

NATIONAL SECURITY GROUP INC

Form 10-Q

May 14, 2015

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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 March 31, 2015

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

(State or Other Jurisdiction of  
Incorporation or Organization)

63-1020300

(IRS Employer  
Identification No.)

661 East Davis Street

Elba, Alabama

(Address of principal executive offices)

36323

(Zip-Code)

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 May 14, 2015, there were 2,507,452 shares, \$1.00 par value, of the registrant's common stock outstanding.

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THE NATIONAL SECURITY GROUP, INC.

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SIGNATURE

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Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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

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

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

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

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

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

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

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

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## PART I. Financial Information

## Item 1. Financial Statements

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

|   | March 31, 2015<br>(UNAUDITED) | December 31,<br>2014 |
|---|-------------------------------|----------------------|
| <b>ASSETS</b>   |                               |                      |
| Investments   |                               |                      |
| Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2015 - \$2,905; 2014 - \$3,182) | \$2,767                       | \$3,108              |
| Fixed maturities available-for-sale, at estimated fair value (cost: 2015 - \$86,454; 2014 - \$84,024)       | 89,901                        | 86,886               |
| Equity securities available-for-sale, at estimated fair value (cost: 2015 - \$2,420; 2014 - \$2,420)        | 4,964                         | 4,995                |
| Trading securities  | 19                            | 19                   |
| Mortgage loans on real estate, at cost  | 208                           | 210                  |
| Investment real estate, at book value   | 3,735                         | 3,735                |
| Policy loans  | 1,556                         | 1,530                |
| Company owned life insurance  | 5,161                         | 5,513                |
| Other invested assets   | 3,484                         | 3,553                |
| Total Investments   | 111,795                       | 109,549              |
| Cash  | 7,108                         | 6,426                |
| Accrued investment income   | 842                           | 797                  |
| Policy receivables and agents' balances, net  | 11,285                        | 10,948               |
| Reinsurance recoverable   | 1,510                         | 939                  |
| Deferred policy acquisition costs   | 8,586                         | 8,592                |
| Property and equipment, net   | 2,035                         | 2,013                |
| Deferred income tax asset, net  | 3,055                         | 3,189                |
| Other assets  | 800                           | 2,412                |
| Total Assets  | \$147,016                     | \$144,865            |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                               |                      |
| Property and casualty benefit and loss reserves   | \$8,876                       | \$8,321              |
| Accident and health benefit and loss reserves   | 2,991                         | 3,017                |
| Life and annuity benefit and loss reserves  | 31,482                        | 31,418               |
| Unearned premiums   | 29,564                        | 28,853               |
| Policy and contract claims  | 1,113                         | 996                  |
| Other policyholder funds  | 1,525                         | 1,510                |
| Short-term notes payable and current portion of long-term debt  | 1,557                         | 857                  |
| Long-term debt  | 17,515                        | 18,715               |
| Accrued income taxes  | 492                           | 487                  |
| Other liabilities   | 7,688                         | 7,934                |
| Total Liabilities   | 102,803                       | 102,108              |
| Contingencies   |                               |                      |
| Shareholders' equity  |                               |                      |
| Common stock  | 2,508                         | 2,508                |

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|  |            |            |
|--|------------|------------|
| Additional paid-in capital                 | 5,267      | 5,267      |
| Accumulated other comprehensive income     | 3,020      | 2,772      |
| Retained earnings                          | 33,418     | 32,210     |
| Total Shareholders' Equity                 | 44,213     | 42,757     |
| Total Liabilities and Shareholders' Equity | \$ 147,016 | \$ 144,865 |

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

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## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(In thousands, except per share amounts)

|   | Three Months Ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2015                            | 2014     |
| REVENUES  |                                 |          |
| Net premiums earned                               | \$14,706                        | \$13,824 |
| Net investment income                             | 974                             | 948      |
| Net realized investment gains                     | 142                             | 88       |
| Other income                                      | 158                             | 154      |
| Total Revenues                                    | 15,980                          | 15,014   |
| BENEFITS, LOSSES AND EXPENSES                     |                                 |          |
| Policyholder benefits and settlement expenses     | 8,262                           | 7,864    |
| Amortization of deferred policy acquisition costs | 899                             | 898      |
| Commissions                                       | 2,055                           | 2,027    |
| General and administrative expenses               | 2,006                           | 2,026    |
| Taxes, licenses and fees                          | 655                             | 530      |
| Interest expense                                  | 317                             | 386      |
| Total Benefits, Losses and Expenses               | 14,194                          | 13,731   |
| Income Before Income Taxes                        | 1,786                           | 1,283    |
| INCOME TAX EXPENSE                                |                                 |          |
| Current   | 471                             | 88       |
| Deferred  | 7                               | 196      |
|   | 478                             | 284      |
| Net Income  | \$1,308                         | \$999    |
| INCOME PER COMMON SHARE BASIC AND DILUTED         | \$0.52                          | \$0.40   |
| DIVIDENDS DECLARED PER SHARE                      | \$0.04                          | \$0.03   |

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



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THE NATIONAL SECURITY GROUP, INC.

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

|   | Three Months Ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2015                            | 2014     |
| Net income  | \$ 1,308                        | \$ 999   |
| Other comprehensive income (loss), net of tax   |                                 |          |
| Changes in:   |                                 |          |
| Unrealized gains on securities, net of reclassification adjustment of \$94 and \$59 for 2015 and 2014, respectively | 365                             | 1,073    |
| Unrealized loss on interest rate swap   | (117)                           | (76)     |
| Other comprehensive income, net of tax  | 248                             | 997      |
| Comprehensive income  | \$ 1,556                        | \$ 1,996 |

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

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THE NATIONAL SECURITY GROUP, INC.

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

|  | Total    | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Common<br>Stock | Additional<br>Paid-in<br>Capital |
|--|----------|----------------------|---|-----------------|----------------------------------|
| Balance at December 31, 2014 (AUDITED)               | \$42,757 | \$32,210             | \$2,772   | \$2,508         | \$5,267                          |
| Net income for the three months ended March 31, 2015 | 1,308    | 1,308                |   |                 |                                  |
| Other comprehensive income (net of tax)              | 248      |                      | 248   |                 |                                  |
| Cash dividends                                       | (100 )   | (100 )               |   |                 |                                  |
| Balance at March 31, 2015                            | \$44,213 | \$33,418             | \$3,020   | \$2,508         | \$5,267                          |

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

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## THE NATIONAL SECURITY GROUP, INC.

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

|   | Three months ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2015                            | 2014     |
| Cash Flows from Operating Activities  |                                 |          |
| Net income  | \$ 1,308                        | \$ 999   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |          |
| Depreciation expense and amortization/accretion, net                              | 79                              | 134      |
| Increase in cash surrender value of company owned life insurance                  | (44)                            | (30)     |
| Net realized gains on investments   | (142)                           | (88)     |
| Deferred income taxes   | 7                               | 196      |
| Amortization of deferred policy acquisition costs                                 | 899                             | 898      |
| Changes in assets and liabilities:  |                                 |          |
| Change in accrued investment income   | (45)                            | (19)     |
| Change in reinsurance recoverable   | (571)                           | 223      |
| Policy acquisition costs deferred   | (893)                           | (856)    |
| Change in accrued income taxes  | 5                               | 38       |
| Change in net policy liabilities and claims                                       | 1,075                           | 1,066    |
| Change in other assets/liabilities, net   | 1,247                           | (71)     |
| Other, net  | 8                               | 8        |
| Net cash provided by operating activities   | 2,933                           | 2,498    |
| Cash Flows from Investing Activities  |                                 |          |
| Purchase of:  |                                 |          |
| Available-for-sale securities   | (7,582)                         | (2,707)  |
| Property and equipment  | (69)                            | (4)      |
| Proceeds from sale or maturities of:  |                                 |          |
| Held-to-maturity securities   | 346                             | 39       |
| Available-for-sale securities   | 5,256                           | 2,370    |
| Property and equipment  | —                               | 3        |
| Other invested assets, net  | 383                             | 34       |
| Net cash used in investing activities   | (1,666)                         | (265)    |
| Cash Flows from Financing Activities  |                                 |          |
| Change in other policyholder funds  | 15                              | 19       |
| Proceeds from long-term debt  | —                               | 275      |
| Repayments of long-term debt  | (500)                           | —        |
| Change in short-term notes payable  | —                               | (700)    |
| Dividends paid  | (100)                           | (75)     |
| Net cash used in financing activities   | (585)                           | (481)    |
| Net change in cash and cash equivalents   | 682                             | 1,752    |
| Cash and cash equivalents, beginning of year                                      | 6,426                           | 4,987    |
| Cash and cash equivalents, end of year  | \$ 7,108                        | \$ 6,739 |

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

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THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED EXCEPT FOR DECEMBER 31, 2014 AMOUNTS)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary, Omega One Insurance Company (Omega). The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). In the opinion of management, all adjustments, consisting of normal and recurring items, necessary for the fair presentation of the condensed consolidated financial statements have been included. All significant intercompany transactions and accounts have been eliminated. The financial information presented herein should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2014, which includes information and disclosures not presented herein.

Use of Estimates

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

Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,507,452 in 2015 and 2,494,480 in 2014.

Reclassifications

Certain 2014 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2015 presentation.

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts subject to FDIC insured limits of \$250,000 per entity. At March 31, 2015, the net amount exceeding FDIC insured limits was \$3,924,000 at one financial institution. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of financial institutions on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

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

losses, are composed of balances due from independent agents. At March 31, 2015, the single largest balance due from one agent totaled \$937,000.

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 March 31, 2015 and December 31, 2014, 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 March 31, 2015, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

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THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED EXCEPT FOR DECEMBER 31, 2014 AMOUNTS)

Accounting Changes Not Yet Adopted

Revenue from Contracts with Customers

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

Presentation of Financial Statements - Going Concern

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

Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

In January 2015, the FASB issued guidance that eliminates from GAAP the concept of extraordinary items. The guidance is effective for fiscal periods ending after December 15, 2015 and interim periods thereafter. Early adoption is permitted. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Amendments to the Consolidation Analysis

In February 2015, the FASB issued additional guidance regarding the consolidation of certain legal entities. The guidance modifies the evaluation of whether or not limited partnerships and similar legal entities are variable interest entities (VIEs) and the consolidation analysis of entities involved with VIEs, particularly those that have fee arrangements and related party relationships. This guidance is effective for fiscal years beginning after December 15, 2015. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Recently Adopted Accounting Standards

Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures

In June 2014, the FASB issued guidance requiring secured borrowing accounting treatment for repurchase-to-maturity transactions and provides guidance on accounting for repurchase financing arrangements. This ASU is effective for interim and annual reporting periods beginning after December 15, 2014. The Company adopted this standard on

January 1, 2015. The Company is the counter party to repurchase agreements and as such, the adoption did not have a material impact on its financial position or results of operations.

**Reporting Discontinued Operations and Disclosure of Disposals of components of an Entity**

In April 2014, the FASB issued guidance which modifies the definition of discontinued operations by limiting discontinued operations reporting to disposals of components of an entity that represent strategic shifts that have (or will have) a major effect on an entity's operations and financial results. Also, this update requires additional financial statement disclosures about discontinued operations, as well as disposals of an individually significant component of an entity that do not qualify for discontinued operations presentation. This ASC update is effective for all disposals (or classifications as held for sale) of components of an entity that occur within annual and interim periods beginning on or after December 15, 2014 and for all businesses that, on acquisition, are classified as held for sale that also occur within interim and annual periods beginning on or after December 15, 2014. The Company adopted this standard on

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THE NATIONAL SECURITY GROUP, INC.  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (UNAUDITED EXCEPT FOR DECEMBER 31, 2014 AMOUNTS)

January 1, 2015. The Company has no discontinued operations, and the adoption of this standard did not have a material impact on its financial position or results of operations.

## NOTE 2 – VARIABLE INTEREST ENTITIES

The Company holds a passive interest in a limited partnership that is considered to be a Variable Interest Entity (VIE) under the provisions of ASC 810 Consolidation. The Company is not the primary beneficiary of the entity and is not required to consolidate under ASC 810. The entity is a private placement investment fund formed for the purpose of investing in private equity investments. The Company owns less than 1% of the limited partnership. The carrying value of the investment totals \$294,000 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 8, are reported in the accompanying condensed consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$279,000 and are included in Other Assets in the accompanying 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.

## NOTE 3 – INVESTMENTS

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

|                                |                   |                     |                     |               |
|--------------------------------|-------------------|---------------------|---------------------|---------------|
| Available-for-sale securities: | Amortized<br>Cost | Gross<br>Unrealized | Gross<br>Unrealized | Fair<br>Value |
|--------------------------------|-------------------|---------------------|---------------------|---------------|



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|   |          | Gains   | Losses |          |
|---|----------|---------|--------|----------|
| Corporate debt securities   | \$36,570 | \$1,904 | \$311  | \$38,163 |
| Mortgage backed securities  | 11,998   | 297     | 132    | 12,163   |
| Private label mortgage backed securities  | 5,111    | 42      | 73     | 5,080    |
| Obligations of states and political subdivisions                                      | 14,885   | 1,043   | 4      | 15,924   |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 17,890   | 727     | 46     | 18,571   |
| Total fixed maturities  | 86,454   | 4,013   | 566    | 89,901   |
| Equity securities   | 2,420    | 2,690   | 146    | 4,964    |
| Total   | \$88,874 | \$6,703 | \$712  | \$94,865 |

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THE NATIONAL SECURITY GROUP, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED EXCEPT FOR DECEMBER 31, 2014 AMOUNTS)

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

| Held-to-maturity securities:   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Mortgage backed securities   | \$2,708           | \$134                        | \$—                           | \$2,842       |
| U.S. Treasury securities and obligations of U.S.<br>Government corporations and agencies | 59                | 4                            | —                             | 63            |
| Total  | \$2,767           | \$138                        | \$—                           | \$2,905       |

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2014 are as follows (dollars in thousands):

| Available-for-sale securities:   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Corporate debt securities  | \$37,299          | \$1,773                      | \$405                         | \$38,667      |
| Mortgage backed securities   | 12,691            | 214                          | 153                           | 12,752        |
| Private label mortgage backed securities   | 1,261             | 38                           | 3                             | 1,296         |
| Obligations of states and political subdivisions   | 14,919            | 993                          | 13                            | 15,899        |
| U.S. Treasury securities and obligations of U.S.<br>Government corporations and agencies | 17,854            | 525                          | 107                           | 18,272        |
| Total fixed maturities   | 84,024            | 3,543                        | 681                           | 86,886        |
| Equity securities  | 2,420             | 2,745                        | 170                           | 4,995         |
| Total  | \$86,444          | \$6,288                      | \$851                         | \$91,881      |

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2014 are as follows (dollars in thousands):

| Held-to-maturity securities:   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Mortgage backed securities   | \$2,818           | \$69                         | \$—                           | \$2,887       |
| U.S. Treasury securities and obligations of U.S.<br>Government corporations and agencies | 290               | 5                            | —                             | 295           |
| Total  | \$3,108           | \$74                         | \$—                           | \$3,182       |

The amortized cost and aggregate fair value of debt securities at March 31, 2015, by contractual maturity, are presented in the following table (dollars in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in Thousands)                | Amortized<br>Cost | Fair<br>Value |
|---------------------------------------|-------------------|---------------|
| Available-for-sale securities:        |                   |               |
| Due in one year or less               | \$1,209           | \$1,220       |
| Due after one year through five years | 17,042            | 18,112        |

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|  |          |          |
|--|----------|----------|
| Due after five years through ten years | 29,435   | 30,121   |
| Due after ten years                    | 38,768   | 40,448   |
| Total                                  | \$86,454 | \$89,901 |

Held-to-maturity securities:

|  |         |         |
|--|---------|---------|
| Due in one year or less                | \$—     | \$—     |
| Due after one year through five years  | 134     | 141     |
| Due after five years through ten years | 129     | 141     |
| Due after ten years                    | 2,504   | 2,623   |
| Total                                  | \$2,767 | \$2,905 |

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A summary of securities available-for-sale with unrealized losses as of March 31, 2015, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows (dollars in thousands):

|   | Less than 12 months |                         | 12 months or longer |                         | Total      |                         |                                     |
|---|---------------------|-------------------------|---------------------|-------------------------|------------|-------------------------|-------------------------------------|
| March 31, 2015  | Fair Value          | Gross Unrealized Losses | Fair Value          | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Total Securities in a Loss Position |
| Fixed maturities  |                     |                         |                     |                         |            |                         |                                     |
| Corporate debt securities   | \$4,612             | \$304                   | \$865               | \$7                     | \$5,477    | \$311                   | 11                                  |
| Mortgage backed securities  | 153                 | 2                       | 1,225               | 130                     | 1,378      | 132                     | 6                                   |
| Private label mortgage backed securities  | 3,924               | 70                      | 91                  | 3                       | 4,015      | 73                      | 7                                   |
| Obligations of state and political subdivisions                                       | —                   | —                       | 338                 | 4                       | 338        | 4                       | 1                                   |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | —                   | —                       | 2,492               | 46                      | 2,492      | 46                      | 4                                   |
| Equity securities   | —                   | —                       | 1,140               | 146                     | 1,140      | 146                     | 1                                   |
|   | \$8,689             | \$376                   | \$6,151             | \$336                   | \$14,840   | \$712                   | 30                                  |

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

A summary of securities available-for-sale with unrealized losses as of December 31, 2014, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows (dollars in thousands):

|   | Less than 12 months |                         | 12 months or longer |                         | Total      |                         |                                     |
|---|---------------------|-------------------------|---------------------|-------------------------|------------|-------------------------|-------------------------------------|
| December 31, 2014   | Fair Value          | Gross Unrealized Losses | Fair Value          | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Total Securities in a Loss Position |
| Fixed maturities  |                     |                         |                     |                         |            |                         |                                     |
| Corporate debt securities   | \$6,306             | \$364                   | \$1,843             | \$41                    | \$8,149    | \$405                   | 18                                  |
| Mortgage backed securities  | 1,386               | 4                       | 1,855               | 149                     | 3,241      | 153                     | 12                                  |
| Private label mortgage backed securities  | —                   | —                       | 97                  | 3                       | 97         | 3                       | 1                                   |
| Obligations of state and political subdivisions                                       | —                   | —                       | 651                 | 13                      | 651        | 13                      | 2                                   |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 1,475               | 6                       | 3,499               | 101                     | 4,974      | 107                     | 10                                  |

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|                   |         |       |         |       |          |       |    |
|-------------------|---------|-------|---------|-------|----------|-------|----|
| Equity securities | —       | —     | 1,116   | 170   | 1,116    | 170   | 1  |
|                   | \$9,167 | \$374 | \$9,061 | \$477 | \$18,228 | \$851 | 44 |

There were no securities held-to-maturity with unrealized losses as of December 31, 2014.

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

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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 3.69% 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 three months ended March 31, 2015 and year ended December 31, 2014, the Company realized no other-than-temporary impairments.

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

|  | Three months ended March 31, |       |
|--|------------------------------|-------|
|  | 2015                         | 2014  |
| Fixed maturities                                       | \$894                        | \$859 |
| Equity securities                                      | 30                           | 29    |
| Mortgage loans on real estate                          | 4                            | 4     |
| Investment real estate                                 | 2                            | 2     |
| Policy loans   | 29                           | 27    |
| Company owned life insurance change in surrender value | 44                           | 30    |
| Other  | 42                           | 54    |
|  | 1,045                        | 1,005 |
| Less: Investment expenses                              | 71                           | 57    |
| Net investment income                                  | \$974                        | \$948 |

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

|                                | Three months ended March 31, |       |
|--------------------------------|------------------------------|-------|
|                                | 2015                         | 2014  |
| Fixed maturities               | \$ 142                       | \$ 90 |
| Other, principally real estate | —                            | (2 )  |
| Net realized investment gains  | \$ 142                       | \$ 88 |



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

|  | March 31, 2015 | December 31, 2014 |
|--|----------------|-------------------|
| Net change in unrealized appreciation on available-for-sale securities before deferred tax | \$553          | \$3,123           |
| Deferred income tax  | (188           | ) (1,062          |
| Net change in unrealized appreciation on available-for-sale securities                     | \$365          | \$2,061           |

#### 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 condensed 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.

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

Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2015 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

| Description   | Fair Value Measurements at Reporting Date Using |          |          |           |
|---|---|----------|----------|-----------|
|   | Total   | Level 1  | Level 2  | Level 3   |
| Financial Assets  |   |          |          |           |
| Fixed maturities available-for-sale   |   |          |          |           |
| Corporate debt securities   | \$38,163  | \$—      | \$38,163 | \$—       |
| Mortgage backed securities  | 12,163  | —        | 12,163   | —         |
| Private label mortgage backed securities  | 5,080   | —        | 5,080    | —         |
| Obligations of states and political subdivisions                                      | 15,924  | —        | 15,924   | —         |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 18,571  | 18,571   | —        | —         |
| Trading securities  | 19  | 19       | —        | —         |
| Equity securities available-for-sale  | 4,964   | 3,823    | —        | 1,141     |
| Total Financial Assets  | \$94,884  | \$22,413 | \$71,330 | \$1,141   |
| Financial Liabilities   |   |          |          |           |
| Interest rate swap  | \$(1,415)                                       | ) \$—    | \$—      | \$(1,415) |
| Total Financial Liabilities   | \$(1,415)                                       | ) \$—    | \$—      | \$(1,415) |

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 March 31, 2015, Level 3 fair value measurements of assets include \$1,141,000 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.

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As of March 31, 2015, Level 3 fair value measurements of liabilities include \$1,415,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party broker who utilizes financial modeling tools and assumptions on interest and other factors. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 7.

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2015 (in thousands):

| For the three months ended March 31, 2015  | Equity Securities<br>Available-for-Sale | Interest Rate Swap |
|--|---|--------------------|
| Beginning balance  | \$1,116                                 | \$(1,238 )         |
| Total gains or losses (realized and unrealized):   |   |                    |
| Included in earnings   | —                                       | —                  |
| Included in other comprehensive income   | 25                                      | (177 )             |
| Purchases:   | —                                       | —                  |
| Sales:   | —                                       | —                  |
| Issuances:   | —                                       | —                  |
| Settlements:   | —                                       | —                  |
| Transfers in/(out) of Level 3  | —                                       | —                  |
| Ending balance   | \$1,141                                 | \$(1,415 )         |
| 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 March 31, 2015: | \$—                                     | \$—                |

For the three months ended March 31, 2015, 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, 2014 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

| Description   | Fair Value Measurements at Reporting Date Using |          |          |            |
|---|---|----------|----------|------------|
|   | Total   | Level 1  | Level 2  | Level 3    |
| Financial Assets  |   |          |          |            |
| Fixed maturities available-for-sale   |   |          |          |            |
| Corporate debt securities   | \$38,667  | \$—      | \$38,667 | \$—        |
| Mortgage backed securities  | 12,752  | —        | 12,752   | —          |
| Private label mortgage backed securities  | 1,296   | —        | 1,296    | —          |
| Obligations of states and political subdivisions                                      | 15,899  | —        | 15,899   | —          |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 18,272  | 18,272   | —        | —          |
| Trading securities  | 19  | 19       | —        | —          |
| Equity securities available-for-sale  | 4,995   | 3,879    | —        | 1,116      |
| Total Financial Assets  | \$91,900  | \$22,170 | \$68,614 | \$1,116    |
| Financial Liabilities   |   |          |          |            |
| Interest rate swap  | \$(1,238 )                                      | \$—      | \$—      | \$(1,238 ) |

|                             |          |   |     |     |          |   |
|-----------------------------|----------|---|-----|-----|----------|---|
| Total Financial Liabilities | \$(1,238 | ) | \$— | \$— | \$(1,238 | ) |
|-----------------------------|----------|---|-----|-----|----------|---|

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The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2014 (in thousands):

| For the year ended December 31, 2014  | Equity Securities<br>Available-for-Sale | Interest Rate Swap |
|---|---|--------------------|
| Beginning balance   | \$875                                   | \$(897 )           |
| Total gains or losses (realized and unrealized):  |   |                    |
| Included in earnings  | —                                       | —                  |
| Included in other comprehensive income  | 241                                     | (341 )             |
| Purchases:  | —                                       | —                  |
| Sales:  | —                                       | —                  |
| Issuances:  | —                                       | —                  |
| Settlements:  | —                                       | —                  |
| Transfers in/(out) of Level 3   | —                                       | —                  |
| Ending balance  | \$1,116                                 | \$(1,238 )         |
| 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, 2014: | \$—                                     | \$—                |

For the year ended December 31, 2014, 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.

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

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

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

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

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

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

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

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The carrying amount and estimated fair value of the Company's financial instruments as of March 31, 2015 and December 31, 2014 are as follows (in thousands):

|  | March 31, 2015 |                      | December 31, 2014 |                      |
|--|----------------|----------------------|-------------------|----------------------|
|  | Carrying Value | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| Assets and related instruments                                 |                |                      |                   |                      |
| Held-to-maturity securities                                    | \$2,767        | \$2,905              | \$3,108           | \$3,182              |
| Mortgage loans   | 208            | 208                  | 210               | 210                  |
| Policy loans   | 1,556          | 1,556                | 1,530             | 1,530                |
| Company owned life insurance                                   | 5,161          | 5,161                | 5,513             | 5,513                |
| Other invested assets  | 3,484          | 3,484                | 3,553             | 3,553                |
| Liabilities and related instruments                            |                |                      |                   |                      |
| Other policyholder funds                                       | 1,525          | 1,525                | 1,510             | 1,510                |
| Short-term notes payable and current portion of long-term debt | 1,557          | 1,557                | 857               | 857                  |
| Long-term debt   | 17,515         | 17,515               | 18,715            | 18,715               |

## NOTE 5 – PROPERTY AND EQUIPMENT

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

|                                      | March 31, 2015 | December 31, 2014 |
|--------------------------------------|----------------|-------------------|
| Building and improvements            | \$3,348        | \$3,367           |
| Electronic data processing equipment | 1,606          | 1,570             |
| Furniture and fixtures               | 658            | 606               |
|                                      | 5,612          | 5,543             |
| Less accumulated depreciation        | 3,577          | 3,530             |
| Property and equipment, net          | \$2,035        | \$2,013           |

Depreciation expense for the three months ended March 31, 2015 was \$47,000 (\$306,000 for the year ended December 31, 2014).

## NOTE 6 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2009. Tax returns have been filed through the year 2013.

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 \$3,055,000 at March 31, 2015 and \$3,189,000 at December 31, 2014.

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

|   | As of<br>March 31, 2015 | As of<br>December 31, 2014 |
|---|-------------------------|----------------------------|
| General expenses                                  | \$1,415                 | \$1,371                    |
| Unearned premiums                                 | 2,009                   | 1,961                      |
| Claims liabilities                                | 863                     | 849                        |
| Litigation settlement                             | 2,040                   | 2,040                      |
| AMT credit  | 1,121                   | 1,240                      |
| Impairment on real estate owned                   | 187                     | 187                        |
| Unrealized loss on interest rate swaps            | 482                     | 421                        |
| Deferred tax assets                               | 8,117                   | 8,069                      |
| Depreciation                                      | (107                    | ) (111                     |
| Deferred policy acquisition costs                 | (2,919                  | ) (2,921                   |
| Unrealized gains on securities available-for-sale | (2,036                  | ) (1,848                   |
| Deferred tax liabilities                          | (5,062                  | ) (4,880                   |
| Net deferred tax asset                            | \$3,055                 | \$3,189                    |

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

|                                   | Three months ended March 31, |         |
|-----------------------------------|------------------------------|---------|
|                                   | 2015                         | 2014    |
| Deferred policy acquisition costs | \$(2                         | ) \$(14 |
| Unearned premiums                 | (48                          | ) (76   |
| General expenses                  | (44                          | ) (5    |
| Depreciation                      | (4                           | ) (42   |
| Claims liabilities                | (14                          | ) (42   |
| AMT credit                        | 119                          | —       |
| NOL carryforward                  | —                            | 375     |
| Deferred income tax expense       | \$7                          | \$196   |

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

|  | Three months ended March 31, |          |    |
|--|------------------------------|----------|----|
|  | 2015                         | 2014     |    |
| Federal income tax rate applied to pre-tax income/loss | 34.0                         | % 34.0   | %  |
| Dividends received deduction and tax-exempt interest   | (1.5                         | )% (2.4  | )% |
| Company owned life insurance                           | (0.8                         | )% (0.8  | )% |
| Small life deduction                                   | (3.2                         | )% (11.4 | )% |
| AMT  | —                            | % 1.9    | %  |
| Other, net   | (1.8                         | )% 0.8   | %  |
| Effective federal income tax rate                      | 26.7                         | % 22.1   | %  |



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

Short-term debt and current portion of long-term debt consisted of the following as of March 31, 2015 and December 31, 2014 (dollars in thousands):

|  | 2015    | 2014  |
|--|---------|-------|
| Line of credit with variable interest rate equal to the Wall Street Journal (WSJ) prime rate, subject to a 5.0% floor; maturity February 2016. Interest payments due quarterly. Unsecured. | \$ 700  | \$—   |
| Current portion of installment note payable due November 2015 with variable interest rate equal to the WSJ prime rate plus 1%; Unsecured   | 857     | 857   |
|  | \$1,557 | \$857 |

Long-term debt consisted of the following as of March 31, 2015 and December 31, 2014 (dollars in thousands):

|  | 2015     | 2014     |
|--|----------|----------|
| Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 5.0% floor; maturity February 2016. Interest payments due quarterly. Unsecured.   | \$—      | \$700    |
| 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.  | —        | 500      |
| 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 2015. Unsecured.   | 5,143    | 5,143    |
| 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    |
|  | \$17,515 | \$18,715 |

The Company has entered into various swap agreements related to the trust preferred securities. On March 19, 2009, the Company entered into a forward swap effective September 17, 2012, with a notional amount of \$3,000,000 and designated the swap as a hedge against changes in cash flows attributable to changes in the benchmark interest rate (LIBOR) associated with the subordinated debentures issued June 21, 2007. Quarterly, commencing September 17,

2012, under the terms of the forward swap, the Company will pay interest at a fixed rate of 7.02% until March 15, 2019. On May 26, 2010, the Company entered into a forward swap with a notional amount of \$9,000,000 effective December 15, 2015, which 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 \$274,000 (liability) and \$1,141,000 (liability), respectively, for a total liability of \$1,415,000 at March 31, 2015 (\$1,238,000 at December 31, 2014). The swap liability is reported as a component of other liabilities on the condensed consolidated balance sheets. A net valuation loss of \$117,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements at March 31, 2015. A net valuation loss of \$412,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2014.

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

The Company's interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. At March 31, 2015, the Company has securities on deposit with fair market values of \$1,518,000 (all of which is posted as collateral). At December 31, 2014, the Company had securities on deposit with fair market values of \$1,494,000 (all of which is posted as collateral). See Note 4 for additional information about the interest rate swaps.

#### 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 an excess of loss basis to cover losses from catastrophe events. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of re-insurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurance companies and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the companies to minimize their exposure to significant losses from reinsurance insolvencies.

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

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

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

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

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

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

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

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At March 31, 2015, the largest reinsurance recoverable of a single reinsurer was \$24,000 (\$37,000 at December 31, 2014). Amounts reported as ceded incurred losses in both 2015 and 2014 were related to the development of losses from prior year catastrophes.

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 March 31, 2015 and 2014 amounted to \$43,000 and \$46,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limitations.

In January 2006, the Company established a non-qualified plan under which directors are allowed to defer all or a portion of directors' fees into various investment options.

The supplemental executive retirement plan (SERP) became effective March 1, 2008 and covers named executive officers with the Company contributing 15% of executive compensation to the plan. Contributions to the plan are fully vested upon the earlier of death, disability, change in control, or ten years of participation in the plan. Costs for amounts credited to the non-qualified deferred compensation plans for the three months ended March 31, 2015 and 2014 amounted to approximately \$45,000 and \$30,000, respectively.

The Company and its subsidiaries established an Employee Stock Ownership Plan (ESOP) in January 2010, to enable its eligible employees to acquire a proprietary interest in the Company's common stock and to provide retirement and other benefits to such employees. There were no costs incurred during the first three months of 2015 and \$50,000 in costs incurred during the first three months of 2014 related to ESOP plan contributions. All contributions were made in cash for purchase of Company shares in the open market. The Company has not allocated shares directly to the plan and the plan has no debt.

NOTE 10 – SHAREHOLDERS' EQUITY

During the three months ended March 31, 2015, and year ended December 31, 2014, changes in shareholders' equity consisted of net income of \$1,308,000 and \$7,616,000, respectively; dividends paid of \$100,000 in 2015 and \$300,000 in 2014; changes in accumulated other comprehensive income, net of applicable taxes, of \$248,000 in 2015 and other comprehensive income, net of applicable taxes, of \$1,836,000 in 2014. Other comprehensive gains and loss consisted of accumulated unrealized gains and losses on securities available for sale and unrealized loss on interest rate swaps.

Preferred Stock

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

Common Stock



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

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

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The table below provides information regarding the Company's preferred and common stock as of March 31, 2015 and December 31, 2014:

|                                     | Authorized | Issued    | Outstanding |
|-------------------------------------|------------|-----------|-------------|
| Preferred Stock, \$1 par value      | 500,000    | —         | —           |
| Class A Common Stock, \$1 par value | 2,000,000  | —         | —           |
| Common Stock, \$1 par value         | 3,000,000  | 2,507,452 | 2,507,452   |

## NOTE 11 – ACCUMULATED OTHER COMPREHENSIVE INCOME

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

|  | Three months ended<br>March 31,<br>2015 |   | 2014    |   |
|--|---|---|---------|---|
| Gains and Losses on Cash Flow Hedges                             |   |   |         |   |
| Balance at beginning of period                                   | \$(816                                  | ) | \$(591  | ) |
| Other comprehensive income (loss) for period:                    |   |   |         |   |
| Other comprehensive income (loss) before reclassifications       | (117                                    | ) | (76     | ) |
| Amounts reclassified from accumulated other comprehensive income | —                                       |   | —       |   |
| Net current period other comprehensive income (loss)             | (117                                    | ) | (76     | ) |
| Balance at end of period   | \$(933                                  | ) | \$(667  | ) |
| Unrealized Gains and Losses on Available-for-Sale Securities     |   |   |         |   |
| Balance at beginning of period                                   | \$3,588                                 |   | \$1,527 |   |
| Other comprehensive income (loss) for period:                    |   |   |         |   |
| Other comprehensive income before reclassifications              | 459                                     |   | 1,132   |   |
| Amounts reclassified from accumulated other comprehensive income | (94                                     | ) | (59     | ) |
| Net current period other comprehensive income                    | 365                                     |   | 1,073   |   |
| Balance at end of period   | \$3,953                                 |   | \$2,600 |   |
| Total Accumulated Other Comprehensive Income at end of period    | \$3,020                                 |   | \$1,933 |   |

The following table presents the amounts reclassified out of AOCI for the three months ended March 31, 2015 (dollars in thousands):

| Details about Accumulated Other Comprehensive Income Components | Amounts Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Statement Where Net Income is Presented |
|---|--|---|
| Unrealized Gains and Losses on Available-for-Sale Securities    | \$142  | Net realized investment gains                                     |
|   | 142  | Total before tax  |
|   | (48  | ) Tax (expense) or benefit  |
|   | \$94   | Net of Tax  |

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The following table presents the amounts reclassified out of AOCI for the three months ended March 31, 2014 (dollars in thousands):

| Details about Accumulated Other Comprehensive Income Components | Amounts Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Statement Where Net Income is Presented |
|---|--|---|
| Unrealized Gains and Losses on Available-for-Sale Securities    | \$88   | Net realized investment gains                                     |
|   | 88   | Total before tax  |
|   | (29)   | ) Tax (expense) or benefit  |
|   | \$59   | Net of Tax  |

## NOTE 12 – SEGMENTS

The Company's property and casualty insurance operations comprise one business segment. The property and casualty insurance segment primarily underwrites home insurance coverage with primary lines of business consisting of: dwelling fire and extended coverage, homeowners (including mobile homeowners) and other liability. The Company has ceased writing ocean marine coverages and no policies were in-force in this line of business during 2015.

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

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

Total assets by industry segment at March 31, 2015 and at December 31, 2014 are summarized below (dollars in thousands):

|                   | Total     | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|-------------------|-----------|--------------------------|---------------------------|--------------------------|
| March 31, 2015    | \$147,016 | \$82,573                 | \$56,827                  | \$7,616                  |
| December 31, 2014 | \$144,865 | \$81,648                 | \$56,541                  | \$6,676                  |

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Premium revenues and operating income by business segment for the three months ended March 31, 2015 and 2014 are summarized below (dollars in thousands):

| Three months ended March 31, 2015                 | Total    | P&C Insurance<br>Operations | Life Insurance<br>Operations | Non-Insurance<br>Operations |
|---|----------|-----------------------------|------------------------------|-----------------------------|
| <b>REVENUE</b>                                    |          |                             |                              |                             |
| Net premiums earned                               | \$14,706 | \$13,122                    | \$1,584                      | \$—                         |
| Net investment income                             | 974      | 490                         | 465                          | 19                          |
| Net realized investment gains (losses)            | 142      | 31                          | 111                          | —                           |
| Other income                                      | 158      | 157                         | 1                            | —                           |
|   | 15,980   | 13,800                      | 2,161                        | 19                          |
| <b>BENEFITS AND EXPENSES</b>                      |          |                             |                              |                             |
| Policyholder benefits paid                        | 8,262    | 6,777                       | 1,485                        | —                           |
| Amortization of deferred policy acquisition costs | 899      | 675                         | 224                          | —                           |
| Commissions                                       | 2,055    | 1,968                       | 87                           | —                           |
| General and administrative expenses               | 2,006    | 1,540                       | 309                          | 157                         |
| Taxes, licenses and fees                          | 655      | 544                         | 111                          | —                           |
| Interest expense                                  | 317      | —                           | 10                           | 307                         |
|   | 14,194   | 11,504                      | 2,226                        | 464                         |
| Income (Loss) Before Income Taxes                 | \$1,786  | \$2,296                     | \$(65                        | ) \$(445 )                  |

| Three months ended March 31, 2014                 | Total    | P&C Insurance<br>Operations | Life Insurance<br>Operations | Non-Insurance<br>Operations |
|---|----------|-----------------------------|------------------------------|-----------------------------|
| <b>REVENUE</b>                                    |          |                             |                              |                             |
| Net premiums earned                               | \$13,824 | \$12,173                    | \$1,651                      | \$—                         |
| Net investment income                             | 948      | 455                         | 474                          | 19                          |
| Net realized investment gains                     | 88       | 48                          | 40                           | —                           |
| Other income                                      | 154      | 153                         | 1                            | —                           |
|   | 15,014   | 12,829                      | 2,166                        | 19                          |
| <b>BENEFITS AND EXPENSES</b>                      |          |                             |                              |                             |
| Policyholder benefits paid                        | 7,864    | 6,664                       | 1,200                        | —                           |
| Amortization of deferred policy acquisition costs | 898      | 641                         | 257                          | —                           |
| Commissions                                       | 2,027    | 1,945                       | 82                           | —                           |
| General and administrative expenses               | 2,026    | 1,457                       | 460                          | 109                         |
| Taxes, licenses and fees                          | 530      | 464                         | 66                           | —                           |
| Interest expense                                  | 386      | —                           | 17                           | 369                         |
|   | 13,731   | 11,171                      | 2,082                        | 478                         |
| Income Before Income Taxes                        | \$1,283  | \$1,658                     | \$84                         | \$(459 )                    |



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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 months ended March 31, 2015 and 2014, respectively:

|  | Three months ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2015                            | 2014      |
| Life, accident and health operations premiums written: |                                 |           |
| Traditional life insurance                             | \$ 1,137                        | \$ 1,179  |
| Accident and health insurance                          | 419                             | 444       |
| Gross life, accident and health                        | 1,556                           | 1,623     |
| Reinsurance premium ceded                              | (15                             | ) (23     |
| Net life, accident and health premiums written         | \$ 1,541                        | \$ 1,600  |
| Property and Casualty operations premiums written:     |                                 |           |
| Dwelling fire & extended coverage                      | \$ 8,728                        | \$ 8,329  |
| Homeowners (Including mobile homeowners)               | 5,751                           | 5,749     |
| Other liability  | 505                             | 469       |
| Gross property and casualty                            | 14,984                          | 14,547    |
| Reinsurance premium ceded                              | (1,491                          | ) (1,755  |
| Net property and casualty written                      | \$ 13,493                       | \$ 12,792 |
| Consolidated gross premiums written                    | \$ 16,540                       | \$ 16,170 |
| Reinsurance premium ceded                              | (1,506                          | ) (1,778  |
| Consolidated net premiums written                      | \$ 15,034                       | \$ 14,392 |

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 three months ended March 31, 2015 and 2014, respectively:

|   | Three months ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2015                            | 2014      |
| Life, accident and health operations premiums earned: |                                 |           |
| Traditional life insurance                            | \$ 1,178                        | \$ 1,243  |
| Accident and health insurance                         | 421                             | 431       |
| Gross life, accident and health                       | 1,599                           | 1,674     |
| Reinsurance premium ceded                             | (15                             | ) (23     |
| Net life, accident and health premiums earned         | \$ 1,584                        | \$ 1,651  |
| Property and Casualty operations premiums earned:     |                                 |           |
| Dwelling fire & extended coverage                     | \$ 8,200                        | \$ 7,670  |
| Homeowners (Including mobile homeowners)              | 5,948                           | 5,831     |
| Other liability                                       | 465                             | 427       |
| Gross property and casualty                           | 14,613                          | 13,928    |
| Reinsurance premium ceded                             | (1,491                          | ) (1,755  |
| Net property and casualty earned                      | \$ 13,122                       | \$ 12,173 |
| Consolidated gross premiums earned                    | \$ 16,212                       | \$ 15,602 |
| Reinsurance premium ceded                             | (1,506                          | ) (1,778  |

|                                  |           |           |
|----------------------------------|-----------|-----------|
| Consolidated net premiums earned | \$ 14,706 | \$ 13,824 |
|----------------------------------|-----------|-----------|

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THE NATIONAL SECURITY GROUP, INC.  
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NOTE 13 – CONTINGENCIES

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

The Company's property & casualty subsidiaries are defending a limited number of matters filed in the aftermath of 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 14 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the three months ended March 31, 2015 was \$280,000 (\$289,000 in 2014). Cash paid for income taxes during the three months ended March 31, 2015 was \$500,000 (\$50,000 in 2014).

NOTE 15 – SUBSEQUENT EVENTS

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



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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. as of March 31, 2015, and the related condensed consolidated statements of income, comprehensive income and cash flows for the three-month periods ended March 31, 2015 and 2014, and the related condensed consolidated statement of changes in shareholders' equity for the three-month period ended March 31, 2015. These condensed consolidated financial statements are the responsibility of the company's management.

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

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

We have previously audited, in accordance with auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The National Security Group, Inc. as of December 31, 2014, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 20, 2015, 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, 2014, 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  
May 14, 2015

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

Overview

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) and its subsidiaries. We are a “smaller reporting company” under Securities and Exchange Commission (SEC) regulations and therefore qualify for the scaled disclosure of smaller reporting companies. In general, the same information is required to be disclosed in the management discussion and analysis by smaller reporting companies except that the discussion need only cover the latest two year period and disclosures relating to contractual obligations are not required. In accordance with the scaled disclosure requirements, this discussion covers the three month periods ended March 31, 2015 and 2014.

The National Security Group, Inc. is made up of two operating segments: the Life segment and the P&C segment. The Company's life, accident and health insurance business is conducted through National Security Insurance Company (NSIC), a wholly owned subsidiary of the Company organized in 1947. The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992.

This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part 1, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2014.

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

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 ten states with 49.3% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment, accounting for 90.2% of gross earned premium revenue in the first three months of 2015. Revenue generated from the life segment accounted for 9.8% of gross insurance premium revenue in the first three months of 2015.

National Security Insurance Company (NSIC) is a life, accident and health insurance company founded in 1947. 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 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, and Tennessee.

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

which the rates will apply.

All of our insurance companies have been assigned ratings by A.M. Best Co (Best). On November 13, 2014, Best affirmed the financial strength rating (FSR) of B++ (Good) and the issuer credit rating (ICR) of "bbb" of NSFC. Best revised the outlook on both of NSFC's ratings from negative to stable. In addition, Best affirmed the FSR of B+(Good) and ICR of "bbb-" of Omega and NSIC. The outlook for all of these ratings is stable. Best also affirmed the ICR of "bb" of the parent holding company, NSEC, with a revised outlook from negative to stable. The property and casualty subsidiaries have been assigned ratings by Demotech, Inc. On November 22, 2014, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

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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 Omega producing no earned premium revenue and the fact that Omega is a wholly owned subsidiary of NSFC authorized to underwrite 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.

## Overview-Three Months Ended March 31, 2015 compared to Three Months Ended March 31, 2014

Financial results for the three months ended March 31, 2015 and 2014 were as follows:

| Consolidated Financial Summary<br>(dollars in thousands) | Three months ended March 31, |           |
|--|------------------------------|-----------|
|  | 2015                         | 2014      |
| Gross premiums written                                   | \$ 16,540                    | \$ 16,170 |
| Net premiums written                                     | \$ 15,034                    | \$ 14,392 |
| Net premiums earned                                      | \$ 14,706                    | \$ 13,824 |
| Net investment income                                    | 974                          | 948       |
| Net realized investment gains                            | 142                          | 88        |
| Other income   | 158                          | 154       |
| Total Revenues   | 15,980                       | 15,014    |
| Policyholder benefits and settlement expenses            | 8,262                        | 7,864     |
| Amortization of deferred policy acquisition costs        | 899                          | 898       |
| Commissions  | 2,055                        | 2,027     |
| General and administrative expenses                      | 2,006                        | 2,026     |
| Taxes, licenses and fees                                 | 655                          | 530       |
| Interest expense   | 317                          | 386       |
| Total Benefits, Losses and Expenses                      | 14,194                       | 13,731    |
| Income Before Income Taxes                               | 1,786                        | 1,283     |
| Income tax expense                                       | 478                          | 284       |
| Net Income   | \$ 1,308                     | \$ 999    |
| Income Per Common Share                                  | \$0.52                       | \$0.40    |
| Reconciliation of Net Income to non-GAAP Measurement     |                              |           |
| Net income   | \$ 1,308                     | \$ 999    |
| Income tax expense                                       | 478                          | 284       |
| Realized investment gains, net                           | 142                          | 88        |
| Pretax Income From Insurance Operations                  | \$ 1,928                     | \$ 1,371  |

## Premium Revenue:

For the quarter ended March 31, 2015, gross written premium was up 2.3% compared to the same period in 2014. Moderate premium revenue growth in our property and casualty segment is the contributor to the consolidated growth in premium revenue.

For the three months ended March 31, 2015, net premium written was up 4.5% compared to the three months ended March 31, 2014. Growth in property and casualty segment gross premiums written of 3.0%, coupled with a reduction

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in catastrophe reinsurance cost of 11.2% were the factors contributing to the increase in net premium written and earned.

#### Net Income:

For the three months ended March 31, 2015, the Company had net income of \$1,308,000, \$0.52 per share, compared to net income of \$999,000, \$0.40 per share, for the same period in 2014, an increase of \$309,000. Results for the first quarter of 2015 were reflective of good results from insurance operations primarily driven by fewer reported claims from early spring cat events and a lower frequency of non-cat wind and hail losses. Reported claims from cat events were down \$385,000 compared to the same period in 2014. In addition, claims reported from non-cat wind and hail losses in the first three months of 2015 were down \$416,000 compared to the first three months of 2014.

#### Pretax income from insurance operations:

A primary non-GAAP financial measure used by management is pretax income from insurance operations. This measure consists of net income before income taxes adjusted for realized investment gains and losses. This measure provides a means of comparing the results of our core insurance operations without the impact of items that are more unpredictable and less consistent from year to year. A reconciliation of pretax income from insurance operations is presented in the table above.

For the three months ended March 31, 2015, pretax income from insurance operations was \$1,928,000 compared to \$1,371,000 for the three months ended March 31, 2014, an increase of \$557,000. The primary factor contributing to the increase in pretax income from insurance operations was the 6.4% increase in net premiums earned in the first quarter of 2015 compared to the first quarter of 2014. A slight reduction in the loss ratio of policyholder benefits as a percent of premium earned also contributed to the improved results. Policyholder benefits were 56.2% of net earned premium revenue in the first quarter of 2015 compared to 56.9% for the same period in 2014. The reduction in incurred losses was primarily driven by reduced wind related property losses resulting from a calmer early spring storm season. Finally, a reduction in general and administrative expenses also contributed to the improved insurance operating results. For the first quarter of 2015, general and administrative expenses were 13.6% of net premiums earned compared to 14.7% for the same period in 2014. A continued focus by management to improve efficiency and implement cost saving measures to reduce general and administrative expenses was the primary reason for the decline.

#### Overview - Balance Sheet highlights at March 31, 2015 compared to December 31, 2014

| Selected Balance Sheet Highlights<br>(dollars in thousands) | March 31, 2015 | December 31, 2014 |
|---|----------------|-------------------|
| Invested Assets   | \$111,795      | \$109,549         |
| Cash  | \$7,108        | \$6,426           |
| Total Assets  | \$147,016      | \$144,865         |
| Policy Liabilities  | \$75,551       | \$74,115          |
| Total Debt  | \$19,072       | \$19,572          |
| Accumulated Other Comprehensive Income                      | \$3,020        | \$2,772           |
| Shareholders' Equity  | \$44,213       | \$42,757          |
| Book Value Per Share  | \$17.63        | \$17.05           |

#### Invested Assets:

Invested assets as of March 31, 2015 were \$111,795,000 up \$2,246,000, or 2.1%, compared to December 31, 2014. The increase in invested assets was primarily due to the investment of positive cash flow from insurance operations coupled with increases in market values of available for sale securities. The increase in market value of available for sale securities also contributed to the increase in accumulated other comprehensive income to \$3,020,000 as of March 31, 2015, up \$248,000 compared to December 31, 2014.

Cash:

The Company, primarily through its insurance subsidiaries, had \$7,108,000 in cash and cash equivalents at March 31, 2015, compared to \$6,426,000 at December 31, 2014. Property and casualty segment underwriting profitability for the quarter ended March 31, 2015, coupled with growth in property and casualty segment premium revenue, contributed to \$2,933,000 in positive cash flow from operations for the quarter ended March 31, 2015. Similarly, property and

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casualty segment underwriting profitability help drive positive cash flow from operations the same period in 2014 totaling \$2,498,000.

**Total Assets:**

Total assets as of March 31, 2015 were \$147,016,000 compared to \$144,865,000 at December 31, 2014. The increase in invested assets and cash during the first quarter of 2015 were the primary contributors to the increase in total assets.

**Debt Outstanding:**

Total debt at March 31, 2015 was \$19,072,000 compared to \$19,572,000 at December 31, 2014. Debt was reduced \$500,000 during the first quarter in 2015. The primary reason for the decline was the reduction of balances in revolving lines of credit in the Holding Company.

**Shareholders' Equity:**

Shareholders' equity as of March 31, 2015 was \$44,213,000 up \$1,456,000 compared to December 31, 2014 Shareholders' equity of \$42,757,000. Book value per share was \$17.63 at March 31, 2015, compared to \$17.05 per share at December 31, 2014, an increase of \$0.58. The primary factors contributing to the increase in Shareholders' equity were net income of \$1,308,000 and other comprehensive income of \$248,000. The increase in other comprehensive income was primarily driven by increases in market values of available for sale investment securities.

**Premium revenue:**

The table below provides earned premium revenue by segment for the three months ended March 31, 2015 and 2014:

| (dollars in thousands)                                       | Three months ended<br>March 31, |           | Percent<br>increase<br>(decrease) |    |
|--|---------------------------------|-----------|-----------------------------------|----|
|  | 2015                            | 2014      |                                   |    |
| <b>Life, accident and health operations premiums earned:</b> |                                 |           |                                   |    |
| Traditional life insurance                                   | \$ 1,178                        | \$ 1,243  | (5.2                              | )% |
| Accident and health insurance                                | 421                             | 431       | (2.3                              | )% |
| Gross life, accident and health                              | 1,599                           | 1,674     | (4.5                              | )% |
| Reinsurance premium ceded                                    | (15                             | ) (23     | ) (34.8                           | )% |
| Net life, accident and health premiums earned                | \$ 1,584                        | \$ 1,651  | (4.1                              | )% |
| <b>Property and Casualty operations premiums earned:</b>     |                                 |           |                                   |    |
| Dwelling fire & extended coverage                            | \$ 8,200                        | \$ 7,670  | 6.9                               | %  |
| Homeowners (Including mobile homeowners)                     | 5,948                           | 5,831     | 2.0                               | %  |
| Other liability  | 465                             | 427       | 8.9                               | %  |
| Gross property and casualty                                  | 14,613                          | 13,928    | 4.9                               | %  |
| Reinsurance premium ceded                                    | (1,491                          | ) (1,755  | ) (15.0                           | )% |
| Net property and casualty premiums earned                    | \$ 13,122                       | \$ 12,173 | 7.8                               | %  |
| <b>Consolidated gross premiums earned</b>                    |                                 |           |                                   |    |
|  | \$ 16,212                       | \$ 15,602 | 3.9                               | %  |
| Reinsurance premium ceded                                    | (1,506                          | ) (1,778  | ) (15.3                           | )% |
| Consolidated net premiums earned                             | \$ 14,706                       | \$ 13,824 | 6.4                               | %  |

Consolidated net premium earned was up 6.4% for the quarter ended March 31, 2015, at \$14,706,000 compared to \$13,824,000 for the quarter ended March 31, 2014. The growth in net premium earned was due to a 7.8% increase in net premium earned in the P&C segment which was driven by increases in direct premium due to rate adjustments and a moderate rise in production. An 15.0% reduction in catastrophe reinsurance cost also contributed to the increase in net premium earned in the P&C segment. The reduction in catastrophe reinsurance cost was due to a catastrophe



reinsurance rate reduction in our 2015 calendar year contract renewal.

The reduction in ceded catastrophe reinsurance cost contributed to the improvement in underwriting margins in our property and casualty segment. The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. Our catastrophe retention remained unchanged at \$4 million and we maintain catastrophe reinsurance covering incurred claims of a single catastrophe event up to \$72.5 million after exceeding the retention. Our catastrophe reinsurance also covers the cost of a second event up to the same \$72.5 million upper limit. In our reinsurance structure, management attempts to limit the impact on pretax earnings of a single modeled 100 year cat

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event to no more than \$4 million. It is noted, however, that hurricane models are subject to significant risk and are only a tool to estimate the impact of catastrophe events. The Company also has risk associated with multiple smaller catastrophe events that individually may not exceed our \$4 million retention.

Under the catastrophe reinsurance program in 2014, the Company retained the first \$4,000,000 in losses from each event. Reinsurance coverage for 2015 was maintained in three layers as follows:

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

**Investment income:**

For the three months ended March 31, 2015, net investment income was \$974,000 compared to \$948,000 for the same period in 2014; an increase of \$26,000. The primary reason for the increase in net investment income in the first quarter of 2015 compared to the first quarter of 2014 was an increase in invested assets.

**Realized investment gains and losses:**

For the three months ended March 31, 2015, the Company had net realized capital gains totaling \$142,000 compared to \$88,000 for the same period in 2014. The \$54,000 change was primarily associated with a \$71,000 increase in realized investment gains in the life segment compared to the same period in 2014. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and therefore can vary significantly from quarter to quarter and year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to year.

**Other income:**

Other income was comparable at \$158,000 for the three months ended March 31, 2015, compared to \$154,000 for the same period in 2014; an increase of \$4,000. Other income consists primarily of fees related to the issuance of our property insurance policies as well as other miscellaneous income.

**Policyholder benefits:**

Policyholder claims were \$8,262,000 for the three months ended March 31, 2015, compared to \$7,864,000 for the three months ended March 31, 2014; an increase of \$398,000 or 5.1%. Claims as a percentage of premium earned was 56.2% in the first quarter of 2015 compared to 56.9% in the first quarter of 2014. Favorable weather patterns, which reduced windstorm related claims, positively impacted underwriting results in the first quarter of both years.

The table below provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the three months ended March 31, 2015 and 2014 (dollars in thousands):

| For the three months ended March 31, 2015 |                          |                | For the three months ended March 31, 2014 |                          |                |
|---|--------------------------|----------------|---|--------------------------|----------------|
| Cat event                                 | Reported<br>Losses & LAE | Claim<br>Count | Cat event                                 | Reported<br>Losses & LAE | Claim<br>Count |
| Cat 64 (Feb 16-17)                        | \$27                     | 9              | Cat 32 (Jan 5-8)                          | \$4                      | 2              |
| Cat 68 (Feb 16-22)                        | 65                       | 24             | Cat 34 (Feb 11-14)                        | 595                      | 327            |
| Cat 69 (Mar 3-5)                          | 3                        | 2              | Cat 37 (Mar 27-29)                        | 3                        | 1              |
| Cat 70 (Mar 25-26)                        | 372                      | 69             |   |                          |                |
| Total Cat losses                          | \$467                    | 104            | Total Cat losses                          | \$602                    | 330            |
| Non-cat wind & hail                       | \$810                    | 306            | Non-cat wind & hail                       | \$1,226                  | 464            |

Non-catastrophe wind and hail claims reported in the first quarter of 2015 totaled \$810,000 compared to non-catastrophe wind and hail claims reported in the first quarter of 2014 totaling \$1,226,000; a decline of \$416,000 or 33.9%. During the first three months of 2015, the P&C segment had 306 non-cat wind and hail claims reported (an average of \$2,600 per claim) compared to 464 claims reported during the first three months of 2014 (an average of \$2,600 per claim). Non-cat wind and hail claims reported during the first quarter of 2015 accounted for 12% of total P&C segment incurred

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losses and LAE in the current year. Non-cat wind and hail claims reported during the first quarter of 2014 accounted for 18.4% of total P&C segment incurred losses and LAE in 2014.

During the first three months of 2015, the P&C segment was impacted by four catastrophe events totaling \$467,000 from 104 claims compared to reported losses and LAE from three cat events totaling \$602,000 from 330 claims in the first three months of 2014. Claims reported from first quarter 2015 cat events contributed 3.6 percentage points to the first quarter 2015 P&C segment loss ratio. In comparison, claims reported during the first quarter of 2014 from prior year cat events contributed 4.9 percentage points to the first quarter 2014 P&C segment loss ratio. During the first three months of 2015 and 2014, the spring storm season was of relatively low frequency.

While overall policyholder benefit payments were down slightly in the property and casualty segment due to fewer wind related losses, fire losses reported in the first quarter of 2015 were up \$242,000 or 5.9% compared to fire losses reported during the first quarter of 2014. The P&C segment had 165 fire losses reported in the first three months of 2015 totaling \$4,319,000 compared to 161 claims reported in the first three months of 2014 totaling \$4,077,000. The average cost per claim was \$26,200 for fire losses reported in the first quarter of 2015 compared to \$25,300 for fire losses reported in the first quarter of 2014. Many factors can impact the frequency and severity of fire losses, but the primary factor we observe is the duration of cold weather in our coverage areas. Historically, house fires tend to be more frequent in winter months.

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

For the three months ended March 31, 2015, policy acquisition costs were \$2,954,000 compared to \$2,925,000 for the same period in 2014; an increase of \$29,000. Policy acquisition costs consist of amortization of previously capitalized distribution costs and current commission payments to agents. As a percentage of premium revenue, policy acquisition costs were 20.1% in the first quarter of 2015 compared to 21.2% for the same period in 2014.

General Expenses:

General and administrative expenses totaled \$2,006,000 in the first quarter of 2015 compared to \$2,026,000 in the first quarter of 2014; a 1.0% decrease. The primary reason for the \$20,000 decline was a reduction in holding company related expenses as well as an overall reduction in general and administrative expenses in both the P&C and life segments.

Taxes, licenses and fees:

Insurance taxes, licenses and fees were \$655,000 for the three months ended March 31, 2015, compared to \$530,000 for the same period in 2014. The primary reason for the increase was the 3% increase in gross premium written in the first quarter of 2015 compared to the same period in 2014. As a percentage of net premiums earned, insurance taxes, licenses and fees were 4.5% for the three months ended March 31, 2015 compared to 3.8% for the three months ended March 31, 2014.

Interest expense:

Interest expense for the first quarter of 2015 was \$317,000 compared to \$386,000 for the same period in 2014; a decrease of 17.9%. The primary reason for the \$69,000 decline was a decrease in interest expense at the holding company level due to a reduction in long term debt during 2014.

Income taxes:

For the three month period ended March 31, 2015, the Company had pretax income of \$1,786,000 compared to \$1,283,000 for the same period in 2014. The \$478,000 tax expense for the first quarter 2015 consisted of current tax expense of \$471,000 and deferred tax benefit of \$7,000. Tax expense for the first quarter of 2014 consisted of current tax expense of \$88,000 and deferred tax expense of \$196,000. The effective tax rate for the three month period ended March 31, 2015 and 2014 was 26.7% and 22.1%, respectively.

Net income:

The Company ended the first quarter of 2015 with net income of \$1,308,000 compared to net income of \$999,000 for the same period in 2014. Improved underwriting results led to an improvement in operating income for the first quarter in 2015 compared to the first quarter of last year.

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

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periods usually not exceeding five 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.