24,923   | 21,474                      | 3,449                        | —                           |
| Amortization of deferred policy acquisition costs | 2,759    | 1,938                       | 821                          | —                           |
| Commissions                                       | 5,268    | 4,986                       | 282                          | —                           |
| General and administrative expenses               | 6,199    | 4,052                       | 1,572                        | 575                         |
| Taxes, licenses and fees                          | 1,398    | 1,220                       | 178                          | —                           |
| Interest expense                                  | 1,311    | —                           | 72                           | 1,239                       |
|   | 41,858   | 33,670                      | 6,374                        | 1,814                       |
| Income (Loss) Before Income Taxes                 | \$4,997  | \$3,015                     | \$431                        | \$1,551                     |

| Nine months ended September 30, 2012              | Total      | P&C Insurance<br>Operations | Life Insurance<br>Operations | Non-Insurance<br>Operations |
|---|------------|-----------------------------|------------------------------|-----------------------------|
| <b>REVENUE</b>                                    |            |                             |                              |                             |
| Net premiums earned                               | \$38,933   | \$33,801                    | \$5,132                      | \$—                         |
| Net investment income                             | 3,341      | 1,700                       | 1,569                        | 72                          |
| Net realized investment gains                     | 2,774      | 1,082                       | 1,691                        | 1                           |
| Other income                                      | 648        | 560                         | 2                            | 86                          |
|   | 45,696     | 37,143                      | 8,394                        | 159                         |
| <b>BENEFITS AND EXPENSES</b>                      |            |                             |                              |                             |
| Policyholder benefits paid                        | 27,385     | 23,478                      | 3,907                        | —                           |
| Amortization of deferred policy acquisition costs | 2,787      | 2,088                       | 699                          | —                           |
| Commissions                                       | 5,923      | 5,600                       | 323                          | —                           |
| General and administrative expenses               | 6,277      | 4,355                       | 1,528                        | 394                         |
| Litigation settlement and defense costs           | 13,335     | —                           | —                            | 13,335                      |
| Taxes, licenses and fees                          | 1,382      | 1,208                       | 174                          | —                           |
| Interest expense                                  | 891        | —                           | 64                           | 827                         |
|   | 57,980     | 36,729                      | 6,695                        | 14,556                      |
| Income (Loss) Before Income Taxes                 | \$(12,284) | \$414                       | \$1,699                      | \$(14,397)                  |

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company's gross and net premiums written for the property and casualty segment and the life and accident and health segment for the three and nine months ended September 30, 2013 and 2012, respectively:

|  | Three months ended    |          | Nine months ended     |          |
|--|-----------------------|----------|-----------------------|----------|
|  | September 30,<br>2013 | 2012     | September 30,<br>2013 | 2012     |
| Life, accident and health operations premiums written: |                       |          |                       |          |
| Traditional life insurance                             | \$1,184               | \$1,218  | \$3,586               | \$3,711  |
| Accident and health insurance                          | 604                   | 501      | 1,485                 | 1,420    |
| Total life, accident and health                        | 1,788                 | 1,719    | 5,071                 | 5,131    |
| Property and Casualty operations premiums written:     |                       |          |                       |          |
| Dwelling fire & extended coverage                      | 7,630                 | 7,164    | 23,595                | 21,916   |
| Homeowners (Including mobile homeowners)               | 6,245                 | 6,053    | 18,422                | 18,285   |
| Ocean marine   | —                     | 334      | 75                    | 781      |
| Other liability  | 429                   | 369      | 1,311                 | 1,135    |
| Private passenger auto liability                       | —                     | (20      | ) —                   | 37       |
| Commercial auto liability                              | —                     | —        | —                     | 6        |
| Auto physical damage                                   | —                     | (10      | ) —                   | 21       |
| Total property and casualty                            | 14,304                | 13,890   | 43,403                | 42,181   |
| Gross premiums written                                 | 16,092                | 15,609   | 48,474                | 47,312   |
| Reinsurance premium ceded                              | (2,103                | ) (2,087 | ) (6,453              | ) (6,193 |
| Net premiums written                                   | \$13,989              | \$13,522 | \$42,021              | \$41,119 |

The following table presents the Company's gross and net premiums earned for the property and casualty segment and the life and accident and health segment for the three and nine months ended September 30, 2013 and 2012, respectively:

|   | Three months ended    |         | Nine months ended     |         |
|---|-----------------------|---------|-----------------------|---------|
|   | September 30,<br>2013 | 2012    | September 30,<br>2013 | 2012    |
| Life, accident and health operations premiums earned: |                       |         |                       |         |
| Traditional life insurance                            | \$1,159               | \$1,182 | \$3,715               | \$3,776 |
| Accident and health insurance                         | 608                   | 502     | 1,490                 | 1,414   |
| Total life, accident and health                       | 1,767                 | 1,684   | 5,205                 | 5,190   |
| Property and Casualty operations premiums earned:     |                       |         |                       |         |
| Dwelling fire & extended coverage                     | 7,446                 | 6,905   | 21,720                | 20,117  |
| Homeowners (Including mobile homeowners)              | 5,674                 | 5,785   | 17,007                | 17,479  |
| Ocean marine  | —                     | 275     | 524                   | 818     |
| Other liability                                       | 408                   | 357     | 1,172                 | 1,040   |
| Private passenger auto liability                      | —                     | (9      | ) —                   | 319     |
| Commercial auto liability                             | —                     | —       | —                     | 6       |
| Auto physical damage                                  | —                     | (2      | ) —                   | 149     |
| Total property and casualty                           | 13,528                | 13,311  | 40,423                | 39,928  |
| Gross premiums earned                                 | 15,295                | 14,995  | 45,628                | 45,118  |

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|                           |          |          |          |          |   |
|---------------------------|----------|----------|----------|----------|---|
| Reinsurance premium ceded | (2,104   | ) (2,091 | ) (6,465 | ) (6,185 | ) |
| Net premiums earned       | \$13,191 | \$12,904 | \$39,163 | \$38,933 |   |

34

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Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 14 – CONTINGENCIES

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

The Company's property & casualty subsidiaries are defending a limited number of matters filed in the aftermath of Hurricanes Katrina in Mississippi and Louisiana as well as Gustav and Ike in Texas. These actions include individual lawsuits with allegations of underpayment of hurricane-related claims.

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

NOTE 15 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the nine months ended September 30, 2013 was \$976,000. Cash paid for interest during the nine months ended September 30, 2012 was \$886,000. Cash paid for income taxes during the nine months ended September 30, 2013 was \$195,000. Cash received from income tax refunds during the nine months ended September 30, 2012 was \$1,437,000.

During the nine months ended September 30, 2013 non-cash changes in equity included \$27,000 in common stock issued to Directors in lieu of cash compensation along with a corresponding \$196,000 increase in additional paid in capital.

NOTE 16 – SUBSEQUENT EVENTS

Management has evaluated subsequent events and their potential effects on these condensed consolidated financial statements.

Table of Contents

REVIEW REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the accompanying condensed consolidated balance sheet of The National Security Group, Inc. as of September 30, 2013, and the related condensed consolidated statements of income (loss) and comprehensive income (loss) for the three-months and nine-months ended September 30, 2013 and 2012, the condensed consolidated statement of shareholders' equity for the nine-months ended September 30, 2013 and the condensed consolidated statements of cash flows for the nine-months ended September 30, 2013 and 2012. These condensed consolidated financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The National Security Group, Inc. as of December 31, 2012, and the related consolidated statements of income (loss), comprehensive income (loss), shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 21, 2013, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2012, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Warren Averett, LLC

Birmingham, Alabama  
November 14, 2013

Table of Contents

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

Overview

The following discussion addresses the financial condition of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) as of September 30, 2013, compared with December 31, 2012 and its results of operations for the three-month and nine-month periods ending September 30, 2013 and its cash flows for the nine-month period ended September 30, 2013, all compared with the same periods last year along with its statements of shareholders' equity as of September 30, 2013. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part I, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2012.

This discussion will primarily consist of an analysis of the two segments of our operations. The life segment consists of the operations of our life insurance subsidiary, National Security Insurance Company (NSIC). The property and casualty (P&C) segment consists of the operations of our two property and casualty insurance subsidiaries, National Security Fire & Casualty Company (NSFC) and Omega One Insurance Company (Omega).

This discussion contains forward-looking statements that are not historical facts, including statements about our beliefs and expectations. These statements are based upon current plans, estimates and projections. Our actual results may differ materially from those projected in these forward-looking statements as a result of various factors. See "Cautionary Statement Regarding Forward-Looking Statements" contained on Page 3 of this report.

The reader is assumed to have access to the Company's 2012 Annual Report. This discussion should be read in conjunction with the Annual Report and with the condensed consolidated financial information on pages 4 through 35 of this Form 10-Q.

Information in this discussion is presented in whole dollars rounded to the nearest thousand.

The National Security Group operates in the property and casualty and life, accident and supplemental health insurance businesses and markets products primarily through independent agents. The Company operates in eleven states with 50.2% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment, accounting for 88.6% of gross insurance premium revenue for the first nine months of 2013. Revenue generated from the life segment accounted for 11.4% of gross insurance premium revenue for the first nine months of 2013.

National Security Insurance Company (NSIC) is a life, accident and health insurance company founded in 1947. The net premium revenue produced in NSIC from the traditional life products and accident and health products accounted for 9.4% and 3.8%, respectively, of total premium revenue. All references to NSIC in the remainder of this management discussion and analysis will refer to the combined life, accident and health insurance operations and will compose the life segment of the Company. NSIC is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

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 product differentiation between the products underwritten by NSFC and Omega as both underwrite primarily dwelling personal lines coverage. The Property and Casualty segment has premium in-force in the states of Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, Tennessee and Texas.

All of the insurance subsidiaries are Alabama domiciled insurance companies; therefore, the Alabama Department of Insurance is the primary insurance regulator. However, each subsidiary is subject to regulation by the respective insurance regulators of each state in which it is licensed to transact business. Insurance rates charged by each of the insurance subsidiaries are typically reviewed and approved by each insurance department for the respective state in

which the rates will apply.

All of our insurance companies have been assigned ratings by A.M. Best. The property and casualty group has been assigned a group rating of “B++” (Good) with a negative outlook. In addition, A.M. Best has assigned an issuer credit rating of “bbb” with a negative outlook. NSFC, the largest of the insurance subsidiaries, carries the same A.M. Best ratings as the group. Omega carries an A.M. Best rating of “B+” (Good) with a stable outlook and an issuer credit rating of “bbb-” with a stable outlook. The life insurance subsidiary, NSIC, has been assigned a rating of “B+” (Good) with a stable outlook and an issuer credit rating upgrade of "bbb-" with a stable outlook. All ratings are reviewed at

37

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Table of Contents

least annually by A.M. Best with the latest ratings' effective date of November 30, 2012. AM Best is currently undergoing its annual review process of our ratings.

The two primary segments in which we report insurance operations are the personal lines property and casualty segment (NSFC) and the life, accident and health insurance segment (NSIC). Due to the small amount of premium revenue produced by Omega and the fact that Omega is a wholly owned subsidiary of NSFC underwriting similar lines of business, all references to NSFC in the remainder of this management discussion and analysis will include the insurance operations of both NSFC and Omega. 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.

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.

## CONSOLIDATED RESULTS OF OPERATIONS

### Summary:

For the three months ended September 30, 2013, the Company had net income of \$3,339,000, \$1.35 per share, compared to a net loss of \$627,000, \$0.25 per share, for the same period last year. On a pretax basis, during the third quarter of 2013, the Company had income of \$4,863,000 compared to a net loss of \$1,357,000 during the third quarter of 2012. The primary components of third quarter 2013 income were \$1.6 million in income from operations as well as realized capital gains from the sale of 2,739 acres of investment real estate consisting of timber property in Alabama. For the three months ended September 30, 2013, net realized investment gains were \$3,297,000 compared to \$1,703,000 for the same period last year. The realized gain from the timber property sale accounted for 68% of pretax income for the three months ended September 30, 2013.

For the three months ended September 30, 2013, earned premium revenue was \$13,191,000 compared to \$12,904,000 for the three months ended September 30, 2012; a \$287,000 or 2.2% increase. The increase in revenue for the three months ended September 30, 2013 compared to the same period last year was primarily due to growth in dwelling fire premium income in the P&C segment.

Claims for the three months ended September 30, 2013 were \$7,112,000 compared to \$11,564,000 for the same period last year. During the three months ended September 30, 2013, the P&C segment had no material catastrophe losses. Catastrophe claims reported for the three months ended September 30, 2013 were \$216,000 compared to \$3,382,000 for the same period last year. The catastrophe claims reported during the third quarter of 2013 accounted for only 3% of claims incurred during the quarter while catastrophe claims composed 29.2% of incurred claims in the third quarter of 2012. The primary reason for the higher catastrophe claim activity in the prior year was \$3,156,000 in reported losses and LAE from Hurricane Isaac.

For the nine months ended September 30, 2013, the Company had net income of \$3,895,000, or \$1.57 per share, compared to a net loss of \$7,402,000, or \$3.00 per share, for the same period last year. On a pretax basis, we had year to date income of \$4,997,000 compared to a loss of \$12,284,000 for the same period in 2012. In addition to \$643,000 in year to date income from operations, we also had an increase in realized investment gains in 2013 compared to 2012. Year to date realized investment gains were \$4,354,000 in 2013 compared to \$2,774,000 for the same period

last year. As mentioned previously, the Company realized capital gains from the sale of 2,739 acres of investment real estate consisting of timber property in Alabama. The timber property, carried at historical cost of \$1.3 million prior to the sale, was sold for net proceeds of \$4.6 million for a gain of \$3.3 million. With regard to 2012, the primary contributing factors to the loss of \$12,284,000 were expenses totaling \$13,335,000 related to the litigation settlement during second quarter of 2012 as well as \$3,156,000 in reported losses and LAE from Hurricane Isaac.

Year to date earned premium revenue was \$39,163,000 for the nine months ended September 30, 2013 compared to \$38,933,000 for the same period last year; an increase of 0.6%. Increases in dwelling fire premium revenue in the P&C segment were the primary reason for the increase in year to date premium revenue. However, the increase was

Table of Contents

offset by a reduction in premium revenue due to the discontinuation of all automobile lines of insurance which completed run-off in 2012 as well as the termination of our ocean marine program effective June 30, 2013.

Claims were \$24,923,000 (63.6% of net premiums earned) for the nine months ended September 30, 2013 compared to \$27,385,000 (70.3% of net premiums earned) for the same period last year, a 9.0% decrease. The primary reason for the decrease in claims in 2013 was a reduction in reported catastrophe claims and fire losses. Catastrophe claims reported during the first nine months of 2013 totaled \$3,292,000 compared to \$4,033,000 during the first nine months of 2012. The most significant cat event during 2013 occurred on March 18th impacting our policyholders in four states. This single cat event lead to reported losses totaling \$2,475,000 or 75.2% of all catastrophe losses reported in the first nine months of 2013. The most significant cat event during 2012 was Hurricane Isaac (Catastrophe 87) which struck the Louisiana coast on August 29, 2012 and contributed \$3,156,000 in reported losses and LAE. Hurricane Isaac claims accounted for 78.3% of all cat event claims reported through September 30, 2012. P&C segment year to date reported fire claims were down \$653,000 at \$8,886,000 compared to \$9,539,000 for the same period last year; a decrease of 6.8%. During the first nine months of 2013, the P&C segment had 388 fire claims reported leading to an average per claim of \$23,000 compared to 383 fire related claims reported during the first nine months of 2012 with an average per claim of \$25,000.

Shareholders' equity as of September 30, 2013 was \$32,298,000 up \$2,071,000 compared to \$30,227,000 as of December 31, 2012. Book value per share increased \$0.70 per share for the period ended September 30, 2013 to \$12.95 per share compared to \$12.25 per share at December 31, 2012. The primary reasons for the \$0.70 increase in book value per share were \$643,000 in pretax operating income as well as the sale of the timber property mentioned above. The timber property had a book value prior to the sale of \$1.3 million. The property was sold on September 4, 2013, with net proceeds of \$4.6 million and a pretax gain of \$3.3 million.

Three months ended September 30, 2013 compared to three months ended September 30, 2012:

## Premium Revenue:

The table below provides earned premium revenue by segment for the three months ended September 30, 2013 and 2012:

|  | Three months ended September 30, |          | Percent<br>increase<br>(decrease) |    |
|--|----------------------------------|----------|-----------------------------------|----|
|  | 2013                             | 2012     |                                   |    |
| Life, accident and health operations:    |                                  |          |                                   |    |
| Traditional life insurance               | \$1,159                          | \$1,182  | (1.9                              | )% |
| Accident and health insurance            | 608                              | 502      | 21.1                              | %  |
| Total life, accident and health          | 1,767                            | 1,684    | 4.9                               | %  |
| Property and Casualty operations:        |                                  |          |                                   |    |
| Dwelling fire & extended coverage        | 7,446                            | 6,905    | 7.8                               | %  |
| Homeowners (Including mobile homeowners) | 5,674                            | 5,785    | (1.9                              | )% |
| Ocean marine                             | —                                | 275      | (100.0                            | )% |
| Other liability                          | 408                              | 357      | 14.3                              | %  |
| Private passenger auto liability         | —                                | (9       | ) (100.0                          | )% |
| Auto physical damage                     | —                                | (2       | ) (100.0                          | )% |
| Total property and casualty              | 13,528                           | 13,311   | 1.6                               | %  |
| Gross premiums earned                    | 15,295                           | 14,995   | 2.0                               | %  |
| Reinsurance premium ceded                | (2,104                           | ) (2,091 | ) 0.6                             | %  |

|                     |          |          |     |   |
|---------------------|----------|----------|-----|---|
| Net premiums earned | \$13,191 | \$12,904 | 2.2 | % |
|---------------------|----------|----------|-----|---|

Consolidated premium revenue was \$13,191,000 for the three months ended September 30, 2013 compared to \$12,904,000 for the same period last year; an increase of \$287,000 or 2.2%. Our core P&C property programs were the primary source of the increase in earned premium for the current quarter compared to the same period last year. For the three months ended September 30, 2013, the P&C property programs had net earned premium revenue (net of reinsurance ceded) of \$11,038,000 compared to \$10,622,000 for the three months ended September 30, 2012.

Table of Contents

With the discontinuation of all automobile lines in 2012 and the discontinuation of our marine insurance program in June of 2013, we have streamlined our operations to focus on our longtime core lines of property and casualty business, the home insurance market. With a combination of rate increases and modest organic growth, we increased P&C segment net earned premium 3.9% for the quarter compared to last year.

Investment income:

For the three months ended September 30, 2013, investment income was \$1,046,000 compared to \$1,140,000 for the same period last year; a decrease of \$94,000. The decrease was primarily due to a one time increase in investment related expenses.

Realized investment gains and losses:

For the three months ended September 30, 2013, realized investment gains totaled \$3,297,000 compared to \$1,703,000 for the same period last year; an increase of \$1,594,000. The Company realized capital gains from the sale of 2,739 acres of investment real estate consisting of timber property in Alabama. The timber property, carried at historical cost of \$1.3 million prior to the sale, was sold for net proceeds of \$4.6 million leading to a pre-tax gain of \$3.3 million.

Other income:

Other income was \$163,000 for the three-month period ended September 30, 2013 compared to \$258,000 for the three-month period ended September 30, 2012; a decrease of 36.8%. Other income is primarily composed of billing, payment and policy fees associated with residential property and automobile policies issued in the P&C segment. Due to the discontinuation of the automobile program, billing, payment and policy fees decreased \$20,000 in the P&C segment. In addition, we received an \$86,000 recovery related to the timber property at the holding company level during the third quarter of 2012.

Policyholder benefits:

Policyholder benefits (claims) as a percent of net premiums earned were 53.9% for the three months ended September 30, 2013 compared to 89.6% for the three months ended September 30, 2012. Policyholder benefits for the three months ended September 30, 2013 were \$7,112,000 compared to \$11,564,000 for the same period last year; a decrease of 38.5%. The P&C segment had minimal claim activity resulting from storm systems classified as catastrophes by PCS during the three months ended September 30, 2013 compared to the same period last year. Catastrophe claims reported for the three months ended September 30, 2013 were \$216,000 compared to \$3,382,000 for the three months ended September 30, 2012. During the third quarter of 2012, the P&C segment was impacted by an increase in losses and LAE incurred from Hurricane Isaac totaling \$3,156,000. Without the impact of Hurricane Isaac in the third quarter 2012, reported losses and LAE in the P&C segment from cat events were comparable at \$216,000 for third quarter 2013 and \$226,000 for third quarter 2012.

In addition to the reduction in reported claims from cat events in the third quarter of 2013 compared to the third quarter of 2012, the P&C segment also had a decline in non-catastrophe wind and hail claims for the same period. Non-catastrophe wind and hail claims were down 21.5% in the third quarter of 2013 compared to the same period last year. For the three months ended September 30, 2013, reported non-catastrophe wind and hail claims were \$1,771,000 from 683 claims compared to \$2,256,000 from 798 reported non-catastrophe wind and hail claims during the same period last year. The average per claim from non-catastrophe wind and hail claims for the three-month period ended September 30, 2013 and 2012 was \$2,600 and \$2,800, respectively.



Table of Contents

The table below provides P&C segment reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and loss adjustment expenses (LAE) for the three months ended September 30, 2013 and 2012:

| Three months ended September 30, 2013 |                          |                | Three months ended September 30, 2012 |                          |                |
|---------------------------------------|--------------------------|----------------|---------------------------------------|--------------------------|----------------|
|                                       | Reported<br>Losses & LAE | Claim<br>Count |                                       | Reported<br>Losses & LAE | Claim<br>Count |
| Cat event                             |                          |                | Cat event                             |                          |                |
| Cat 14                                | \$24,000                 | 12             | Cat 65                                | \$5,000                  | 3              |
| Cat 15                                | 13,000                   | 5              | Cat 67                                | 42,000                   | 7              |
| Cat 17                                | 11,000                   | 5              | Cat 69                                | —                        | —              |
| Cat 22                                | 21,000                   | 6              | Cat 71                                | —                        | —              |
| Cat 91                                | (1,000 )                 | —              | Cat 72                                | 3,000                    | 1              |
| Cat 92                                | (1,000 )                 | —              | Cat 73                                | —                        | —              |
| Cat 93                                | 141,000                  | 62             | Cat 83                                | 108,000                  | 38             |
| Cat 95                                | 8,000                    | 3              | Cat 87                                | 3,156,000                | 1,070          |
| Cat 99                                | —                        | —              | Cat 88                                | 68,000                   | 12             |
|                                       | \$216,000                | 93             |                                       | \$3,382,000              | 1,131          |
| Non-cat wind & hail                   | \$1,771,000              | 683            | Non-cat wind & hail                   | \$2,256,000              | 798            |

The P&C segment was impacted by two storm systems (Cat 17 and Cat 22) categorized as catastrophes during the three months ended September 30, 2013 compared to three storm systems (Cat 83, Cat 87 and Cat 88) during the three months ended September 30, 2012. Reported losses and LAE from the two cat events in third quarter 2013 totaled \$32,000 from 11 claims, while reported losses and LAE from the three cat events during third quarter 2012 totaled \$3,332,000 from 1,120 claims. The primary reason for the significantly higher reported claims from cat events during third quarter of 2012 was Hurricane Isaac which accounted for 94.7% of the claims reported from third quarter 2012 cat events. In addition to the third quarter cat events in 2013 and 2012, the P&C segment incurred development related to cat events from the first and second quarters of each respective year. For the three months ended September 30, 2013, cats from first and second quarter of 2013 had development totaling \$184,000 with cat 93 from first quarter 2013 being the primary contributor. Cat events from the first and second quarter of 2012 had minimal development during third quarter of 2012 totaling \$50,000.

Claims reported during the third quarter of 2013 from all current year cat events totaled \$216,000, resulted in 93 claims and added 1.9 percentage points to the third quarter 2013 P&C segment loss ratio. Claims reported during the third quarter of 2012 from all 2012 cat events totaled \$3,382,000, resulted in 1,131 claims and added 30.1 percentage points to the third quarter 2012 P&C segment loss ratio. The primary reason for the decrease for the three months ended September 30, 2013 compared to the same period last year were claims associated with Hurricane Isaac which occurred during third quarter 2012. The increase in the third quarter 2012 loss ratio was primarily associated with Hurricane Isaac which accounted for 28.1 of the 30.1 percentage point increase. The average cost per claim for the three months ended September 30, 2013 and 2012 from cat events in each year, was \$2,300 and \$3,000, respectively. None of the catastrophe events occurring in the first nine months of 2013 or 2012 exceeded our company retention under our catastrophe reinsurance agreement, therefore none of the losses are covered by reinsurance.

Policy acquisition cost (commissions and amortization of deferred acquisition cost):

For the three months ended September 30, 2013, policy acquisition costs were \$2,694,000 compared to \$3,005,000 for the same period last year. Policy acquisition costs were 20.4% of premium revenue for the third quarter of 2013 compared to 23.3% for the same period last year. A change in terms of one of our general agent contingent commission contracts in the P&C segment coupled with a decrease in first year commissions in the life segment were the primary reasons for the \$311,000 decrease in policy acquisition costs for the third quarter of 2013 compared to the same period last year.

General Expenses:

General expenses were up \$202,000 for the three months ended September 30, 2013 at \$2,156,000 compared to \$1,954,000 for the same period last year. General expenses were 16.3% and 15.1% of earned premium for the three months ended September 30, 2013 and 2012, respectively. The primary reason for the increase in third quarter general



Table of Contents

expenses was actuarial fees related to a system conversion in the life segment and an ongoing rate filing project in the P&C segment.

Litigation settlement and defense costs:

Litigation settlement costs were \$0 for the three months ended September 30, 2013 compared to \$76,000 for the same period last year. This line item reflects cost associated with Mobile Attic litigation which was settled in 2012. The primary reason for the decrease was that during the second quarter of 2012, the Company settled longstanding litigation related to the Company's sale of Mobile Attic, Inc. For additional information regarding litigation settlement expenses, refer to the Company's 2012 Annual Report on Form 10-K.

Taxes, licenses and fees:

Taxes, licenses and fees for the three months ended September 30, 2013 and 2012 were comparable at \$438,000 and \$452,000, respectively. Taxes, licenses and fees as a percentage of earned premiums were 3.3% for the three months ended September 30, 2013 and 3.5% for the same period last year.

Interest expense:

Interest expense was up \$123,000 or 39.5% at \$434,000 for the three months ended September 30, 2013 compared to \$311,000 for the same period last year. The primary reason for the increase was the addition of \$10.5 million in debt related to the Mobile Attic litigation settlement.

Income taxes:

For the three-month period ended September 30, 2013, income tax expense was \$1,524,000 compared to income tax benefit of \$730,000 for the same period last year. An increase in deferred tax assets in our life segment from deferred premium and small life insurance deduction during the three-month period ended September 30, 2013 was the primary contributor to the reduction in income tax expense below the 34% statutory rate. In contrast, the primary reason for the \$730,000 income tax benefit for the same period last year was the litigation settlement discussed previously which generated significant net operating loss carryforwards.

Net income (loss):

For the three months ended September 30, 2013, the Company had net income of \$3,339,000 compared to a net loss of \$627,000 for the same period last year. On a pretax basis, the Company ended the third quarter of 2013 with income of \$4,863,000 compared to a loss of \$1,357,000 for the same period last year. The primary components of third quarter 2013 pretax income were \$1.6 million in operational income as well as \$3,297,000 in capital gains. The primary contributor of the capital gains was the sale of 2,739 acres of timber property in September 2013. The property was carried at historical cost of \$1.3 million and net proceeds from the sale were \$4.6 million leading to a pretax gain of \$3.3 million. The primary reason for the net loss for the three months ended September 30, 2012 were claims incurred from Hurricane Isaac totaling \$3,156,000.

Table of Contents

Nine months ended September 30, 2013 compared to nine months ended September 30, 2012:

## Premium Revenue:

The table below provides earned premium revenue by segment for the nine months ended September 30, 2013 and 2012:

|  | Nine months ended September 30, |          | Percent increase (decrease) |    |
|--|---------------------------------|----------|-----------------------------|----|
|  | 2013                            | 2012     |                             |    |
| Life, accident and health operations:    |                                 |          |                             |    |
| Traditional life insurance               | \$3,715                         | \$3,776  | (1.6                        | )% |
| Accident and health insurance            | 1,490                           | 1,414    | 5.4                         | %  |
| Total life, accident and health          | 5,205                           | 5,190    | 0.3                         | %  |
| Property and Casualty operations:        |                                 |          |                             |    |
| Dwelling fire & extended coverage        | 21,720                          | 20,117   | 8.0                         | %  |
| Homeowners (Including mobile homeowners) | 17,007                          | 17,479   | (2.7                        | )% |
| Ocean marine                             | 524                             | 818      | (35.9                       | )% |
| Other liability                          | 1,172                           | 1,040    | 12.7                        | %  |
| Private passenger auto liability         | —                               | 319      | (100.0                      | )% |
| Commercial auto liability                | —                               | 6        | (100.0                      | )% |
| Auto physical damage                     | —                               | 149      | (100.0                      | )% |
| Total property and casualty              | 40,423                          | 39,928   | 1.2                         | %  |
| Gross premiums earned                    | 45,628                          | 45,118   | 1.1                         | %  |
| Reinsurance premium ceded                | (6,465                          | ) (6,185 | ) 4.5                       | %  |
| Total earned premium revenue             | \$39,163                        | \$38,933 | 0.6                         | %  |

Consolidated premium revenue was \$39,163,000 for the nine months ended September 30, 2013 compared to \$38,933,000 for the same period last year; an increase of \$230,000 or 0.6%. The increase was driven by growth in earned premium in the P&C segment dwelling fire program as well as growth in the life segment accident and health line of business. The P&C segment had a moderate 1.2% increase in gross premium revenue in 2013 compared to 2012. While the dwelling fire program had an 8% increase in year to date gross premium earned, the increase was partially offset by a decline in gross premiums earned in the ocean marine program which was discontinued on June 30, 2013 coupled with the termination of the automobile program in 2012.

Partially offsetting the increase in P&C gross premium revenue was an increase in ceded premium in the current year compared to the same period last year. For the nine months ended September 30, 2013, reinsurance premium ceded was up 4.5% compared to nine months ended September 30, 2012. The primary reason for the \$280,000 increase was a timing difference related to the contract implementation date of our reinsurance premium protection (RPP) which was added to our reinsurance structure in April of 2012.

The life segment ended September 2013 with year to date gross premium revenue of \$5,205,000; an increase of 0.3% compared to \$5,190,000 through September 2012. A 5.4% increase in new business production from accident and health products was the primary factor contributing to the increase.

Investment income:

Investment income decreased \$483,000 to \$2,858,000 through September 30, 2013 compared to \$3,341,000 through September 30, 2012. During the first nine months of 2013, the value of our COLI decreased leading to investment expense totaling \$100,000. In contrast, during the first nine months of 2012, the value of our COLI increased leading to investment income of \$284,000. The changes in value were the primary reason for the decrease in investment income in the current year compared to the same period last year. In addition, average invested assets were down for the first nine months of 2013 compared to the same period last year and contributed to the overall decline in investment income.

Table of Contents

## Realized investment gains and losses:

For the nine months ended September 30, 2013 and 2012, realized investment gains were \$4,354,000 and \$2,774,000, respectively. The primary factor contributing to the \$1,580,000 year to date increase in realized capital gains was the \$3.3 million pretax gain on the sale of timber property in the holding company. The timber property, carried at historical cost of \$1.3 million dollars, was sold for \$4.6 million.

## Other income:

Other income was \$480,000 through September 30, 2013 compared to \$648,000 through September 30, 2012; a decrease of 25.9%. Other income is primarily composed of billing, payment and policy fees associated with residential property and automobile policies issued in the P&C segment. Due to the termination of our automobile programs, billing, payment and policy fees declined and was the primary reason for the overall reduction in other income for the current year.

## Policyholder benefits:

Claims were \$24,923,000 for the nine months ended September 30, 2013 compared to \$27,385,000 for the same period last year; a decrease of \$2,462,000 or 9.0%. The primary reason for the current year decrease was a decline in claim activity from cat events and fire related losses the P&C segment in 2013 compared to 2012.

The table below provides P&C segment reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and loss adjustment expenses (LAE) for the nine months ended September 30, 2013 and 2012:

| Nine months ended September 30, 2013 |                          |                | Nine months ended September 30, 2012 |                          |                |
|--------------------------------------|--------------------------|----------------|--------------------------------------|--------------------------|----------------|
|                                      | Reported<br>Losses & LAE | Claim<br>Count |                                      | Reported<br>Losses & LAE | Claim<br>Count |
| Cat event                            |                          |                | Cat event                            |                          |                |
| Cat 14                               | \$222,000                | 64             | Cat 65                               | \$187,000                | 50             |
| Cat 15                               | 159,000                  | 49             | Cat 67                               | 486,000                  | 156            |
| Cat 17                               | 11,000                   | 5              | Cat 69                               | 3,000                    | 1              |
| Cat 22                               | 21,000                   | 6              | Cat 71                               | 10,000                   | 1              |
| Cat 91                               | 233,000                  | 46             | Cat 72                               | 10,000                   | 6              |
| Cat 92                               | 101,000                  | 25             | Cat 73                               | 5,000                    | 1              |
| Cat 93                               | 2,475,000                | 743            | Cat 83                               | 108,000                  | 38             |
| Cat 95                               | 35,000                   | 9              | Cat 87                               | 3,156,000                | 1,070          |
| Cat 99                               | 35,000                   | 9              | Cat 88                               | 68,000                   | 12             |
|                                      | \$3,292,000              | 956            |                                      | \$4,033,000              | 1,335          |
| Non-cat wind & hail                  | \$6,222,000              | 2,227          | Non-cat wind & hail                  | \$6,244,000              | 2,273          |

During the first nine months of 2013, the P&C segment was impacted by nine cat events totaling \$3,292,000. The P&C subsidiaries incurred 956 claims from these cat events. These claims contributed 9.7 percentage points to the P&C segment loss ratio. The average cost per claim related to the 2013 cat events was \$3,400. The largest 2013 cat event was Cat 93 having reported losses totaling \$2,475,000. Cat 93 increased the P&C segment loss ratio 7.3 percentage points and accounted for 75.2% of all 2013 reported cat losses. In comparison, the P&C subsidiaries were also impacted by nine cat events during the first nine months of the prior year totaling \$4,033,000 and incurred 1,335 claims. The average cost per claim was \$3,000 from the 2012 cat events. The largest cat event during 2012 was Hurricane Isaac (Cat 87) which struck the Louisiana coast on August 29, 2012 and contributed \$3,156,000 in reported losses and LAE. Hurricane Isaac claims accounted for 78.3% of all cat event claims reported through September 30, 2012.

Year to date 2013 non-catastrophe wind and hail claims in the P&C segment was virtually unchanged compared to the same period last year. For the nine months ended September 30, 2013, the P&C segment had reported non-cat wind and hail losses of \$6,222,000 compared to \$6,244,000 for the same period last year; a decrease of \$22,000 or 0.4%. The reported non-cat wind and hail losses added 18.3 percentage points to the 2013 P&C segment loss ratio while reported non-cat wind and hail losses added 18.5 percentage points to the 2012 P&C segment loss ratio. The

Table of Contents

non-cat wind and hail claims reported in 2013 had an average cost per claim of \$2,800 compared to \$2,700 for non-cat wind and hail claims reported during the same period last year. Claims from events that are not severe enough to be classified as catastrophes by Property Claims Service typically consist of isolated straight line wind and hail events and thus typically have a significantly lower cost per claim compared to tornado losses.

Fire losses incurred in the P&C segment were down \$653,000 through September 2013 compared to the same period last year. The P&C subsidiaries incurred fire losses totaling \$8,886,000 in 2013 compared to \$9,539,000 in 2012. The fire losses reported during 2013 resulted in 388 claims compared to fire losses reported during 2012 from 383 claims. These losses had an average cost per claim of \$23,000 and \$25,000 for 2013 and 2012, respectively.

Life segment claims were down 11.7% ending September 2013 at \$3,449,000 compared to \$3,907,000 for the same period last year. Declines in claims incurred in both the ordinary and industrial lines of business were the primary reasons for the \$458,000 decrease in year to date claims in the life segment for 2013 compared to 2012.

Policy acquisition cost (commissions and amortization of deferred acquisition cost):

For the nine months ended September 30, 2013, policy acquisition costs were \$8,027,000 compared to \$8,710,000 for the same period last year; a decrease of \$683,000. A change in terms of one of our general agent contingent commission contracts in the P&C segment coupled with a 13% decrease in year to date first year commissions in the life segment were the primary reasons for the decrease in policy acquisition costs for 2013 compared to the same period last year.

General Expenses:

General expenses were down \$78,000 through September 30, 2013 at \$6,199,000 compared to \$6,277,000 through September 30, 2012. General expenses were 15.8% of earned premium revenue in 2013 compared to 16.1% of earned premium revenue in 2012. The reduction in general expenses was primarily associated with a reduction in costs associated with the discontinued auto programs, reduction of litigation expense and continued company wide cost reduction measures.

Litigation Settlement:

Litigation settlement expenses were \$0 for the nine months ended September 30, 2013 compared to \$13,335,000 for the same period last year. On June 18, 2012, the Company settled longstanding litigation related to the Company's sale of Mobile Attic, Inc. The final settlement and legal costs incurred resulted in expenses of \$13,335,000 in the first nine months of 2012. Additional information and discussion related to the settlement can be found in the 2012 Annual Report on Form 10-K.

Taxes, licenses and fees:

Taxes, licenses and fees were up \$16,000 for the nine months ended September 30, 2013 at \$1,398,000 compared to \$1,382,000 for the same period last year. Taxes, licenses and fees as a percentage of earned premiums were 3.6% through September 2013 compared to 3.5% through September 2012.

Interest expense:

Interest expense was \$1,311,000 for the nine months ended September 30, 2013 compared to \$891,000 for the same period last year. The primary reason for the increase was interest associated with debt associated with the Mobile Attic litigation settlement.

Income taxes:

For the period ended September 30, 2013, income tax benefit totaled \$1,102,000 compared to income tax benefit of \$4,882,000 for the same period last year. Income tax expense was composed of current taxes totaling \$552,000 for the nine months ended September 30, 2013 compared to \$583,000 for the nine months ended September 30, 2012.

Deferred tax expense totaled \$550,000 for 2013 compared to a deferred tax benefit of \$5,465,000 for 2012. The primary changes impacting current year income taxes were an increase in deferred tax assets from deferred premium and the small life deduction in the life segment coupled with the reduction in litigation settlement expense in 2013 compared to 2012.

Net (loss) income:

For the nine months ended September 30, 2013, the Company had net income of \$3,895,000 compared to a net loss of \$7,402,000 for the same period last year. On a pretax basis, the Company had year to date income of \$4,997,000 compared to a loss \$12,284,000 for the same period last year. The primary components of the current year income

Table of Contents

were \$643,000 in income from operations coupled with an increase in year to date capital gains compared to the same period in 2012. Year to date capital gains were \$4,354,000 with the \$3.3 million gain from the timber property sale mentioned previously being the primary contributor. The timber property was carried at historical cost of \$1.3 million and net proceeds from the sale were \$4.6 million leading to the pretax gain of \$3.3 million. The primary reason for the net loss for 2012 were claims incurred from Hurricane Isaac totaling \$3,156,000.

## 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. 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 September 30, 2013, 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-<br>for-Sale | Held-to-Maturity | Total    | Percentage of<br>Total |   |
|------------------------------|------------------------|------------------|----------|------------------------|---|
| Maturity in less than 1 year | \$1,155                | \$—              | \$1,155  | 1.50                   | % |
| Maturity in 1-5 years        | 15,140                 | 271              | 15,411   | 19.98                  | % |
| Maturity in 5-10 years       | 26,309                 | 195              | 26,504   | 34.35                  | % |
| Maturity after 10 years      | 33,661                 | 412              | 34,073   | 44.17                  | % |
|                              | \$76,265               | \$878            | \$77,143 | 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 \$3,800,000 declines in the market value of fixed income investment.

Alternatively, a 100 basis point decrease in interest rates will generate approximately \$3,800,000 in increases in market value of fixed income investments.

At September 30, 2013, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$32,298,000, up \$2,071,000 compared to \$30,227,000 at December 31, 2012. Components of the change in equity were a net income of \$3,895,000, reduction in accumulated unrealized gains on investments of \$2,185,000, a net unrealized gain of \$324,000 related to interest rate swaps, common stock issued of \$27,000, additional paid in capital of \$196,000 and cash dividends paid totaling \$186,000.



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

Table of Contents

being enacted and regular contractual maturities, we expect approximately 7% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.

The Company, primarily through its insurance subsidiaries, had \$5,596,000 in cash and cash equivalents at September 30, 2013, compared to \$4,899,000 at September 30, 2012. Net income of \$3,895,000 for the nine months ended September 30, 2013 contributed to the \$452,000 in cash provided by operations compared to cash used the same period last year totaling \$13,819,000. The Company sold 2,739 acres of investment real estate with a carrying value of approximately \$1.3 million on September 3, 2013. A realized pretax gain of \$3,308,000 on the sale was a primary contributor to net income for the period. Negative cash flows from operations in the prior year were related to the settlement of Mobile Attic litigation and losses from Hurricane Isaac.

Net cash provided by investing activities totaled \$2,288,000 for the nine months ended September 30, 2013, compared to \$3,863,000 for the same period last year. At December 31, 2012, the Company had \$6,779,000 in cash which was subsequently reduced by the purchase of available-for-sale securities, primarily fixed income investments. These purchases were partially offset by \$4,847,000 in proceeds from the sale of investment real estate.

Net cash used in financing activities totaled \$3,923,000 for the nine months ended September 30, 2013 compared to net cash provided of \$11,462,000 for the same period last year. As previously discussed, the Company sold investment real estate during the quarter. This property collateralized a \$4,000,000 operating line of credit. Proceeds from the sale were used to pay off the \$4,000,000 credit line as well as an additional \$200,000 drawn on a short-term operating line of credit. In July 2012, the Company executed an installment note in the amount of \$13,000,000 to finance the settlement obligation related to the Mobile Attic litigation. As of September 30, 2013, a total of \$10,500,000 was outstanding including a current installment due in November of 2013 of \$1,167,000 included in short-term notes payable and current portion of long-term debt. Also included in long-term debt held by the Company is the issuance of \$9,279,000 in subordinated debentures completed on December 15, 2005. The subordinated debentures mature December 15, 2035. In addition, a second issuance of \$3,093,000 in subordinated debentures completed June 21, 2007. The second issue matures June 15, 2037 and may be redeemed following the fifth anniversary of issuance. The Company had a total of \$21,705,000 of long-term debt outstanding as of September 30, 2013, down \$3,634,000 from \$25,339,000 at December 31, 2012. As of September 30, 2013, the Company had \$1,200,000 in available lines of credit to allow flexibility with respect to cash management at the holding company level. The Company maintains a \$700,000 operating line of credit with a local bank that is up for renewal in February 2014. The Company also has a \$500,000 line of credit with another local bank that matures in September 2017. The company had no outstanding short-term notes payable as of September 30, 2013.

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 lower 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, 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 and, while capital levels remain adequate to operate our existing business, the lack of growth in P&C capital has hampered the subsidiary's ability to pay dividends upstream to the holding company in the near term despite capacity within regulatory limits. While operating results in the P&C segment improved in the third quarter of 2013, future poor operating results could adversely impact the holding company's ability to meet debt service requirements as subsidiary dividend capacity remains under pressure. Management continues to monitor subsidiary capital levels with respect to paying dividends to the holding company. Managing liquidity of the holding company is a continued 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 10, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company during 2013 is limited to \$1,034,000 in the life insurance

Table of Contents

subsidiary and \$2,468,000 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 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 recent adverse impacts on regulatory surplus, will likely lead to dividend payments to NSG substantially below the above referenced regulatory maximums.

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.

Due to the erosion in capital levels in the P&C subsidiaries over the past two years, we have made changes in order to reduce capital/surplus strain in the P&C subsidiaries and help protect capital levels from substantial further erosion resulting from a major catastrophic event. These changes include a combination of reduction in underwriting leverage and an increase in catastrophe reinsurance protection. A summary of each change follows:

In late 2011, we discontinued both our private passenger and commercial automobile programs. These two programs accounted for approximately 6% of net written premium in 2011, down from nearly 10% in 2010 but had produced significant underwriting losses over the last five years. Due to a combination of reduced capital levels and a view that it would take some time to achieve underwriting profitability, we made the decision to discontinue the program in order to reduce surplus strain and underwriting leverage in the P&C subsidiaries. The final in-force policies in this program expired in mid-2012.

We have incurred substantial losses from catastrophe events over the past seven years. These events have driven up catastrophe reinsurance cost and forced our catastrophe reinsurance deductible up from \$2 million in 2005 to \$4 million in our 2013 renewal. As our cat retention has increased, we have attempted to achieve higher margins in our insurance rate structure in order to compensate for the additional risk of the higher catastrophe reinsurance retention but with limited success due to regulatory constraints primarily because this additional retention was not a "hard dollar" cost in our rate structure. So, since we were limited in our ability to increase margins for this additional retained risk and due to the capital erosion incurred in 2011, in the second quarter of 2012, we placed additional reinsurance cover in the form of reinsurance premium protection (RPP). The RPP cover will serve to reduce our risk from a major catastrophe and strengthen our capital position. The effect of adding this additional RPP cover is to reduce our modeled 100 year event net cost (net of reinsurance recoveries) from approximately \$9 million (pretax) to an estimated \$4.5 million (pretax). A 100 year event is defined as an event that has approximately a 1% probability of occurring in a given year. This additional cover added \$1,050,000 to our cat reinsurance cost in the first nine months of 2013.

The Company reached settlement in litigation related to its divestiture of Mobile Attic, Inc. in June 2012. Under the terms of the settlement agreement, the Company will pay a total of \$13 million to the plaintiff. In order to manage the liquidity constraints, the settlement is in the form of an interest-bearing note with amounts to be paid over nine years with the ability to defer payments in years in which the Company's P&C subsidiaries incur cumulative catastrophe losses exceeding \$3.5 million, thus allowing capital management flexibility in the P&C subsidiaries. To date in 2013, the Company has incurred just over \$3.3 million in catastrophe losses. Under the terms of the agreement, the annual

debt service on the note cannot be less than the dividends paid to our shareholders in the last twelve months. The Company made an initial payment of \$2,500,000 in September 2012. The remaining principal will be repaid in nine annual installments of \$1,167,000. Accrued and unpaid interest shall be payable with each installment of principal based on the prime rate published in the Wall Street Journal plus 1%.

Cash to fund the litigation settlement will come from two primary sources. First, the holding Company has significant deferred tax assets associated with a net operating loss (NOL) carryforward generated by a combination of this settlement and defense costs incurred over the prior two years. This NOL carryforward will generate tax benefits that will offset a portion of future tax liabilities of the P&C insurance subsidiaries in our consolidated tax returns. It is expected that this NOL carryforward will generate approximately \$5 million in tax benefits over the term of the settlement.

Table of Contents

Second, dividends and management fees paid by the insurance subsidiaries will provide an additional source of proceeds to pay this obligation. Although not a preferred source of flexibility, the Company can also defer interest payments on the trust preferred securities to provide additional operating cash flow. In the event that the Company elects to defer interest payments, shareholder dividends will be suspended until interest payments are current.

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.

We have taken and continue to take corrective action to improve our profitability and capital position. However, due to the adverse effects of six major hurricanes in the last eight years, the financial market meltdown in 2008, continued historically low interest rates, an unprecedented tornado outbreak in April of 2011 and the recently settled litigation, we have experienced significant reduction in equity capital. While we are beginning to see improvement and have put some major obstacles behind us, we are in a position where we have to preserve capital in the near term in order to put our Company in the best position to be successful moving forward. In order to improve our capital position, we will continue to monitor our dividend policy on a quarterly basis and could take action including the suspension of dividends should operating conditions warrant such action. Due to various factors discussed herein, we must remain flexible in our dividend policy until we achieve more consistent profitability and capital growth.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

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

The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk, and default risk. The Company incurred a reduction in the market value of fixed income investments during the second quarter of 2013 due to a rise in interest rates. While interest rates stabilized during the third quarter of 2013, the upward shift in interest rates during the second quarter did lead to a reduction in market value of our fixed income investments. During the second quarter of 2013, the 10-year treasury interest rate increased 66 basis points from 1.86% to 2.52%, a 35.5% increase. During this same period, the 5-year treasury interest rate increased 65 basis points from .76% to 1.41%, an 85.5% increase. The impact of these substantial and sudden increases in interest rates during the second quarter is reflected in the decline in the Company's accumulated gross unrealized gains on available-for-sale fixed maturity investments which were \$1,337,000 at September 30, 2013 compared to \$4,616,000 at December 31, 2012. In order to successfully implement the Company's investment strategies, including strategies necessary to pass regulatory scrutiny, and to reasonably match liability durations of the insurance subsidiaries, interest rate risk cannot be eliminated. The Company uses various methods of analysis to monitor the impact of significant changes in interest rates including shock analysis. The following table shows the projected percent and portfolio market price change in value of the fixed income portfolio (holdings as of September 30, 2013) of a 100 and 200 basis point parallel shift in market interest rates.

#### Fixed Income Portfolio Market Risk Shock Analysis at September 30, 2013

|                |          |          |           |        |         |
|----------------|----------|----------|-----------|--------|---------|
| Data Category  | Down 200 | Down 100 | Base Case | Up 100 | Up 200  |
| Percent Change | 9.35     | 5.02     | —         | (5.00) | (10.21) |

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|              |        |        |        |       |       |
|--------------|--------|--------|--------|-------|-------|
| Market Price | 112.61 | 108.15 | 102.99 | 97.84 | 92.47 |
|--------------|--------|--------|--------|-------|-------|

The primary risk related to the Company's equity portfolio is equity price risk. The Company has not incurred material losses in its investment portfolio in the nine months ended September 30, 2013 related to changes in value of equity investments. Changes are discussed in detail under Item 2 of this Form 10-Q.

For further information regarding market risk, reference is made to the Company's Form 10-K for the year ended December 31, 2012.

Table of Contents

Item 4. Controls and Procedures

Our management carried out an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as of September 30, 2013. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There has not been any change in our internal control over financial reporting in connection with the evaluation required by Rule 13A-15(d) under the Exchange Act that occurred during the nine-month period ended September 30, 2013, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

Item 1. Legal Proceedings

Please refer to Note 14 to the condensed consolidated financial statements included herein, and the 2012 Annual Report filed on Form 10-K.

Item 1A. Risk Factors

There has been no material change in risk factors previously disclosed under Item 1A. of the Company's Annual Report for 2012 on Form 10-K.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

None

Item 5. Other Information

None



Table of Contents

## Item 6. Exhibits

## a. Exhibits

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

## b. Reports on Form 8-K during the quarter ended September 30, 2013

| Date of Report    | Date Filed        | Description   |
|-------------------|-------------------|---|
| July 19, 2013     | July 23, 2013     | Press release, dated July 23, 2013, issued by The National Security Group, Inc.   |
| August 14, 2013   | August 14, 2013   | Press release, dated August 14, 2013, issued by The National Security Group, Inc. |
| September 4, 2013 | September 5, 2013 | Item 7.01- announcement of sale of investment real estate.                        |

Table of Contents

SIGNATURE

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

The National Security Group, Inc.  
/s/ Brian R. McLeod  
Brian R. McLeod  
Chief Financial Officer and Treasurer

/s/ William L. Brunson, Jr.  
William L. Brunson, Jr.  
President, Chief Executive Officer and Director

Date: November 14, 2013