

NATIONAL SECURITY GROUP INC

Form 10-K

March 15, 2019

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal period ended December 31, 2018

or

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

For the transition period from _____ to _____.

Commission File Number 0-18649

The National Security Group, Inc.

(Exact name of registrant as specified in its charter)

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

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

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

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

None

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

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

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

Yes No

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

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

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

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller Reporting Company

Emerging Growth Company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes

No

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of the last business day of the registrant's most recently completed second fiscal quarter, based upon the bid price of these shares on NASDAQ on such date, was \$19,777,251.

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

| Class | Outstanding March 15, 2019 |
|-------|----------------------------|
|-------|----------------------------|

| | |
|-------------------------------|------------------|
| Common Stock \$1.00 par value | 2,527,136 shares |
|-------------------------------|------------------|

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Certifications

DOCUMENTS INCORPORATED BY REFERENCE

Definitive proxy statement for the 2019 Annual Meeting of Stockholders to be held May 17, 2019 is incorporated by 1. reference into Part III of this report. The proxy statement will be filed no later than 120 days from December 31, 2018.

2. Current Report on Form 8-K for event occurring on February 28, 2019 is incorporated into Part IV of this report.

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PART I. Financial Information

Item 1. Business

Summary Description of The National Security Group, Inc.

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

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

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

The property and casualty subsidiaries of the Company, National Security Fire and Casualty (NSFC), and Omega One Insurance Company (Omega), primarily write personal lines dwelling coverage including dwelling fire and windstorm, homeowners and mobile homeowners lines of insurance in ten states. Property and casualty insurance is the most significant industry segment, accounting for 90.9% of total premium revenues.

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

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

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

Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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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 variance 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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Industry Segment and Geographical Area Information

Property and Casualty Insurance Segment

The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992. This segment will be referred to throughout this report as NSFC, property-casualty segment or P&C segment. NSFC is licensed to write property and casualty insurance in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia, and operates on a surplus lines basis in the state of Louisiana. Omega is licensed to write insurance in Alabama and Louisiana.

The following table indicates allocation of direct premium written by state for the years ended December 31, 2018 and 2017:

| State | Percent of Direct Written Premium | | | |
|----------------|-----------------------------------|----------|--------------|----------|
| | 2018 | | 2017 | |
| Alabama | \$16,261,000 | 26.65 % | \$16,966,000 | 27.59 % |
| Arkansas | 1,941,000 | 3.18 % | 2,086,000 | 3.39 % |
| Georgia | 9,786,000 | 16.04 % | 9,172,000 | 14.91 % |
| Louisiana | 5,178,000 | 8.49 % | 6,068,000 | 9.87 % |
| Mississippi | 10,816,000 | 17.73 % | 10,808,000 | 17.58 % |
| Oklahoma | 6,828,000 | 11.19 % | 6,580,000 | 10.70 % |
| South Carolina | 6,793,000 | 11.14 % | 6,477,000 | 10.53 % |
| Tennessee | 3,404,000 | 5.58 % | 3,341,000 | 5.43 % |
| | \$61,007,000 | 100.00 % | \$61,498,000 | 100.00 % |

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

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

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

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

| | Year Ended December 31, | |
|-----------------------------------|-------------------------|--------------|
| | 2018 | 2017 |
| Net premiums earned: | | |
| Fire, allied lines and homeowners | \$54,837,000 | \$55,044,000 |
| Other | — | — |
| Total net earned premium | \$54,837,000 | \$55,044,000 |

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Property and Casualty Loss Reserves

Our property and casualty insurance subsidiaries are required to maintain reserves to cover their ultimate liability for losses and adjustment expenses. Our staff periodically conducts reviews throughout the year of projected loss development information in order to adjust estimates. The liability for loss and adjustment expense reserves consists of an estimated liability for the ultimate settlement of claims that have been reported as well as an estimate of loss and adjustment expenses for incurred claims that have not yet been reported (IBNR). IBNR estimates are based primarily on historical development patterns using quantitative data generated from statistical information and qualitative analysis of legal developments, economic conditions and development caused by events deemed to be infrequent in occurrence. The reserves are based on an estimate made by management. Management estimates are based on an analysis of historical paid and incurred loss development patterns for the ten prior loss years. Prior year period-to-period loss development factors are applied to latest reported loss reserve estimates in order to estimate the ultimate incurred losses for each given loss year. The amount of loss reserves estimated in excess of current reported case losses are recorded as IBNR reserves.

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

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

While the information in the table provides a historical perspective on the adequacy of unpaid losses and loss adjustment expenses established in previous years, it should not be assumed to be predictive of redundancies or deficiencies on current year unpaid losses in future periods. Company management believes that the reserves established at the end of 2018 are adequate. However, due to inherent uncertainties in the loss reserve estimation process, management cannot guarantee that current year reserve balances will prove to be adequate. Due to the relatively short tail nature of the property and casualty subsidiaries' claim liabilities, the Company does not discount loss reserves for the time value of money. Dollar amounts in the following table are in thousands.

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| Gross unpaid losses per | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|-----------------------------|----------|----------|----------|----------|----------|---------|---------|----------|----------|---------|----------|
| Consolidated Balance Sheet | \$14,436 | \$12,646 | \$13,184 | \$14,386 | \$11,214 | \$8,734 | \$8,321 | \$9,645 | \$7,530 | \$7,075 | \$8,208 |
| Ceded reserves | (2,421) | (549) | (1,329) | (2,381) | (1,229) | (782) | (839) | (1,381) | (1,184) | (327) | (1,384) |
| Net unpaid losses | \$12,015 | \$12,097 | \$11,855 | \$12,005 | \$9,985 | \$7,952 | \$7,482 | \$8,264 | \$6,346 | \$6,748 | \$6,824 |
| Cumulative net payments: | | | | | | | | | | | |
| 1 year later | \$5,636 | \$5,349 | \$5,738 | \$4,035 | \$4,827 | \$2,900 | \$2,990 | \$4,482 | \$2,950 | \$3,069 | |
| 2 years later | 6,350 | 6,305 | 7,239 | 5,346 | 6,670 | 3,539 | 3,503 | 4,839 | 3,364 | | |
| 3 years later | 6,725 | 6,764 | 7,841 | 6,483 | 7,426 | 3,782 | 3,863 | 5,007 | | | |
| 4 years later | 6,980 | 7,244 | 8,382 | 7,001 | 7,496 | 3,910 | 4,113 | | | | |
| 5 years later | 7,295 | 7,701 | 8,419 | 7,001 | 7,536 | 4,085 | | | | | |
| 6 years later | 7,390 | 7,725 | 8,433 | 7,060 | 7,572 | | | | | | |
| 7 years later | 7,406 | 7,743 | 8,453 | 7,108 | | | | | | | |
| 8 years later | 7,509 | 7,746 | 8,452 | | | | | | | | |
| 9 years later | 7,512 | 7,746 | | | | | | | | | |
| 10 years later | 7,512 | | | | | | | | | | |
| Net Liability re-estimated: | | | | | | | | | | | |
| 1 year later | 9,438 | 8,621 | 11,443 | 9,606 | 9,354 | 6,698 | 5,597 | 6,333 | 4,495 | 5,060 | |
| 2 years later | 7,916 | 8,869 | 11,064 | 8,439 | 9,360 | 5,185 | 4,559 | 5,756 | 4,642 | | |
| 3 years later | 8,179 | 9,033 | 9,725 | 8,500 | 8,483 | 4,348 | 4,605 | 5,916 | | | |
| 4 years | 8,514 | 8,418 | 9,178 | 7,661 | 7,700 | 4,460 | 4,428 | | | | |

| | | | | | | |
|-------|-------|-------|-------|-------|-------|-------|
| later | | | | | | |
| 5 | | | | | | |
| years | 7,855 | 8,064 | 8,854 | 7,091 | 7,683 | 4,365 |
| later | | | | | | |
| 6 | | | | | | |
| years | 7,641 | 8,092 | 8,453 | 7,157 | 7,592 | |
| later | | | | | | |
| 7 | | | | | | |
| years | 7,707 | 7,762 | 8,457 | 7,124 | | |
| later | | | | | | |
| 8 | | | | | | |
| years | 7,528 | 7,750 | 8,452 | | | |
| later | | | | | | |
| 9 | | | | | | |
| years | 7,516 | 7,746 | | | | |
| later | | | | | | |
| 10 | | | | | | |
| years | 7,512 | | | | | |
| later | | | | | | |

Net cumulative
redundancy \$4,503 \$4,351 \$3,403 \$4,881 \$2,393 \$3,587 \$3,054 \$2,348 \$1,704 \$1,688
(deficiency)

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

| Change in Loss and LAE Reserves | For The Years Ended December 31, | | | |
|---|----------------------------------|--------------------|----------|-------------|
| | 2018 | | 2017 | |
| | Adjusted | | Adjusted | |
| | Loss and | % Change in Equity | Loss and | % Change in |
| | LAE | | LAE | Equity |
| | Reserves | | Reserves | |
| *Loss and LAE reserves are in thousands | | | | |
| (10.0)% | \$ 7,387 | 1.79% | \$ 6,368 | 1.48% |
| (7.5)% | 7,592 | 1.34% | 6,544 | 1.11% |
| (5.0)% | 7,798 | 0.89% | 6,721 | 0.74% |
| (2.5)% | 8,003 | 0.45% | 6,898 | 0.37% |
| Reported | 8,208 | —% | 7,075 | —% |
| 2.5% | 8,413 | (0.45)% | 7,252 | (0.37)% |
| 5.0% | 8,618 | (0.89)% | 7,429 | (0.74)% |
| 7.5% | 8,824 | (1.34)% | 7,606 | (1.11)% |
| 10.0% | 9,029 | (1.79)% | 7,782 | (1.48)% |

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

Life Insurance Segment

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

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The following table indicates NSIC's percentage of direct premiums collected by state for the two years ended December 31, 2018 and 2017:

| State | Percentage of Total Direct Premiums | | | | | |
|----------------|-------------------------------------|--------|---|-------------|--------|---|
| | 2018 | | | 2017 | | |
| Alabama | \$3,538,000 | 57.37 | % | \$3,616,000 | 57.96 | % |
| Florida | 62,000 | 1.01 | % | 60,000 | 0.96 | % |
| Georgia | 1,316,000 | 21.34 | % | 1,319,000 | 21.14 | % |
| Mississippi | 590,000 | 9.57 | % | 615,000 | 9.86 | % |
| South Carolina | 419,000 | 6.79 | % | 415,000 | 6.65 | % |
| Tennessee | 50,000 | 0.81 | % | 37,000 | 0.59 | % |
| Texas | 192,000 | 3.11 | % | 177,000 | 2.84 | % |
| | \$6,167,000 | 100.00 | % | \$6,239,000 | 100.00 | % |

NSIC has two primary methods of distribution of insurance products: independent agents and home service (career) agents. The independent agent distribution method accounts for 66.9% of total premium revenue in the life insurance segment. Approximately 200 of the Company's independent agents produced new business during 2018. The home service distribution method of life insurance products accounts for 28.2% of total premium revenue in the life insurance segment. Home service life products consist of products marketed directly at the home or other premises of the insured by an employee agent. The Company employed three career agents and one regional manager as of December 31, 2018. The remaining 4.9% of premium revenue consists of the following: a book of business acquired from a state guaranty association in 2000 (0.1%), premium generated through direct sales of school accident insurance (4.4%), and other miscellaneous business serviced directly through the home office (0.4%).

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

The following table displays a schedule of 2018 life segment premium produced by product and distribution method:

| Line of Business | Home Service Agent | Independent Agent | Other |
|--------------------------------------|--------------------|-------------------|-----------|
| Industrial | \$43,000 | \$— | \$32,000 |
| Ordinary | 1,437,000 | 2,588,000 | 21,000 |
| Group Life | — | 9,000 | 63,000 |
| A&H Group | — | 105,000 | 158,000 |
| A&H Other | 215,000 | 1,329,000 | 19,000 |
| Total Premium by Distribution Method | \$1,695,000 | \$4,031,000 | \$293,000 |

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

| | Year ended December 31, | |
|---|-------------------------|----------------|
| | 2018 | 2017 |
| Life insurance in force at end of period: | | |
| Ordinary-whole life | \$ 164,231,000 | \$ 166,112,000 |
| Term life | 23,243,000 | 24,483,000 |
| Industrial life | 15,735,000 | 16,231,000 |
| | \$ 203,209,000 | \$ 206,826,000 |
| Life insurance issued: | | |
| Ordinary-whole life | \$ 16,742,000 | \$ 20,957,000 |
| | \$ 16,742,000 | \$ 20,957,000 |
| Net premiums earned: | | |
| Life insurance | \$ 4,193,000 | \$ 4,291,000 |
| Accident and health insurance | 1,826,000 | 1,828,000 |
| | \$ 6,019,000 | \$ 6,119,000 |

Life Insurance Segment Reserves

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

Investments

A significant percentage of the total income for the Company is tied to the performance of our investments. Assets that will eventually be used to pay reserve liabilities and other policyholder obligations, along with our capital, are invested to generate investment income while held by the Company. Our investment income is comprised primarily of interest and dividend income on fixed maturity securities and equity securities along with capital gains/losses generated by these investment securities. At December 31, 2018, cash and investments comprise 82% of total assets, and investment income (including realized losses) comprises 5.5% of total revenue evidencing the significant impact investments can have on financial results. Because our insurance subsidiaries are regulated as to the types of investments they may make and the amount of funds they may maintain in any one type of investment, the Company has developed a conservative value oriented investment philosophy, in order to meet regulatory requirements. The Company's investment goals are to conserve capital resources and assets, obtain the necessary investment income threshold to meet reserves, and provide a reasonable return. Current yield from invested assets and capital appreciation of investments create this return.

Marketing and Distribution

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

P&C products are marketed through a network of independent agents and brokers, who are independent contractors and generally maintain relationships with one or more competing insurance companies. NSFC employs field

marketing representatives who visit in the offices of our independent agents regularly to give the agents opportunities for feedback. Our NSFC marketing representatives also host training seminars throughout our service areas. The goal of these seminars is to educate the independent agent sales force about our products and services.

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Agents receive compensation for their sales efforts. In the case of life insurance agents, compensation is paid in the form of sales commissions plus a servicing commission. Commissions paid by the Life segment in 2018 averaged approximately 10.4% of premiums and are generally higher for new business production and decline each year at subsequent renewals. Commission rates paid by the P&C segment in 2018 averaged approximately 15% of premiums on both new and renewal business. During 2018, no independent agent, accounted for more than 10% of total net earned premium of the property-casualty insurance subsidiaries. The net earned premium from the largest general agent totaled \$4,818,000 or 8.8% of total P&C segment net earned premium. NSFC also offers a “profit sharing bonus plan” to independent agents in order to promote better field underwriting and encourage retention of profitable business. This plan not only rewards our agents but also enhances profitability by giving the agent a vested interest in our success and also aids in maintaining price stability for all our customers as agents have a financial incentive to use good field underwriting practices when completing an application for insurance.

At December 31, 2018, NSIC employed three career agents and one regional manager. NSIC also had approximately 200 independent agents actively producing new business in seven states. At December 31, 2018, NSFC had contracts with approximately 1,700 independent agencies in eight states.

Competition

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

NSFC's primary insurance products are dwelling fire and homeowners, including mobile homeowners. Dwelling fire and homeowners are collectively referred to as the dwelling property line of business. We focus on providing niche insurance products within the markets we serve. We are in the top twenty-five dwelling property insurance carriers in our two largest states, Alabama and Mississippi. However, due to the large concentration of business among the top five carriers, our total market share in the dwelling fire line of business is approximately 2.6% in Alabama and 1.6% in Mississippi. In the homeowners line of business, our market share in both Alabama and Mississippi is less than 1%. The homeowners markets are even more concentrated with the top three homeowners carriers in both Alabama and Mississippi controlling nearly 50% of the market.

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

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

Regulation

Our insurance subsidiaries are directly regulated by the insurance department in our state of domicile, Alabama. We are subject to the Alabama Insurance Holding Company System Regulatory Act and report to the Alabama Department

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of Insurance. Consequently, we are subject to periodic examination and regulation under Alabama Insurance Laws. We underwent our latest periodic regulatory examination which concluded in 2015 with no material issues noted and no financial adjustments made as a result of the examination. The Alabama Department of Insurance is expected to commence a periodic examination of our insurance subsidiaries in 2019.

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

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

Our insurance subsidiaries are subject to risk based capital requirements adopted by the National Association of Insurance Commissioners (NAIC). These requirements direct our insurance companies to calculate and report information according to a risk based formula which attempts to measure statutory capital and surplus needs based on the risk in our product mix and investment portfolio. The formula is designed to allow state insurance regulators to identify companies that are potentially inadequately capitalized. Under the formula, the Company calculates Risk Based Capital (RBC) by taking into account certain risks inherent in an insurer's assets, including investments and an insurer's liabilities. Risk based capital rules provide for different levels of action depending on the ratio of a company's total adjusted capital to its "authorized control level" RBC. Based on calculations made by each of our insurance subsidiaries at December 31, 2018, each subsidiary exceeds any levels that would require regulatory actions.

A.M. Best Rating

A.M. Best Company is a leading provider of insurance company financial strength ratings and insurance company issuer credit ratings. Best's financial strength ratings and issuer credit ratings provide an independent opinion based on comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. All of our insurance companies have been assigned ratings by A.M. Best Company (Best). On April 12, 2018, A. M. Best affirmed the financial strength rating (FSR) of B++ (Good) and the issuer credit rating (ICR) of "bbb" of NSFC. In addition, Best affirmed the FSR of B+(Good) and ICR of "bbb-" of Omega and NSIC. The A.M. Best outlook for all of the ratings is "stable" for NSFC and Omega. Best upgraded the outlook from "stable" to "positive" for NSIC. Best also affirmed the ICR of "bb" of the parent holding company, NSEC, with a "stable" outlook. For the latest ratings, you can access www.ambest.com.

Demotech Rating

The property and casualty subsidiaries have been assigned ratings by Demotech, Inc. On September 30, 2018, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega

Employees

The Company itself has no management or operational employees. Instead, all human resource activities are within the subsidiary National Security Insurance Company. NSIC employed 81 staff members as of December 31, 2018, none of which were represented by a labor union. The Company and its property and casualty subsidiary have a Management Service Agreement (“Agreement”) with National Security Insurance Company whereby the property and casualty subsidiaries reimburse NSIC for salaries and expenses of employees provided under the Agreement. Involved are employees in the areas of Underwriting, Customer Service, Policy Services, Accounting, Marketing, Administration, Document Management, Data Processing, Programming, Personnel, Claims, and Management. We consider our employee relations to be good.

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

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

Item 1A. Risk Factors

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

Underwriting and Product Pricing

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

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

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

Approval of Rates

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

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Maintenance of Profit Margins and Potential for Margin Compression

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

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

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

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

Reinsurance, Risk of Loss from Catastrophic Event and Geographic Concentration

Both insurance subsidiaries customarily reinsure with other insurers certain portions of the insurance risk. The primary purpose of such reinsurance arrangements is to enable the Company to limit its risk on individual policies, and in the case of property insurance, limit its risk in the event of a catastrophe in various geographic areas. A reinsurance arrangement does not discharge the issuing company from primary liability to the insured, and the issuing company is required to discharge its liability to the insured even if the reinsurer is unable to meet its obligations under the reinsurance arrangements. Reinsurance, however, does make the reinsurer liable to the issuing company to the extent of any reinsurance in force at the time of the loss. Reinsurance arrangements also decrease premiums retained by the issuing company since that company pays the reinsuring company a portion of total premiums based upon the amount of liability reinsured. NSIC generally reinsures all risks in excess of \$50,000 with respect to any one insured. The property and casualty subsidiaries have catastrophe excess reinsurance, which provide protection in part with respect to aggregate property losses arising out of a single catastrophe, such as a hurricane.

During 2018, the property and casualty segment maintained a catastrophe contract, which covered losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeded the \$4 million company retention stated in the contract, reinsurers would reimburse the company 100% of gross losses up to the upper limits of the reinsurance agreement, which was \$72.5 million in 2018 and 2017. Any losses above the \$72.5 million upper limit are the responsibility of our Company. The contract in place during 2018 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed.

The property and casualty subsidiaries utilize our actual in force policy data modeled applying two different industry accepted catastrophe models to structure catastrophe reinsurance and determine upper limits of catastrophe reinsurance agreements. Based on modeling results utilized in 2018 and 2017, the Company was reinsured at approximately a 250 year event level. While this estimate is subject to some uncertainty and model risk, the models indicate that we maintain catastrophe reinsurance upper limits to cover an event that has less than a 0.5% probability of occurring in a given year.

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

As described above, we maintain catastrophe reinsurance in amounts that provides protection to the Company's financial condition in all but the most remote likelihood of occurrences. Our most critical catastrophe risk is from hurricanes due to our proximity to the Atlantic Ocean and the Gulf of Mexico. Our results of operations are very likely

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to be materially impacted in the event of the landfall of a hurricane or tropical storm striking the Northern Gulf Coast or Southern Atlantic Coast in Georgia or South Carolina where we maintain significant concentrations of business. We are also exposed to the risk of significant tornado activity in many of the states in which we operate. Our most significant catastrophic event risk is the risk of a loss in excess of the Company's upper catastrophe limit which could adversely impact the Company's financial condition if such an event occurs. We are also subject to assessments from windstorm underwriting pools in various states. These risks are often difficult to measure and in the event of a major catastrophe, could exceed the upper limits of our available reinsurance protection. We also face risk from a high frequency of catastrophe events. While these events may not exceed the upper limits of our catastrophe reinsurance retention, a large number of smaller events within our retention can materially impact our results of operations.

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

Climate Change

Some scientific evidence supports that there have been and continue to be significant changes in climate including temperature, precipitation and wind resulting from various natural factors, processes, and human activities. Rising temperatures and changes in weather patterns could impact storm frequency and severity in our coverage areas. Increases in storm frequency and severity could negatively impact reinsurance costs impacting product pricing and the areas in which we offer our products. With respect to our property and casualty segment, climate change may impact the types of storms in our coverage areas as well as the frequency and severity of storms, thereby adversely impacting underwriting results, reinsurance placement and rates. With respect to our life insurance segment, climate change may impact life expectancies, thereby influencing mortality assumptions used in pricing assumptions and reserve calculations. Climate change could impact future product offerings, exclusions and/or policy limitations.

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

Reserve Liabilities

NSIC maintains life insurance reserves for future policy benefits to meet future obligations under outstanding policies. These reserves are calculated to be sufficient to meet policy and contract obligations as they arise. Liabilities for future policy benefits are calculated using assumptions for interest, mortality, morbidity, expense and withdrawals determined at the time the policies were issued. As of December 31, 2018, the total reserves of NSIC (consisting of reserves for accident and health insurance) were approximately \$37,474,000. We believe, based on current available information, reserves for future policy benefits are adequate. However, we are currently in a period of persistent and historically low interest rates. Should this period of low rates be sustained over the long term, it can impair our ability to make sufficient returns to cover future policy liabilities. Also, should actual mortality, morbidity, expense or withdrawal assumption differ materially from assumptions, our operating results could be negatively impacted.

The property and casualty subsidiaries are also required to maintain loss reserves (claim liabilities) for all lines of insurance. Such reserves are intended to cover the probable ultimate cost of settling all claims, including those

incurred but not yet reported. The reserves of the property and casualty subsidiaries reflect estimates of the liability with respect to incurred claims and are determined by evaluating reported claims on an ongoing basis and by estimating liabilities for incurred but not reported claims. Such reserves include adjustment expenses to cover the cost of investigating losses and defending lawsuits. The establishment of accurate reserves is complicated by the fact that claims in some lines of insurance are settled many years after the policies have been issued, thus raising the possibility that inflation may have a significant effect on the amount of ultimate loss payment, especially when compared to initial loss estimates. The subsidiaries, however, attempt to restrict their writing to risks that settle within one to four years of issuance of the policy. As of December 31, 2018, the property and casualty subsidiaries had reserves for unpaid claims of approximately \$8,208,000, before subtracting unpaid claims due from reinsurers of \$1,384,000, leaving net unpaid claims of \$6,824,000. The reserves are not discounted for the time value of money. No changes were made in the assumptions

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used in estimating the reserves during the years ending December 31, 2018 or 2017. The Company believes, based on current available information, such reserves are adequate to provide for settlement of claims.

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

Financial Ratings

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

Regulation

The insurance subsidiaries are each subject to regulation by the insurance departments of those states in which they are licensed to conduct business. Although the extent of regulation varies from state to state, the insurance laws of the various states generally establish supervisory departments having broad administrative powers with respect to, among other matters: the granting and revocation of licenses to transact business, the licensing of agents, the establishment of standards of financial solvency (including reserves to be maintained), the nature of investments and in most cases premium rates, the approval of forms and policies, and the form and content of financial statements. The primary purpose of these regulations is the protection of policyholders. Compliance with regulations does not necessarily confer a benefit upon shareholders.

Many states in which the insurance subsidiaries operate, including Alabama, have laws requiring that insurers become members of guaranty associations. These associations guarantee that benefits due policyholders of insurance companies will continue to be provided even if the insurance company which wrote the business is financially unable to fulfill its obligations. To provide these benefits, the associations assess the insurance companies licensed in a state that write the line of insurance for which coverage is guaranteed. The amount of an insurer's assessment is generally based on the relationship between that company's premium volume in the state and the premium volume of all companies writing the particular line of insurance in the state. The Company has paid no material amounts to guaranty associations over the past two years. These payments, when made, are principally related to association costs incurred due to the insolvency of various insurance companies. Future assessments depend on the number and magnitude of insurance company insolvencies, and such assessments are therefore difficult to predict.

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

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

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Competition

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

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

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

The property and casualty subsidiaries market their products through independent agents and brokers, concentrating primarily on dwelling fire and homeowners coverage. NSFC, though one of the larger writers of lower value dwelling fire insurance in Alabama, nevertheless faces a number of competitors in this niche market. Moreover, larger general line insurers also compete with NSFC. The market share in states other than Alabama is small. Price is the primary method of competition. Because the Company utilizes independent agents, commission rates and service to the agent are also important factors in whether the independent agent agrees to offer NSFC products over those of its competitors. The Company primarily relies on an established independent agency force to market our insurance products. The loss of independent agents could adversely impact both the retention of existing business and production of new business.

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

Inflation

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

Investment Risk and Liquidity

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

to sell fixed maturity securities at a loss to cover these liquidity needs. Changes in general economic conditions, the stock market and various other external factors could also adversely impact the value of our investments and consequently our results of operations and financial condition.

Impact of Economic and Credit Market Conditions on Our Investments

Our investment portfolio is exposed to economic and financial market risks, including changes in interest rates, credit markets and prices of marketable equity and fixed-income securities. Events that unfolded in the latest recession had a material impact on the valuations of our investments. Economic and credit market conditions during the recession adversely affected the ability of some issuers of investment securities to repay their obligations and may further affect

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the values of investment securities. If the carrying value of our investments exceeds the fair value, and the decline in fair value is deemed to be other-than-temporary, we will be required to write down the value of our investments, which could adversely impact our results of operations and financial condition.

Litigation

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

Dependence of the Company on Dividends from Insurance Subsidiaries

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

Low Common Stock Trading Volume and Liquidity Limitations

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

Debt Covenants

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

Technology and Cyber Security

Our insurance subsidiaries are dependent on computer technology and internet based platforms in the delivery of insurance products. Our ability to innovate and manage technological change is key to remaining competitive in the insurance industry. A breakdown of major systems, critical infrastructure or failure to maintain up-to-date technology could impact our ability to write new business and service existing policyholders, which would adversely impact our results of operations and financial condition. Due to the nature of our business, we maintain confidential customer information. The occurrence of computer viruses, information security breaches or unanticipated events could affect the data processing systems of the Company, our service providers or information maintained on our customers. The occurrence of any of these events could impact the Company's business and adversely affect our financial condition and results of operations.

Access to Capital

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

Key Personnel

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

Accounting Standards

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

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operations and financial conditions. Potential changes in accounting standards that are currently expected to impact the Company are disclosed in the Consolidated Notes to Financial Statements included herein.

Item 1B. Unresolved Staff Comments

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

Item 2. Properties

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

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

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

Item 3. Legal Proceedings

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

Item 4. Mine Safety Disclosures

This section is not applicable.

Part II

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

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

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

| | Stock Closing Prices | | | |
|----------------|----------------------|---------|---------|---------|
| | 2018 | | 2017 | |
| | High | Low | High | Low |
| First Quarter | \$17.17 | \$15.20 | \$17.57 | \$14.35 |
| Second Quarter | \$16.75 | \$15.45 | \$16.59 | \$13.81 |
| Third Quarter | \$17.24 | \$13.52 | \$14.74 | \$11.81 |
| Fourth Quarter | \$14.75 | \$12.00 | \$16.40 | \$12.18 |

Shareholders

The number of shareholders of the Company's common stock was approximately 1,200 and the Company had 2,527,136 shares of common stock outstanding on March 15, 2019.

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Dividends

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

| | Dividends | |
|----------------|-----------|--------|
| | Per Share | |
| | 2018 | 2017 |
| First Quarter | \$0.05 | \$0.05 |
| Second Quarter | \$0.05 | \$0.05 |
| Third Quarter | \$0.05 | \$0.05 |
| Fourth Quarter | \$0.05 | \$0.05 |

Discussion regarding dividend restrictions may be found on page 40 of the Managements' Discussion and Analysis as well as in Note 12 of the Consolidated Financial Statements.

The payment of shareholder dividends is subject to the discretion of our Board of Directors and is dependent upon many factors including our operating results, financial condition, capital requirements and general economic conditions. Total shareholder dividends paid in 2018 totaled \$505,000.

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

Securities authorized for issuance under equity compensation plans

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

| Plan category | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c) |
|--|---|---|---|
| Equity compensation plans approved by security holders | — | — | 139,464 |
| Equity compensation plans not approved by security holders | — | — | — |
| Total | — | — | 139,464 |

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Item 6. Selected Financial Data

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

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

| | | | | | |
|--|------------|------------|-----------|-----------|-----------|
| Selected Financial Data: | 2018 | 2017 | 2016 | 2015 | 2014 |
| Net premiums written | \$60,717 | \$61,388 | \$61,525 | \$60,389 | \$58,204 |
| Net premiums earned | \$60,856 | \$61,163 | \$61,398 | \$59,462 | \$56,653 |
| Net investment income | 3,567 | 3,647 | 3,892 | 3,462 | 3,823 |
| Net investment gains (losses) | (178) | 234 | 998 | 503 | 100 |
| Other income | 612 | 596 | 605 | 623 | 3,816 |
| Total revenues | \$64,857 | \$65,640 | \$66,893 | \$64,050 | \$64,392 |
| Net income (loss) | \$779 | \$(1,203) | \$3,063 | \$4,697 | \$7,616 |
| Comprehensive income (loss) | \$(1,330) | \$1 | \$3,545 | \$2,450 | \$9,452 |
| Total assets | \$144,231 | \$146,438 | \$148,579 | \$147,841 | \$144,865 |
| Total debt outstanding | \$14,352 | \$15,639 | \$17,126 | \$17,957 | \$19,572 |
| Total shareholders' equity | \$45,866 | \$47,625 | \$48,052 | \$44,883 | \$42,757 |
| Shares outstanding (at year end, in thousands) | 2,527 | 2,522 | 2,517 | 2,512 | 2,507 |

Key measures:

| | | | | | | |
|---|----------|------------|---------|---------|---------|---|
| Return on average equity | 1.67 | % (2.51)% | 6.59 | % 10.72 | % 19.98 | % |
| Yield on investments, before tax | 3.1 | % 3.2 | % 3.4 | % 3.1 | % 3.6 | % |
| Debt to equity | 31.3 | % 32.8 | % 35.6 | % 40.0 | % 45.8 | % |
| US GAAP combined ratio (P&C Segment) | 102.4 | % 102.3 | % 94.6 | % 91.0 | % 87.4 | % |
| P&C Catastrophe losses, net | \$18,516 | \$14,280 | \$9,742 | \$5,373 | \$2,628 | |
| Catastrophe loss impact on combined ratio (percentage points) | 16.66 | 25.67 | 17.47 | 10.11 | 5.23 | |

Per share data:

| | | | | | |
|-------------------|---------|-----------|---------|---------|---------|
| Book value | \$18.15 | \$18.88 | \$19.09 | \$17.87 | \$17.05 |
| Net income (loss) | \$0.31 | \$(0.48) | \$1.22 | \$1.87 | \$3.04 |
| Dividends paid | \$0.20 | \$0.20 | \$0.18 | \$0.16 | \$0.12 |

| Quarterly Information: | Premiums | Investment & Other Income | Investment Gains (Losses) | Claims and Benefit Payments | Net Income (Loss) | Net Income (Loss) Per Share |
|------------------------|-----------|---------------------------|---------------------------|-----------------------------|-------------------|-----------------------------|
| 2018 | | | | | | |
| First Quarter | \$ 15,059 | \$ 942 | \$ (125) | \$ 9,427 | \$ 471 | \$ 0.19 |
| Second Quarter | 15,260 | 1,146 | (203) | 9,772 | 457 | 0.18 |
| Third Quarter | 15,445 | 1,168 | 453 | 9,825 | 907 | 0.36 |
| Fourth Quarter | 15,092 | 923 | (303) | 11,385 | (1,056) | (0.42) |
| | \$ 60,856 | \$ 4,179 | \$ (178) | \$ 40,409 | \$ 779 | \$ 0.31 |

2017

| | | | | | | |
|----------------|----------|---------|-------|----------|----------|----------|
| First Quarter | \$15,040 | \$1,078 | \$160 | \$11,146 | \$(316) | \$(0.13) |
| Second Quarter | 15,331 | 1,075 | 77 | 12,581 | (999) | (0.39) |
| Third Quarter | 15,467 | 1,089 | 75 | 11,184 | (557) | (0.22) |
| Fourth Quarter | 15,325 | 1,001 | (78) | 7,958 | 669 | 0.26 |

\$61,163 \$4,243 \$234 \$42,869 \$(1,203) \$(0.48)

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

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) and its subsidiaries. We are a "smaller reporting company" under Securities and Exchange Commission (SEC) regulations and therefore qualify for the scaled disclosure of smaller reporting companies. In general, the same information is required to be disclosed in the management discussion and analysis by smaller reporting companies except that the discussion need only cover the latest two year period and disclosures relating to contractual obligations are not required. In accordance with the scaled disclosure requirements, this discussion covers the two year period ended December 31, 2018.

The National Security Group, Inc. operates in ten states with 46.7% of total premium revenue generated in the states of Alabama and Mississippi. The Company is made up of the following two segments:

The Property and Casualty (P&C) segment is the most significant segment, accounting for 90.9% of gross earned premium in 2018. The P&C segment has insurance in-force in the states of Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, and Tennessee.

The Life segment accounted for 9.1% of gross premium revenue in 2018. The Life segment is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

The Company's P&C segment is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992. Due to Omega producing no direct written premium and the fact that Omega is a wholly owned subsidiary of NSFC authorized to underwrite similar lines of business, all references to NSFC or P&C segment in the remainder of this management discussion and analysis will include the insurance operations of both NSFC and Omega.

Life segment business is conducted through National Security Insurance Company (NSIC), a wholly owned subsidiary of the Company organized in 1947. All references to NSIC or life segment in the remainder of this management discussion and analysis will refer to the combined life, accident and health insurance operations.

Our income is principally derived from net underwriting profits and investment income. Net underwriting profit is principally derived from earned premiums received less claims paid, sales commissions to agents, costs of underwriting and insurance taxes and fees. Investment income includes interest and dividend income and gains and losses on investment holdings.

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

All of our insurance companies have been assigned ratings by A.M. Best Co (Best). On April 12, 2018, A. M. Best affirmed the financial strength rating (FSR) of B++ (Good) and the issuer credit rating (ICR) of "bbb" of NSFC. In addition, Best affirmed the FSR of B+(Good) and ICR of "bbb-" of Omega and NSIC. The A.M. Best outlook for all of the ratings is "stable" for NSFC and Omega. Best upgraded the outlook from "stable" to "positive" for NSIC. Best also affirmed the ICR of "bb" of the parent holding company, NSEC, with a "stable" outlook.

The property and casualty subsidiaries have been assigned ratings by Demotech, Inc. On September 30, 2018, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

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

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A primary process management utilizes to review financial information of the Company is evaluating the operating performance of each segment before intercompany eliminations. By performing the evaluation in this manner, management can assess the profitability of each segment on a standalone basis. We have altered the presentation of our Management Discussion and Analysis related to industry segment data to provide pretax income income by segment before eliminations. We have restated prior year to follow the same format. Note 15 to the consolidated financial statements in this Form 10-K contains a reconciliation of net income by segment before eliminations to consolidated net income.

This discussion and analysis of the consolidated results of operations and financial condition of the Company should be read in conjunction with the Selected Financial Data and Consolidated Financial Statements and related notes included in this Form 10-K. Please refer to our note regarding forward-looking statements on pages 4-5 of this report.

In order to present information as analyzed by Company management, industry segment data in this Management Discussion and Analysis is presented before certain intercompany eliminations. These intercompany eliminations, which are presented in Note 15 to the Consolidated Financial Statements, primarily include management and service fees paid by each subsidiary to NSEC, along with fees and expenses of the Company's employee claims adjusters. Claims adjusters are employees of NSIC but provide claim adjustment services to NSFC at rates comparable to those paid to independent (non-employee) adjusters utilized by NSFC. Management believes that the analysis of segment information prior to elimination of the intercompany transactions provides a more realistic view of performance relative to subsidiary capital allocation and product pricing strategies. While segment data is presented prior to intercompany eliminations, all intercompany transactions are eliminated in all Consolidated Financial Statements and other consolidated financial information presented in accordance with accounting principles generally accepted in the United States (GAAP).

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

Summary:

For the year ended December 31, 2018, net income for the Company totaled \$779,000, \$0.31 income per share, compared to a net loss of \$1,203,000, \$0.48 loss per share, for the year ended December 31, 2017; a year over year increase of \$1,982,000. While the Company ended 2018 with net income from operations, results for 2018 were negatively impacted by Hurricane Michael. On October 10, 2018, Hurricane Michael made landfall in the panhandle of Florida, as a Category 4 storm. Hurricane Michael primarily impacted our policyholders in Georgia; but also affected policyholders in Alabama and South Carolina. The losses incurred from Hurricane Michael reduced fourth quarter net income by \$3,160,000.

Results for 2017 were negatively impacted by Hurricane Irma coupled with an active spring storm season. During September 2017, Hurricane Irma made landfall in the Florida Keys as a Category 4 storm. After moving through the Florida peninsula, Hurricane Irma impacted our policyholders in Alabama, Georgia, South Carolina and Tennessee. Georgia was the primary state in our coverage area impacted by Hurricane Irma. Also adversely impacting 2017 earnings was a fourth quarter charge to income tax expense of \$803,000 from the net impact of recognition and revaluation of deferred tax assets and liabilities due to enactment of the Tax Cuts and Jobs Act (TCJA).

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Financial results for the year ended December 31, 2018 and 2017 were as follows:

| Consolidated Financial Summary | Year ended | |
|---|--------------|------------|
| | December 31, | |
| (dollars in thousands, except per share) | 2018 | 2017 |
| Gross premiums written | \$67,174 | \$67,737 |
| Net premiums written | \$60,717 | \$61,388 |
| Net premiums earned | \$60,856 | \$61,163 |
| Net investment income | 3,567 | 3,647 |
| Investment gains (losses) | (178) | 234 |
| Other income | 612 | 596 |
| Total Revenues | 64,857 | 65,640 |
| Policyholder benefits and settlement expenses | 40,409 | 42,869 |
| Amortization of deferred policy acquisition costs | 3,597 | 3,589 |
| Commissions | 7,555 | 7,723 |
| General and administrative expenses | 8,839 | 8,821 |
| Taxes, licenses and fees | 2,157 | 2,445 |
| Interest expense | 1,235 | 1,307 |
| Total Benefits, Losses and Expenses | 63,792 | 66,754 |
| Income (Loss) Before Income Taxes | 1,065 | (1,114) |
| Income tax expense | 286 | 89 |
| Net Income (Loss) | \$779 | \$(1,203) |
| Income (Loss) Per Common Share | \$0.31 | \$(0.48) |
| Reconciliation of Net Income (Loss) to non-GAAP Measurement | | |
| Net income (loss) | \$779 | \$(1,203) |
| Income tax expense | 286 | 89 |
| Investment (gains) losses, net | 178 | (234) |
| Pretax Income (Loss) From Operations | \$1,243 | \$(1,348) |

Premium Revenue:

For the year ended December 31, 2018, net premiums earned were down \$307,000 at \$60,856,000 compared to \$61,163,000 in 2017. The decrease in premium revenue was primarily driven by a decline in net earned premium in the P&C segment of \$207,000. This decline was primarily attributable to a decrease in our surplus lines business in coastal Louisiana.

Investment Gains (Losses):

In 2018, due to a change in GAAP, unrealized gains and losses on equity investments are required to be reported as a component of investment gains/losses on the statement of operations. These amounts were previously reported as a component of Other Comprehensive Income. For the year ended December 31, 2018, investment losses include a \$203,000 decrease in accumulated gains on equity securities held for investment. This decrease in accumulated gains was driven by an overall decline in stock market values experienced late in the fourth quarter of 2018.

Net Income (Loss):

For the year ended December 31, 2018, the Company had net income of \$779,000, \$0.31 income per share, compared to a net loss of \$1,203,000, \$0.48 loss per share, for the same period in 2017. The primary reason for the increase in 2018 year to date earnings compared to 2017 was the reduction in retained catastrophe losses over the twelve month period in 2018. Also, results in 2017 were adversely impacted by an increase in income tax expense due to revaluation of deferred tax assets under the Tax Cuts and Jobs Act (TCJA). Retained catastrophe losses were down \$5,142,000 in 2018 compared to 2017. In addition, we had a fourth quarter 2017 charge to income tax expense of \$803,000 from the

net impact of recognition and revaluation of deferred tax assets and liabilities due to enactment of the TCJA.

Table of Contents**Pretax Income (Loss) from Operations:**

For the year ended December 31, 2018, our pretax income from operations was \$1,243,000 compared to a pretax loss from operations of \$1,348,000 for the year ended December 31, 2017; an improvement of \$2,591,000. The primary reason for the pretax income from operations in 2018 compared to the pretax loss from operations in the prior year was a decrease in the frequency and severity of catastrophe related claims in the P&C segment. While our P&C segment was impacted by Hurricane Michael in the fourth quarter of 2018 and Hurricane Irma in the third quarter of 2017, our property and casualty subsidiary was also impacted by numerous tornado and severe thunderstorm related catastrophe events in the first half of 2017. The reduction in non-hurricane cat events in 2018 compared to the prior year was the primary reason for the decrease in claims and improvement in pretax income from operations.

P&C Segment Combined Ratio:

For the year ended December 31, 2018, the P&C segment had a GAAP combined ratio of 102.4%. Reported claims from Hurricane Michael coupled with reported claims from Hurricane Florence and 17 additional severe weather events in 2018 totaled \$9,138,000 (net of reinsurance recoveries) and increased the P&C segment combined ratio by 16.7 percentage points. In comparison, for the year ended December 31, 2017, the P&C segment had a GAAP combined ratio of 102.3%. Reported claims from Hurricane Irma and 25 additional severe weather events in 2017 totaled \$14,280,000 and increased the P&C segment combined ratio by 25.7 percentage points. Partially offsetting the 2018 decrease in catastrophe losses was an increase in fire related losses compared to the prior year.

Overview - Balance Sheet highlights at December 31, 2018 compared to December 31, 2017

| Selected Balance Sheet Highlights | December 31, 2018 | December 31, 2017 |
|---|----------------------|----------------------|
| (dollars in thousands) | | |
| Invested Assets | \$112,690 | \$114,731 |
| Cash | \$5,676 | \$6,644 |
| Total Assets | \$144,231 | \$146,438 |
| Policy Liabilities | \$77,988 | \$76,674 |
| Total Debt | \$14,352 | \$15,639 |
| Accumulated Other Comprehensive (Loss) Income | \$(1,570) | \$2,646 |
| Shareholders' Equity | \$45,866 | \$47,625 |
| Book Value Per Share | \$18.15 | \$18.88 |

Invested Assets:

Invested assets as of December 31, 2018 were \$112,690,000 compared to \$114,731,000 as of December 31, 2017. The primary reason for the decline in invested assets was the increase in market interest rates which reduced the market value of our bond portfolio held for sale by \$3,043,000.

Cash:

The Company, primarily through its insurance subsidiaries, had \$5,676,000 in cash and cash equivalents at December 31, 2018, compared to \$6,644,000 at December 31, 2017. The moderate decline in cash for 2018 was primarily due to payment of claims from Hurricane Michael which occurred in the fourth quarter of 2018.

Total Assets:

Total assets as of December 31, 2018 were \$144,231,000 compared to \$146,438,000 at December 31, 2017. Asset growth in 2018 was hindered by losses from Hurricane Michael along with a decrease in value of our bond portfolio investments due to increases in market interest rates.

Policy Liabilities:

Policy liabilities were \$77,988,000 at December 31, 2018, compared to \$76,674,000 at December 31, 2017; an increase of \$1,314,000 or 1.7%. The primary reason for the increase in policy liabilities in 2018 compared to the same period last year was a \$1,133,000 increase in P&C segment loss reserves.

Debt Outstanding:

Total debt at December 31, 2018 was \$14,352,000 compared to \$15,639,000 at December 31, 2017. Debt was reduced \$1,287,000 during 2018 primarily from the reduction of long-term debt in our holding company. The improvement of

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balance sheet strength through both capital growth and reduction of debt continues to be a primary focus of management.

Shareholders' Equity:

Shareholders' equity as of December 31, 2018 was \$45,866,000, down \$1,759,000 compared to December 31, 2017 Shareholders' equity of \$47,625,000. Book value per share was \$18.15 at December 31, 2018, compared to \$18.88 per share at December 31, 2017, a decrease of \$0.73 per share. The primary factors contributing to the decrease in both book value per share and Shareholders' equity were an accumulated other comprehensive loss of \$2,109,000, shareholder dividends of \$505,000 and new shares issued under our director compensation plan which totaled \$76,000. Partially offsetting these factors was net income of \$779,000. The accumulated other comprehensive loss was largely driven by a \$2,404,000 net of tax decline in market values in our bond portfolio due to an increase in market interest rates.

Industry Segment Data

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

| (dollars in thousands) | 2018 | % | 2017 | % |
|-------------------------------------|----------|--------|----------|--------|
| Life, accident and health insurance | \$6,019 | 9.9 % | \$6,119 | 10.0 % |
| Property and casualty insurance | 54,837 | 90.1 % | 55,044 | 90.0 % |
| | \$60,856 | 100.0% | \$61,163 | 100.0% |

The property and casualty segment composed 90.1% of total net earned premium revenue in 2018 compared to 90.0% in 2017. Through the P&C segment, we offer primarily dwelling fire and homeowners insurance coverage to our customers. The life segment composed 9.9% of net earned premium revenue in 2018 compared to 10.0% in 2017 with revenue produced from life, accident and supplemental health insurance products. While reading this discussion regarding segment information, reference is made to Note 15 to the Consolidated Financial Statements which provides additional segment related information.

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

Life and Accident and Health Insurance Operations:

Premium revenues and operating income for the life segment for the year ended December 31, 2018 and 2017 are summarized below (amounts in thousands):

| (dollars in thousands) | 2018 | 2017 |
|---|---------|---------|
| REVENUE | | |
| Net premiums earned | \$6,019 | \$6,119 |
| Net investment income | 2,722 | 2,551 |
| Net investment gains (losses) | (78) | 71 |
| Other income | 1,078 | 1,045 |
| Total Revenues | \$9,741 | \$9,786 |
| BENEFITS AND EXPENSES | | |
| Policyholder benefits paid or provided | \$5,242 | \$5,045 |
| Amortization of deferred policy acquisition costs | 838 | 812 |
| Commissions | 288 | 343 |
| General and administrative expenses | 2,111 | 1,929 |
| Insurance taxes, licenses and fees | 220 | 208 |

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| | | |
|----------------------------|---------|---------|
| Interest expense | 48 | 73 |
| Total Expenses | \$8,747 | \$8,410 |
| INCOME BEFORE INCOME TAXES | \$994 | \$1,376 |

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Year Ended December 31, 2018 Compared to Year Ended December 31, 2017:

Net earned premium revenue in the life segment was \$6,019,000 at December 31, 2018 compared to \$6,119,000 at December 31, 2017; a decrease of 1.6%. The \$100,000 decrease in net earned premium revenue was primarily due to a decline in new business production in both the traditional life and supplemental accident and health insurance products offered in NSIC.

The table below provides the major categories of investment income for the year ended December 31, 2018 and 2017:

| | Year ended | |
|-------------------------------|--------------|---------|
| | December 31, | |
| | 2018 | 2017 |
| Fixed maturities | \$2,108 | \$1,942 |
| Equity securities | 37 | 32 |
| Mortgage loans on real estate | 8 | 9 |
| Investment real estate | 543 | 544 |
| Policy loans | 141 | 130 |
| Other | 1 | 18 |
| | 2,838 | 2,675 |
| Less: Investment expenses | 116 | 124 |
| Net investment income | \$2,722 | \$2,551 |

While NSIC composes only 9.9% of premium revenue, the segment makes up 41.2% of consolidated assets. The majority of these assets consist of fixed maturity investments. Net investment income was up \$171,000 or 6.7% at \$2,722,000 for the year ended December 31, 2018 compared to \$2,551,000 for the same period last year. A combination of increased investment in fixed income securities due to positive cash flow from operations and the recent rise in interest rates was the primary factor contributing to the increase in investment income.

The table below provides investment gains and losses for the year ended December 31, 2018 and 2017:

| | Year ended | |
|---|--------------|---------|
| | December 31, | |
| | 2018 | 2017 |
| Fixed maturities | \$96 | \$(105) |
| Equity securities | — | 174 |
| Change in fair value of equity securities | (87) | — |
| Other, principally real estate | (71) | 2 |
| Other-than-temporary impairments | (16) | — |
| Net investment gains (losses) | \$(78) | \$71 |

NSIC ended 2018 with net investment losses of \$78,000 compared to net investment gains of \$71,000 for the same period in 2017. Investment gains and losses are highly dependent on several factors including market conditions, tax position and liquidity needs of the Company and can vary significantly from period to period. In 2018, due to a change in GAAP, increases and decreases in accumulated gains/losses on equity investments held for investment are required to be reported as a component of investment gains/losses on the income statement. These amounts were previously reported as a component of Other Comprehensive Income. For the year ended December 31, 2018, life segment investment losses include a \$71,000 decrease in accumulated gains on equity securities held for investment. This decrease in accumulated gains was driven by an overall decline in stock market values experienced late in the fourth quarter of 2018. The net investment gains in 2017, were primarily from the disposition of available-for-sale investments.

Other income was \$1,078,000 in 2018 compared to \$1,045,000 for the same period in 2017; an increase of \$33,000. Other income consists primarily of adjuster fees paid to NSIC from the P&C segment and rent from affiliates which is eliminated upon consolidation. As a percent of net earned premium, other income was 17.9% in 2018 and 17.1% in 2017.

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Claims were \$5,242,000 through December 31, 2018 compared to \$5,045,000 through December 31, 2017; an increase of \$197,000 or 3.9%. NSIC experienced a moderate increase in life insurance claims in 2018 compared to the same period last year due to an increase in both ordinary life and industrial life related claims.

Deferred policy acquisition cost amortization and commission expenses decreased \$29,000 for the year ended December 31, 2018 at \$1,126,000 compared to \$1,155,000 for the same period in 2017; a decline of 2.5%. As a percent of net premiums earned, policy acquisition cost amortization and commission expense was 18.7% in 2018 compared to 18.9% in 2017. A decline in the rate of new business production was the primary reason for the decline in commission expenses.

General and administrative expenses were \$2,111,000 in 2018 compared to \$1,929,000 in 2017. As a percent of earned premium, general and administrative expenses were 35.1% and 31.5% at December 31, 2018 and 2017, respectively. The most significant factor contributing to the change in general and administrative expenses was the reversal of a bonus accrual which reduced general and administrative expenses in 2017.

For the year ended December 31, 2018 and 2017, insurance taxes, licenses and fees were \$220,000 and \$208,000, respectively. As a percent of earned premium, insurance taxes, licenses and fees were comparable at 3.7% in 2018 and 3.4% in 2017.

Interest expense was \$48,000 for the year ended December 31, 2018 compared to \$73,000 for the year ended December 31, 2017. Interest expense is related to our life insurance policies which contain a savings account component. The primary reason for the \$25,000 decrease in interest expense, in 2018 compared to 2017, was a reduction in the minimum interest rate required to be paid to policyholders from 5% to 3%.

For the year ended December 31, 2018, the life segment had pretax income of \$994,000 compared to a pretax income of \$1,376,000 for the same period in 2017. The increase in claims and general and administrative expenses were the primary factors contributing to the decline in pretax income.

Property & Casualty Operations:

Premium revenues and operating income for the P&C segment for the year ended December 31, 2018 and 2017 are summarized below:

| (dollars in thousands) | 2018 | 2017 |
|---|--------------|-------------------|
| REVENUE | | |
| Net premiums earned | \$54,837 | \$55,044 |
| Net investment income | 1,330 | 1,571 |
| Net investment gains (losses) | (100) | 163 |
| Other income | 609 | 592 |
| Total Revenues | \$56,676 | \$57,370 |
| BENEFITS AND EXPENSES | | |
| Policyholder benefits paid or provided | \$35,735 | \$38,391 |
| Amortization of deferred policy acquisition costs | 2,759 | 2,777 |
| Commissions | 7,267 | 7,380 |
| General and administrative expenses | 8,472 | 8,087 |
| Insurance taxes, licenses and fees | 1,937 | 2,237 |
| Total Expenses | \$56,170 | \$58,872 |
| INCOME (LOSS) BEFORE INCOME TAXES | \$506 | \$(1,502) |

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Year Ended December 31, 2018 Compared to Year Ended December 31, 2017:

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

| Line of Business | 2018 | | 2017 | | 2018 Increase (Decrease) over 2017 |
|---------------------------------------|-------------------|-------------|-------------------|-------------|---|
| | Premium Earned | % of NPE | Premium Earned | % of NPE | |
| Dwelling Fire/Allied Lines | \$39,412 | 71.9 % | \$38,485 | 69.9 % | 2.4 % |
| Homeowners | 21,801 | 39.7 % | 22,831 | 41.5 % | (4.5)% |
| Catastrophe Reinsurance Premium Ceded | (6,376) | (11.6)% | (6,272) | (11.4)% | 1.7 % |
| Net Premium Earned | \$54,837 | 100.0 % | \$55,044 | 100.0 % | (0.4)% |

Property and casualty segment net premium earned for 2018 was \$54,837,000 compared to \$55,044,000 for the same period in 2017. The primary reason for the moderate decline in 2018 compared to 2017 was a 4.5% decrease in gross premium revenue in our homeowners program primarily driven by a reduction in premium revenue in coastal Louisiana. An increase in catastrophe reinsurance cost (ceded premium) of 1.7% also contributed to our 0.4% decrease in net premium earned.

The primary source of premium revenue growth in the P&C segment was in our non-coastal states; primarily the states of Georgia and Oklahoma. Premium revenue in Georgia increased 8.0% in 2018 with policy counts up 3.7% compared to December 31, 2017. Increased rates were implemented in Georgia, along with growth in policy count, which lead to the year over year increase in premium revenue in the state. In addition, Oklahoma premium revenue increased 4.1% in 2018, with policy counts up 3.7%. An increase in new business production coupled with the implementation of increased rates were the primary reasons for the increase in premium revenue in Oklahoma in 2018 compared to the same period last year. We expect to continue to look for opportunities to increase premium revenue in non-coastal and less hurricane prone regions of the states in which we operate in order to create more geographic diversification and seek appropriate risk adjusted rates in coastal areas.

The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. Our per event catastrophe retention remained unchanged at \$4 million in 2018 and we maintain catastrophe reinsurance coverage with an upper limit of \$72.5 million. Our catastrophe reinsurance also covers the cost of a second event up to the same \$72.5 million upper limit, again with a \$4 million retention.

Under the catastrophe reinsurance program in 2018, the Company retained the first \$4,000,000 in losses from each event. Reinsurance coverage for 2018 was maintained in three layers as follows:

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

In our reinsurance structure, management attempts to limit the impact on pretax earnings of a single modeled 100 year cat event to no more than \$4 million and the primary models utilized indicate that the Company's upper limit of reinsurance is adequate to cover up to approximately a 250 year event (a single event with an estimated probability of exceedance of 0.4% in a given year). It is noted, however, that hurricane models are subject to significant risks and uncertainties and are continuously evolving. Catastrophe models are only a tool to estimate the impact of catastrophe events and actual results can differ materially from model estimates.

We use the results of the Risk Management Solutions (RMS) and AIR Worldwide (AIR) models in our review of exposure to hurricane risk. Each of these third party vendors provides two views of the modeled results as follows: (i) a long-term view that closely relates modeled event frequency to historical hurricane activity; and (ii) a shorter-term

view that adjusts historical frequencies to reflect expectations of elevated hurricane activity in the near future. We believe that modeled estimates provide a range of potential outcomes and we review multiple estimates for purposes of understanding our catastrophic risk and variability. However, due to regulatory and competitive limitations, we generally utilize long-term model output in the development of our product pricing.

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The following table provides severe thunderstorm and hurricane single event model estimates for a range of return periods based on a blended view of the RMS and AIR long-term models utilizing our actual in-force P&C segment policy data as of August 31, 2018:

| Loss Return Period | Yearly Probability of Exceeding | Gross Losses | | Net Losses ¹ | | Net Losses as a Percent Equity ² | |
|--------------------|---------------------------------|---------------------|-----------|-------------------------|-----------|---|-----------|
| | | Severe Thunderstorm | Hurricane | Severe Thunderstorm | Hurricane | Severe Thunderstorm | Hurricane |
| 20 Years | 5 % | \$3,143 | \$16,833 | \$2,483 | \$3,160 | 5.41% | 6.89 % |
| 50 Years | 2 % | \$4,708 | \$30,128 | \$3,160 | \$3,160 | 6.89% | 6.89 % |
| 100 Years | 1 % | \$6,096 | \$42,765 | \$3,160 | \$3,160 | 6.89% | 6.89 % |
| 250 Years | 0.4 % | \$8,448 | \$63,604 | \$3,160 | \$3,160 | 6.89% | 6.89 % |
| 500 Years | 0.2 % | \$10,811 | \$79,525 | \$3,160 | \$8,710 | 6.89% | 18.99 % |

1 - Net losses are net of reinsurance and after a 21% Federal income tax benefit.

2 - Equity as of December 31, 2017

In 2018, the P&C segment was impacted by Hurricane Michael which exceeded our \$4 million catastrophe reinsurance retention. The P&C segment was also impacted, in 2018, by 18 smaller catastrophe events that individually did not exceed our catastrophe reinsurance retention; but contributed incurred losses totaling \$5,138,000. In 2017, we incurred losses from 26 catastrophe events totaling \$14,280,000 with none exceeding our reinsurance retention. This led to a record year for retained catastrophe losses for the Company and adversely impacted our 2017 underwriting results. While we have sought reinsurance coverage to reduce the impact of smaller serial events, it has been challenging to obtain cost effective coverage and structure. However, through improvement in our rate structure and implementation of more adequate risk adjusted rates over the past five years, we are able to limit the adverse impact of catastrophe losses on our capital position.

Additional details regarding the structure of our 2018 catastrophe reinsurance program can be found in Note 10 to the Consolidated Financial Statements.

The table below provides the major categories of investment income for the year ended December 31, 2018 and 2017:

| | Year ended | |
|--|-------------------|-------------------|
| | December 31, 2018 | December 31, 2017 |
| Fixed maturities | \$1,663 | \$1,389 |
| Equity securities | 47 | 45 |
| Company owned life insurance change in surrender value | (374) | 110 |
| Other | 23 | 56 |
| | 1,359 | 1,600 |
| Less: Investment expenses | 29 | 29 |
| Net investment income | \$1,330 | \$1,571 |

Net investment income totaled \$1,330,000 in 2018 compared to \$1,571,000 in 2017; a decrease of \$241,000. The primary reason for the decrease in net investment income was a \$374,000 decline in the value of investments in the cash value of our company owned life insurance in the current year compared to the same period last year.

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The table below provides investment gains and losses for the year ended December 31, 2018 and 2017:

| | Year ended December 31, | |
|---|-------------------------------|-------|
| | 2018 | 2017 |
| Fixed maturities | \$32 | \$163 |
| Change in fair value of equity securities | (132) | — |
| Net investment gains (losses) | \$(100) | \$163 |

The P&C segment ended 2018 with capital losses of \$100,000, compared to capital gains totaling \$163,000 for the same period in 2017; a decrease of \$263,000. Investment gains and losses are highly dependent on several factors including market conditions, tax position and liquidity needs of the Company and can vary significantly from period to period. In 2018, due to a change in GAAP, unrealized gains and losses on equity investments are required to be reported as a component of investment gains/losses on the income statement. These amounts were previously reported as a component of Other Comprehensive Income. For the year ended December 31, 2018, P&C segment investment losses include a \$132,000 decrease in accumulated gains on equity securities held for investment. This decrease in accumulated gains was driven by an overall decline in stock market values experienced late in the fourth quarter of 2018. There were no net investment gains in 2017.

Other income was \$609,000 in 2018 compared to \$592,000 for the same period in 2017; an increase of \$17,000. Other income consists primarily of fees related to the issuance of our property insurance policies as well as other miscellaneous income. As a percent of net earned premium, other income was 1.1% in both 2018 and 2017.

Policyholder benefits and settlement expenses in the property and casualty segment were \$35,735,000 in 2018 compared to \$38,391,000 for the same period in 2017; a decrease of \$2,656,000 or 6.9%. The P&C segment ended 2018 with a loss ratio of 65.2% compared to 68.0% for the same period in 2017. The primary reason for the decrease in claims and the loss ratio in 2018 compared to 2017 was fewer losses and loss adjustment expenses (LAE) reported from cat events in the current year compared to the same period in the prior year.

Weather related losses consistently create the most significant variability in our loss and loss adjustment expense payments from year to year in our P&C segment. The following table provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the year ended December, 2018 and 2017 (dollars in thousands):

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| For the year ended December 31, 2018 | | | For the year ended December 31, 2017 | | |
|--------------------------------------|-----------------------------|----------------|--------------------------------------|-----------------------------|----------------|
| Catastrophe event | Reported Losses & LAE | Claim Count | Catastrophe event | Reported Losses & LAE | Claim Count |
| Cat 1814 (Feb 24-26) | \$160 | 52 | Cat 1711 (Jan 1-3) | \$ 800 | 181 |
| Cat 1817 (Mar 18-20) | 1,151 | 215 | Cat 1713 (Jan 18-22) | 2,162 | 371 |
| Cat 1821 (Apr 13-16) | 631 | 147 | Cat 1719 (Feb 28-Mar 2) | 562 | 146 |
| Cat 1824 (May 12-16) | 149 | 36 | Cat 1720 (Mar 6-9) | 127 | 44 |
| Cat 1827 (May 29-June 1) | 255 | 50 | Cat 1721 (Mar 21-22) | 304 | 76 |
| Cat 1835 (June 24-26) | 290 | 48 | Cat 1722 (Mar 26-28) | 440 | 80 |
| Cat 1836 (June 28) | 419 | 69 | Cat 1724 (Apr 2-3) | 775 | 154 |
| Cat 1840 (July 19-22) | 338 | 64 | Cat 1725 (Apr 4-6) | 673 | 167 |
| Cat 1852 (Sept 13-16) | 1,292 | 371 | Cat 1728 (Apr 21-25) | 433 | 68 |
| Cat 1857 (Oct 10-14) | 13,378 | 2,312 | Cat 1730 (Apr 28-May 1) | 799 | 182 |
| | | | Cat 1731 (May 3-5) | 498 | 104 |
| | | | Cat 1732 (May 8-11) | 314 | 61 |
| | | | Cat 1733 (May 15-18) | 323 | 57 |
| | | | Cat 1734 (May 27-28) | 628 | 84 |
| | | | Cat 1738 (June 16-19) | 154 | 52 |
| | | | T.S. Cindy (June 21-25) | 555 | 105 |
| | | | Cat 1742 (Aug 5-8) | 120 | 42 |
| | | | Cat 1743 (Aug 25-31) | 309 | 77 |
| | | | Cat 1744 (Sept 11-15) | 3,622 | 992 |
| | | | Cat 1746 (Oct 7-9) | 292 | 103 |
| | | | Cat 1751 (Oct 23-24) | 147 | 19 |
| Misc cats less than \$100k | 453 | 144 | Misc cats less than \$100k | 243 | 51 |
| Total Before Reinsurance | \$18,516 | 3,508 | Total Cat losses | \$ 14,280 | 3,216 |
| Less: Reinsurance (Cat 1857) | (9,378) | | | | |
| Total Net Cat Losses | \$9,138 | | | | |
| Non-cat wind & hail | \$6,792 | 2,025 | Non-cat wind & hail | \$5,649 | 1,596 |

During 2018, we were impacted by 19 catastrophe events producing 3,508 policyholder claims totaling \$18,516,000 on a gross basis and, \$9,138,000 net of reinsurance recoveries. The primary contributor to 2018 reported cat losses was Hurricane Michael. On October 10, 2018, Hurricane Michael made landfall along Florida's Panhandle near Mexico Beach. At landfall, Michael was a Category 4 hurricane with winds of approximately 155 mph. Based on data collected from the National Weather Service, Michael was the third most intense hurricane to make landfall in the continental United States with minimum pressure on the afternoon of landfall at 919 millibars. As Hurricane Michael moved inland into southeast Alabama and southwest Georgia, it remained a very strong Category 3 storm before finally weakening to a tropical storm as it moved through central Georgia and South Carolina. We had policyholders in Alabama, Georgia and South Carolina exposed to hurricane or tropical storm force winds from October 10th through October 11th. Hurricane Michael contributed \$13,378,000 in reported losses on a gross basis (\$4,000,000 net of reinsurance recoveries). Net of tax, Hurricane Michael losses reduced net income by \$3,160,000 or \$1.25 per share.

In 2017, the P&C segment was impacted by 26 catastrophe events generating 3,216 claims totaling \$14,280,000. Because each of these events remained below our \$4 million catastrophe reinsurance retention, none were covered by reinsurance. Our 2017 catastrophe losses were a Company record for retained catastrophe losses. Net of tax, 2017 catastrophe losses reduced net income by \$9,425,000 or \$3.74 per share. The single largest catastrophe event in 2017 was Hurricane Irma, which caused \$3,622,000 in reported losses in 2017 from 992 claims. Hurricane Irma impacted

our policyholders in Alabama, Georgia, South Carolina and Tennessee. Georgia was the primary state in our coverage area impacted by Hurricane Irma comprising approximately 85% of reported claims.

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Non-catastrophe wind and hail claims reported in 2018 totaled \$6,792,000 compared to non-catastrophe wind and hail claims reported in 2017 totaling \$5,649,000; an increase of \$1,143,000 or 20.2%. During 2018, the P&C segment had 2,025 non-cat wind and hail claims reported (an average of \$3,400 per claim) compared to 1,596 claims reported during 2017 (an average of \$3,500 per claim). Non-cat wind and hail claims reported during 2018 accounted for 19.0% of total P&C segment incurred losses and LAE in the current year. Non-cat wind and hail claims reported during 2017 accounted for 14.9% of total P&C segment incurred losses and LAE in the prior year.

Year to date policyholder benefit payments were down in the property and casualty segment due to a decrease in frequency of reported losses from catastrophe events; however, reported fire losses were up in 2018 compared to 2017. Reported fire losses were up \$993,000 or 7.1% in 2018 compared to fire losses reported during 2017. The P&C segment had 479 fire losses reported for the year ended December 31, 2018, totaling \$14,968,000 compared to 486 fire claims reported for the same period in 2017 totaling \$13,975,000. The average cost per claim was \$31,200 for fire losses reported in 2018 compared to \$28,800 for fire losses reported in 2017. Reported fire losses in 2018 added 27.3 percentage points to the combined ratio compared to 25.4 percentage points to the 2017 combined ratio.

Deferred policy acquisition costs totaled \$2,759,000 in 2018 compared to \$2,777,000 in 2017. Deferred policy acquisition costs were 5.0% of net earned premium revenue for 2018 and 2017. Deferred policy acquisition costs consist of amortization of previously capitalized distribution costs, primarily commissions.

Commission expense for 2018 was \$7,267,000 (13.3% of premium revenue) compared to \$7,380,000 (13.4% of premium revenue) for the same period in 2017. The primary reason for the \$113,000 decrease in commission expense was a reduction in bonus commissions to agents in 2018 compared to 2017.

General and administrative expenses in the property and casualty segment totaled \$8,472,000 in 2018 compared to \$8,087,000 in 2017; an increase of \$385,000 or 4.8%. General and administrative expenses were 15.4% of premium revenue in 2018 and 14.7% of premium revenue in 2017. The primary reason for the increase in general and administrative expenses in 2018 compared to 2017 was an increase in actuarial fees associated with rate filings in the P&C segment.

Insurance taxes, licenses and fees were \$1,937,000 through December 31, 2018 compared to \$2,237,000 for the same period in 2017. Insurance taxes, licenses and fees were 3.5% of premium revenue in 2018 compared to 4.1% of premium in 2017. The primary reason for the decrease in taxes, licenses and fees in 2018 compared to 2017 was an increase in 2017 taxes due to a one time charge for state taxes in the P&C segment totaling \$185,000.

The P&C segment ended 2018 with pretax income of \$506,000 compared to a pretax loss of \$1,502,000 for the same period in 2017. The \$2,008,000 increase in pretax income was primarily due to the reduction of claims incurred from catastrophe losses in 2018 compared to 2017.

Property & Casualty Combined Ratio:

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

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

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

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

| | 2018 | | 2017 | |
|------------------------------|-------|---|-------|---|
| Loss and LAE Ratio (Non-Cat) | 48.50 | % | 42.32 | % |
| Loss and LAE Ratio (Cat) | 16.67 | % | 25.67 | % |

Underwriting Expense Ratio 37.26 % 34.26 %

Combined Ratio 102.43 % 102.25 %

Maintaining a combined ratio below 100%, which indicates that the company is making an underwriting profit, depends upon many factors including hurricane activity in the Gulf of Mexico and the southern Atlantic coast, strict underwriting of risks, catastrophe reinsurance costs, severe thunderstorm frequency and the ability to obtain adequate and timely

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premium rates. A major hurricane hitting the coast of Alabama, Georgia, South Carolina, Mississippi or Louisiana could cause the combined ratio to fluctuate materially from year to year. In addition, most of the states that we write business are prone to severe thunderstorm and tornado activity with significant variations in the level of activity from year to year. The property and casualty subsidiaries maintain catastrophe reinsurance to minimize the effect of a major catastrophe; however, the geography of our coverage area, frequency of smaller catastrophe events and prohibitive cost of maintaining lower catastrophe deductibles and/or catastrophe aggregate coverage prevents us from further mitigating catastrophe risks.

During 2018, the P&C segment experienced an increase of 0.18 percentage points in the combined ratio compared to 2017. While catastrophe loss is the primary source of variability in our combined ratio, as noted in the table above, over the past two years, non-catastrophe losses and LAE were the primary source of the increase in our combined ratio in 2018 compared to 2017. Non-catastrophe losses increased the P&C segment combined ratio 6.18 percentage points in the current year compared to the same period in the prior year. Offsetting this increase was a 9.0 percentage point decrease in the catastrophe loss component of the P&C combined ratio, in 2018 compared to 2017. Management continues to improve rate adequacy, reduce significant exposure concentrations and implement other risk management strategies in order to further improve underwriting profitability, mitigate earnings volatility and reduce downside risk to our capital position.

Non-insurance Operations:

The non-insurance operations of the Company consist of our parent company, The National Security Group, Inc. (NSG). The National Security Group has no material sources of revenue and relies on dividends and management service fees from our insurance subsidiaries to pay expenses. Dividends from subsidiaries are subject to insurance department approval and are also subject to statutory restrictions. Subsidiary dividends and service fees are eliminated upon consolidation of the subsidiaries in the audited financial statements included herein. Revenues and expense (excluding intercompany dividends from subsidiaries) for non-insurance operations for the year ended December 31, 2018 and 2017 are summarized as follows (amounts in thousands):

| (dollars in thousands) | 2018 | 2017 |
|-------------------------------------|-----------------|-----------------|
| REVENUE | | |
| Net investment income | \$55 | \$65 |
| Other income | 1,006 | 1,019 |
| Total Revenues | \$1,061 | \$1,084 |
| EXPENSES | | |
| General and administrative expenses | \$309 | \$838 |
| Interest expense | 1,187 | 1,234 |
| Total Expenses | \$1,496 | \$2,072 |
| LOSS BEFORE INCOME TAXES | \$(435) | \$(988) |

Year Ended December 31, 2018 Compared to Year Ended December 31, 2017:

Revenue for non-insurance operations primarily consists of interest on investments and other income. Other income is composed of management service fees from subsidiaries which are eliminated upon consolidation. General and administrative expenses totaled \$309,000 in 2018 compared to \$838,000 for the same period last year; a 63.1% decrease. The expenses of NSG are primarily associated with the public listing of our stock, taxes and fees, and directors' fees. The most significant item impacting the decrease in general expenses was a decrease in interest costs related to deferred compensation plans. Total interest expense associated with short-term and long-term borrowings of NSG was \$1,187,000 for the year ended December 31, 2018 and \$1,234,000 for the same period in 2017. The decline in interest expense is related to a reduction in debt outstanding.

Investments:

The insurance subsidiaries primarily invest in highly liquid investment grade fixed maturity securities and equity securities. The types of assets in which the Company can invest are influenced by various state insurance laws which prescribe qualified investment assets. While working within the parameters of these regulatory requirements and

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further considering liquidity and capital needs, the Company considers investment quality, investment return, asset/liability matching and composition of the investment portfolio when making investment decisions.

At December 31, 2018, the Company's holdings in fixed maturity securities amounted to 85.7% of total investments and 66.9% of total assets. The Company utilizes the ratings of various Nationally Recognized Statistical Rating Organizations when classifying fixed maturity investments by credit quality.

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

| S&P or Equivalent Ratings | % of Total Bond Portfolio | |
|---------------------------|------------------------------|--------|
| | 2018 | 2017 |
| AAA/AA+ | 43.69% | 38.08% |
| AA | 4.01% | 6.29% |
| AA- | 3.39% | 2.88% |
| A+ | 0.75% | 2.47% |
| A | 4.76% | 5.57% |
| A- | 5.83% | 6.11% |
| BBB+ | 6.13% | 8.39% |
| BBB | 19.13% | 18.46% |
| BBB- | 7.62% | 5.14% |
| Below Investment Grade | 4.69% | 6.61% |

Fixed maturity portfolio credit quality in the AAA/AA+ rating category increased over five percentage points in 2018 primarily primarily due to new investment in Government National Mortgage Association (GNMA) collateralized mortgage obligations (CMO's) and commercial mortgage backed securities (CMBS). Higher interest rates in 2018 allowed us to improve fixed maturity portfolio credit quality while maintaining portfolio yield.

Our holdings in below investment grade securities are primarily comprised of energy and natural resource sector investments and collateralized debt obligations (CDO's). We have evaluated our current below investment grade holdings for potential impairment, along with any other security with a market value substantially below our amortized cost. We currently have no investment below 80% of amortized cost and based on presently available information, we do not believe any below investment grade securities are other-than-temporarily impaired. We also currently have no fixed income investments in default.

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The amortized cost and aggregate fair values of investments in investment securities at December 31, 2018 and December 31, 2017 are as follows (dollars in thousands):

| December 31, 2018 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| Available-for-sale securities: | | | | |
| U.S. Government corporations and agencies | \$ 4,820 | \$ 31 | \$ 107 | \$4,744 |
| Agency mortgage backed securities | 27,492 | 159 | 545 | 27,106 |
| Asset backed securities | 10,901 | 7 | 248 | 10,660 |
| Private label mortgage backed securities | 5,869 | 105 | 27 | 5,947 |
| Corporate bonds | 36,935 | 407 | 1,551 | 35,791 |
| States, municipalities and political subdivisions | 10,059 | 105 | 91 | 10,073 |
| Foreign governments | 801 | 3 | — | 804 |
| Total fixed maturities | \$ 96,877 | \$ 817 | \$ 2,569 | \$95,125 |
| Equity securities | 1,842 | 2,464 | — | 4,306 |
| Total | \$ 98,719 | \$ 3,281 | \$ 2,569 | \$99,431 |
| Held-to-maturity securities: | | | | |
| Agency mortgage backed securities | \$ 1,449 | \$ 16 | \$ 22 | \$1,443 |
| Total | \$ 1,449 | \$ 16 | \$ 22 | \$1,443 |
| | | | | |
| December 31, 2017 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available-for-sale securities: | | | | |
| U.S. Government corporations and agencies | \$ 6,307 | \$ 131 | \$ 51 | \$6,387 |
| Agency mortgage backed securities | 20,858 | 232 | 468 | 20,622 |
| Asset backed securities | 9,000 | 132 | 72 | 9,060 |
| Private label mortgage backed securities | 4,637 | 258 | — | 4,895 |
| Corporate bonds | 39,127 | 1,103 | 321 | 39,909 |
| States, municipalities and political subdivisions | 13,758 | 389 | 54 | 14,093 |
| Foreign governments | 780 | 12 | — | 792 |
| 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 |
| Held-to-maturity securities: | | | | |
| Agency mortgage backed securities | \$ 1,616 | \$ 29 | \$ — | \$1,645 |
| Total | \$ 1,616 | \$ 29 | \$ — | \$1,645 |

As shown in the tables above, the Company experienced an increase in unrealized losses on fixed maturity investments in 2018 compared to the portfolio composition at December 31, 2017. The increase in unrealized losses was primarily driven by an overall increase in market interest rates.

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

subsidiary due to more predictable cash needs.

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

At December 31, 2018, 4.69% of total investments in the fixed income portfolio were classified as below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, management evaluated financial information on each company and, where available, reviewed analyst reports from independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the securities in an accumulated loss position in the portfolio were temporary impairments. Management has evaluated each security in a significant unrealized loss position. For the year ended December 31, 2018, the Company realized \$16,000 in other-than-temporary impairments related to fixed maturities.

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

| (Dollars in Thousands) | Amortized Fair | |
|--|----------------|----------|
| | Cost | Value |
| Available-for-sale securities: | | |
| Due in one year or less | \$ 2,183 | \$2,190 |
| Due after one year through five years | 17,179 | 17,027 |
| Due after five years through ten years | 27,625 | 27,052 |
| Due after ten years | 49,890 | 48,856 |
| Total | \$ 96,877 | \$95,125 |
| Held-to-maturity securities: | | |
| Due in one year or less | \$ — | \$— |
| Due after one year through five years | 43 | 45 |
| Due after five years through ten years | — | — |
| Due after ten years | 1,406 | 1,398 |
| Total | \$ 1,449 | \$1,443 |

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

Investment portfolio income

Investment returns with respect to the investment portfolio for the years ended December 31, 2018 and 2017 follows:

| | Year Ended | | | |
|--------------------------------------|--------------|---------|---|--|
| | December 31, | | | |
| | 2018 | 2017 | | |
| Net investment income | \$3,567 | \$3,647 | | |
| Average current yield on investments | 3.1 | % 3.2 | % | |
| Total return on investments | 0.3 | % 4.6 | % | |

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| | | |
|---|-----------|---------|
| Net gains (losses) on investments (before taxes) | \$(178) | \$234 |
| Change in accumulated net unrealized gains (losses) (before income taxes) | \$(3,042) | \$1,403 |

Average current yield on investments in 2018 decreased 0.01% compared to 2017. The marginal decrease in average current yield was primarily due to a decline in cash value of our company owned life insurance investment of \$374,000.

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This decrease was primarily driven by the late 2018 decline in the equity markets. Our income on fixed maturity investments increased \$426,000 in 2018, up 12.6%, due to an increase in market interest rates.

The total return on investments in 2018 was only 0.3% compared to 4.6% in 2017. The decreased total return was driven by a significant increase in market interest rates in 2018 which decreased the value of our fixed maturity investment holdings.

Repurchase agreements

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

Liquidity and capital resources:

Due to regulatory restrictions, the majority of the Company's cash is required to be invested in investment-grade securities to provide protection for policyholders. The liabilities of the property and casualty insurance subsidiaries are of various terms, and therefore, those subsidiaries invest in securities with various effective maturities spread over periods usually not exceeding 10 years with an average portfolio duration typically of less than 5 years. The liabilities of the life insurance subsidiary are typically of a longer duration, and therefore, a higher percentage of securities in the life insurance subsidiary are invested for periods exceeding 10 years.

The liquidity requirements for the Company are primarily met by funds generated from operations of the life insurance and property/casualty insurance subsidiaries. All operations and virtually all investments are maintained by the insurance subsidiaries. Premium and investment income as well as maturities and sales of invested assets provide the primary sources of cash for both the life and property/casualty businesses, while applications of cash are applied by both businesses to the payment of policy benefits, the cost of acquiring new business (principally commissions), operating expenses, purchases of new investments, and in the case of life insurance, policy loans.

Virtually all invested assets of the Company are held in the insurance subsidiaries. As of December 31, 2018, the contractual maturity schedule for all bonds and notes held by the Company, stated at amortized cost, was as follows (dollars in thousands):

| Maturity | Available- for-Sale | Held-to-Maturity | Total | Percentage of Total | |
|------------------------------|------------------------|------------------|-----------|------------------------|---|
| Maturity in less than 1 year | \$ 2,183 | \$ — | \$ 2,183 | 2.21 | % |
| Maturity in 1-5 years | 17,179 | 43 | 17,222 | 17.52 | % |
| Maturity in 5-10 years | 27,625 | — | 27,625 | 28.10 | % |
| Maturity after 10 years | 49,890 | 1,406 | 51,296 | 52.17 | % |
| | \$ 96,877 | \$ 1,449 | \$ 98,326 | 100.00 | % |

It should be noted that the above table represents maturities based on stated/contractual maturity. Due to call and prepayment features inherent in some fixed maturity securities, actual repayment, or effective maturities, will differ from stated maturities. The Company routinely evaluates the impact of changing interest rates on the projected maturities of bonds in the portfolio and actively manages the portfolio in order to minimize the impact of interest rate risk. However, due to other factors, both regulatory and those associated with good investment management practices

associated with asset/liability matching, we do have exposure to changes in market values of securities due to changes in interest rates. Currently, a 100 basis point immediate increase in interest rates would generate approximately a \$4,688,000, or 4.9%, decline in the market value of fixed maturity investments. Alternatively, a 100 basis point decrease in interest rates will generate approximately \$4,690,000, or 4.9%, increase in market value of fixed income investments. Management has attempted, to the extent possible, to reduce risk in a rising rate environment. However, due to asset liability matching requirements, particularly in the life subsidiary portfolio, interest rate risk can not be eliminated and exposure to market volatility can cause some variability in our accumulated other comprehensive income, total return on investments, total shareholders' equity and book value per share.

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At December 31, 2018, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$45,866,000, down \$1,759,000 compared to \$47,625,000 at December 31, 2017. Components of the change in equity were net income of \$779,000, comprehensive loss due to changes in value of fixed maturity securities of \$2,404,000, comprehensive income of \$295,000 related to change in value of interest rate swaps and cash dividends paid totaling \$505,000.

As discussed above, changing interest rates can have a significant impact on the market value of fixed maturity investments. Fixed maturity securities classified as available-for-sale increase the liquidity resources of the Company as they can be sold at any time to pay claims or meet other Company obligations. However, these securities are required to be carried at market value with net of tax change in accumulated unrealized gains and losses directly impacting shareholder's equity. While the increase in interest rates causes near term declines in the value of fixed income securities, we are able to reap the benefit of reinvesting at higher rates as current fixed income investments are called, amortized (mortgage backed securities) or reach contractual maturity. Over the next twelve months, based on cash flow projection modeling that considers such factors as anticipated principal payments on mortgage backed securities, likelihood of call provisions being enacted and regular contractual maturities, we expect approximately 6% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.

The Company, primarily through its insurance subsidiaries, had \$5,676,000 in cash and cash equivalents at December 31, 2018, compared to \$6,644,000 at December 31, 2017. Cash provided by operating activities increased cash by \$3,177,000 during the year ended December 31, 2018. The increase in cash from operating activities was primarily driven by net income from operations. Cash provided by operating activities increased cash by \$2,316,000 for the year ended December 31, 2017. The increase in cash provided by operating activities in 2017 was primarily related to collections of reinsurance recoverable balances associated with Hurricane Matthew. Net cash used in investing activities totaled \$2,149,000 for the year ended December 31, 2018, compared to \$1,113,000 in 2017. Cash used in investing activities in 2018 primarily consisted of the investment of positive cash flow from operations. Net cash used in financing activities totaled \$1,996,000 for the year ended December 31, 2018, compared to \$1,927,000 for the same period last year. During the year ended December 31, 2018, the Company repaid \$1,300,000 in short-term debt. The Company maintains a \$700,000 line of credit which matures in March of 2020. We had \$700,000 available on our revolving line of credit at December 31, 2018.

The Company had a total of \$12,152,000 of long-term debt outstanding as of December 31, 2018, compared to \$14,339,000 at December 31, 2017, which includes \$12,372,000 in trust preferred securities issued by the Company in addition to the installment note. Current year and prior year amounts were reduced by the unamortized portion of the placement fees associated with the issuance of the trust preferred securities, \$220,000 and \$233,000, respectively. The following table reflects the anticipated cash flows associated with our short- and long-term contractual obligations and commitments as of December 31, 2018 (dollars in thousands):

| Contractual Obligations | Total | Payments due by period | | | |
|---|----------|------------------------|-------------------|-------------------|-------------------|
| | | Less than 1 year | Years 1 through 3 | Years 4 through 5 | More than 5 years |
| Notes payable | \$2,200 | \$2,200 | \$— | \$— | \$— |
| Debt obligations ¹ | \$12,152 | \$— | \$— | \$— | \$12,152 |
| Interest on debt obligations ¹ | \$14,237 | \$1,118 | \$2,443 | \$1,598 | \$9,078 |
| Property and casualty claim reserves ² | \$8,208 | \$7,207 | \$911 | \$74 | \$16 |
| Future life insurance obligations ³ | \$70,496 | \$4,493 | \$12,004 | \$6,917 | \$47,082 |

¹ Long-term debt, consisting of two separate issues of trust preferred securities, a line of credit and the long-term portion of an installment note is assumed to be settled at contractual maturity. Interest on long-term debt is calculated using the

interest rates in effect at December 31, 2018 for each issue. Interest on long-term debt is accrued and settled quarterly on the trust preferred securities, monthly on the line of credit and annually on the installment note. Therefore, the timing and amount of interest payments may vary from the calculated value included in the table above. These calculations do not take into account any potential prepayments. For additional information regarding long-term debt and interest on long-term debt, please see Note 8, Notes Payable and Long-term Debt, in the notes to Consolidated Financial Statements.

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

³ Future life insurance obligations consist primarily of estimated future contingent benefit payments and surrender benefits on policies in force at December 31, 2018. These estimated payments are computed using assumptions for future mortality, morbidity and persistency. In contrast to this table, the majority of NSIC's obligations is recorded on the balance sheet at the current account values and do not incorporate an expectation of future market growth, interest crediting or future deposits. Therefore, the estimated future life insurance obligations presented in this table significantly exceed the liabilities recorded in the Company's consolidated balance sheet. Due to the significance of the assumptions used, the actual amount and timing of such payments may differ significantly from the estimated amounts. Management believes that current assets, future premiums and investment income will be sufficient to fund all future life insurance obligations.

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Contractual obligations reflected in the table above include the issuance of \$9,111,000 in subordinated debentures completed on December 15, 2005. The subordinated debentures mature December 15, 2035. It is anticipated that principal payments will not be made before maturity. Also included in long-term debt is the issuance of \$3,028,000 in subordinated debentures on June 21, 2007. This issue matures June 15, 2037 and may be prepaid at any time. Also reflected in the table above is a \$2,200,000 unsecured loan obtained in December 2016. The unsecured loan matures in November 2019.

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

The ability of the Company to meet its commitments for timely payment of claims and other expenses depends, in addition to current cash flow, on the liquidity of its investments. The Company has relatively little exposure to below investment grade fixed income investments, which might be especially subject to liquidity problems due to thinly traded markets.

The Company's liquidity requirements are primarily met by funds provided from operations of the insurance subsidiaries. The Company receives funds from its subsidiaries through payment of dividends, management fees, reimbursements for federal income taxes and reimbursement of expenses incurred at the corporate level for the subsidiaries. These funds are used to pay stockholder dividends, principal and interest on debt, corporate administrative expenses, federal income taxes, and for funding investments in the subsidiaries. The Company maintains minimal liquidity in order to maximize liquidity within the insurance subsidiaries in order to support ongoing insurance operations. The Company has no separate source of revenue other than dividends and fees from the insurance subsidiaries. Also, dividends from the insurance subsidiaries are subject to regulatory restrictions and, therefore, are limited depending on capital levels and earnings of the subsidiaries.

Our P&C segment is the primary source of dividends to the holding company. Consideration of insurance subsidiary growth opportunities, regulatory capital adequacy, rating agency impact and holding company debt reduction, among other items, are factors that influence our subsidiary dividend requirements. While we have made significant progress in recent years, continued strengthening capital levels in the insurance subsidiaries and reduction of debt remains a top priority.

Dividends paid from the insurance subsidiaries are subject to regulatory restrictions and prior approval of the Alabama Department of Insurance. As disclosed in Note 12 to the audited consolidated financial statements included in our 2018 Annual Report on Form 10-K, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company during 2019 is statutorily limited to \$1,640,000 in the life insurance subsidiary and \$3,464,000 in the property/casualty insurance subsidiary. Dividends are limited to the greater of net income (operating income for life subsidiary) or 10% of statutory capital, and regulators consider dividends paid within the preceding twelve months when calculating the available dividend capacity. Therefore, all of the above referenced dividend capacity will not be available for consideration of payment until dividends paid in the preceding twelve months have been considered on a rolling basis. The Company also has to continuously evaluate other factors such as subsidiary operating performance, subsidiary capital requirements and potential impact by rating agencies in making decisions on how much capital can be released from insurance subsidiaries for payment of dividends to NSG. These factors are considered along with the goal of growing year over year statutory surplus in the subsidiaries, and these considerations along with potential adverse impacts on regulatory surplus, will likely lead to dividend payments

to NSG substantially below the above referenced regulatory maximums. The Company received \$750,000 dividends from its subsidiaries during the year ended December 31, 2018.

The Company's subsidiaries require cash in order to fund policy acquisition costs, claims, other policy benefits, interest expense, general expenses, and dividends to the Company. Premium and investment income, as well as maturities, calls, and sales of invested assets, provide the primary sources of cash for both subsidiaries. A significant portion of the Company's investment portfolio, which is held by the insurance subsidiaries, consists of readily marketable securities, which can be sold for cash.

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The Company continues to monitor liquidity and subsidiary capital closely. Despite challenging weather patterns in the property and casualty subsidiaries over the past three years, the insurance subsidiaries are well capitalized. However, further strengthening of subsidiary capital continues to be a top priority for management.

Except as discussed above, the Company is unaware of any known trends, events, or uncertainties reasonably likely to have a material effect on its liquidity, capital resources, or operations. Additionally, the Company has not been made aware of any recommendations of regulatory authorities, which if implemented, would have such an effect.

Statutory Risk-Based Capital of Insurance Subsidiaries

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

The levels and ratios are as follows:

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

The ratios of Total Adjusted Capital to Authorized Control Level RBC for The National Security Group's life/health and property/casualty insurance subsidiaries are all in excess of 4 to 1 at December 31, 2018.

National Security Insurance Company (life insurer) has regulatory adjusted capital of \$16.1 million and \$15.7 million at December 31, 2018 and 2017, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 16.2 and 17.6 at December 31, 2018 and 2017, respectively. Accordingly, National Security Insurance Company exceeds the minimum RBC requirements.

National Security Fire & Casualty Company (property/casualty insurer) has regulatory adjusted capital of \$34.6 million and \$35.2 million at December 31, 2018 and 2017, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 4.7 at December 31, 2018 and 2017, respectively. Accordingly, National Security Fire & Casualty Company exceeds the minimum RBC requirements.

Omega One Insurance Company (property/casualty insurer), which began writing business in late 1995, has regulatory adjusted capital of \$10.8 million and \$10.9 million at December 31, 2018 and 2017, and a ratio of regulatory total adjusted capital to authorized control level RBC of 18.9 and 19.6 at December 31, 2018 and 2017, respectively. Accordingly, Omega One Insurance Company exceeds the minimum RBC requirements.

Application of Critical Accounting Policies

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

Reinsurance

Deferred Policy Acquisition Costs

Income Taxes

Fair Values of Financial Instruments

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Claim Liabilities
Recognition of Revenue
Contingencies

Reinsurance

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

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

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

During 2018, the property and casualty segment maintained a catastrophe contract, which covered losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeded the \$4 million company retention stated in the contract, reinsurers would reimburse the company 100% of gross losses up to the upper limits of the reinsurance agreement, which was \$72.5 million in 2018 and 2017. Any losses above the \$72.5 million upper limit are the responsibility of our Company. The contract in place during 2018 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed.

The property and casualty subsidiaries utilize our actual in force policy data modeled utilizing two different industry accepted catastrophe models to structure catastrophe reinsurance and determine upper limits of catastrophe reinsurance agreements. Based on modeling results utilized in 2018 and 2017, the Company was reinsured at approximately a 250 year event level. While this estimate is subject to some uncertainty and model risk, the models indicate that we maintain catastrophe reinsurance upper limits to cover an event that has less than a 0.5% probability of occurring in a given year.

At December 31, 2018, the estimated reinsurance recoverable recorded was \$1,772,000 compared to \$366,000 for the same period last year. The Company does not anticipate any issues with collection of the recorded amount. In 2018, catastrophe reinsurance premiums ceded totaled \$5,486,000 compared to \$5,431,000 ceded in 2017. Catastrophe reinsurance premiums are based on a premium calculation applying the agreed upon rate to the total insured value of the covered lines of business. Due to the moderate decline in property and casualty premium revenue in 2018, ceded premium was relatively unchanged. In addition to catastrophe reinsurance, the Company placed reinstatement premium protection (RPP) reinsurance during 2018 and 2017 totaling \$833,000 and \$824,000, respectively.

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

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

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

Deferred Policy Acquisition Costs

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

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

At December 31, 2018 and 2017, the Company recorded \$7,834,000 and \$8,124,000, respectively, as an asset for DAC in the Consolidated Financial Statements. We do not foresee any issues related to recoverability of these capitalized costs. For more information regarding deferred policy acquisition costs, see Note 1 to our Consolidated Financial Statements.

Income Taxes

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

At December 31, 2018, there is no evidence to suggest to management that any deferred tax asset is unrealizable. For more information regarding deferred income taxes, see Note 7 to our Consolidated Financial Statements.

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

Fair Values of Financial Instruments

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

Claim Liabilities

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

At December 31, 2018 and 2017, the recorded liability for loss and loss adjustment expense was \$8,208,000 and \$7,075,000, respectively, a \$1,133,000 increase. The increase in claim and claim adjustment expense reserves is primarily due to claims arising from Hurricane Michael in the fourth quarter of 2018. We believe the estimate of unpaid losses and loss adjustment expenses to be sufficient based on currently available information and a review of our historical reserving practices. For more information regarding loss and loss adjustment expense, see Note 9 to our Consolidated Financial Statements.

Recognition of Revenue

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

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

Contingencies

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

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

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

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

Since the Company's assets and liabilities are largely monetary in nature, the Company's financial position and earnings are subject to risks resulting from changes in interest rates at varying maturities, changes in spreads over U.S. Treasuries on new investment opportunities and changes in the yield curve and equity pricing risks.

The Company is exposed to equity price risk on its equity securities. The Company holds common stock with a fair value of \$4,306,000. Our portfolio has historically been highly correlated to the S&P 500 with regard to market risk. Based on an evaluation of the historical risk measure of our portfolio relative to the S&P 500, if the market value of the S&P 500 Index decreased 10% from its December 31, 2018 value, the fair value of the Company's common stock investments would decrease by approximately \$431,000.

Certain fixed interest rate market risk sensitive instruments may not give rise to incremental income or loss during the period illustrated but may be subject to changes in fair values. Note 4 in the consolidated financial statements present additional disclosures concerning fair values of Financial Assets and Financial Liabilities and are incorporated by reference herein.

The Company limits the extent of its market risk by purchasing securities that are backed by entities considered to be financially stable, the majority of the assets are issued by U.S. government sponsored entities or corporate entities with debt considered to be "investment grade". Also, the majority of all of the subsidiaries' CMO's are Planned Amortization Class (PAC) bonds. PAC bonds are typically the lowest risk CMO's, and provide greater cash flow predictability. Such securities with reduced risk typically have a lower yield, but higher liquidity, than higher-risk mortgage backed bonds. To reduce the risk of losing principal should prepayments exceed expectations, the Company generally does not purchase mortgage backed securities at significant premiums over par value.

The Company's investment approach in the equity markets is based primarily on a fundamental analysis of value. This approach requires the investment committee to invest in well managed, primarily dividend paying companies, which have a low debt to capital ratio, above average return on capital for a sustained period of time, and low volatility rating

(beta) relative to the market. The dividends provide a steady cash flow to help pay current claim liabilities, and it has been the Company's experience that by following this investment strategy, long term investment results have been superior to those offered by bonds, while keeping the risk of loss of capital to a minimum relative to the overall equity market.

As for shifts in investment allocations, the Company has used improved cash flows from insurance operations to increase allocations to corporate and US Government bonds.

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of The National Security Group, Inc. as of December 31, 2018 and 2017 and the related consolidated statements of operations, comprehensive income (loss), changes in shareholders' equity, and cash flows for the years then ended, and the related notes and financial statement schedules I, II, III, IV and V (collectively referred to as the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of The National Security Group, Inc. as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of The National Security Group, Inc.'s management. Our responsibility is to express an opinion on The National Security Group, Inc.'s consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to The National Security Group, Inc. in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Warren Averett, LLC

We have served as The National Group, Inc.'s auditor since 2009.
Birmingham, Alabama

March 15, 2019

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THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED BALANCE SHEETS (In thousands)

| | December 31, 2018 | December 31, 2017 |
|---|-------------------------|----------------------|
| ASSETS | | |
| Investments | | |
| Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2018 - \$1,443; 2017 - \$1,645) | \$1,449 | \$1,616 |
| Fixed maturities available-for-sale, at estimated fair value (cost: 2018 - \$96,877; 2017 - \$94,467) | 95,125 | 95,758 |
| Equity securities, at estimated fair value (cost: 2018 - \$1,842; 2017 - \$1,842) | 4,306 | 4,509 |
| Trading securities | 107 | 107 |
| Mortgage loans on real estate, at cost | 156 | 162 |
| Investment real estate, at book value | 2,945 | 3,221 |
| Policy loans | 1,854 | 1,810 |
| Company owned life insurance | 4,600 | 4,974 |
| Other invested assets | 2,148 | 2,574 |
| Total Investments | 112,690 | 114,731 |
| Cash and cash equivalents | 5,676 | 6,644 |
| Accrued investment income | 774 | 768 |
| Policy receivables and agents' balances, net | 11,185 | 11,653 |
| Reinsurance recoverable | 1,772 | 366 |
| Deferred policy acquisition costs | 7,834 | 8,124 |
| Property and equipment, net | 1,649 | 1,781 |
| Income tax recoverable | 1,463 | 393 |
| Deferred income tax asset, net | 716 | 1,487 |
| Other assets | 472 | 491 |
| Total Assets | \$144,231 | \$146,438 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Property and casualty benefit and loss reserves | \$8,208 | \$7,075 |
| Accident and health benefit and loss reserves | 3,803 | 3,595 |
| Life and annuity benefit and loss reserves | 33,671 | 33,283 |
| Unearned premiums | 29,999 | 30,112 |
| Policy and contract claims | 792 | 903 |
| Other policyholder funds | 1,515 | 1,706 |
| Short-term notes payable and current portion of long-term debt | 2,200 | 1,300 |
| Long-term debt | 12,152 | 14,339 |
| Other liabilities | 6,025 | 6,500 |
| Total Liabilities | 98,365 | 98,813 |
| Contingencies | | |
| Shareholders' equity | | |
| Common stock | 2,527 | 2,522 |
| Additional paid-in capital | 5,554 | 5,483 |
| Accumulated other comprehensive income (loss) | (1,570) |) 2,646 |
| Retained earnings | 39,355 | 36,974 |
| Total Shareholders' Equity | 45,866 | 47,625 |

| | | |
|--|-----------|-----------|
| Total Liabilities and Shareholders' Equity | \$144,231 | \$146,438 |
|--|-----------|-----------|

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

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THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

| | Year ended December 31, | |
|---|----------------------------|------------|
| | 2018 | 2017 |
| REVENUES | | |
| Net premiums earned | \$60,856 | \$61,163 |
| Net investment income | 3,567 | 3,647 |
| Investment gains (losses) | (178) | 234 |
| Other income | 612 | 596 |
| Total Revenues | 64,857 | 65,640 |
| BENEFITS, LOSSES AND EXPENSES | | |
| Policyholder benefits and settlement expenses | 40,409 | 42,869 |
| Amortization of deferred policy acquisition costs | 3,597 | 3,589 |
| Commissions | 7,555 | 7,723 |
| General and administrative expenses | 8,839 | 8,821 |
| Taxes, licenses and fees | 2,157 | 2,445 |
| Interest expense | 1,235 | 1,307 |
| Total Benefits, Losses and Expenses | 63,792 | 66,754 |
| Income (Loss) Before Income Taxes | 1,065 | (1,114) |
| INCOME TAX EXPENSE (BENEFIT) | | |
| Current | (1,045) | (206) |
| Deferred | 1,331 | 295 |
| | 286 | 89 |
| Net Income (Loss) | \$779 | \$(1,203) |
| INCOME (LOSS) PER COMMON SHARE BASIC AND DILUTED | \$0.31 | \$(0.48) |
| DIVIDENDS DECLARED PER SHARE | \$0.20 | \$0.20 |

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

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THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

| | Year ended December 31, | |
|--|----------------------------|-----------|
| | 2018 | 2017 |
| Net income (loss) | \$779 | \$(1,203) |
| Other comprehensive income (loss), net of tax | | |
| Changes in: | | |
| Unrealized gains (losses) on securities, net of reclassification adjustment of \$100 and \$153 for 2018 and 2017, respectively | (2,404) | 926 |
| Unrealized gain on interest rate swap | 295 | 278 |
| Other comprehensive income (loss), net of tax | (2,109) | 1,204 |
| Comprehensive income (loss) | \$(1,330) | \$1 |

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

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THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(In thousands)

| | Total | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Common Stock | Additional Paid-in Capital |
|---|----------|-------------------|---|--------------|----------------------------|
| Balance at December 31, 2016 | \$48,052 | \$39,116 | \$ 1,007 | \$ 2,517 | \$ 5,412 |
| Comprehensive income: | | | | | |
| Net loss for 2017 | (1,203) | (1,203) | — | — | — |
| Other comprehensive income (net of tax) | 1,204 | — | 1,204 | — | — |
| Reclassification of tax effects to AOCI | — | (435) | 435 | — | — |
| Common stock issued | 76 | — | — | 5 | 71 |
| Cash dividends | \$(504) | \$(504) | \$ — | \$ — | \$ — |
| 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 2018 | 779 | 779 | — | — | — |
| Other comprehensive loss (net of tax) | (2,109) | — | (2,109) | — | — |
| Common stock issued | 76 | — | — | 5 | 71 |
| Cash dividends | (505) | (505) | — | — | — |
| Balance at December 31, 2018 | \$45,866 | \$39,355 | \$ (1,570) | \$ 2,527 | \$ 5,554 |

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

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THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

| | Year ended | |
|---|--------------|-----------|
| | December 31, | |
| | 2018 | 2017 |
| Cash Flows from Operating Activities | | |
| Net income (loss) | \$779 | \$(1,203) |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation expense and amortization/accretion, net | 312 | 514 |
| (Increase) decrease in cash surrender value of company owned life insurance | 374 | (110) |
| Net (gains) losses on investments | 178 | (234) |
| Deferred income taxes | 1,331 | 295 |
| Amortization of deferred policy acquisition costs | 3,597 | 3,589 |
| Changes in assets and liabilities: | | |
| Change in receivable for securities sold | — | 499 |
| Change in accrued investment income | (6) | 8 |
| Change in reinsurance recoverable | (1,406) | 1,414 |
| Policy acquisition costs deferred | (3,307) | (3,362) |
| Change in accrued income taxes | (1,070) | 548 |
| Change in net policy liabilities and claims | 1,969 | 200 |
| Change in other assets/liabilities, net | 420 | 155 |
| Other, net | 6 | 3 |
| Net cash provided by operating activities | 3,177 | 2,316 |
| Cash Flows from Investing Activities | | |
| Purchase of: | | |
| Available-for-sale securities | (16,621) | (18,720) |
| Property and equipment | (29) | (62) |
| Proceeds from sale or maturities of: | | |
| Held-to-maturity securities | 179 | 280 |
| Available-for-sale securities | 14,172 | 17,477 |
| Real estate held for investment | 188 | — |
| Property and equipment | — | 2 |
| Other invested assets, net | (38) | (90) |
| Net cash used in investing activities | (2,149) | (1,113) |
| Cash Flows from Financing Activities | | |
| Change in other policyholder funds | (191) | 77 |
| Repayments of long-term debt | — | (2,000) |
| Change in short-term notes payable | (1,300) | 500 |
| Dividends paid | (505) | (504) |
| Net cash used in financing activities | (1,996) | (1,927) |
| Net change in cash and cash equivalents | (968) | (724) |
| Cash and cash equivalents, beginning of year | 6,644 | 7,368 |
| Cash and cash equivalents, end of period | \$5,676 | \$6,644 |

The Notes to 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

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES AND PRACTICES

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 (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 in the consolidated financial statements. 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, 2018, which includes information and disclosures not presented herein.

Description of Business

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

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

Omega is licensed in the states of Alabama and Louisiana. Omega currently has no insurance policies in-force but is party to an intercompany reinsurance agreement with NSFC. Intercompany transactions are eliminated upon consolidation in the accompanying consolidated financial statements.

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

Use of Estimates

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

Concentration of Risk

The Company's property and casualty subsidiaries, composing 90% of consolidated direct written premium, produced business during 2018 in eight states. However, 53% of property and casualty segment direct written premium is generated in the states of Alabama, Mississippi and Louisiana, subjecting the Company to significant geographic concentration. Consequently, adverse weather conditions or changes in the legal, regulatory or economic environment could adversely impact the Company.

The Company's life, accident and health insurance subsidiary, composing approximately 10% of consolidated direct written premium, is licensed in seven states. However, over 79% of life segment direct premium is generated in the

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

states of Alabama and Georgia. Consequently, changes in the legal, regulatory or economic environment in these states could adversely impact the Company.

For the year ended December 31, 2018, one agency individually produced greater than 5% of the Company's direct written premium.

Investments

The Company's investment securities are classified as follows:

Held-to-maturity investments are fixed maturity securities for which the Company has the positive intent and ability to hold to maturity. These securities are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.

Trading securities are securities acquired with the intent to sell in the near term and are carried at fair value with changes in fair value reported in earnings.

Securities available-for-sale are fixed maturity securities and equity securities not classified as either held-to-maturity or trading. These securities are reported at fair value. Substantially all of our fixed maturity and equity securities are classified as available-for-sale.

Changes in fair value of trading securities are reported in the statement of operations.

Changes in fair value of fixed maturity securities available-for-sale are reported as net unrealized gains or losses as a component of other comprehensive income.

Changes in fair value of equity securities available-for-sale are reported as investment gains/losses in the statement of operations. Prior to January 1, 2018, changes in fair value of equity securities available-for-sale were reported as net unrealized gains or losses as a component of other comprehensive income. Gains and losses were recorded in the statement of operations only when equity securities were sold or were other-than-temporarily impaired.

Investment gains and losses on fixed maturity securities arise when the investments are sold. Investment gains and losses on the sale of fixed maturity investments available-for-sale are determined using the specific-identification method and include write downs for fixed maturity securities considered to be other-than-temporarily impaired.

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

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

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

amount related to all other factors, which is recognized in other comprehensive income.

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

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

yield that will equate the carrying amount of the investment to the present value of the projected future cash flows. The recalculated yield is used to accrue income on investments for subsequent periods.

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

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

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

The Company owns life insurance (COLI) contracts on certain management and supervisory employees each having a face amount of approximately \$2,000,000 (including cash surrender value at the time of payment). The Company's original investment in currently in-force company owned life insurance is \$4,315,000. The primary purpose of the program is to offset future employee benefit expenses through earnings on the cash value of the policies. The Company is the owner and principal beneficiary of these policies. The life insurance contracts are carried at their current cash surrender value. Cash surrender value at December 31, 2018 and December 31, 2017 was \$4,600,000 and \$4,974,000, respectively. Changes in cash surrender values are included in the statement of operations. The change in surrender value included in the statement of operations for the years ended December 31, 2018 and 2017 was a decrease of \$374,000 and an increase of \$110,000, respectively. Proceeds from the COLI contracts are recorded when the benefits become payable under the terms of the policy and proceeds in excess of cash surrender value are recognized as a gain on company owned life insurance.

Cash and cash equivalents consist of demand deposit and money market accounts and investments with maturities of three months or less when purchased. Cash and cash equivalents are carried at cost, which approximates fair value.

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

Fair Values of Financial Instruments

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

Investments

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

Equity security fair values are based on quoted market prices.

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

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

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

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

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

Policy Receivables

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

Accounts Receivable

Accounts receivable are reported at net realizable value. Management determines the allowance for doubtful accounts based on historical losses and current economic conditions. On a continuing basis, management analyzes delinquent receivables, and once these receivables are determined to be uncollectible, they are written off through a charge against an existing allowance account or against earnings.

Property and Equipment

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

Statement of Cash Flows

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

Premium Revenue

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

Deferred Policy Acquisition Costs

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

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

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

Policy Liabilities

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

| Years of Issue | Interest Rate |
|----------------|-----------------|
| 1947 - 1968 | 4% |
| 1969 - 1978 | 6% graded to 5% |
| 1979 - 2003 | 7% graded to 6% |
| 2004 - 2012 | 5.25% |
| 2013 - 2014 | 4.25% |
| 2015 - 2018 | 4% |

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

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

Policyholder Benefit and Claim Settlement Expenses

The liability for unpaid claims represents the estimated liability for unpaid loss and loss adjustment expenses incurred but not yet reported under insurance contracts for loss events that have occurred on or before the balance sheet date. The liability for claims and related adjustment expenses are determined using case-basis evaluations and statistical analysis and represent estimates of the ultimate net cost of all losses incurred through December 31 of each year. Liability estimates are continually reviewed and adjusted as necessary; such adjustments are included in the period in which they are determined. Liability estimates are based on reports of losses from policyholders, individual case loss estimates, and estimates of losses incurred but not yet reported. Policyholder benefit and settlement expenses in the consolidated statement of operations include paid claims, settlement cost and changes in claim liability estimates. Loss and adjustment expenses charged to earnings are net of amounts recovered and estimates of recoverable amounts under ceded reinsurance contracts.

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 2,525,325 at December 31, 2018 and 2,520,431 at December 31, 2017. The Company did not have any dilutive securities as of December 31, 2018 and 2017.

Reinsurance

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

Income Taxes

The Company files a consolidated United States federal income tax return that includes the holding company and its subsidiaries. The Company is currently subject to a statutory rate of 21%. Tax related interest and penalties are reported as components of income tax expense.

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

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

Contingencies

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

Reclassifications

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

Advertising

The Company expenses advertising costs as incurred.

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

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts subject to FDIC insured limits of \$250,000 per entity. At December 31, 2018, the net amount exceeding FDIC insured limits was \$3,897,000 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 December 31, 2018, the single largest balance due from one agent totaled \$516,000.

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 December 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 December 31, 2018, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Accounting Changes Not Yet Adopted

Changes to the Disclosure Requirements for Fair Value Measurement

In August 2018, the FASB issued guidance to that removes, modifies and adds to the disclosure requirements related to fair value measurements. The guidance removes the requirements to disclose the amount and reasons for transfers between Level 1 and Level 2 assets, the policy for timing and transfers between levels and the valuation process for Level 3 fair value measurements. The guidance modifies disclosure requirements for investments in certain entities that calculate net asset value and clarifies the purpose of the measurement uncertainty disclosure. The guidance adds requirements to disclose changes in unrealized gains or losses included in other comprehensive income for recurring Level 3 fair value measurements and to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. The guidance is effective for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Targeted Improvements to the Accounting for Long-Duration Contracts

In August 2018, the FASB issued guidance to improve the existing recognition, measurement, presentation and disclosure requirements for long-duration contracts issued by an insurance entity. The guidance improves timeliness of recognizing changes in the liability for future policy benefits and modifies the rate used to discount future cash flows. The guidance will simplify and improve accounting for certain market-based options or guarantees associated with deposit type contracts and simplify the amortization of deferred policy acquisition costs. The guidance also introduces certain financial statement presentation requirements, as well as significant additional quantitative and qualitative disclosures. The guidance is effective for fiscal years beginning after December 15, 2020 and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the impact of this new guidance. Due to the nature and extent of the changes required to the Company's life insurance operations, the adoption of this standard is expected to have a material impact on the consolidated financial statements.

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. The FASB released additional guidance in November 2018 that provides scope clarification. This guidance is effective for fiscal years beginning after December 15, 2019,

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

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.

Recently Adopted Accounting Standards

Improvements to Nonemployee Share-Based Payment Accounting

In June 2018, the FASB issued guidance to simplify the accounting for nonemployee share-based payment awards. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. The Company does not make any material share-based payments. The Company adopted this guidance on January 1, 2019. The adoption of this guidance did not have a material impact on its financial position or results of operations.

Income Statement - Reporting Comprehensive Income

In February 2018, the 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.

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 adopted this guidance on January 1, 2019. The adoption of this guidance did not 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 adopted this guidance on January 1, 2019. The Company has two swaps designated as cash flow hedges. One expires March 15, 2019 and one expires March 15, 2020. The adoption of this guidance did not have a significant impact on our financial position, results of operations, cash flows or related disclosures.

Leases

In February 2016, the FASB issued guidance that requires lessees (for capital and operating leases) to recognize the lease liability and right-of-use asset at the commencement date of the lease. Additional transition guidance was issued in 2018. This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those years. The Company adopted this guidance on January 1, 2019. The Company leases automobiles and some office equipment. These leases are not considered material. The adoption of this guidance did not have a material impact on its financial position or results of operations.

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.

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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 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 \$160,000 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 \$116,000 and is included as a component of Other Invested Assets in the accompanying consolidated balance sheets.

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, \$9,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$9,279,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the

subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 8, are reported in the accompanying consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$279,000 and are included in Other Assets in the accompanying consolidated balance sheets.

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, \$3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$3,093,000 unsecured junior

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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 8, are reported in the accompanying consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$93,000 and are included in Other Assets in the accompanying consolidated balance sheets.

NOTE 3 – STATUTORY ACCOUNTING PRACTICES

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which vary in certain respects from reporting practices prescribed or permitted by insurance regulatory authorities. The significant differences for statutory reporting include: (a) acquisition costs of acquiring new business are charged to operations as incurred, (b) life policy liabilities are established utilizing interest and mortality factors specified by regulatory authorities, (c) the Asset Valuation Reserve (AVR) and the Interest Maintenance Reserve (IMR) are recorded as liabilities in the life subsidiary, and (d) non-admitted assets (primarily furniture and equipment, agents' debit balances and prepaid expenses) are charged directly to surplus.

Statutory net income (loss) and capital and surplus, excluding intercompany transactions, are summarized as follows:

| | 2018 | 2017 |
|---|-----------|-----------|
| NSIC - including realized capital gains of \$71 and \$71, respectively | \$ 1,558 | \$ 1,554 |
| NSFC - including realized capital gains of \$39 and \$114, respectively | \$ 786 | \$ (921) |
| Omega - including realized capital gains of \$7 and \$49, respectively | \$ (64) | \$ 34 |
| Statutory risk-based adjusted capital: | | |
| NSIC - including AVR of \$766 and \$841, respectively | \$ 16,043 | \$ 15,689 |
| NSFC - including investment in Omega of \$7,280 and \$7,482, respectively | \$ 34,645 | \$ 34,188 |
| Omega | \$ 10,783 | \$ 10,983 |

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

NOTE 4 – INVESTMENTS

Our investment in available-for-sale securities, which are reported at fair value, includes fixed maturity securities and 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 reported in investment gains/losses as a component of net income.

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

| Available-for-sale securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| U.S. Government corporations and agencies | \$ 4,820 | \$ 31 | \$ 107 | \$4,744 |
| Agency mortgage backed securities | 27,492 | 159 | 545 | 27,106 |
| Asset backed securities | 10,901 | 7 | 248 | 10,660 |
| Private label mortgage backed securities | 5,869 | 105 | 27 | 5,947 |
| Corporate bonds | 36,935 | 407 | 1,551 | 35,791 |
| States, municipalities and political subdivisions | 10,059 | 105 | 91 | 10,073 |
| Foreign governments | 801 | 3 | — | 804 |
| Total fixed maturities | 96,877 | 817 | 2,569 | 95,125 |
| Equity securities | 1,842 | 2,464 | — | 4,306 |
| Total | \$ 98,719 | \$ 3,281 | \$ 2,569 | \$99,431 |

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

| Held-to-maturity securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|-----------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Agency mortgage backed securities | \$ 1,449 | \$ 16 | \$ 22 | \$1,443 |
| Total | \$ 1,449 | \$ 16 | \$ 22 | \$1,443 |

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 |
|---|-------------------|------------------------------|-------------------------------|---------------|
| U.S. Government corporations and agencies | \$ 6,307 | \$ 131 | \$ 51 | \$6,387 |
| Agency mortgage backed securities | 20,858 | 232 | 468 | 20,622 |
| Asset backed securities | 9,000 | 132 | 72 | 9,060 |
| Private label mortgage backed securities | 4,637 | 258 | — | 4,895 |
| Corporate bonds | 39,127 | 1,103 | 321 | 39,909 |
| States, municipalities and political subdivisions | 13,758 | 389 | 54 | 14,093 |
| Foreign governments | 780 | 12 | — | 792 |
| 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 |
|-----------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| Agency mortgage backed securities | \$ 1,616 | \$ 29 | \$ | —\$1,645 |
| Total | \$ 1,616 | \$ 29 | \$ | —\$1,645 |

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The amortized cost and aggregate fair value of debt securities at December 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 | \$ 2,183 | \$2,190 |
| Due after one year through five years | 17,179 | 17,027 |
| Due after five years through ten years | 27,625 | 27,052 |
| Due after ten years | 49,890 | 48,856 |
| Total | \$ 96,877 | \$95,125 |

Held-to-maturity securities:

| | | |
|--|----------|---------|
| Due in one year or less | \$ — | \$— |
| Due after one year through five years | 43 | 45 |
| Due after five years through ten years | — | — |
| Due after ten years | 1,406 | 1,398 |
| Total | \$ 1,449 | \$1,443 |

A summary of securities available-for-sale with unrealized losses as of December 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):

| | 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 |
| December 31, 2018 | | | | | | | |
| U.S. Government corporations and agencies | \$— | \$ — | \$3,209 | \$ 107 | \$3,209 | \$ 107 | 6 |
| Agency mortgage backed securities | 5,504 | 45 | 10,969 | 500 | 16,473 | 545 | 38 |
| Asset backed securities | 5,824 | 146 | 2,741 | 102 | 8,565 | 248 | 12 |
| Private label mortgage backed securities | 1,348 | 27 | — | — | 1,348 | 27 | 2 |
| Corporate bonds | 16,583 | 709 | 9,823 | 842 | 26,406 | 1,551 | 51 |
| States, municipalities and political subdivisions | 1,242 | 10 | 4,420 | 81 | 5,662 | 91 | 11 |
| | \$30,501 | \$ 937 | \$31,162 | \$ 1,632 | \$61,663 | \$ 2,569 | 120 |

A summary of securities held-to-maturity with unrealized losses as of December 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:

| | 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 |
| December 31, 2018 | | | | | | | |
| | \$1,026 | \$ 22 | \$ — | \$ — | \$1,026 | \$ 22 | 2 |

Agency mortgage backed
securities

\$1,026 \$ 22 \$ —\$ —\$1,026 \$ 22 2

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

| December 31, 2017 | Less than 12 months | | 12 months or longer | | Total | | |
|---|---------------------|-------------------------|---------------------|-------------------------|------------|-------------------------|-------------------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Total Securities in a Loss Position |
| U.S. Government corporations and agencies | \$2,275 | \$ 31 | \$991 | \$ 20 | \$3,266 | \$ 51 | 5 |
| Agency mortgage backed securities | 8,475 | 204 | 5,544 | 264 | 14,019 | 468 | 26 |
| Asset backed securities | — | — | 2,413 | 72 | 2,413 | 72 | 4 |
| Private label mortgage backed securities | — | — | — | — | — | — | 0 |
| Corporate bonds | 6,567 | 166 | 5,607 | 155 | 12,174 | 321 | 20 |
| States, municipalities and political subdivisions | 2,176 | 7 | 2,574 | 47 | 4,750 | 54 | 9 |
| | \$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 the fixed maturity investment portfolio. The Company has no material exposure to sub-prime mortgage loans and approximately 4.69% of the fixed income investment portfolio is rated below investment grade. 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, other than the impairment described below, the securities in an accumulated loss position in the portfolio were temporary impairments.

For the year ended December 31, 2018, the Company realized a \$16,000 other-than-temporary impairment representing a credit loss on a mortgage backed security. For the year ended December 31, 2017, the Company realized no other-than-temporary impairments. At December 31, 2018, the three largest losses not realized as an impairment in the fixed maturity portfolio totaled \$145,000, \$99,000 and \$94,000. Each of these losses were driven by changes in market interest rates. At December 31, 2017, the single largest loss not realized as an impairment was in

the fixed maturity portfolio totaled \$75,000. The second largest loss position in the fixed maturity portfolio totaled \$60,000. The third largest loss position in fixed maturity portfolio totaled \$53,000.

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

| | Year ended | |
|--|--------------|---------|
| | December 31, | |
| | 2018 | 2017 |
| Fixed maturities | \$3,803 | \$3,377 |
| Equity securities | 106 | 95 |
| Mortgage loans on real estate | 7 | 9 |
| Investment real estate | 3 | 4 |
| Policy loans | 142 | 130 |
| Company owned life insurance change in surrender value | (374) | 110 |
| Other | 25 | 74 |
| | 3,712 | 3,799 |
| Less: Investment expenses | 145 | 152 |
| Net investment income | \$3,567 | \$3,647 |

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

| | Year ended | |
|---|------------|-------|
| | December | |
| | 31, | |
| | 2018 | 2017 |
| Fixed maturities | \$128 | \$58 |
| Equity securities | — | 174 |
| Change in fair value of equity securities | (203) | — |
| Other, principally real estate | (87) | 2 |
| Other-than-temporary impairments | (16) | — |
| Net investment gains (losses) | \$(178) | \$234 |

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

| | December 31, December 31, | |
|--|---------------------------|----------|
| | 2018 | 2017 |
| Net change in unrealized gains (losses) on available-for-sale securities before deferred tax | \$ (3,042) | \$ 1,402 |
| Deferred income tax | 638 | (476) |
| Net change in unrealized gains (losses) on available-for-sale securities | \$ (2,404) | \$ 926 |

NOTE 5 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Our available-for-sale securities consists of fixed maturity and equity securities which are recorded at fair value in the accompanying consolidated balance sheets.

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:

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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.

Assets/Liabilities Measured at Fair Value on a Recurring Basis

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

| Description | Fair Value Measurements at Reporting Date Using | | | |
|---|---|----------|----------|---------|
| | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets | | | | |
| Fixed maturities available-for-sale | | | | |
| U.S. Government corporations and agencies | \$4,744 | \$4,147 | \$597 | \$— |
| Agency mortgage backed securities | 27,106 | 11,756 | 15,350 | — |
| Asset backed securities | 10,560 | 2,839 | 7,721 | — |
| Corporate bonds | 35,791 | — | 35,791 | — |
| Private label asset backed securities | 5,947 | — | 5,947 | — |
| States, municipalities and political subdivisions | 10,073 | — | 10,073 | — |
| Foreign governments | 804 | 804 | — | — |
| Trading securities | 107 | 107 | — | — |
| Equity securities | 4,306 | 3,181 | — | 1,125 |
| Total Financial Assets | \$99,438 | \$22,834 | \$75,479 | \$1,125 |

Financial Liabilities

| | | | | |
|-----------------------------|----------|-----|-----|----------|
| Interest rate swap | \$(234) | \$— | \$— | \$(234) |
| Total Financial Liabilities | \$(234) | \$— | \$— | \$(234) |

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.

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

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

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

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

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

As of December 31, 2018, Level 3 fair value measurements of assets include \$1,125,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of December 31, 2018, Level 3 fair value measurements of liabilities include \$234,000 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 8.

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

| | Equity Securities | Interest Rate Swap |
|--|-------------------|--------------------|
| For the year ended December 31, 2018 | | |
| Beginning balance | \$ 1,073 | \$(608) |
| Total gains or losses (realized and unrealized): | | |
| Included in earnings | 52 | — |
| Included in other comprehensive income | — | 374 |
| Purchases: | — | — |
| Sales: | — | — |
| Issuances: | — | — |
| Settlements: | — | — |
| Transfers in/(out) of Level 3 | — | — |
| Ending balance | \$ 1,125 | \$(234) |
| | \$ — | \$ — |

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, 2018:

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

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

| Description | Fair Value Measurements at Reporting Date Using | | | |
|---|---|-----------------|-----------------|-----------------|
| | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets | | | | |
| Fixed maturities available-for-sale | | | | |
| U.S. Government corporations and agencies | \$6,387 | \$6,387 | \$— | \$— |
| Agency mortgage backed securities | 20,622 | 7,827 | 12,795 | — |
| Asset backed securities | 9,060 | 3,445 | 5,615 | — |
| Corporate bonds | 39,909 | — | 39,909 | — |
| Private label asset backed securities | 4,895 | — | 4,895 | — |
| States, municipalities and political subdivisions | 14,093 | — | 14,093 | — |
| Foreign governments | 792 | 792 | — | — |
| Trading securities | 107 | 107 | — | — |
| Equity securities available-for-sale | 4,509 | 3,436 | — | 1,073 |
| Total Financial Assets | \$100,374 | \$21,994 | \$77,307 | \$1,073 |
| Financial Liabilities | | | | |
| Interest rate swap | \$(608) | \$— | \$— | \$(608) |
| Total Financial Liabilities | \$(608) | \$— | \$— | \$(608) |

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.

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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.

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

| | December 31, 2018 | | December 31, 2017 | |
|--|----------------------|----------------------------|----------------------|----------------------------|
| | Carrying Value | Estimated Fair Value | Carrying Value | Estimated Fair Value |
| Assets and related instruments | | | | |
| Held-to-maturity securities | \$1,449 | \$ 1,443 | \$1,616 | \$ 1,645 |
| Mortgage loans | 156 | 156 | 162 | 162 |
| Policy loans | 1,854 | 1,854 | 1,810 | 1,810 |
| Company owned life insurance | 4,600 | 4,600 | 4,974 | 4,974 |
| Other invested assets | 2,148 | 2,148 | 2,574 | 2,574 |
| Liabilities and related instruments | | | | |
| Other policyholder funds | 1,515 | 1,515 | 1,706 | 1,706 |
| Short-term notes payable and current portion of long-term debt | 2,200 | 2,200 | 1,300 | 1,300 |
| Long-term debt | 12,152 | 12,152 | 14,339 | 14,339 |

NOTE 6 – PROPERTY AND EQUIPMENT

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

| | December 31, 2018 | December 31, 2017 |
|--------------------------------------|----------------------|----------------------|
| Building and improvements | \$ 3,378 | \$ 3,378 |
| Electronic data processing equipment | 1,504 | 1,512 |

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| | | |
|-------------------------------|----------|----------|
| Furniture and fixtures | 477 | 486 |
| | 5,359 | 5,376 |
| Less accumulated depreciation | 3,710 | 3,595 |
| Property and equipment, net | \$ 1,649 | \$ 1,781 |

Depreciation expense for the year ended ended December 31, 2018 was \$161,000 (\$121,000 for the year ended December 31, 2017).

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NOTE 7 – 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. At December 31, 2017, \$1,575,000 in AMT credit was booked as a deferred tax asset. Effective December 31, 2018, the Company recognized the AMT credit in federal income tax recoverable as Management anticipates \$1,077,000 will be recovered with the 2018 return and the remainder recovered by 2021 pursuant to allowable amounts under the TCJA. 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 \$716,000 at December 31, 2018 and \$1,487,000 at December 31, 2017.

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

| | As of December 31, 2018 | As of December 31, 2017 |
|--|----------------------------------|-------------------------------|
| General expenses | \$ 1,067 | \$ 1,069 |
| Unearned premiums | 1,265 | 1,269 |
| Claims liabilities | 552 | 484 |
| AMT credit | — | 1,575 |
| Impairment on real estate owned | 119 | 116 |
| Unrealized losses on securities available-for-sale | 368 | — |
| Unrealized loss on interest rate swaps | 49 | 128 |
| Deferred tax assets | 3,420 | 4,641 |
| Depreciation | (79) | (88) |
| Deferred policy acquisition costs | (1,645) | (1,706) |
| Pre-1984 policyholder surplus account | (463) | (529) |
| Unrealized gains on securities available-for-sale | — | (831) |
| Unrealized gains on equity securities | (517) | — |
| Deferred tax liabilities | (2,704) | (3,154) |
| Net deferred tax asset | \$ 716 | \$ 1,487 |

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

| | Years ended December 31, | |
|-----------------------------------|-----------------------------|---------|
| | 2018 | 2017 |
| Deferred policy acquisition costs | \$(61) | \$(77) |
| Other-than-temporary impairments | (3) | — |
| Unearned premiums | 4 | (10) |
| General expenses | 2 | (45) |
| Depreciation | (9) | 7 |
| Claims liabilities | (68) | (38) |
| AMT credit | 1,575 | (345) |

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| | | | |
|--|---------|-----|-------|
| Impact of repeal of special provision on pre-1984 policyholder surplus | (66 |) | 857 |
| Unrealized gains on equity securities | (43 |) | — |
| Impact of TCJA change in corporate tax rate | — | (54 |) |
| Deferred income tax expense (benefit) | \$1,331 | | \$295 |

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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:

| | Years ended | |
|---|--------------|---------|
| | December 31, | |
| | 2018 | 2017 |
| Federal income tax rate applied to pre-tax income/loss | 21.0 % | 34.0 % |
| Dividends received deduction and tax-exempt interest | (2.4)% | 5.8 % |
| Company owned life insurance | 7.4 % | 3.4 % |
| Small life deduction | — % | 30.7 % |
| Pre-1984 policyholder surplus account at current statutory rate | — % | (76.9)% |
| Other, net | 0.9 % | (5.0)% |
| Effective federal income tax rate | 26.9 % | (8.0)% |

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 2014. Tax returns have been filed through the year 2017.

NOTE 8 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of December 31, 2018 and December 31, 2017 (dollars in thousands):

| | December 31, 2018 | December 31, 2017 |
|--|-------------------|-------------------|
| Current portion of installment note payable due in November with variable interest rate equal to the WSJ prime rate plus 0.5%. Unsecured. | \$ 2,200 | \$ 800 |
| Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 5.0% floor; maturity March 2020 (renewed March 2018). Interest payments due quarterly. Unsecured. | — | 500 |
| | \$ 2,200 | \$ 1,300 |
| Long-term debt consisted of the following as of December 31, 2018 and December 31, 2017 (dollars in thousands): | | |
| | December 31, 2018 | December 31, 2017 |
| Promissory note with variable interest rate equal to the WSJ prime rate plus 0.5%; maturity November 2019. Annual installment payments beginning November 2017 with final balloon payment due November 30, 2019. Unsecured. | \$ — | \$ 2,200 |
| Subordinated debentures issued on December 15, 2005 with floating rate interest equal to 3-Month LIBOR plus 375 basis points; net of \$159,000 in debt issuance cost (\$168,000 in 2017); maturity December 2035. Interest payable quarterly. Redeemable prior to maturity. Unsecured. | 9,120 | 9,111 |
| Subordinated debentures issued on June 21, 2007 with floating rate interest equal to 3-Month LIBOR plus 340 basis points; net of \$61,000 in debt issuance cost (\$65,000 in 2017); maturity June 15, 2037. Interest payable quarterly. Redeemable prior to maturity. Unsecured. | 3,032 | 3,028 |

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

| 2019 | 2020 | 2021 | 2022 | 2023 | Thereafter |
|---------|------|------|------|------|------------|
| \$2,200 | \$ — | \$ — | \$ — | \$ — | \$ 12,152 |

The Company has entered into various swap agreements related to the trust preferred securities. On March 19, 2009, the Company entered into a forward swap effective September 17, 2012, with a notional amount of \$3,000,000 and designated the swap as a hedge against changes in cash flows attributable to changes in the benchmark interest rate (LIBOR) associated with the subordinated debentures issued June 21, 2007. Quarterly, commencing September 17, 2012, under the terms of the forward swap, the Company will pay interest at a fixed rate of 7.02% until March 15, 2019. On May 26, 2010, the Company entered into a forward swap with a notional amount of \$9,000,000 effective December 15, 2015, which hedges against changes in cash flows following the termination of the fixed rate period. Quarterly, commencing March 16, 2016 under the terms of the forward swap, the Company pays interest at a fixed rate of 8.49% until March 15, 2020.

The swaps entered into in 2009 and 2010 have fair values of \$6,000 (liability) and \$228,000 (liability), respectively, for a total liability of \$234,000 at December 31, 2018 (\$608,000 at December 31, 2017). The swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of \$295,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements at December 31, 2018. A net valuation gain of \$278,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2017.

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

The Company's interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. At December 31, 2018, the Company has securities on deposit with fair market values of \$932,000 (all of which is posted as collateral). At December 31, 2017, the Company had securities on deposit with fair market values of \$1,446,000 (all of which is posted as collateral). See Note 5 for additional information about the interest rate swaps.

NOTE 9 – POLICY AND CLAIM RESERVES

The Company regularly updates its reserve estimates as new information becomes available and events occur that may impact the resolution of unsettled claims. Reserve estimation can be an inherently uncertain process and reserves estimates can be revised up or down depending on changes in circumstances. Changes in prior years' reserve estimates are reflected in the results of operations in the year such changes are determined.

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

| | Years ended December 31, | |
|---|-----------------------------|----------|
| | 2018 | 2017 |
| Summary of claims and claim adjustment expense reserves | | |
| Balance, beginning of year | \$7,075 | \$7,531 |
| Less reinsurance recoverable on unpaid losses | 327 | 1,184 |
| Net balances at beginning of year | 6,748 | 6,347 |
| Net losses: | | |
| Provision for claims and claim adjustment expenses for claims arising in current year | 36,457 | 39,604 |
| Estimated claims and claim adjustment expenses for claims arising in prior years | (722) | (1,213) |
| Total increases | 35,735 | 38,391 |
| Claims and claim adjustment expense payments for claims arising in: | | |
| Current year | 31,833 | 34,609 |
| Prior years | 3,826 | 3,381 |
| Total payments | 35,659 | 37,990 |
| Net balance at end of period | 6,824 | 6,748 |
| Plus reinsurance recoverable on unpaid losses | 1,384 | 327 |
| Claims and claim adjustment expense reserves at end of period | \$8,208 | \$7,075 |

The slight increase in claim and claim adjustment expense reserves before reinsurance recoverable is primarily due to the increase in reserves associated with Hurricane Florence which occurred in September of 2018. The estimate for claims arising in prior years was reduced \$250,000 in 2018 (reduced \$1,355,000 in 2017) due to favorable loss development during the year on claims arising in prior years.

The Company has a geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather, explosions and fires, and the incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophe losses are restricted to small geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. The Company generally seeks to reduce its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance. At December 31, 2018, the Company's estimate of unpaid losses and adjustment expenses for claims incurred in prior years related to catastrophes that exceeded our retention totaled \$18,000 before reinsurance (\$115,000 in 2017). Because the Company has exhausted its catastrophe coverage limits available for Hurricane Katrina any additional development will not be covered by reinsurance.

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

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Homeowners, Dwelling Fire and Other Liability

| For the Years Ended December 31, | | | | | | | | | | | IBNR Reserves Dec. 31, 2018 | Cumulative Number of Reported Claims |
|--|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|---|--|
| 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | | | |
| Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance | | | | | | | | | | | | |
| Unaudited | | | | | | | | | | | | |
| 2009 | \$31,425 | \$30,236 | \$30,442 | \$30,432 | \$30,484 | \$30,362 | \$30,306 | \$30,280 | \$30,280 | \$30,280 | \$ | —7,996 |
| 2010 | — | 30,610 | 29,918 | 29,805 | 29,718 | 29,687 | 29,672 | 29,641 | 29,660 | 29,659 | — | 5,888 |
| 2011 | — | — | 35,203 | 33,957 | 34,233 | 34,711 | 34,806 | 34,650 | 34,658 | 34,663 | 7 | 8,127 |
| 2012 | — | — | — | 29,959 | 30,190 | 30,402 | 30,091 | 29,948 | 29,885 | 29,827 | — | 5,198 |
| 2013 | — | — | — | — | 27,436 | 27,147 | 27,076 | 27,023 | 27,191 | 27,236 | 154 | 5,204 |
| 2014 | — | — | — | — | — | 25,929 | 26,422 | 26,290 | 26,225 | 26,130 | 8 | 4,747 |
| 2015 | — | — | — | — | — | — | 31,484 | 30,861 | 30,360 | 30,890 | 372 | 5,842 |
| 2016 | — | — | — | — | — | — | — | 36,287 | 35,343 | 35,399 | 204 | 5,183 |
| 2017 | — | — | — | — | — | — | — | — | 40,210 | 38,958 | 425 | 5,321 |
| 2018 | — | — | — | — | — | — | — | — | — | 37,079 | 3,254 | 4,500 |
| | | | | | | | | | | Total | \$320,121 | |

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

Unaudited

| | | | | | | | | | | | |
|--|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|-----------|
| 2009 | \$25,245 | \$29,281 | \$29,869 | \$29,847 | \$30,004 | \$30,265 | \$30,274 | \$30,280 | \$30,280 | \$30,280 | |
| 2010 | — | 26,064 | 29,201 | 29,404 | 29,507 | 29,639 | 29,640 | 29,640 | 29,660 | 29,659 | |
| 2011 | — | — | 31,488 | 33,080 | 33,484 | 34,167 | 34,622 | 34,621 | 34,641 | 34,647 | |
| 2012 | — | — | — | 26,162 | 29,135 | 29,614 | 29,765 | 29,834 | 29,835 | 29,823 | |
| 2013 | — | — | — | — | 24,157 | 26,114 | 26,487 | 26,661 | 26,788 | 26,976 | |
| 2014 | — | — | — | — | — | 22,844 | 25,461 | 25,800 | 26,033 | 26,095 | |
| 2015 | — | — | — | — | — | — | 25,923 | 30,066 | 30,190 | 30,296 | |
| 2016 | — | — | — | — | — | — | — | 31,893 | 34,722 | 35,029 | |
| 2017 | — | — | — | — | — | — | — | — | 35,209 | 38,245 | |
| 2018 | — | — | — | — | — | — | — | — | — | 32,456 | |
| | | | | | | | | | | Total | \$313,506 |
| All outstanding liabilities before 2008, net of reinsurance | | | | | | | | | | 209 | |
| Liabilities for claims and claim adjustment expenses, net of reinsurance | | | | | | | | | | \$6,824 | |

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

Average Annual Percentage Payout of Incurred Claims

by Age (in Years), Net of Reinsurance

Unaudited

| Years | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|-------|-------|------|------|------|------|------|------|---|---|----|
| | 87.8% | 9.5% | 1.1% | 0.5% | 0.7% | 0.2% | 0.2% | % | % | % |

The tables presented above represent homeowners, dwelling fire and other liability lines of business. The Company combined the data for these lines of business because the policy coverage and payout pattern for homeowners and dwelling fire are not materially different. Also, other liability is combined with dwelling fire because liability coverage

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is only sold as an additional coverage offered only with the dwelling fire policy. The Company offers no stand alone liability products.

Management periodically estimates the liability for claims that have been reported but not paid and for claims incurred but not reported (IBNR). Management utilizes expected losses along with historical data analysis of paid and incurred loss development patterns over the past ten years to aide in establishing the claims liability. Management also separately evaluates any recent large events in establishing claim reserves. The Company also engages a consulting actuary to review managements' estimates of claim liabilities each year. There has been no material change in reserving methodology in 2018 compared to prior years.

As shown in the table above depicting average annual payout of incurred claims, 87.8% of claims are settled within twelve months of the date of loss and cumulatively, 97.3% of claims are settled within two years of the date of loss. While reserves for reported but unpaid and incurred but not reported claims can ultimately prove to be excessive or deficient, the short duration of the Company's claim liabilities serves to lesson the uncertainty compared to longer tail lines of insurance. The Company has no material exposure to difficult to estimate long tail liabilities such as toxic waste cleanup, asbestos related illness or other environmental remediation exposures.

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

| | December 31, 2018 | December 31, 2017 |
|---|----------------------|----------------------|
| Net outstanding liabilities | | |
| Homeowners' insurance | \$ 2,418 | \$ 2,384 |
| Dwelling fire insurance | 2,602 | 2,799 |
| Other Liability insurance | 1,804 | 1,463 |
| Other short-duration insurance lines | — | 102 |
| Liabilities for unpaid claims and claim adjustment expenses, net of reinsurance | 6,824 | 6,748 |
| Reinsurance recoverable on unpaid claims | | |
| Homeowners' insurance | 537 | 327 |
| Dwelling fire insurance | 847 | — |
| Other Liability insurance | — | — |
| Other short-duration insurance lines | — | — |
| Total reinsurance recoverable on unpaid claims | 1,384 | 327 |
| Insurance lines other than short-duration | — | — |
| Unallocated claims adjustment expenses | — | — |
| Other | — | — |
| | — | — |
| Total gross liability for unpaid claims and claim adjustment expense | \$ 8,208 | \$ 7,075 |

Accident and Health Claim Reserves

The Company, through its life insurance subsidiary, underwrites a limited number of short duration accident and health contracts. These claims are typically settled in three years or less and the reserve for unpaid claims totaled \$358,000 at December 31, 2018 (\$367,000 at December 31, 2017). These claims are a component of policy and

contract claims which totaled \$792,000 at December 31, 2018 (\$903,000 at December 31, 2017).

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

| For the Years Ended December 31, 2016 2017 2018 | | | | IBNR | Cumulative |
|---|-------|-------|-------|------------------------------|---------------------------------|
| Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance Unaudited | | | | Reserves Dec. 31, 2018 | Number of Reported Claims |
| 2016 | \$960 | \$962 | \$883 | \$ | —1,185 |
| 2017 | | 1,008 | 964 | — | 1,826 |
| 2018 | | | 1,037 | 358 | 1,141 |
| Cumulative Paid Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance Unaudited | | | | | |
| 2016 | \$658 | \$874 | \$882 | | |
| 2017 | | 725 | 881 | | |
| 2018 | | | 747 | | |
| Average Annual Percentage Payout of Incurred Claims by Age Unaudited | | | | | |
| Years 1 | 2 | 3 | | | |
| | 73.9% | 21.3% | 4.7% | | |

NOTE 10 – REINSURANCE

The Company's insurance operations utilize reinsurance in the risk management process in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is placed through yearly renewable term coverage. Property and casualty reinsurance is placed on an excess of loss basis to cover losses from catastrophe events. Reinsurance contracts do not relieve the insurance subsidiaries of the obligation indemnify policyholders with respect to the underlying insurance contracts.

Failure of re-insurers to honor their obligations could result in credit related 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 or have adverse impacts on regulatory capital levels 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 and tropical storms.

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

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

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

The Company's catastrophe reinsurance contract allows for one reinstatement. The Company maintains reinstatement premium protection (RPP) to cover reinstatement premiums incurred. The RPP further reduces risk from a major catastrophe and serves to protect 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. Cost is amortized over the reinsurance contract period.

At December 31, 2018, the largest reinsurance recoverable of a single reinsurer was \$125,000 (\$322,000 at December 31, 2017). Amounts reported as ceded incurred losses were related to development of losses from prior year catastrophes.

NOTE 11 – EMPLOYEE BENEFIT PLANS

The Company and its subsidiaries have an established retirement savings plan (401K Plan). All full-time employees are eligible to participate, and all employer contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for the years ended December 31, 2018 and 2017 amounted to \$201,000 and \$187,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limits.

The Company established a non-qualified plan under which Company directors are allowed to defer all or a portion of directors' fees into various investment options. A supplemental executive retirement plan (SERP) 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 related to the non-qualified deferred compensation plans for the years ended December 31, 2018 and 2017 amounted to an approximate decrease of \$128,000 and increase of \$215,000 in employee benefit related expenses, respectively.

The Company and its subsidiaries established an Employee Stock Ownership Plan (ESOP) in January 2010, to enable 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 contributions of \$232,000 during the year ended December 31, 2018 and contributions of \$268,000 during the year ended December 31, 2017. All contributions were made in cash for

purchase of Company shares in the open market. The Company has not allocated newly issued shares directly to the plan and the plan has no debt.

NOTE 12 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

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

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The amount of dividends paid from NSIC to the Company in any year may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2018, NSIC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to \$1,583,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. At December 31, 2018, NSFC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to \$3,464,000.

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

At December 31, 2018, securities with market values of \$3,031,000 (\$2,928,000 at December 31, 2017) were pledged with various states pursuant to statutory requirements.

NOTE 13 – SHAREHOLDERS' EQUITY

During the year ended December 31, 2018 and year ended December 31, 2017, changes in shareholders' equity consisted of net income of \$779,000 and net loss of \$1,203,000, respectively; dividends paid of \$505,000 in 2018 and \$504,000 in 2017; other comprehensive loss of \$2,109,000 in 2018 and other comprehensive income of \$1,204,000 in 2017. Other comprehensive income/loss consisted of changes in accumulated unrealized gains/losses on securities available-for-sale and changes in accumulated unrealized losses on interest rate swaps.

Preferred Stock

Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference. There is currently no Preferred Stock issued or outstanding.

Common Stock

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

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

The table below provides information regarding the Company's preferred and common stock as of December 31, 2018 and December 31, 2017:

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| | December 31, 2018 | | | December 31, 2017 | | |
|-------------------------------------|-------------------|-----------|-------------|-------------------|-----------|-------------|
| | Authorized | Issued | Outstanding | Authorized | Issued | Outstanding |
| Preferred Stock, \$1 par value | 500,000 | — | — | 500,000 | — | — |
| Class A Common Stock, \$1 par value | 2,000,000 | — | — | 2,000,000 | — | — |
| Common Stock, \$1 par value | 3,000,000 | 2,527,136 | 2,527,136 | 3,000,000 | 2,522,312 | 2,522,312 |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

On May 18, 2018, 4,824 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

NOTE 14 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

| | Year ended December 31, | |
|---|----------------------------|----------------|
| | 2018 | 2017 |
| Gains and Losses on Cash Flow Hedges | | |
| Balance at beginning of period | \$(480) | \$(679) |
| Other comprehensive income for period: | | |
| Other comprehensive gain before reclassifications | 295 | 278 |
| Reclassification adjustment - legislative tax rate change | — | (79) |
| Net current period other comprehensive income | 295 | 199 |
| Balance at end of period | \$(185) | \$(480) |
| Unrealized Gains and Losses on Available-for-Sale Securities | | |
| Balance at beginning of period | \$3,126 | \$1,686 |
| Other comprehensive income (loss) for period: | | |
| Other comprehensive income (loss) before reclassifications | (2,304) | 1,079 |
| Reclassification adjustment - legislative tax rate change | — | 514 |
| Reclassification adjustment - gains on equity securities | (2,107) | — |
| Amounts reclassified from accumulated other comprehensive income (loss) | (100) | (153) |
| Net current period other comprehensive income (loss) | (4,511) | 1,440 |
| Balance at end of period | \$(1,385) | \$3,126 |
| Total Accumulated Other Comprehensive Income (Loss) at end of period | \$(1,570) | \$2,646 |

The following table presents the amounts reclassified out of AOCI for the year ended December 31, 2018 (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 | \$ 127 | Net investment gains |
| | 127 | Total before tax |
| | (27) | Tax (expense) or benefit |
| | \$ 100 | Net of Tax |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the amounts reclassified out of AOCI for the year ended December 31, 2017 (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 | \$ 232 | Net investment gains |
| | 232 | Total before tax |
| | (79) | Tax (expense) or benefit |
| | \$ 153 | Net of Tax |

NOTE 15 – SEGMENTS

The Company's property and casualty insurance operations comprise one business segment. The property and casualty insurance segment primarily underwrites home insurance coverage with primary lines of business consisting of dwelling fire and extended coverage, homeowners (including mobile homeowners) and other liability.

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

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

Total assets by industry segment at December 31, 2018 and December 31, 2017 are summarized below (dollars in thousands):

| Assets by industry segment | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|----------------------------|------------|--------------------------------|---------------------------------|-----------------------------|
| December 31, 2018 | \$ 144,231 | \$ 80,994 | \$ 59,479 | \$ 3,758 |
| December 31, 2017 | \$ 146,438 | \$ 80,241 | \$ 60,709 | \$ 5,488 |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Premium revenues and operating income by business segment for the years ended December 31, 2018 and 2017 are summarized below (dollars in thousands):

| Year ended December 31, 2018 | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations | Inter- company Eliminations | Total |
|---|--------------------------------|---------------------------------|-----------------------------|-----------------------------------|-------------|
| REVENUE | | | | | |
| Net premiums earned | \$ 54,837 | \$ 6,019 | \$ — | \$ — | \$60,856 |
| Net investment income | 1,330 | 2,722 | 55 | (540) | 3,567 |
| Investment losses | (100) | (78) | — | — | (178) |
| Other income | 609 | 1,078 | 1,006 | (2,081) | 612 |
| | 56,676 | 9,741 | 1,061 | (2,621) | 64,857 |
| BENEFITS AND EXPENSES | | | | | |
| Policyholder benefits paid | 35,735 | 5,242 | — | (568) | 40,409 |
| Amortization of deferred policy acquisition costs | 2,759 | 838 | — | — | 3,597 |
| Commissions | 7,267 | 288 | — | — | 7,555 |
| General and administrative expenses | 8,472 | 2,111 | 309 | (2,053) | 8,839 |
| Taxes, licenses and fees | 1,937 | 220 | — | — | 2,157 |
| Interest expense | — | 48 | 1,187 | — | 1,235 |
| | 56,170 | 8,747 | 1,496 | (2,621) | 63,792 |
| Income (Loss) Before Income Taxes | 506 | 994 | (435) | — | 1,065 |
| INCOME TAX EXPENSE (BENEFIT) | (97) | 232 | 151 | — | 286 |
| Net Income (Loss) | \$ 603 | \$ 762 | \$ (586) | \$ — | \$779 |
| | | | | | |
| Year ended December 31, 2017 | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations | Inter- company Eliminations | Total |
| REVENUE | | | | | |
| Net premiums earned | \$ 55,044 | \$ 6,119 | \$ — | \$ — | \$61,163 |
| Net investment income | 1,571 | 2,551 | 65 | (540) | 3,647 |
| Investment gains | 163 | 71 | — | — | 234 |
| Other income | 592 | 1,045 | 1,019 | (2,060) | 596 |
| | 57,370 | 9,786 | 1,084 | (2,600) | 65,640 |
| BENEFITS AND EXPENSES | | | | | |
| Policyholder benefits paid | 38,391 | 5,045 | — | (567) | 42,869 |
| Amortization of deferred policy acquisition costs | 2,777 | 812 | — | — | 3,589 |
| Commissions | 7,380 | 343 | — | — | 7,723 |
| General and administrative expenses | 8,087 | 1,929 | 838 | (2,033) | 8,821 |
| Taxes, licenses and fees | 2,237 | 208 | — | — | 2,445 |
| Interest expense | — | 73 | 1,234 | — | 1,307 |
| | 58,872 | 8,410 | 2,072 | (2,600) | 66,754 |
| Income (Loss) Before Income Taxes | (1,502) | 1,376 | (988) | — | (1,114) |
| INCOME TAX EXPENSE (BENEFIT) | (142) | 157 | 74 | — | 89 |
| Net Income (Loss) | \$ (1,360) | \$ 1,219 | \$ (1,062) | \$ — | \$ (1,203) |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the Company's gross and net premiums written for the property and casualty segment and the life and accident and health segment for the years ended December 31, 2018 and 2017, respectively:

| | Year ended December 31, | |
|--|----------------------------|----------|
| | 2018 | 2017 |
| Life, accident and health operations premiums written: | | |
| Traditional life insurance | \$4,336 | \$4,411 |
| Accident and health insurance | 1,831 | 1,828 |
| Gross life, accident and health | 6,167 | 6,239 |
| Reinsurance premium ceded | (81) | (77) |
| Net life, accident and health premiums written | \$6,086 | \$6,162 |
| Property and Casualty operations premiums written: | | |
| Dwelling fire & extended coverage | \$37,598 | \$37,034 |
| Homeowners (Including mobile homeowners) | 21,214 | 22,319 |
| Other liability | 2,195 | 2,145 |
| Gross property and casualty | 61,007 | 61,498 |
| Reinsurance premium ceded | (6,376) | (6,272) |
| Net property and casualty written | \$54,631 | \$55,226 |
| Consolidated gross premiums written | \$67,174 | \$67,737 |
| Reinsurance premium ceded | (6,457) | (6,349) |
| Consolidated net premiums written | \$60,717 | \$61,388 |

The following table presents the Company's gross and net premiums earned for the property and casualty segment and the life and accident and health segment for the years ended December 31, 2018 and 2017, respectively:

| | Year ended December 31, | |
|---|----------------------------|----------|
| | 2018 | 2017 |
| Life, accident and health operations premiums earned: | | |
| Traditional life insurance | \$4,273 | \$4,368 |
| Accident and health insurance | 1,827 | 1,828 |
| Gross life, accident and health | 6,100 | 6,196 |
| Reinsurance premium ceded | (81) | (77) |
| Net life, accident and health premiums earned | \$6,019 | \$6,119 |
| Property and Casualty operations premiums earned: | | |
| Dwelling fire & extended coverage | \$37,232 | \$36,373 |
| Homeowners (Including mobile homeowners) | 21,801 | 22,831 |
| Other liability | 2,180 | 2,112 |
| Gross property and casualty | 61,213 | 61,316 |
| Reinsurance premium ceded | (6,376) | (6,272) |
| Net property and casualty earned | \$54,837 | \$55,044 |
| Consolidated gross premiums earned | \$67,313 | \$67,512 |

| | | |
|----------------------------------|----------|----------|
| Reinsurance premium ceded | (6,457) | (6,349) |
| Consolidated net premiums earned | \$60,856 | \$61,163 |

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

NOTE 16 – CONTINGENCIES

In the ordinary course of business, the Company and its subsidiaries are routinely a defendant in or party to pending or threatened legal actions and proceedings related to the conduct of their insurance operations. These suits can 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. It is inherently difficult to predict the outcome of such matters, particularly when the claimant seeks very large or indeterminate damages or when the matters present novel legal theories or involve multiple parties. An accrued liability is established when loss contingencies are both probable and estimable. However, there is potential loss exposure in excess of any accrued amounts. The Company monitors pending matters for further development that could affect the amount of the accrued liability.

The Company's property & casualty subsidiaries had one action remaining in Texas filed in the aftermath of Hurricane Ike at December 31, 2018. This is an individual action with allegations of underpayment of a hurricane-related claim. The suit seeks a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief.

The Company maintains loss and loss adjustment expense reserves on litigated claims that occur in the routine course of business in the insurance operations of the subsidiaries. These reserves are included in the liability for benefit and loss reserves on the balance sheet.

NOTE 17 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the year ended December 31, 2018 was \$1,231,000 (\$1,285,000 in 2017). Cash paid for income taxes during the year ended December 31, 2018 was \$25,000. There was no cash paid for income taxes during the year ended December 31, 2017.

During the year ended December 31, 2018, non-cash changes in equity included \$5,000 in common stock issued to Directors in lieu of cash compensation along with a corresponding \$71,000 increase in additional paid-in capital.

NOTE 18 – SUBSEQUENT EVENTS

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

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FINANCIAL STATEMENT SCHEDULES

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

THE NATIONAL SECURITY GROUP, INC.

(dollars in thousands)

| | December 31, 2018 | | | December 31, 2017 | | |
|---|-------------------|------------|------------------------------|-------------------|------------|------------------------------|
| | Cost | Fair Value | Amount per the Balance Sheet | Cost | Fair Value | Amount per the Balance Sheet |
| Securities Held-to-Maturity: | | | | | | |
| Agency mortgage backed securities | \$1,449 | \$1,443 | \$1,449 | \$1,616 | \$1,645 | \$1,616 |
| Total Securities Held-to-Maturity | 1,449 | 1,443 | 1,449 | 1,616 | 1,645 | 1,616 |
| Securities Available-for-Sale: | | | | | | |
| Equity Securities: | | | | | | |
| Banks and insurance companies | 1,064 | 2,044 | 2,044 | 1,064 | 1,966 | 1,966 |
| Industrial and all other | 778 | 2,262 | 2,262 | 778 | 2,543 | 2,543 |
| Total equity securities | 1,842 | 4,306 | 4,306 | 1,842 | 4,509 | 4,509 |
| Debt Securities: | | | | | | |
| U.S. Government corporations and agencies | 4,820 | 4,744 | 4,744 | 6,307 | 6,387 | 6,387 |
| Agency mortgage backed securities | 27,492 | 27,106 | 27,106 | 20,858 | 20,622 | 20,622 |
| Asset backed securities | 10,901 | 10,660 | 10,660 | 9,000 | 9,060 | 9,060 |
| Private label asset backed securities | 5,869 | 5,947 | 5,947 | 4,637 | 4,895 | 4,895 |
| Corporate bonds | 36,935 | 35,791 | 35,791 | 39,127 | 39,909 | 39,909 |
| States, municipalities and political subdivisions | 10,059 | 10,073 | 10,073 | 13,758 | 14,093 | 14,093 |
| Foreign governments | 801 | 804 | 804 | 780 | 792 | 792 |
| Total Debt Securities | 96,877 | 95,125 | 95,125 | 94,467 | 95,758 | 95,758 |
| Total Available-for-Sale | 98,719 | 99,431 | 99,431 | 96,309 | 100,267 | 100,267 |
| Total Securities | 100,168 | 100,874 | 100,880 | 97,925 | 101,912 | 101,883 |
| Trading securities | 107 | 107 | 107 | 107 | 107 | 107 |
| Mortgage loans on real estate | 156 | 156 | 156 | 162 | 162 | 162 |
| Investment real estate | 2,945 | 2,945 | 2,945 | 3,221 | 3,221 | 3,221 |
| Policy loans | 1,854 | 1,854 | 1,854 | 1,810 | 1,810 | 1,810 |
| Company owned life insurance | 4,315 | 4,600 | 4,600 | 4,315 | 4,974 | 4,974 |
| Other invested assets | 2,148 | 2,148 | 2,148 | 2,574 | 2,574 | 2,574 |
| Total investments | \$111,693 | \$112,684 | \$112,690 | \$110,114 | \$114,760 | \$114,731 |

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

BALANCE SHEETS

(dollars in thousands)

| | December 31, | |
|--|--------------|----------|
| | 2018 | 2017 |
| Assets | | |
| Fixed maturities available-for-sale, at estimated fair value | \$932 | \$1,446 |
| Investment real estate, at book value | 356 | 356 |
| Cash | 523 | 1,753 |
| Investment in subsidiaries (equity method) eliminated upon consolidation | 59,229 | 61,001 |
| Income tax recoverable | 1,012 | — |
| Deferred income tax asset | 601 | 1,745 |
| Other assets | 490 | 494 |
| Total Assets | \$63,143 | \$66,795 |
| Liabilities and Shareholders' Equity | | |
| Liabilities | | |
| Accrued general expenses | \$2,691 | \$2,923 |
| Interest rate swaps | 234 | 608 |
| Short-term notes payable | 2,200 | 1,300 |
| Long-term debt | 12,152 | 14,339 |
| Total Liabilities | 17,277 | 19,170 |
| Total Shareholders' Equity | 45,866 | 47,625 |
| Total Liabilities and Shareholders' Equity | \$63,143 | \$66,795 |

THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)

STATEMENTS OF INCOME

(dollars in thousands)

| | Years Ended | |
|--|--------------|-----------|
| | December 31, | |
| | 2018 | 2017 |
| Income | | |
| Dividends (eliminated upon consolidation) | \$750 | \$900 |
| Holding company management service fees | 1,006 | 1,019 |
| Other income | 55 | 65 |
| | 1,811 | 1,984 |
| Expenses | | |
| State taxes | 43 | 43 |
| Interest | 1,187 | 1,234 |
| Other expenses | 266 | 792 |
| | 1,496 | 2,069 |
| Income (loss) before income taxes and equity in undistributed earnings of subsidiaries | 315 | (85) |
| Income tax expense (benefit) | 151 | 74 |
| Income (loss) before equity in undistributed earnings of subsidiaries | 164 | (159) |
| Equity in undistributed earnings of subsidiaries | 615 | (1,044) |
| Net income (loss) | \$779 | \$(1,203) |

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

| | Years Ended December 31, | |
|---|-----------------------------|-----------|
| | 2018 | 2017 |
| Cash Flows from Operating Activities: | | |
| Net income | \$ 779 | \$(1,203) |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Equity in undistributed earnings of subsidiaries | (615) | 1,044 |
| Income taxes | 58 | 210 |
| Other, net | (137) | 2,016 |
| Net cash provided by operating activities | 85 | 2,067 |
| Cash Flows from Investing Activities: | | |
| Net sales (purchases) of investments | 490 | — |
| Net cash provided by investing activities | 490 | — |
| Cash Flows from Financing Activities: | | |
| Net (repayments) proceeds from debt | (1,300) | (1,500) |
| Cash dividends | (505) | (504) |
| Net cash used in financing activities | (1,805) | (2,004) |
| Net change in cash and cash equivalents | (1,230) | 63 |
| Cash and cash equivalents, at beginning of year | 1,753 | 1,690 |
| Cash and cash equivalents, at end of year | \$ 523 | \$ 1,753 |

Notes to Condensed Financial Information of Registrant

Note 1 - Basis of Presentation

Pursuant to the rules and regulations of the Securities and Exchange Commission, the Condensed Financial Information of the Registrant does not include all of the information and notes normally included with financial statements prepared in accordance with generally accepted accounting principles. It is, therefore, suggested that this Condensed Financial Information be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Registrant's Annual Report as referenced in Form 10-K, Part II, Item 8, page 45.

Note 2 - Cash Dividends and Asset Transfers from Insurance Subsidiaries

In 2018, cash dividends of \$750,000 were paid to the Registrant by its subsidiaries (\$900,000 in 2017).

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

| (dollars in thousands) | | Deferred Acquisition Costs | Future Policy Benefits | Unearned Premiums | Unpaid Losses | |
|--|--------------------|----------------------------------|------------------------------|--|---|--|
| At December 31, 2018: | | | | | | |
| Life and accident and health insurance | | \$ 4,416 | \$ 37,474 | \$ 10 | \$ 792 | |
| Property and casualty insurance | | 3,418 | — | 30,102 | 7,075 | |
| Total | | \$ 7,834 | \$ 37,474 | \$ 30,112 | \$ 7,867 | |
| At December 31, 2017: | | | | | | |
| Life and accident and health insurance | | \$ 4,690 | \$ 36,878 | \$ 10 | \$ 903 | |
| Property and casualty insurance | | 3,434 | — | 30,102 | 7,075 | |
| Total | | \$ 8,124 | \$ 36,878 | \$ 30,112 | \$ 7,978 | |
| | Premium Revenue | Net Investment Income | Other Income | Benefits, Claims, Losses and Settlement Expenses | Commissions, Amortization of Policy Acquisition Costs | General Expenses, Taxes, Licenses and Fees |
| For the year ended December 31, 2018: | | | | | | |
| Life and accident and health insurance | \$ 6,019 | \$ 2,722 | \$ 1,078 | \$ 5,242 | \$ 1,126 | \$ 2,331 |
| Property and casualty insurance | 54,837 | 1,330 | 609 | 35,735 | 10,026 | 10,409 |
| Other | — | 55 | 1,006 | — | — | 309 |
| Total | \$ 60,856 | \$ 4,107 | \$ 2,693 | \$ 40,977 | \$ 11,152 | \$ 13,049 |
| For the year ended December 31, 2017: | | | | | | |
| Life and accident and health insurance | \$ 6,119 | \$ 2,551 | \$ 1,045 | \$ 5,045 | \$ 1,155 | \$ 2,137 |
| Property and casualty insurance | 55,044 | 1,571 | 592 | 38,391 | 10,157 | 10,324 |
| Other | — | 65 | 1,019 | — | — | 838 |
| Total | \$ 61,163 | \$ 4,187 | \$ 2,656 | \$ 43,436 | \$ 11,312 | \$ 13,299 |

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

Schedule IV. Reinsurance

THE NATIONAL SECURITY GROUP, INC.

| (dollars in thousands) | Gross Amount | Ceded to Other Companies | Assumed from Other Companies | Net Amount | Percentage of Amount Assumed to Net |
|--|-----------------|--------------------------------|------------------------------------|---------------|--|
| For the year ended December 31, 2018 | | | | | |
| Life insurance in force | \$ 203,209 | \$ 9,730 | \$ | —\$193,479 | —% |
| Premiums: | | | | | |
| Life insurance and accident and health insurance | \$ 6,100 | \$ 81 | \$ | —\$6,019 | —% |
| Property and casualty insurance | 61,213 | 6,376 | — | 54,837 | —% |
| Total premiums | \$ 67,313 | \$ 6,457 | \$ | —\$60,856 | —% |
| For the year ended December 31, 2017 | | | | | |
| Life insurance in force | \$ 206,826 | \$ 10,413 | \$ | —\$196,413 | —% |
| Premiums: | | | | | |
| Life insurance and accident and health insurance | \$ 6,196 | \$ 77 | \$ | —\$6,119 | —% |

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| | | | | | |
|---------------------------------|----------|----------|----|-----------|----|
| Property and casualty insurance | 61,316 | 6,272 | — | 55,044 | —% |
| Total premiums | \$67,512 | \$ 6,349 | \$ | —\$61,163 | —% |

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FINANCIAL STATEMENT SCHEDULES

Schedule V. Valuation and Qualifying Accounts

The National Security Group, Inc.

Years ended December 31, 2018 and 2017

(dollars in thousands)

| | 2018 | 2017 |
|--|------|------|
| Balance, January 1 Allowance for Doubtful Accounts | \$ 4 | \$ 7 |
| Additions | 8 | 1 |
| Deletions | 8 | 4 |
| Balance, December 31 Allowance for Doubtful Accounts | \$ 4 | \$ 4 |

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

Item 9A. Controls and Procedures

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

Management's Report on Internal Control over Financial Reporting

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

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

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

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

over financial reporting was effective as of December 31, 2018.

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

The National Security Group, Inc.
March 15, 2019

Item 9B. Other Information
None.

Part III

Item 10. Directors, Executive Officers and Corporate Governance
Executive Officers

JACK E. BRUNSON (62) has served as a director since 1999 and as President of NSFC since 1997. He also serves on the Boards of Directors of NSFC and Omega. He joined the Company in 1982. Mr. Brunson is a Chartered Property and Casualty Underwriter.

W. L. BRUNSON, JR. (60) has served as a director since 1999 and as President and Chief Executive Officer of the Company since 2000. He also holds the position of President of NSIC. He joined the Company in 1983. Mr. Brunson is also a director of NSFC, NATSCO, NSIC, and Omega. Mr. Brunson is a member of the Alabama State Bar.

BRIAN R. MCLEOD (50) currently serves as Vice President of Finance & Operations, CFO and Treasurer of the Company. From 1992-2002 he served as Controller. He joined the Company in 1992. Mr. McLeod is a Director of NSIC, NSFC, Omega and NATSCO. Mr. McLeod is also a member of the Board of Directors for Trinity Bank, a community bank in Dothan, Alabama. Mr. McLeod is a Certified Public Accountant.

The information contained in The National Security Group's definitive proxy statement for the 2019 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 5, 2019 with respect to directors and executive officers of the Company as well as Corporate Governance, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2019 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 5, 2019 with respect to Audit Committee and Audit Committee financial expert, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2019 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 5, 2019 with respect to information on the beneficial ownership reporting for directors and executive officers, is incorporated herein by reference in response to this item.

Item 11. Executive Compensation

The information contained in The National Security Group's definitive proxy statement, filed pursuant to Regulation 14A, for the 2019 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 5, 2019, with respect to executive compensation and transactions, is incorporated herein by reference in response to this item.

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

The information contained in The National Security Group's definitive proxy statement, filed pursuant to Regulation 14A, for the 2019 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 5, 2019, with respect to security ownership of certain beneficial owners and management is incorporated herein by reference in response to this item.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information contained in The National Security Group's definitive proxy statement, filed pursuant to Regulation 14A, for the 2019 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 5, 2019, with respect to certain relationships and related transactions, is incorporated herein by reference in response to this item.

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Item 14. Principal Accounting Fees and Services

The information contained in The National Security Group's definitive proxy statement, filed pursuant to Regulation 14A, for the 2019 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 5, 2019, with respect to principal accountant fees and services, is incorporated herein by reference in response to this item.

PART IV

Item 15. Exhibits and Financial Statement Schedules

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

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

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets - December 31, 2018 and 2017

Consolidated Statements of Income (Loss) - Years ended December 31, 2018 and 2017

Consolidated Statements of Comprehensive Income - Years ended December 31, 2018 and 2017

Consolidated Statements of Shareholders' Equity - Years ended December 31, 2018 and 2017

Consolidated Statements of Cash Flows - Years ended December 31, 2018 and 2017

Notes to the Consolidated Financial Statements

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

The National Security Group, Inc.

Schedule I Summary of Investments Other Than Investments in Related Parties

Schedule II Condensed Financial Information of the Registrant

Schedule III Supplementary Insurance Information

Schedule IV Reinsurance

Schedule V Valuation and Qualifying Accounts

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

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

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

21.1 Subsidiaries of the Registrant

31.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS XBRL Instance Document

101.SCHXBRL Taxonomy Extension Schema Document

101.CALXBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LABXBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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(b) During the last fiscal quarter of the period covered by this Report, the Company filed the following Current Reports on Form 8-K:

| Date of Report | Date Filed | Description |
|-------------------|-------------------|--|
| October 18, 2018 | October 18, 2018 | <u>Press release announcing estimated losses from Hurricane Michael.</u> |
| October 19, 2018 | October 22, 2018 | <u>Press release announcing quarterly dividend.</u> |
| November 13, 2018 | November 13, 2018 | <u>Press release announcing financial results for the period ended September 30, 2018.</u> |

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SIGNATURE

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

THE NATIONAL SECURITY GROUP, INC.

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

Date: March 15, 2019

POWER OF ATTORNEY

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

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in their capacity as a Director of The National Security Group, Inc. on March 15, 2019:

SIGNATURE

| | |
|-----------------------------|-------------------------|
| /s/ Charles Arnold | /s/ Mickey L. Murdock |
| /s/ Fleming Brooks | /s/ Frank B. O'Neil |
| /s/ Jack E. Brunson | /s/ Donald Pittman |
| /s/ William L. Brunson, Jr. | /s/ Paul C. Wesch |
| /s/ Fred D. Clark, Jr. | /s/ L. Brunson White |
| /s/ Elizabeth Crawford | /s/ Walter P. Wilkerson |

/s/ Brian R. McLeod

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