

NATIONAL SECURITY GROUP INC  
Form 10-Q  
May 14, 2018  
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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, 2018

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-18649

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

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

661 East Davis Street 36323  
Elba, Alabama  
(Address of principal executive offices) (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, 2018, there were 2,522,312 shares, \$1.00 par value, of the registrant's common stock outstanding.

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THE NATIONAL SECURITY GROUP, INC.

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Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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

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

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

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

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

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

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

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

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## PART I. Financial Information

## Item 1. Financial Statements

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

	March 31, 2018	December 31, 2017
	(UNAUDITED)	
<b>ASSETS</b>		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2018 - \$1,575; 2017 - \$1,645)	\$ 1,573	\$ 1,616
Fixed maturities available-for-sale, at estimated fair value (cost: 2018 - \$96,277; 2017 - \$94,467)	95,825	95,758
Equity securities, at estimated fair value (cost: 2018 - \$1,842; 2017 - \$1,842)	4,303	4,509
Trading securities	107	107
Mortgage loans on real estate, at cost	161	162
Investment real estate, at book value	3,221	3,221
Policy loans	1,842	1,810
Company owned life insurance	4,835	4,974
Other invested assets	2,451	2,574
Total Investments	114,318	114,731
Cash and cash equivalents	5,586	6,644
Accrued investment income	826	768
Policy receivables and agents' balances, net	11,985	11,653
Reinsurance recoverable	771	366
Deferred policy acquisition costs	8,031	8,124
Property and equipment, net	1,743	1,781
Income tax recoverable	926	393
Deferred income tax asset, net	1,123	1,487
Other assets	765	491
Total Assets	\$ 146,074	\$ 146,438
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Property and casualty benefit and loss reserves	\$ 6,927	\$ 7,075
Accident and health benefit and loss reserves	3,603	3,595
Life and annuity benefit and loss reserves	33,329	33,283
Unearned premiums	30,773	30,112
Policy and contract claims	913	903
Other policyholder funds	1,705	1,706
Short-term notes payable and current portion of long-term debt	800	1,300
Long-term debt	14,342	14,339
Other liabilities	6,956	6,500
Total Liabilities	99,348	98,813
Contingencies		
Shareholders' equity		
Common stock	2,522	2,522
Additional paid-in capital	5,483	5,483
Accumulated other comprehensive income (loss)	(705)	) 2,646
Retained earnings	39,426	36,974

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Total Shareholders' Equity	46,726	47,625
Total Liabilities and Shareholders' Equity	\$ 146,074	\$ 146,438

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

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## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In thousands, except per share amounts)

	Three months ended March 31,	
	2018	2017
<b>REVENUES</b>		
Net premiums earned	\$15,059	\$15,040
Net investment income	781	926
Net realized investment gains (losses)	(125 )	160
Other income	161	152
Total Revenues	15,876	16,278
<b>BENEFITS, LOSSES AND EXPENSES</b>		
Policyholder benefits and settlement expenses	9,427	11,146
Amortization of deferred policy acquisition costs	803	945
Commissions	2,060	2,093
General and administrative expenses	2,003	1,797
Taxes, licenses and fees	649	689
Interest expense	302	323
Total Benefits, Losses and Expenses	15,244	16,993
Income (Loss) Before Income Taxes	632	(715 )
<b>INCOME TAX EXPENSE (BENEFIT)</b>		
Current	(534 )	(325 )
Deferred	695	(74 )
	161	(399 )
Net Income (Loss)	\$471	\$(316 )
INCOME (LOSS) PER COMMON SHARE BASIC AND DILUTED	\$0.19	\$(0.13 )
DIVIDENDS DECLARED PER SHARE	\$0.05	\$0.05

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



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## THE NATIONAL SECURITY GROUP, INC.

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

	Three months ended March 31, 2018 2017	
Net income (loss)	\$471	\$(316)
Other comprehensive income (loss), net of tax Changes in:		
Unrealized gains (losses) on securities, net of reclassification adjustment of \$68 and \$106 for 2018 and 2017, respectively	(1,376)	344
Unrealized gain on interest rate swap	132	70
Other comprehensive income (loss), net of tax	(1,244)	414
Comprehensive income (loss)	\$(773)	\$98

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

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## THE NATIONAL SECURITY GROUP, INC.

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

	Total	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock	Additional Paid-in Capital
Balance at December 31, 2017	\$47,625	\$36,974	\$ 2,646	\$ 2,522	\$ 5,483
Cumulative effect of change in accounting principle	—	2,107	(2,107 )	—	—
Comprehensive income (loss):					
Net income for March 31, 2018	471	471	—	—	—
Other comprehensive loss (net of tax)	(1,244 )	—	(1,244 )	—	—
Cash dividends	(126 )	(126 )	—	—	—
Balance at March 31, 2018	\$46,726	\$39,426	\$ (705 )	\$ 2,522	\$ 5,483

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

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## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

	Three months ended March 31,	
	2018	2017
Cash Flows from Operating Activities		
Net income (loss)	\$471	\$(316 )
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense and amortization/accretion, net	100	146
(Increase) decrease in cash surrender value of company owned life insurance	139	(42 )
Net realized gains on investments	125	(160 )
Deferred income taxes	695	(74 )
Amortization of deferred policy acquisition costs	803	945
Changes in assets and liabilities:		
Change in receivable for securities sold	—	499
Change in accrued investment income	(58 )	(26 )
Change in reinsurance recoverable	(405 )	776
Policy acquisition costs deferred	(710 )	(935 )
Change in accrued income taxes	(533 )	(325 )
Change in net policy liabilities and claims	240	698
Change in other assets/liabilities, net	472	(520 )
Other, net	6	5
Net cash provided by operating activities	1,345	671
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(5,601 )	(3,324 )
Property and equipment	—	(8 )
Proceeds from sale or maturities of:		
Held-to-maturity securities	43	92
Available-for-sale securities	3,813	3,939
Property and equipment	—	2
Other invested assets, net	(31 )	(13 )
Net cash provided by (used in) investing activities	(1,776 )	688
Cash Flows from Financing Activities		
Change in other policyholder funds	(1 )	22
Change in short-term notes payable	(500 )	(500 )
Dividends paid	(126 )	(126 )
Net cash used in financing activities	(627 )	(604 )
Net change in cash and cash equivalents	(1,058 )	755
Cash and cash equivalents, beginning of year	6,644	7,368
Cash and cash equivalents, end of period	\$5,586	\$8,123

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

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

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary, Omega One Insurance Company (Omega). The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). In the opinion of management, all adjustments, consisting of normal and recurring items, necessary for the fair presentation of the consolidated financial statements have been included. All significant intercompany transactions and accounts have been eliminated. The financial information presented herein should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017, which includes information and disclosures not presented herein.

Use of Estimates

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

Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,522,312 at March 31, 2018 and 2,517,339 at March 31, 2017. The Company did not have any dilutive securities as of March 31, 2018 and 2017.

Reclassifications

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

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts subject to FDIC insured limits of \$250,000 per entity. At March 31, 2018, the net amount exceeding FDIC insured limits was \$3,654,000 at three financial institutions. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of financial institutions on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At March 31, 2018, the single largest balance due from one agent totaled \$729,000.

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

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

Accounting Changes Not Yet Adopted

Recognition and Measurement of Financial Assets and Financial Liabilities

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

Leases

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

Contingent Put and Call Options in Debt Instruments

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

Financial Instruments - Credit Losses

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

Receivables - Nonrefundable Fees and Other Costs

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

Derivatives and Hedging

In August 2017, the FASB issued guidance that amends and simplifies hedge accounting guidance in order to enable entities to better portray the economic results of their risk management activities. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those periods. Early adoption is permitted. The Company is currently evaluating the impact of the standard on its consolidated financial statements and related disclosures.

Recently Adopted Accounting Standards

Income Statement - Reporting Comprehensive Income

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

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

Revenue from Contracts with Customers

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

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

Recognition and Measurement of Financial Assets and Financial Liabilities

In January 2016, the FASB issued guidance that requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The guidance requires entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset. The guidance eliminates the requirement for public companies to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. This guidance is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company adopted this guidance as of January 1, 2018. The adoption of this guidance resulted in a \$2,107,000 reclassification to retained earnings from accumulated other comprehensive income related to accumulated unrealized gains on equity securities as well as recognition of a \$162,000 loss, net of tax, related to the change in value of equity securities.

Classification of Certain Cash Receipts and Cash Payments

In August 2016, the FASB issued guidance that clarifies how certain cash receipts and cash payments shall be presented and classified in the statement of cash flows. This guidance addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The guidance is effective for annual and interim reporting periods beginning after December 15, 2017. The Company adopted this guidance as of January 1, 2018. The adoption of this guidance did not have a significant impact on our financial position, results of operations or cash flows.

Compensation - Stock Compensation

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

NOTE 2 – VARIABLE INTEREST ENTITIES



The Company holds a passive interest in a limited partnership that is considered to be a Variable Interest Entity (VIE) under the provisions of ASC 810 Consolidation. The Company is not the primary beneficiary of the entity and is not required to consolidate under ASC 810. The entity is a private placement investment fund formed for the purpose of investing in private equity investments. The Company owns less than 1% of the limited partnership. The carrying value of the investment totals \$142,000 and is included as a component of Other Invested Assets in the accompanying consolidated balance sheets.

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, \$9,000,000 of trust preferred

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2017 AMOUNTS)

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

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

## NOTE 3 – INVESTMENTS

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

The amortized cost and aggregate fair values of investments in available-for-sale securities as of March 31, 2018 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$ 38,963	\$ 625	\$ 748	\$38,840
Mortgage backed securities	11,979	101	456	11,624
Private label asset backed securities	12,637	294	3	12,928
Obligations of states and political subdivisions	13,422	299	124	13,597
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	19,276	63	503	18,836
Total	\$ 96,277	\$ 1,382	\$ 1,834	\$95,825

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The amortized cost and aggregate fair values of investments in held-to-maturity securities as of March 31, 2018 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$ 1,573	\$ 16	\$ 14	\$1,575
Total	\$ 1,573	\$ 16	\$ 14	\$1,575

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

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

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

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

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

The amortized cost and aggregate fair value of debt securities at March 31, 2018, by contractual maturity, are presented in the following table (dollars in thousands). Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in Thousands)	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	\$ 1,284	\$1,284
Due after one year through five years	16,803	16,854
Due after five years through ten years	29,218	29,206
Due after ten years	48,972	48,481
Total	\$ 96,277	\$95,825
Held-to-maturity securities:		
Due in one year or less	\$ —	\$—
Due after one year through five years	—	—
Due after five years through ten years	57	61
Due after ten years	1,516	1,514
Total	\$ 1,573	\$1,575



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A summary of securities available-for-sale with unrealized losses as of March 31, 2018, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows (dollars in thousands):

March 31, 2018	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
Fixed maturities							
Corporate debt securities	\$17,812	\$ 471	\$5,950	\$ 277	\$23,762	\$ 748	40
Mortgage backed securities	7,180	257	2,124	199	9,304	456	21
Private asset backed securities	1,163	3	—	—	1,163	3	2
Obligations of state and political subdivisions	3,928	43	2,528	81	6,456	124	13
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	8,188	223	6,349	280	14,537	503	22
	\$38,271	\$ 997	\$16,951	\$ 837	\$55,222	\$ 1,834	98

A summary of securities held-to-maturity with unrealized losses as of March 31, 2018 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

March 31, 2018	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
Fixed maturities:							
Mortgage backed securities	\$1,145	\$ 14	\$ —	\$ —	—\$1,145	\$ 14	1
	\$1,145	\$ 14	\$ —	\$ —	—\$1,145	\$ 14	1

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

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

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

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

Management has evaluated each security in a significant unrealized loss position in both the debt and equity investment portfolios. The Company has no material exposure to sub-prime mortgage loans and approximately 5.94% 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, 2018 and year ended December 31, 2017, the Company realized no other-than-temporary impairments. At March 31, 2018, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$88,000. The second largest loss position was in the bond portfolio and totaled \$87,000. The third largest loss position was in the bond portfolio and totaled \$81,000. At December 31, 2017, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$75,000. The second largest loss position was in the bond portfolio and totaled \$60,000. The third largest loss position was in the bond portfolio and totaled \$53,000.





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

	Three months ended March 31,	
	2018	2017
Fixed maturities	\$891	\$817
Equity securities	20	24
Mortgage loans on real estate	2	2
Investment real estate	1	2
Policy loans	35	33
Company owned life insurance change in surrender value	(139 )	43
Other	8	45
	818	966
Less: Investment expenses	37	40
Net investment income	\$781	\$926

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

	Three months ended March 31,	
	2018	2017
Fixed maturities	\$81	\$160
Change in fair value of equity securities	(206 )	—
Net realized investment gains (losses)	\$(125)	\$160

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

	March 31, December 31,	
	2018	2017
Net change in unrealized gains (losses) on available-for-sale securities before deferred tax	\$(1,742 )	\$ 1,402
Deferred income tax	366	(476 )
Net change in unrealized gains (losses) on available-for-sale securities	\$(1,376 )	\$ 926

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NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

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

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

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

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

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

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

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

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

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

Financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2018 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
<b>Financial Assets</b>				
Fixed maturities available-for-sale				
Corporate debt securities	\$38,840	\$—	\$38,840	\$—
Mortgage backed securities	11,624	—	11,624	—
Private label asset backed securities	12,928	—	12,928	—
Obligations of states and political subdivisions	13,597	—	13,597	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,836	18,836	—	—
Trading securities	107	107	—	—
Equity securities	4,303	3,201	—	1,102
<b>Total Financial Assets</b>	<b>\$100,235</b>	<b>\$22,144</b>	<b>\$76,989</b>	<b>\$1,102</b>
<b>Financial Liabilities</b>				
Interest rate swap	\$(441 )	\$—	\$—	\$(441 )
<b>Total Financial Liabilities</b>	<b>\$(441 )</b>	<b>\$—</b>	<b>\$—</b>	<b>\$(441 )</b>

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

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

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

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

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

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

As of March 31, 2018, Level 3 fair value measurements of assets include \$1,102,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of March 31, 2018, Level 3 fair value measurements of liabilities include \$441,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party that utilizes financial modeling tools and assumptions on interest and other factors. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 7.

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The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2018 (in thousands):

	Equity Securities	Interest Rate Swap
For the three months ended March 31, 2018		
Beginning balance	\$ 1,073	\$(608)
Total gains or losses (realized and unrealized):		
Included in earnings	29	—
Included in other comprehensive income	—	167
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$ 1,102	\$(441)
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, 2018:	\$ —	\$ —

For the three months ended March 31, 2018, there were no assets or liabilities measured at fair values on a nonrecurring basis.

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2017 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

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



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The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2017 (in thousands):

For the year ended December 31, 2017	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$ 1,258	\$(1,030)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	114	422
Purchases:	46	—
Sales:	(345 )	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$ 1,073	\$(608 )
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, 2017:	\$ —	\$—

For the year ended December 31, 2017, there were no assets or liabilities measured at fair values on a nonrecurring basis.

The Company is exposed to certain risks in the normal course of its business operations. The primary risk that is managed through the use of derivatives is interest rate risk on floating rate borrowings. This risk is managed through the use of interest rate swap agreements which are designated as cash flow hedges. For cash flow hedges, the effective portion of the gain or loss on the interest rate swap is included as a component of other comprehensive income and reclassified into earnings in the same period during which the hedged transaction is recognized in earnings. The Company does not hold or issue derivatives that are not designated as hedging instruments. See Note 8 for additional information about the interest rate swap agreements.

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

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

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

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

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

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



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

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

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

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The carrying amount and estimated fair value of the Company's financial instruments as of March 31, 2018 and December 31, 2017 are as follows (in thousands):

	March 31, 2018		December 31, 2017	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related instruments				
Held-to-maturity securities	\$1,573	\$ 1,575	\$1,616	\$ 1,645
Mortgage loans	161	161	162	162
Policy loans	1,842	1,842	1,810	1,810
Company owned life insurance	4,835	4,835	4,974	4,974
Other invested assets	2,451	2,451	2,574	2,574
Liabilities and related instruments				
Other policyholder funds	1,705	1,705	1,706	1,706
Short-term notes payable and current portion of long-term debt	800	800	1,300	1,300
Long-term debt	14,342	14,342	14,339	14,339

## NOTE 5 – PROPERTY AND EQUIPMENT

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

	March 31, December 31,	
	2018	2017
Building and improvements	\$ 3,378	\$ 3,378
Electronic data processing equipment	1,511	1,512
Furniture and fixtures	486	486
	5,375	5,376
Less accumulated depreciation	3,632	3,595
Property and equipment, net	\$ 1,743	\$ 1,781

Depreciation expense for the three months ended March 31, 2018 was \$38,000 (\$121,000 for the year ended December 31, 2017).

## NOTE 6 – INCOME TAXES

On December 22, 2017, the President signed the Tax Cuts and Jobs Act (TCJA), a comprehensive tax legislation which, among other things, reduced the Company's statutory federal income tax rate from 34% to 21% effective January 1, 2018. In addition to the reduction in tax rates, the TCJA makes broad and complex changes to the Internal Revenue Code that will introduce changes to many tax related exclusions, deductions and credits. 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 \$1,123,000 at March 31, 2018 and \$1,487,000 at December 31, 2017.

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

	As of March 31, 2018	As of December 31, 2017
General expenses	\$1,068	\$ 1,069
Unearned premiums		