

Section 1: 10-Q (10-Q)

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

FORM 10-Q

(Mark One)

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

For Quarterly Period Ended September 30, 2016

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
(State or Other Jurisdiction of
Incorporation or Organization)

63-1020300
(IRS Employer
Identification No.)

661 East Davis Street
Elba, Alabama
(Address of principal executive offices)

36323
(Zip-Code)

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

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

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

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

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

As of November 11, 2016, there were 2,517,339 shares, \$1.00 par value, of the registrant's common stock outstanding.

THE NATIONAL SECURITY GROUP, INC.

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Cautionary Statement Regarding Forward-Looking Statements

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

- The insurance industry is highly competitive and the Company encounters significant competition in all lines of business from other insurance companies. Many of the competing companies have more abundant financial resources than the Company.
- Insurance is a highly regulated industry. It is possible that legislation may be enacted which would have an adverse effect on the Company's business.
- The Company is subject to regulation by state governments for each of the states in which it conducts business. The Company cannot predict the subject of any future regulatory initiative(s) or its (their) impact on the Company's business.
- The Company is rated by various insurance rating agencies. If a rating is downgraded from its current level by one of these agencies, sales of the Company's products and stock price could be adversely impacted.
- The Company's financial results are adversely affected by increases in policy claims received by the Company. While a manageable risk, this fluctuation is often unpredictable.
- The Company's investments are subject to a variety of risks. Investments are subject to defaults and changes in market value. Market value can be affected by changes in interest rates, market performance and the economy.
- The Company mitigates risk associated with life policies through implementing effective underwriting and reinsurance strategies. These factors mitigate, not eliminate, risk related to mortality and morbidity exposure. The Company has established reserves for claims and future policy benefits based on amounts determined by independent actuaries. There is no assurance that these estimated reserves will prove to be sufficient or that the Company will not incur claims exceeding reserves, which could result in operating losses and loss of capital.
- The Company mitigates risk associated with property and casualty policies through implementing effective underwriting and reinsurance strategies. The Company obtains reinsurance which increases underwriting capacity and limits the risk associated with policy claims. The Company is subject to credit risk with regard to reinsurers as reinsurance does not alleviate the Company's liability to its insured's for the ceded risks. The Company utilizes a third-party to develop a reinsurance treaty with reinsurers who are reliable and financially stable. However, there is no guarantee that booked reinsurance recoverable will actually be recovered. A reinsurer's insolvency or inability to make payments due could have a material adverse impact on the financial condition of the Company.
- The Company's ability to continue to pay dividends to shareholders is contingent upon profitability and capital adequacy of the insurance subsidiaries. The insurance subsidiaries operate under regulatory restrictions that could limit the ability to fund future dividend payments of the Company. An adverse event or series of events could materially impact the ability of the insurance subsidiaries to fund future dividends, and consequently, the Board of Directors would have to suspend the declaration of dividends to shareholders.
- The Company is subject to the risk of adverse settlements or judgments resulting from litigation of contested claims. It is difficult to predict or quantify the expected results of litigation because the outcome depends on decisions of the court and jury that are based on facts and legal arguments presented at the trial.

PART I. Financial Information

Item 1. Financial Statements

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

| | September 30, 2016 | December 31, 2015 |
|---|-----------------------|----------------------|
| | (UNAUDITED) | |
| ASSETS | | |
| Investments | | |
| Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2016 - \$2,175; 2015 - \$2,504) | \$ 2,072 | \$ 2,439 |
| Fixed maturities available-for-sale, at estimated fair value (cost: 2016 - \$97,454; 2015 - \$92,077) | 100,454 | 91,812 |
| Equity securities available-for-sale, at estimated fair value (cost: 2016 - \$2,420; 2015 - \$2,420) | 5,204 | 4,897 |
| Trading securities | 107 | 107 |
| Mortgage loans on real estate, at cost | 174 | 202 |
| Investment real estate, at book value | 3,291 | 3,291 |
| Policy loans | 1,708 | 1,655 |
| Company owned life insurance | 4,978 | 4,898 |
| Other invested assets | 3,027 | 3,256 |
| Total Investments | 121,015 | 112,557 |
| Cash | 5,525 | 6,763 |
| Accrued investment income | 870 | 797 |
| Policy receivables and agents' balances, net | 12,552 | 11,296 |
| Reinsurance recoverable | 527 | 1,660 |
| Deferred policy acquisition costs | 8,713 | 8,485 |
| Property and equipment, net | 1,910 | 1,946 |
| Deferred income tax asset, net | 2,311 | 3,824 |
| Other assets | 742 | 513 |
| Total Assets | \$ 154,165 | \$ 147,841 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Property and casualty benefit and loss reserves | \$ 7,433 | \$ 9,645 |
| Accident and health benefit and loss reserves | 3,297 | 3,197 |
| Life and annuity benefit and loss reserves | 32,548 | 31,962 |
| Unearned premiums | 32,307 | 29,852 |
| Policy and contract claims | 1,044 | 826 |
| Other policyholder funds | 1,614 | 1,561 |
| Short-term notes payable and current portion of long-term debt | 857 | 857 |
| Long-term debt | 16,409 | 17,100 |
| Accrued income taxes | 58 | 101 |
| Other liabilities | 8,401 | 7,857 |
| Total Liabilities | 103,968 | 102,958 |
| Contingencies | | |
| Shareholders' equity | | |
| Common stock | 2,517 | 2,512 |
| Additional paid-in capital | 5,412 | 5,341 |
| Accumulated other comprehensive income | 2,935 | 525 |
| Retained earnings | 39,333 | 36,505 |

| | | |
|---|-------------------|-------------------|
| Total Shareholders' Equity | <u>50,197</u> | <u>44,883</u> |
| Total Liabilities and Shareholders' Equity | <u>\$ 154,165</u> | <u>\$ 147,841</u> |

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

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THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(In thousands, except per share amounts)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|-----------------|------------------------------------|-----------------|
| | 2016 | 2015 | 2016 | 2015 |
| REVENUES | | | | |
| Net premiums earned | \$ 15,675 | \$ 15,104 | \$ 46,067 | \$ 44,690 |
| Net investment income | 1,005 | 737 | 3,025 | 2,552 |
| Net realized investment gains | 287 | 130 | 536 | 517 |
| Other income | 152 | 154 | 456 | 468 |
| Total Revenues | 17,119 | 16,125 | 50,084 | 48,227 |
| BENEFITS, LOSSES AND EXPENSES | | | | |
| Policyholder benefits and settlement expenses | 10,082 | 8,170 | 27,991 | 25,867 |
| Amortization of deferred policy acquisition costs | 758 | 905 | 2,451 | 2,722 |
| Commissions | 2,088 | 2,086 | 6,313 | 6,230 |
| General and administrative expenses | 2,026 | 1,726 | 6,313 | 5,876 |
| Taxes, licenses and fees | 529 | 468 | 1,703 | 1,641 |
| Interest expense | 339 | 350 | 1,017 | 1,018 |
| Total Benefits, Losses and Expenses | 15,822 | 13,705 | 45,788 | 43,354 |
| Income Before Income Taxes | 1,297 | 2,420 | 4,296 | 4,873 |
| INCOME TAX EXPENSE | | | | |
| Current | 238 | 446 | 858 | 1,078 |
| Deferred | 129 | 358 | 271 | 248 |
| | 367 | 804 | 1,129 | 1,326 |
| Net Income | \$ 930 | \$ 1,616 | \$ 3,167 | \$ 3,547 |
| INCOME PER COMMON SHARE BASIC AND DILUTED | \$ 0.37 | \$ 0.64 | \$ 1.26 | \$ 1.41 |
| DIVIDENDS DECLARED PER SHARE | \$ 0.045 | \$ 0.04 | \$ 0.135 | \$ 0.12 |

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

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THE NATIONAL SECURITY GROUP, INC.

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

(In thousands)

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|-----------------|------------------------------------|-----------------|
| | 2016 | 2015 | 2016 | 2015 |
| Net income | <u>\$ 930</u> | <u>\$ 1,616</u> | <u>\$ 3,167</u> | <u>\$ 3,547</u> |
| Other comprehensive income (loss), net of tax | | | | |
| Changes in: | | | | |
| Unrealized gains (losses) on securities, net of reclassification adjustment of \$223 and \$345 for 2016 and 2015, respectively | 69 | (78) | 2,357 | (953) |
| Unrealized gain (loss) on interest rate swap | <u>134</u> | <u>(157)</u> | <u>53</u> | <u>(218)</u> |
| Other comprehensive income (loss), net of tax | <u>203</u> | <u>(235)</u> | <u>2,410</u> | <u>(1,171)</u> |
| Comprehensive income (Loss) | <u>\$ 1,133</u> | <u>\$ 1,381</u> | <u>\$ 5,577</u> | <u>\$ 2,376</u> |

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

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THE NATIONAL SECURITY GROUP, INC.

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

| | Total | Retained Earnings | Accumulated Other Comprehensive Income | Common Stock | Additional Paid-in Capital |
|---|------------------|-------------------|--|-----------------|----------------------------|
| Balance at December 31, 2015 (AUDITED) | \$ 44,883 | \$ 36,505 | \$ 525 | \$ 2,512 | \$ 5,341 |
| Net income for September 30, 2016 | 3,167 | 3,167 | | | |
| Other comprehensive income (net of tax) | 2,410 | | 2,410 | | |
| Common stock issued | 76 | | | 5 | 71 |
| Cash dividends | (339) | (339) | | | |
| Balance at September 30, 2016 | <u>\$ 50,197</u> | <u>\$ 39,333</u> | <u>\$ 2,935</u> | <u>\$ 2,517</u> | <u>\$ 5,412</u> |

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

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THE NATIONAL SECURITY GROUP, INC.

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

| | Nine months ended September 30, | |
|---|------------------------------------|------------------|
| | 2016 | 2015 |
| Cash Flows from Operating Activities | | |
| Net income | \$ 3,167 | \$ 3,547 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation expense and amortization/accretion, net | 255 | 235 |
| (Increase) decrease in cash surrender value of company owned life insurance | (80) | 208 |
| Net realized gains on investments | (536) | (517) |
| Deferred income taxes | 271 | 248 |
| Amortization of deferred policy acquisition costs | 2,451 | 2,722 |
| Changes in assets and liabilities: | | |
| Change in accrued investment income | (73) | 23 |
| Change in reinsurance recoverable | 1,133 | (515) |
| Policy acquisition costs deferred | (2,679) | (2,797) |
| Change in accrued income taxes | (43) | (434) |
| Change in net policy liabilities and claims | (116) | 2,500 |
| Change in other assets/liabilities, net | 699 | 1,655 |
| Other, net | 7 | 7 |
| Net cash provided by operating activities | <u>4,456</u> | <u>6,882</u> |
| Cash Flows from Investing Activities | | |
| Purchase of: | | |
| Available-for-sale securities | (23,357) | (23,183) |
| Trading securities and short-term investments | — | (88) |
| Property and equipment | (84) | (124) |
| Proceeds from sale or maturities of: | | |
| Held-to-maturity securities | 383 | 580 |
| Available-for-sale securities | 18,384 | 20,841 |
| Real estate held for investment | — | 444 |
| Property and equipment | — | 5 |
| Other invested assets, net | (34) | 327 |
| Net cash used in investing activities | <u>(4,708)</u> | <u>(1,198)</u> |
| Cash Flows from Financing Activities | | |
| Change in other policyholder funds | 53 | 35 |
| Repayments of long-term debt | (700) | (500) |
| Change in short-term notes payable | — | (700) |
| Dividends paid | (339) | (301) |
| Net cash used in financing activities | <u>(986)</u> | <u>(1,466)</u> |
| Net change in cash and cash equivalents | (1,238) | 4,218 |
| Cash and cash equivalents, beginning of year | 6,763 | 6,426 |
| Cash and cash equivalents, end of period | <u>\$ 5,525</u> | <u>\$ 10,644</u> |

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

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2015 AMOUNTS)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary, Omega One Insurance Company (Omega). The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). In the opinion of management, all adjustments, consisting of normal and recurring items, necessary for the fair presentation of the condensed consolidated financial statements have been included. All significant intercompany transactions and accounts have been eliminated. The financial information presented herein should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2015, which includes information and disclosures not presented herein.

Use of Estimates

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

Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,514,828 at September 30, 2016 and 2,509,857 at September 30, 2015. The Company did not have any dilutive securities as of September 30, 2016 and 2015.

Reclassifications

Certain 2015 amounts have been reclassified from the prior year condensed consolidated financial statements to conform to the 2016 presentation.

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts subject to FDIC insured limits of \$250,000 per entity. At September 30, 2016, the net amount exceeding FDIC insured limits was \$2,527,000 at two 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 September 30, 2016, the single largest balance due from one agent totaled \$857,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At September 30, 2016 and December 31, 2015, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At September 30, 2016, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

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THE NATIONAL SECURITY GROUP, INC. NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2015 AMOUNTS)

Change in Accounting Principle:

Effective January 1, 2016, the Company elected to change its method of presentation relating to placement fees associated with the issuance of trust preferred securities in accordance with FASB ASU 2015-03. Prior to 2016, the Company's policy was to present these fees in Other Assets on the balance sheet, net of accumulated amortization. Beginning in 2016, the Company has presented these fees as a direct reduction in the related note payable.

Accounting Changes Not Yet Adopted

Revenue from Contracts with Customers

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

Presentation of Financial Statements - Going Concern

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

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 does not expect the adoption to have a material impact on its financial position or results of operations.

Leases

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

Contingent Put and Call Options in Debt Instruments

In March 2016, the FASB issued guidance that clarifies the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt hosts. This guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within

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THE NATIONAL SECURITY GROUP, INC. NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2015 AMOUNTS)

those years. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Financial Instruments - Credit Losses

In June 2016, the FASB issued guidance that replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. This guidance is effective for fiscal years beginning after December 15, 2016, 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.

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 does not expect the adoption of this new guidance to have a significant impact on our financial position, results of operations or cash flows.

Recently Adopted Accounting Standards

Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items

In January 2015, the FASB issued guidance that eliminates from GAAP the concept of extraordinary items. The Company adopted this standard on January 1, 2016. This guidance did not have a material effect on results of operations or financial position.

Amendments to the Consolidation Analysis

In February 2015, the FASB issued additional guidance regarding the consolidation of certain legal entities. The guidance modifies the evaluation of whether or not limited partnerships and similar legal entities are variable interest entities (VIEs) and the consolidation analysis of entities involved with VIEs, particularly those that have fee arrangements and related party relationships. The Company adopted this standard on January 1, 2016. This guidance did not have a material effect on results of operations or financial position.

Interest - Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs.

In April 2015, the FASB issued guidance to simplify the presentation of debt issuance costs. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability. The Company adopted this standard retrospectively on January 1, 2016, which resulted in the reclassification of \$258,000 of unamortized debt issuance costs related to Company borrowings from other assets to long-term debt within our condensed consolidated balance sheet as of December 31, 2015. The adoption also resulted in the reclassification of \$10,000 from general expenses to interest expense for the nine months ended September 30, 2015.

Disclosure about Short-Duration Contracts

In May 2015, the FASB issued guidance that enhances disclosure about short-duration insurance liabilities to help users understand the nature, amount, timing and uncertainty of future cash flows related to insurance liabilities and the effect of those cash flows on the statement of comprehensive income. The Company adopted this standard on January 1, 2016. Required disclosures will be included in the notes to consolidated financial statements included in the Company's 2016 Annual Report on Form 10-K and in interim reports beginning in 2017.

Simplifying the Accounting for Measurement-Period Adjustments

In September 2015, the FASB issued guidance that requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The acquirer must record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The guidance requires an entity to present on the face of the income statement or to disclose in the notes the portion of the amount recorded in current-period

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2015 AMOUNTS)

earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The Company adopted this standard on January 1, 2016. This guidance did not have a material effect on results of operations or financial position.

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 \$228,000 and is included as a component of Other Invested Assets in the accompanying condensed consolidated balance sheets.

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

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

NOTE 3 – INVESTMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of September 30, 2016 are as follows (*dollars in thousands*):

| Available-for-sale securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|------------------|------------------------|-------------------------|-------------------|
| Corporate debt securities | \$ 42,723 | \$ 1,799 | \$ 394 | \$ 44,128 |
| Mortgage backed securities | 11,743 | 353 | 60 | 12,036 |
| Private label asset backed securities | 6,658 | 30 | 206 | 6,482 |
| Obligations of states and political subdivisions | 14,837 | 836 | 28 | 15,645 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 21,493 | 719 | 49 | 22,163 |
| Total fixed maturities | 97,454 | 3,737 | 737 | 100,454 |
| Equity securities | 2,420 | 2,812 | 28 | 5,204 |
| Total | \$ 99,874 | \$ 6,549 | \$ 765 | \$ 105,658 |

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The amortized cost and aggregate fair values of investments in held-to-maturity securities as of September 30, 2016 are as follows (dollars in thousands):

| Held-to-maturity securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-----------------|------------------------|-------------------------|-----------------|
| Mortgage backed securities | \$ 2,042 | \$ 100 | \$ — | \$ 2,142 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 30 | 3 | — | 33 |
| Total | \$ 2,072 | \$ 103 | \$ — | \$ 2,175 |

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

| Available-for-sale securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|------------------|------------------------|-------------------------|------------------|
| Corporate debt securities | \$ 38,245 | \$ 747 | \$ 1,728 | \$ 37,264 |
| Mortgage backed securities | 15,324 | 157 | 224 | 15,257 |
| Private label asset backed securities | 6,029 | 24 | 380 | 5,673 |
| Obligations of states and political subdivisions | 14,654 | 869 | 47 | 15,476 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 17,825 | 413 | 96 | 18,142 |
| Total fixed maturities | 92,077 | 2,210 | 2,475 | 91,812 |
| Equity securities | 2,420 | 2,590 | 113 | 4,897 |
| Total | \$ 94,497 | \$ 4,800 | \$ 2,588 | \$ 96,709 |

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

| Held-to-maturity securities: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-----------------|------------------------|-------------------------|-----------------|
| Mortgage backed securities | \$ 2,395 | \$ 62 | \$ — | \$ 2,457 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 44 | 3 | — | 47 |
| Total | \$ 2,439 | \$ 65 | \$ — | \$ 2,504 |

The amortized cost and aggregate fair value of debt securities at September 30, 2016, by contractual maturity, are presented in the following table (dollars in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

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| <i>(Dollars in Thousands)</i> | Amortized Cost | Fair Value |
|--|-------------------|-------------------|
| Available-for-sale securities: | | |
| Due in one year or less | \$ 3,232 | \$ 3,291 |
| Due after one year through five years | 15,624 | 15,986 |
| Due after five years through ten years | 34,761 | 35,867 |
| Due after ten years | 43,837 | 45,310 |
| Total | \$ 97,454 | \$ 100,454 |
| Held-to-maturity securities: | | |
| Due in one year or less | \$ 1 | \$ 1 |
| Due after one year through five years | 39 | 41 |
| Due after five years through ten years | 86 | 95 |
| Due after ten years | 1,946 | 2,038 |
| Total | \$ 2,072 | \$ 2,175 |

A summary of securities available-for-sale with unrealized losses as of September 30, 2016, 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 | | Total Securities in a Loss Position |
|---|---------------------|-------------------------------|---------------------|-------------------------------|------------------|-------------------------------|--|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | |
| September 30, 2016 | | | | | | | |
| Fixed maturities | | | | | | | |
| Corporate debt securities | \$ 3,715 | \$ 24 | \$ 3,559 | \$ 370 | \$ 7,274 | \$ 394 | 13 |
| Mortgage backed securities | 1,193 | 41 | 387 | 19 | 1,580 | 60 | 7 |
| Private label asset backed securities | 821 | 3 | 3,431 | 203 | 4,252 | 206 | 9 |
| Obligations of state and political subdivisions | 2,028 | 28 | — | — | 2,028 | 28 | 4 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 4,236 | 42 | 313 | 7 | 4,549 | 49 | 5 |
| Equity securities | — | — | 1,258 | 28 | 1,258 | 28 | 1 |
| | \$ 11,993 | \$ 138 | \$ 8,948 | \$ 627 | \$ 20,941 | \$ 765 | 39 |

There were no securities held-to-maturity with unrealized losses as of September 30, 2016.

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

| December 31, 2015 | Less than 12 months | | 12 months or longer | | Total | | Total Securities in a Loss Position |
|---|---------------------|-------------------------|---------------------|-------------------------|------------------|-------------------------|-------------------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | |
| Fixed maturities | | | | | | | |
| Corporate debt securities | \$ 18,205 | \$ 821 | \$ 3,783 | \$ 907 | \$ 21,988 | \$ 1,728 | 44 |
| Mortgage backed securities | 9,069 | 161 | 675 | 63 | 9,744 | 224 | 20 |
| Private label asset backed securities | 4,962 | 379 | 84 | 1 | 5,046 | 380 | 10 |
| Obligations of state and political subdivisions | 1,920 | 36 | 331 | 11 | 2,251 | 47 | 5 |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 6,131 | 70 | 1,452 | 26 | 7,583 | 96 | 12 |
| Equity securities | — | — | 1,173 | 113 | 1,173 | 113 | 1 |
| | <u>\$ 40,287</u> | <u>\$ 1,467</u> | <u>\$ 7,498</u> | <u>\$ 1,121</u> | <u>\$ 47,785</u> | <u>\$ 2,588</u> | <u>92</u> |

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

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

Management has evaluated each security in a significant unrealized loss position. The Company has no material exposure to sub-prime mortgage loans and approximately 5.3% of the fixed income investment portfolio is rated below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, Management evaluated financial information on each company and where available, reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the securities in an accumulated loss position in the portfolio were temporary impairments.

For the nine months ended September 30, 2016 and year ended December 31, 2015, the Company realized no other-than-temporary impairments. At September 30, 2016, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$180,000. The second largest loss position was in the bond portfolio and totaled \$103,000. The third largest loss position was in the bond portfolio and totaled \$101,000. At December 31, 2015, the single largest loss not realized as an impairment was in the bond portfolio and totaled \$252,000. The second largest loss position was in the bond portfolio and totaled \$211,000. The third largest loss position was in the bond portfolio and totaled \$186,000.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|--------|------------------------------------|----------|
| | 2016 | 2015 | 2016 | 2015 |
| Fixed maturities | \$ 895 | \$ 829 | \$ 2,744 | \$ 2,591 |
| Equity securities | 23 | 30 | 77 | 90 |
| Mortgage loans on real estate | 4 | 3 | 11 | 11 |
| Investment real estate | 1 | 3 | 5 | 7 |
| Policy loans | 32 | 30 | 96 | 89 |
| Company owned life insurance change in surrender value | 27 | (156) | 80 | (208) |
| Other | 61 | 41 | 136 | 116 |
| | 1,043 | 780 | 3,149 | 2,696 |
| Less: Investment expenses | 38 | 43 | 124 | 144 |
| Net investment income | \$ 1,005 | \$ 737 | \$ 3,025 | \$ 2,552 |

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|--------------------------------|-------------------------------------|--------|------------------------------------|--------|
| | 2016 | 2015 | 2016 | 2015 |
| Fixed maturities | \$ 78 | \$ 130 | \$ 338 | \$ 522 |
| Other, principally real estate | 209 | — | 198 | (5) |
| Net realized investment gains | \$ 287 | \$ 130 | \$ 536 | \$ 517 |

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

| | September 30, 2016 | December 31, 2015 |
|--|--------------------|-------------------|
| Net change in unrealized appreciation on available-for-sale securities before deferred tax | \$ 3,571 | \$ (3,225) |
| Deferred income tax | (1,214) | 1,097 |
| Net change in unrealized appreciation on available-for-sale securities | \$ 2,357 | \$ (2,128) |

NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

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

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

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

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

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

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

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

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

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Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2016 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

| Description | Fair Value Measurements at Reporting Date Using | | | |
|---|---|------------------|------------------|-------------------|
| | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets | | | | |
| Fixed maturities available-for-sale | | | | |
| Corporate debt securities | \$ 44,128 | \$ — | \$ 44,128 | \$ — |
| Mortgage backed securities | 12,036 | — | 12,036 | — |
| Private label asset backed securities | 6,482 | — | 6,482 | — |
| Obligations of states and political subdivisions | 15,645 | — | 15,645 | — |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 22,163 | 22,163 | — | — |
| Trading securities | 107 | 107 | — | — |
| Equity securities available-for-sale | 5,204 | 3,946 | — | 1,258 |
| Total Financial Assets | \$ 105,765 | \$ 26,216 | \$ 78,291 | \$ 1,258 |
| Financial Liabilities | | | | |
| Interest rate swap | \$ (1,338) | \$ — | \$ — | \$ (1,338) |
| Total Financial Liabilities | \$ (1,338) | \$ — | \$ — | \$ (1,338) |

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

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

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

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

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

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

As of September 30, 2016, Level 3 fair value measurements of assets include \$1,258,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of September 30, 2016, Level 3 fair value measurements of liabilities include \$1,338,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party broker who utilizes financial modeling tools and assumptions on interest and other factors. The Company does not develop the unobservable

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inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 7.

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2016 (in thousands):

| For the nine months ended September 30, 2016 | Equity Securities Available-for-Sale | Interest Rate Swap |
|--|---|--------------------|
| Beginning balance | \$ 1,173 | \$ (1,419) |
| Total gains or losses (realized and unrealized): | | |
| Included in earnings | — | — |
| Included in other comprehensive income | 85 | 81 |
| Purchases: | — | — |
| Sales: | — | — |
| Issuances: | — | — |
| Settlements: | — | — |
| Transfers in/(out) of Level 3 | — | — |
| Ending balance | <u>\$ 1,258</u> | <u>\$ (1,338)</u> |
| The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of September 30, 2016: | <u>\$ —</u> | <u>\$ —</u> |

For the nine months ended September 30, 2016, there were no assets or liabilities measured at fair values on a nonrecurring basis.

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

| Description | Fair Value Measurements at Reporting Date Using | | | |
|---|---|------------------|------------------|-------------------|
| | Total | Level 1 | Level 2 | Level 3 |
| Financial Assets | | | | |
| Fixed maturities available-for-sale | | | | |
| Corporate debt securities | \$ 37,264 | \$ — | \$ 37,264 | \$ — |
| Mortgage backed securities | 15,257 | — | 15,257 | — |
| Private label asset backed securities | 5,673 | — | 5,673 | — |
| Obligations of states and political subdivisions | 15,476 | — | 15,476 | — |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 18,142 | 18,142 | — | — |
| Trading securities | 107 | 107 | — | — |
| Equity securities available-for-sale | 4,897 | 3,724 | — | 1,173 |
| Total Financial Assets | <u>\$ 96,816</u> | <u>\$ 21,973</u> | <u>\$ 73,670</u> | <u>\$ 1,173</u> |
| Financial Liabilities | | | | |
| Interest rate swap | \$ (1,419) | \$ — | \$ — | \$ (1,419) |
| Total Financial Liabilities | <u>\$ (1,419)</u> | <u>\$ —</u> | <u>\$ —</u> | <u>\$ (1,419)</u> |

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

| For the year ended December 31, 2015 | Equity Securities Available-for-Sale | Interest Rate Swap |
|---|---|--------------------|
| Beginning balance | \$ 1,116 | \$ (1,238) |
| Total gains or losses (realized and unrealized): | | |
| Included in earnings | — | — |
| Included in other comprehensive income | 57 | (181) |
| Purchases: | — | — |
| Sales: | — | — |
| Issuances: | — | — |
| Settlements: | — | — |
| Transfers in/(out) of Level 3 | — | — |
| Ending balance | <u>\$ 1,173</u> | <u>\$ (1,419)</u> |
| 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, 2015: | <u>\$ —</u> | <u>\$ —</u> |

For the year ended December 31, 2015, there were no assets or liabilities measured at fair values on a nonrecurring basis.

The Company is exposed to certain risks in the normal course of its business operations. The primary risk that is managed through the use of derivatives is interest rate risk on floating rate borrowings. This risk is managed through the use of interest rate swap agreements which are designated as cash flow hedges. For cash flow hedges, the effective portion of the gain or loss on the interest rate swap is included as a component of other comprehensive income and reclassified into earnings in the same period during which the hedged transaction is recognized in earnings. The Company does not hold or issue derivatives that are not designated as hedging instruments. See Note 7 for additional information about the interest rate swap agreements.

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

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

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

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

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

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

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

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

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

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The carrying amount and estimated fair value of the Company's financial instruments as of September 30, 2016 and December 31, 2015 are as follows (in thousands):

| | September 30, 2016 | | December 31, 2015 | |
|--|--------------------|----------------------|-------------------|----------------------|
| | Carrying Value | Estimated Fair Value | Carrying Value | Estimated Fair Value |
| Assets and related instruments | | | | |
| Held-to-maturity securities | \$ 2,072 | \$ 2,175 | \$ 2,439 | \$ 2,504 |
| Mortgage loans | 174 | 174 | 202 | 202 |
| Policy loans | 1,708 | 1,708 | 1,655 | 1,655 |
| Company owned life insurance | 4,978 | 4,978 | 4,898 | 4,898 |
| Other invested assets | 3,027 | 3,027 | 3,256 | 3,256 |
| Liabilities and related instruments | | | | |
| Other policyholder funds | 1,614 | 1,614 | 1,561 | 1,561 |
| Short-term notes payable and current portion of long-term debt | 857 | 857 | 857 | 857 |
| Long-term debt | 16,409 | 16,409 | 17,100 | 17,100 |

NOTE 5 – PROPERTY AND EQUIPMENT

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

| | September 30, 2016 | December 31, 2015 |
|--------------------------------------|--------------------|-------------------|
| Building and improvements | \$ 3,348 | \$ 3,350 |
| Electronic data processing equipment | 1,560 | 1,631 |
| Furniture and fixtures | 533 | 529 |
| | 5,441 | 5,510 |
| Less accumulated depreciation | 3,531 | 3,564 |
| Property and equipment, net | \$ 1,910 | \$ 1,946 |

Depreciation expense for the nine months ended September 30, 2016 was \$119,000 (\$168,000 for the year ended December 31, 2015).

NOTE 6 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2010. Tax returns have been filed through the year 2015.

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax assets. The Company recognized net deferred tax asset positions of \$2,311,000 at September 30, 2016 and \$3,824,000 at December 31, 2015.

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

| | As of September 30, 2016 | As of December 31, 2015 |
|---|-----------------------------|----------------------------|
| General expenses | \$ 1,566 | \$ 1,569 |
| Unearned premiums | 2,206 | 2,039 |
| Claims liabilities | 739 | 730 |
| Litigation settlement | 1,748 | 1,748 |
| AMT credit | 455 | 816 |
| Impairment on real estate owned | 187 | 187 |
| Unrealized loss on interest rate swaps | 455 | 483 |
| Deferred tax assets | <u>7,356</u> | <u>7,572</u> |
| Depreciation | (117) | (111) |
| Deferred policy acquisition costs | (2,962) | (2,885) |
| Unrealized gains on securities available-for-sale | (1,966) | (752) |
| Deferred tax liabilities | <u>(5,045)</u> | <u>(3,748)</u> |
| Net deferred tax asset | <u>\$ 2,311</u> | <u>\$ 3,824</u> |

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

| | Nine months ended September 30, | |
|---------------------------------------|------------------------------------|---------------|
| | 2016 | 2015 |
| Deferred policy acquisition costs | \$ 77 | \$ 26 |
| Unearned premiums | (167) | (206) |
| General expenses | 3 | (57) |
| Depreciation | 6 | (10) |
| Claims liabilities | (9) | 10 |
| AMT credit | 361 | 485 |
| Deferred income tax expense (benefit) | <u>\$ 271</u> | <u>\$ 248</u> |

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:

| | Nine months ended September 30, | |
|--|------------------------------------|---------------|
| | 2016 | 2015 |
| Federal income tax rate applied to pre-tax income/loss | 34.0 % | 34.0 % |
| Dividends received deduction and tax-exempt interest | (1.4)% | (1.6)% |
| Company owned life insurance | (0.6)% | 1.5 % |
| Small life deduction | (5.9)% | (4.3)% |
| Other, net | 0.2 % | (2.4)% |
| Effective federal income tax rate | <u>26.3 %</u> | <u>27.2 %</u> |

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NOTE 7 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of September 30, 2016 and December 31, 2015 (*dollars in thousands*):

| | September 30, 2016 | December 31, 2015 |
|---|-----------------------|----------------------|
| Current portion of installment note payable due November 2016 with variable interest rate equal to the WSJ prime rate plus 1%. Unsecured. | \$ 857 | \$ 857 |
| | <u>\$ 857</u> | <u>\$ 857</u> |

Long-term debt consisted of the following as of September 30, 2016 and December 31, 2015 (*dollars in thousands*):

| | September 30, 2016 | December 31, 2015 |
|--|-----------------------|----------------------|
| Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 5.0% floor; maturity March 2018. Interest payments due quarterly. Unsecured. | \$ — | \$ 700 |
| Line of credit, \$1,000,000 available, with variable interest rate equal to the WSJ prime rate, subject to a 4.5% floor; maturity September 2017. Interest payments due monthly. Secured. | — | — |
| Long-term portion of installment note with variable interest rate equal to the WSJ prime rate plus 1% and adjustable each November; maturity November 2021. Interest payable annually with principal payable in equal annual installments. Next principal installment on long-term portion due November 2016. Unsecured. | 4,286 | 4,286 |
| Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-Month LIBOR plus 3.75% applied to the outstanding principal; net of \$183,000 in debt issuance cost (\$187,000 in 2015); maturity December 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured. | 9,098 | 9,092 |
| Subordinated debentures issued on June 21, 2007 with a floating interest rate equal to the 3-Month LIBOR plus 3.40% applied to the outstanding principal; applied to the outstanding principal; net of \$70,000 in debt issuance cost (\$71,000 in 2015); maturity June 15, 2037. Interest payments due quarterly. All may be redeemed at any time following the fifth anniversary of issuance. Unsecured. | 3,025 | 3,022 |
| | <u>\$ 16,409</u> | <u>\$ 17,100</u> |

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 \$194,000 (liability) and \$1,144,000 (liability), respectively, for a total liability of \$1,338,000 at September 30, 2016 (\$1,419,000 at December 31, 2015). The swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of \$53,000 (net

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of tax) is included in accumulated other comprehensive income related to the swap agreements at September 30, 2016. A net valuation loss of \$119,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2015.

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 September 30, 2016, the Company has securities on deposit with fair market values of \$1,526,000 and cash of \$231,000 (all of which is posted as collateral). At December 31, 2015, the Company had securities on deposit with fair market values of \$1,482,000 and cash of \$130,000 (all of which is posted as collateral). See Note 4 for additional information about the interest rate swaps.

NOTE 8 – REINSURANCE

The Company's insurance operations utilize reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term coverage. Property and casualty reinsurance is placed on an excess of loss basis to cover losses from catastrophe events. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of re-insurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurance companies and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the companies to minimize their exposure to significant losses from reinsurance insolvencies.

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

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

| Layer | Reinsurers' Limits of Liability |
|--------------|---|
| First Layer | 100% of \$13,500,000 in excess of \$4,000,000 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 strengthen the Company's capital position by reducing the modeled 100 year event net cost.

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

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

At September 30, 2016, the largest reinsurance recoverable of a single reinsurer was \$4,000 (\$12,000 at December 31, 2015). Amounts reported as ceded incurred losses in both 2016 and 2015 were related to the development of losses from prior year catastrophes.

NOTE 9 – EMPLOYEE BENEFIT PLANS

The Company and its subsidiaries have an established retirement savings plan (401K Plan). All full-time employees are eligible to participate, and all employer contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for the nine months ended September 30, 2016 and 2015 amounted to \$155,000 and \$157,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limitations.

In January 2006, the Company established a non-qualified plan under which directors are allowed to defer all or a portion of directors' fees into various investment options. The supplemental executive retirement plan (SERP) became effective March 1, 2008 and covers named executive officers, with the Company contributing 15% of executive compensation to the plan. Contributions to the plan are fully vested upon the earlier of death, disability, change in control, or ten years of participation in the plan. Costs for amounts credited to the non-qualified deferred compensation plans for the nine months ended September 30, 2016 and 2015 amounted to approximately \$176,000 and \$89,000, respectively.

The Company and its subsidiaries established an Employee Stock Ownership Plan (ESOP) in January 2010, to enable its eligible employees to acquire a proprietary interest in the Company's common stock and to provide retirement and other benefits to such employees. There were \$188,000 costs incurred during the nine months ended September 30, 2016 and \$169,000 costs incurred during the nine months ended September 30, 2015 related to ESOP plan contributions. All contributions were made in cash for purchase of Company shares in the open market. The Company has not allocated shares directly to the plan and the plan has no debt.

NOTE 10 – SHAREHOLDERS' EQUITY

During the nine months ended September 30, 2016 and year ended December 31, 2015, changes in shareholders' equity consisted of net income of \$3,167,000 and \$4,697,000, respectively; dividends paid of \$339,000 in 2016 and \$402,000 in 2015; increases in accumulated other comprehensive income, net of applicable taxes, of \$2,410,000 in 2016 and decreases in accumulated other comprehensive income, net of applicable taxes, of \$2,247,000 in 2015. Other comprehensive gains and loss consisted of accumulated unrealized gains and losses on securities available-for-sale and unrealized loss on interest rate swaps.

Preferred Stock

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

Common Stock

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

In the event of any liquidation, dissolution or distribution of the assets of the Company remaining after the payments to the holders of the Preferred Stock of the full preferential amounts to which they may be entitled as provided in the resolution or resolutions creating any series thereof, the remaining assets of the Company shall be divided and

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distributed among the holders of both classes of common stock, except as may otherwise be provided in any such resolution or resolutions.

The table below provides information regarding the Company's preferred and common stock as of September 30, 2016 and December 31, 2015:

| | September 30, 2016 | | | December 31, 2015 | | |
|-------------------------------------|--------------------|-----------|-------------|-------------------|-----------|-------------|
| | 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 | 2,517,339 | 2,517,339 | 3,000,000 | 2,512,425 | 2,512,425 |

On May 20, 2016, 4,914 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

NOTE 11 – ACCUMULATED OTHER COMPREHENSIVE INCOME

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

| | Nine months ended September 30, | |
|--|------------------------------------|-----------------|
| | 2016 | 2015 |
| Gains and Losses on Cash Flow Hedges | | |
| Balance at beginning of period | \$ (935) | \$ (816) |
| Other comprehensive loss for period: | | |
| Other comprehensive loss before reclassifications | 53 | (218) |
| Amounts reclassified from accumulated other comprehensive income | — | — |
| Net current period other comprehensive loss | 53 | (218) |
| Balance at end of period | \$ (882) | \$ (1,034) |
| Unrealized Gains and Losses on Available-for-Sale Securities | | |
| Balance at beginning of period | \$ 1,460 | \$ 3,588 |
| Other comprehensive income for period: | | |
| Other comprehensive income (loss) before reclassifications | 2,580 | (608) |
| Amounts reclassified from accumulated other comprehensive income | (223) | (345) |
| Net current period other comprehensive income (loss) | 2,357 | (953) |
| Balance at end of period | \$ 3,817 | \$ 2,635 |
| Total Accumulated Other Comprehensive Income at end of period | \$ 2,935 | \$ 1,601 |

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The following table presents the amounts reclassified out of AOCI for the nine months ended September 30, 2016 (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 | \$ 338 | Net realized investment gains |
| | 338 | Total before tax |
| | (115) | Tax (expense) or benefit |
| | <u>\$ 223</u> | Net of Tax |

The following table presents the amounts reclassified out of AOCI for the nine months ended September 30, 2015 (dollars in thousands):

| Details about Accumulated Other Comprehensive Income Components | Amounts Reclassified from Accumulated Other Comprehensive Income | Affected Line Item in the Statement Where Net Income is Presented |
|---|--|---|
| Unrealized Gains and Losses on Available-for-Sale Securities | \$ 522 | Net realized investment gains |
| | 522 | Total before tax |
| | (177) | Tax (expense) or benefit |
| | <u>\$ 345</u> | Net of Tax |

NOTE 12 – SEGMENTS

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

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

Total assets by industry segment at September 30, 2016 and at December 31, 2015 are summarized below (*dollars in thousands*):

| | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|---------------------------|-------------------|--------------------------|---------------------------|--------------------------|
| September 30, 2016 | <u>\$ 154,165</u> | <u>\$ 88,569</u> | <u>\$ 60,152</u> | <u>\$ 5,444</u> |
| December 31, 2015 | <u>\$ 147,841</u> | <u>\$ 84,435</u> | <u>\$ 57,067</u> | <u>\$ 6,339</u> |

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Premium revenues and operating income by business segment for the three and nine months ended September 30, 2016 and 2015 are summarized below (*dollars in thousands*):

| <i>Three months ended September 30, 2016</i> | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|---|-----------------|-------------------------------------|----------------------------------|---------------------------------|
| REVENUE | | | | |
| Net premiums earned | \$ 15,675 | \$ 14,016 | \$ 1,659 | \$ — |
| Net investment income | 1,005 | 449 | 540 | 16 |
| Net realized investment gains (losses) | 287 | 81 | 206 | — |
| Other income | 152 | 151 | 1 | — |
| | <u>17,119</u> | <u>14,697</u> | <u>2,406</u> | <u>16</u> |
| BENEFITS AND EXPENSES | | | | |
| Policyholder benefits paid | 10,082 | 8,466 | 1,616 | — |
| Amortization of deferred policy acquisition costs | 758 | 696 | 62 | — |
| Commissions | 2,088 | 1,999 | 89 | — |
| General and administrative expenses | 2,026 | 1,428 | 400 | 198 |
| Taxes, licenses and fees | 529 | 482 | 47 | — |
| Interest expense | 339 | — | 19 | 320 |
| | <u>15,822</u> | <u>13,071</u> | <u>2,233</u> | <u>518</u> |
| Income (Loss) Before Income Taxes | <u>\$ 1,297</u> | <u>\$ 1,626</u> | <u>\$ 173</u> | <u>\$ (502)</u> |

| <i>Three months ended September 30, 2015</i> | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|---|-----------------|-------------------------------------|----------------------------------|---------------------------------|
| REVENUE | | | | |
| Net premiums earned | \$ 15,104 | \$ 13,414 | \$ 1,690 | \$ — |
| Net investment income | 737 | 237 | 481 | 19 |
| Net realized investment gains | 130 | 51 | 79 | — |
| Other income | 154 | 153 | 1 | — |
| | <u>16,125</u> | <u>13,855</u> | <u>2,251</u> | <u>19</u> |
| BENEFITS AND EXPENSES | | | | |
| Policyholder benefits paid | 8,170 | 6,440 | 1,730 | — |
| Amortization of deferred policy acquisition costs | 905 | 676 | 229 | — |
| Commissions | 2,086 | 1,988 | 98 | — |
| General and administrative expenses | 1,726 | 1,445 | 346 | (65) |
| Taxes, licenses and fees | 468 | 426 | 42 | — |
| Interest expense | 350 | — | 21 | 329 |
| | <u>13,705</u> | <u>10,975</u> | <u>2,466</u> | <u>264</u> |
| Income (Loss) Before Income Taxes | <u>\$ 2,420</u> | <u>\$ 2,880</u> | <u>\$ (215)</u> | <u>\$ (245)</u> |

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| <i>Nine months ended September 30, 2016</i> | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|---|-----------------|--------------------------|---------------------------|--------------------------|
| REVENUE | | | | |
| Net premiums earned | \$ 46,067 | \$ 41,263 | \$ 4,804 | \$ — |
| Net investment income | 3,025 | 1,357 | 1,620 | 48 |
| Net realized investment gains (losses) | 536 | 266 | 270 | — |
| Other income | 456 | 454 | 2 | — |
| | 50,084 | 43,340 | 6,696 | 48 |
| BENEFITS AND EXPENSES | | | | |
| Policyholder benefits paid | 27,991 | 23,905 | 4,086 | — |
| Amortization of deferred policy acquisition costs | 2,451 | 2,087 | 364 | — |
| Commissions | 6,313 | 6,035 | 278 | — |
| General and administrative expenses | 6,313 | 4,553 | 1,215 | 545 |
| Taxes, licenses and fees | 1,703 | 1,546 | 157 | — |
| Interest expense | 1,017 | — | 57 | 960 |
| | 45,788 | 38,126 | 6,157 | 1,505 |
| Income (Loss) Before Income Taxes | \$ 4,296 | \$ 5,214 | \$ 539 | \$ (1,457) |

| <i>Nine months ended September 30, 2015</i> | Total | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|---|-----------------|--------------------------|---------------------------|--------------------------|
| REVENUE | | | | |
| Net premiums earned | \$ 44,690 | \$ 39,812 | \$ 4,878 | \$ — |
| Net investment income | 2,552 | 1,063 | 1,432 | 57 |
| Net realized investment gains | 517 | 181 | 336 | — |
| Other income | 468 | 466 | 2 | — |
| | 48,227 | 41,522 | 6,648 | 57 |
| BENEFITS AND EXPENSES | | | | |
| Policyholder benefits paid | 25,867 | 21,751 | 4,116 | — |
| Amortization of deferred policy acquisition costs | 2,722 | 2,026 | 696 | — |
| Commissions | 6,230 | 5,953 | 277 | — |
| General and administrative expenses | 5,876 | 4,604 | 1,036 | 236 |
| Taxes, licenses and fees | 1,641 | 1,442 | 199 | — |
| Interest expense | 1,018 | — | 44 | 974 |
| | 43,354 | 35,776 | 6,368 | 1,210 |
| Income (Loss) Before Income Taxes | \$ 4,873 | \$ 5,746 | \$ 280 | \$ (1,153) |

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The following table presents the Company's gross and net premiums written for the property and casualty segment and the life and accident and health segment for the three and nine months ended September 30, 2016 and 2015, respectively:

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|----------------------------------|-----------|---------------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| Life, accident and health operations premiums written: | | | | |
| Traditional life insurance | \$ 1,112 | \$ 1,140 | \$ 3,355 | \$ 3,381 |
| Accident and health insurance | 562 | 600 | 1,389 | 1,441 |
| Gross life, accident and health | 1,674 | 1,740 | 4,744 | 4,822 |
| Reinsurance premium ceded | (10) | (19) | (58) | (49) |
| Net life, accident and health premiums written | \$ 1,664 | \$ 1,721 | \$ 4,686 | \$ 4,773 |
| Property and Casualty operations premiums written: | | | | |
| Dwelling fire & extended coverage | \$ 8,947 | \$ 8,793 | \$ 27,855 | \$ 26,975 |
| Homeowners (Including mobile homeowners) | 6,017 | 6,220 | 18,403 | 18,686 |
| Other liability | 528 | 500 | 1,621 | 1,554 |
| Gross property and casualty | 15,492 | 15,513 | 47,879 | 47,215 |
| Reinsurance premium ceded | (1,516) | (1,745) | (4,215) | (4,465) |
| Net property and casualty written | \$ 13,976 | \$ 13,768 | \$ 43,664 | \$ 42,750 |
| Consolidated gross premiums written | \$ 17,166 | \$ 17,253 | \$ 52,623 | \$ 52,037 |
| Reinsurance premium ceded | (1,526) | (1,764) | (4,273) | (4,514) |
| Consolidated net premiums written | \$ 15,640 | \$ 15,489 | \$ 48,350 | \$ 47,523 |

The following table presents the Company's gross and net premiums earned for the property and casualty segment and the life and accident and health segment for the three and nine months ended September 30, 2016 and 2015, respectively:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|----------------------------------|-----------|---------------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| Life, accident and health operations premiums earned: | | | | |
| Traditional life insurance | \$ 1,108 | \$ 1,111 | \$ 3,475 | \$ 3,488 |
| Accident and health insurance | 561 | 598 | 1,387 | 1,439 |
| Gross life, accident and health | 1,669 | 1,709 | 4,862 | 4,927 |
| Reinsurance premium ceded | (10) | (19) | (58) | (49) |
| Net life, accident and health premiums earned | \$ 1,659 | \$ 1,690 | \$ 4,804 | \$ 4,878 |
| Property and Casualty operations premiums earned: | | | | |
| Dwelling fire & extended coverage | \$ 8,941 | \$ 8,547 | \$ 26,410 | \$ 25,150 |
| Homeowners (Including mobile homeowners) | 5,923 | 5,957 | 17,710 | 17,860 |
| Other liability | 515 | 488 | 1,511 | 1,433 |
| Gross property and casualty | 15,379 | 14,992 | 45,631 | 44,443 |
| Reinsurance premium ceded | (1,363) | (1,578) | (4,368) | (4,631) |
| Net property and casualty earned | \$ 14,016 | \$ 13,414 | \$ 41,263 | \$ 39,812 |
| Consolidated gross premiums earned | \$ 17,048 | \$ 16,701 | \$ 50,493 | \$ 49,370 |
| Reinsurance premium ceded | (1,373) | (1,597) | (4,426) | (4,680) |
| Consolidated net premiums earned | \$ 15,675 | \$ 15,104 | \$ 46,067 | \$ 44,690 |

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NOTE 13 – CONTINGENCIES

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

The Company's property & casualty subsidiaries are defending a limited number of matters filed in the aftermath of Hurricane Ike in Texas. These actions include individual lawsuits with allegations of underpayment of hurricane-related claims.

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

NOTE 14 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the nine months ended September 30, 2016 was \$823,000 (\$842,000 in 2015). Cash paid for income taxes during the nine months ended September 30, 2016 was \$750,000 (\$1,546,000 in 2015).

During the nine months ended September 30, 2016, 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 15 – SUBSEQUENT EVENTS

Management has evaluated subsequent events and their potential effects on these condensed consolidated financial statements through the filing date of this Form 10-Q. There were no events that impacted the accompanying condensed consolidated financial statements. However, from October 7, 2016 to October 9, 2016, Hurricane Matthew moved up the Atlantic Coast impacting policyholders in Georgia and South Carolina. Insured property in the path of Matthew was exposed to category 1 hurricane and tropical storm force winds. Losses from Hurricane Matthew will materially impact net income for the three months and year ended December 31, 2016. No provision for losses from Hurricane Matthew has been made in the accompanying condensed consolidated financial statements.

Net of re-insurance, Hurricane Matthew will reduce fourth quarter and full year pre-tax income by \$4,000,000. Hurricane Matthew will reduce fourth quarter and full year net income by \$2,640,000. Management estimates ultimate gross losses from Hurricane Matthew (before re-insurance recoveries) to be within a range of \$7,000,000 to \$8,000,000. Under catastrophe reinsurance coverage, the Company retains 100% of losses up to \$4,000,000 from a single event with losses above the retention being 100% reinsured up to \$72,500,000. For additional details of reinsurance coverage see Note 8.

REVIEW OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. as of September 30, 2016, and the related condensed consolidated statements of income and comprehensive income (loss) for the three-month and nine-month periods ended September 30, 2016 and 2015 and the condensed consolidated statement of changes in shareholders' equity for the nine-month period ended September 30, 2016 and the statement of cash flows for the nine-month periods ended September 30, 2016 and 2015. These condensed consolidated financial statements are the responsibility of the company's management.

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

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

We have previously audited, in accordance with auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The National Security Group, Inc. as of December 31, 2015, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 18, 2016, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2015, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Warren Averett, LLC

Birmingham, Alabama
November 11, 2016

Item 2. 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 three month and nine month periods ended September 30, 2016 and 2015.

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

This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part 1, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2015.

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

The National Security Group operates in the property and casualty and life, accident and supplemental health insurance businesses and markets products primarily through independent agents. The Company operates in ten states with 48.0% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment, accounting for 90.4% of gross earned premium revenue in the first nine months of 2016. Revenue generated from the life segment accounted for 9.6% of gross insurance premium revenue in the first nine months 2016.

National Security Insurance Company (NSIC) is a life, accident and health insurance company founded in 1947. All references to NSIC in the remainder of this management discussion and analysis will refer to the combined life, accident and health insurance operations and will compose the life segment of the Company. NSIC is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

The property and casualty segment consists of the consolidated operations of two subsidiaries, National Security Fire and Casualty Company and its wholly owned subsidiary, Omega One Insurance Company. Omega One currently has no direct written premium. The Property and Casualty segment has premium in-force in the states of Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, and Tennessee.

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

All of our insurance companies have been assigned ratings by A.M. Best Co (Best). On February 10, 2016, 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 outlook for all of these ratings is stable. 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 November 23, 2015, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

The two primary segments in which we report insurance operations are the personal lines property and casualty segment (NSFC) and the life, accident and health insurance segment (NSIC). Due to Omega currently 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 in the remainder of this management discussion and analysis will include

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

The property and casualty segment can be impacted by severe storm activity resulting in incurred losses and loss adjustment expenses primarily from tornado, wind and hail related damage. These storm systems or other natural disasters are classified as catastrophes (referred to as "cat events" or "catastrophe events" throughout the remainder of this document) by Property Claim Service (PCS) when these events cause \$25 million or more in industry wide direct insured losses and affect a significant number of policyholders and insurers.

Consolidated Results of Operations:

Financial results for the three months and nine months ended September 30, 2016 and 2015 were as follows:

| Unaudited Consolidated Financial Summary <i>(dollars in thousands)</i> | Three months ended September 30, | | Nine months ended September 30, | |
|--|---|-----------------|--|-----------------|
| | 2016 | 2015 | 2016 | 2015 |
| Gross premiums written | \$ 17,166 | \$ 17,253 | \$ 52,623 | \$ 52,037 |
| Net premiums written | \$ 15,640 | \$ 15,489 | \$ 48,350 | \$ 47,523 |
| Net premiums earned | \$ 15,675 | \$ 15,104 | \$ 46,067 | \$ 44,690 |
| Net investment income | 1,005 | 737 | 3,025 | 2,552 |
| Net realized investment gains | 287 | 130 | 536 | 517 |
| Other income | 152 | 154 | 456 | 468 |
| Total Revenues | 17,119 | 16,125 | 50,084 | 48,227 |
| Policyholder benefits and settlement expenses | 10,082 | 8,170 | 27,991 | 25,867 |
| Amortization of deferred policy acquisition costs | 758 | 905 | 2,451 | 2,722 |
| Commissions | 2,088 | 2,086 | 6,313 | 6,230 |
| General and administrative expenses | 2,026 | 1,726 | 6,313 | 5,876 |
| Taxes, licenses and fees | 529 | 468 | 1,703 | 1,641 |
| Interest expense | 339 | 350 | 1,017 | 1,018 |
| Total Benefits, Losses and Expenses | 15,822 | 13,705 | 45,788 | 43,354 |
| Income Before Income Taxes | 1,297 | 2,420 | 4,296 | 4,873 |
| Income tax expense | 367 | 804 | 1,129 | 1,326 |
| Net Income | \$ 930 | \$ 1,616 | \$ 3,167 | \$ 3,547 |
| Income Per Common Share | \$ 0.37 | \$ 0.64 | \$ 1.26 | \$ 1.41 |
| Reconciliation of Net Income to non-GAAP Measurement | | | | |
| Net income | \$ 930 | \$ 1,616 | \$ 3,167 | \$ 3,547 |
| Income tax expense | 367 | 804 | 1,129 | 1,326 |
| Realized investment gains, net | (287) | (130) | (536) | (517) |
| Pretax Income From Operations | \$ 1,010 | \$ 2,290 | \$ 3,760 | \$ 4,356 |

Three months ended September 30, 2016 compared to three months ended September 30, 2015:

Premium Revenue:

For the quarter ended September 30, 2016, net premiums earned were up \$571,000 at \$15,675,000 compared to \$15,104,000 in the same period last year; an increase of 3.8%. The primary reasons for the increase were a 14.0% decline in catastrophe reinsurance costs for the quarter coupled with a 2.1% increase in gross earned premium for the quarter. The increase in gross earned premium was primarily related to the P&C segment which had an increase of 2.6% during the third quarter of 2016 compared to the same period in 2015. It should be noted that our premium revenue growth is slowing with written premium for the quarter down marginally compared to the same quarter last

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year. Our primary focus over the last four years has been rate adequacy, capital growth and improved management of risk concentrations, particularly in our property and casualty segment. While this focus has been successful, these actions have led to rate increases in several states in which we operate and thus has reduced our growth rate. With our improved capital position and downward trend in catastrophe reinsurance cost, we are implementing plans to increase top line growth but implementation of these plans to increase written premium will be deliberate as we do not intend to sacrifice long term underwriting profitability.

Net Income:

For the three months ended September 30, 2016, the Company had net income of \$930,000, \$0.37 per share, compared to net income of \$1,616,000, \$0.64 per share, for the same period in 2015, a decrease of \$686,000. The primary reason for the decrease in net income was a \$1,912,000 increase in policyholder benefits and settlement expenses (claims) in the third quarter of 2016 compared to the same period in 2015. This increase in claims was primarily the result of increased frequency of cat events in the property and casualty segment. For the three months ended September 30, 2016, reported losses from cat events were up \$1,240,000 compared to the same period last year. In addition, fire losses were up 31.3% in the third quarter of 2016 compared to the third quarter of 2015. For the three months ended September 30, 2016, reported fire losses were up \$1,029,000 compared to the same period last year. The increase in policyholder benefits was partially offset by a \$571,000 increase in net premium earned and a \$157,000 increase in net realized capital gains.

Pretax income from operations:

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

For the three months ended September 30, 2016, pretax income from insurance operations was \$1,010,000 compared to pretax income from insurance operations of \$2,290,000 for the three months ended September 30, 2015. The primary factor contributing to the decline in pretax income from insurance operations was a \$1,912,000 increase in claims; primarily due to an increase in frequency cat events. Partially offsetting this increase in claims was an increase in net premium earned of \$571,000.

Nine months ended September 30, 2016 compared to nine months ended September 30, 2015:

Premium Revenue:

For the period ended September 30, 2016, net premiums earned totaled \$46,067,000 compared to \$44,690,000 for the same period in 2015; an increase of \$1,377,000 or 3.1%. The primary reason for the increase was a 5.7% decrease in catastrophe reinsurance ceded premium coupled with a 2.3% increase in gross earned premium. The P&C segment was the primary contributor to the increase in gross earned premium revenue; up 2.7% in 2016 compared to the same period in 2015.

Net Income:

For the period ended September 30, 2016, the Company had net income of \$3,167,000, \$1.26 per share, compared to net income of \$3,547,000, \$1.41 per share, for the same period in 2015, a decrease of \$380,000. As discussed above, an increase in claims was the primary reason for the decrease in net income in 2016 compared to 2015. Net income for the nine-month periods of 2016 and 2015 were adversely impacted by a widespread and elevated frequency of wind, isolated tornado and hail losses in the property and casualty insurance segment.

Pretax income from operations:

For the period ended September 30, 2016, pretax income from operations was \$3,760,000 compared to \$4,356,000 for the period ended September 30, 2015, a decrease of \$596,000 or 13.7%. Increases in reported claims from cat events coupled with an increase in reported non-cat wind and hail claims in the P&C segment, were the primary reasons for the lower results through September 30, 2016 compared to the same period in 2015.

Balance Sheet highlights at September 30, 2016 compared to December 31, 2015

| Selected Balance Sheet Highlights | September 30, 2016 | December 31, 2015 |
|--|-------------------------------|------------------------------|
| <i>(dollars in thousands)</i> | <i>(UNAUDITED)</i> | |
| Invested Assets | \$ 121,015 | \$ 112,557 |
| Cash | \$ 5,525 | \$ 6,763 |
| Total Assets | \$ 154,165 | \$ 147,841 |
| Policy Liabilities | \$ 78,243 | \$ 77,043 |
| Total Debt | \$ 17,266 | \$ 17,957 |
| Accumulated Other Comprehensive Income | \$ 2,935 | \$ 525 |
| Shareholders' Equity | \$ 50,197 | \$ 44,883 |
| Book Value Per Share | \$ 19.94 | \$ 17.87 |

Invested Assets:

Invested assets as of September 30, 2016 were \$121,015,000 up \$8,458,000, or 7.5%, compared to December 31, 2015. The increase in invested assets was primarily driven by \$4,708,000 in new investments with the remainder of the increase consisting of increases in market value of available-for-sale fixed income investments primarily associated with price recoveries of investments in energy sector fixed income securities.

Cash:

The Company, primarily through its insurance subsidiaries, had \$5,525,000 in cash and cash equivalents at September 30, 2016, compared to \$6,763,000 at December 31, 2015. The moderate change in cash was primarily due to an increased investment in fixed income securities.

Total Assets:

Total assets as of September 30, 2016 reached an all time record level for the company of \$154,165,000 compared to \$147,841,000 at December 31, 2015. The increase in total assets was primarily due to positive cash flow from operations which was utilized primarily to increase fixed income investments.

Policy Liabilities:

Policy liabilities were \$78,243,000 at September 30, 2016 compared to \$77,043,000 at December 31, 2015; an increase of \$1,200,000. The increase in policy liabilities was primarily due to an increase in outstanding claims in the life insurance segment.

Debt Outstanding:

Total debt at September 30, 2016 was \$17,266,000 compared to \$17,957,000 at December 31, 2015. A reduction in long-term debt in our holding company was the primary reason for the decline.

Shareholders' Equity:

Shareholders' equity as of September 30, 2016 reached an all time high for the Company totaling \$50,197,000 up \$5,314,000 compared to December 31, 2015 Shareholders' equity of \$44,883,000. Book value per share was \$19.94 at September 30, 2016, compared to \$17.87 per share at December 31, 2015, an increase of \$2.07. The primary factors contributing to the increase in Shareholders' equity were net income of \$3,167,000 coupled with an increase in accumulated other comprehensive income of \$2,410,000. The increase in accumulated other comprehensive income was driven by increases in market values of available-for-sale investment securities primarily in our fixed income portfolio. Partially offsetting the increase in Shareholders' equity was shareholder dividends paid of \$339,000.

Update on 4th Quarter Event - Hurricane Matthew:

In addition to our third quarter earnings release, we are updating our loss estimates from Hurricane Matthew which will impact our fourth quarter earnings. We emphasize that no provision for losses from Hurricane Matthew has been made in our third quarter results presented above as Matthew occurred early in the fourth quarter.

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Net of re-insurance, Hurricane Matthew will reduce our fourth quarter and full year pre-tax income by \$4,000,000. Hurricane Matthew will reduce fourth quarter and full year net income by \$2,640,000. The impact on net income is at the upper end of our initial range of estimates.

We have revised our estimates of ultimate gross loss (before re-insurance recoveries) to a range of \$7,000,000 to \$8,000,000. Under our catastrophe reinsurance coverage, we retain 100% of losses up to \$4,000,000 from a single event. After exceeding our retention, losses are 100% re-insured up to \$72,500,000 under our catastrophe reinsurance program.

Hurricane Matthew has exceeded our expectations in both frequency and severity of loss which has led to the upward revision in our loss estimates. Through November 5th we had 1,735 claims reported from Hurricane Matthew in the states of Georgia and South Carolina. We have closed 632 of these claims with payments on closed claims totaling \$2,532,000 for an average of \$4,000 per claim. The average severity of closed claims exceeded our initial estimates by approximately 30% which has contributed to our upward revision in gross loss estimates. Our current estimate of incurred losses on our remaining 1,103 reported but open claims is \$4,541,000, or an average of \$4,100 per claim. In total, our current estimate of incurred losses on reported claims is \$7,073,000. This upward revision in our estimate is due to both an increase in both number of claims reported and average loss per claim compared to our initial estimates.

Three months ended September 30, 2016 compared to three months ended September 30, 2015:

Premium Revenue:

The table below provides earned premium revenue by segment for the three months ended September 30, 2016 and 2015:

| | Three months ended September 30, | | Percent increase (decrease) |
|---|-------------------------------------|-----------|-----------------------------------|
| | 2016 | 2015 | |
| <i>(dollars in thousands)</i> | | | |
| Life, accident and health operations premiums earned: | | | |
| Traditional life insurance | \$ 1,108 | \$ 1,111 | (0.3)% |
| Accident and health insurance | 561 | 598 | (6.2)% |
| Gross life, accident and health | 1,669 | 1,709 | (2.3)% |
| Reinsurance premium ceded | (10) | (19) | (47.4)% |
| Net life, accident and health premiums earned | \$ 1,659 | \$ 1,690 | (1.8)% |
| Property and Casualty operations premiums earned: | | | |
| Dwelling fire & extended coverage | \$ 8,941 | \$ 8,547 | 4.6 % |
| Homeowners (Including mobile homeowners) | 5,923 | 5,957 | (0.6)% |
| Other liability | 515 | 488 | 5.5 % |
| Gross property and casualty | 15,379 | 14,992 | 2.6 % |
| Reinsurance premium ceded | (1,363) | (1,578) | (13.6)% |
| Net property and casualty premiums earned | \$ 14,016 | \$ 13,414 | 4.5 % |
| Consolidated gross premiums earned | \$ 17,048 | \$ 16,701 | 2.1 % |
| Reinsurance premium ceded | (1,373) | (1,597) | (14.0)% |
| Consolidated net premiums earned | \$ 15,675 | \$ 15,104 | 3.8 % |

Consolidated net premium earned was up 3.8% for the quarter ended September 30, 2016, at \$15,675,000 compared to \$15,104,000 for the quarter ended September 30, 2015. The growth in net premium earned was due to a 4.5% increase in net premium earned in the P&C segment. A 13.6% reduction in catastrophe reinsurance cost also contributed to the increase in net premium earned in the P&C segment. The reduction in catastrophe reinsurance cost was due to a catastrophe reinsurance rate reduction in our 2016 calendar year contract renewal.

Investment Income:

For the three months ended September 30, 2016, net investment income was \$1,005,000 compared to \$737,000 for the same period in 2015; an increase of \$268,000. The primary reason for the increase was a \$184,000 increase in company owned life insurance (COLI) for the third quarter of 2016 compared to the same period in the prior year.

Realized Investment Gains and Losses:

For the three months ended September 30, 2016, the Company had net realized capital gains totaling \$287,000 compared to \$130,000 for the same period in 2015; an increase of \$157,000. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and therefore can vary significantly from quarter to quarter and year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to year. The gains realized in both 2016 and 2015 were primarily associated with gains on sale of fixed income investments.

Other Income:

Other income was comparable at \$152,000 for the three months ended September 30, 2016, compared to \$154,000 for the same period in 2015; a decrease of \$2,000. Other income consists primarily of fees related to the issuance of our property insurance policies as well as other miscellaneous income.

Policyholder Benefits:

Policyholder claims were \$10,082,000 for the three months ended September 30, 2016, compared to \$8,170,000 for the three months ended September 30, 2015; an increase of \$1,912,000 or 23.4%. Claims as a percentage of premium earned was 64.3% in the third quarter of 2016 compared to 54.1% in the third quarter of 2015. The primary reason for the increase in claims was a \$1,240,000 increase in reported losses from increased frequency of cat events in the P&C segment in the third quarter of 2016 compared to the same period in the prior year. In addition, P&C segment reported fire losses in the third quarter of 2016 were up \$1,029,000 compared to third quarter 2015. However, on a year to date basis, fire claims are comparable to last year.

The table below provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the three months ended September 30, 2016 and 2015 (dollars in thousands):

| For the three months ended September 30, 2016 | | | For the three months ended September 30, 2015 | | |
|---|-----------------------|-------------|---|-----------------------|-------------|
| Cat event | Reported Losses & LAE | Claim Count | Cat event | Reported Losses & LAE | Claim Count |
| Cat 16 (Feb 22-24) | \$ (12) | 1 | Cat 70 (Mar 25-26) | \$ 56 | 7 |
| Cat 17 (Mar 5-11) | (6) | — | Cat 71 (Mar 31-Apr 1) | 17 | 6 |
| Cat 22 (Mar 30-Apr 1) | 5 | 2 | Cat 75 (Apr 18-21) | 20 | 5 |
| Cat 27 (Apr 25-28) | (10) | (1) | Cat 76 (Apr 24-28) | 26 | 7 |
| Cat 28 (Apr 29-May 3) | 47 | 11 | Cat 79 (May 6-13) | 27 | 10 |
| Cat 29 (May 7-10) | 53 | 4 | Cat 81 (May 23-28) | 38 | 11 |
| Cat 31 (May 16-19) | 30 | 1 | | | |
| Cat 32 (May 26-28) | (1) | 2 | | | |
| Cat 35 (Jun 16-18) | 85 | 7 | | | |
| Cat 40 (Jul 13-15) | 311 | 87 | | | |
| Cat 44 (Aug 11-13) | 647 | 262 | | | |
| Cat 46 (Aug 31-Sept 4) | 357 | 114 | | | |
| Misc cats less than \$100k | 136 | 44 | Misc cats less than \$100k | 218 | 83 |
| Total Cat losses | \$ 1,642 | 534 | Total Cat losses | \$ 402 | 129 |
| Non-cat wind & hail | \$ 1,574 | 538 | Non-cat wind & hail | \$ 1,542 | 528 |

Non-catastrophe wind and hail claims reported in the third quarter of 2016 totaled \$1,574,000 compared to non-catastrophe wind and hail claims reported in the third quarter of 2015 totaling \$1,542,000; an increase of \$32,000 or 2.1%. During the third quarter of 2016, the P&C segment had 538 non-cat wind and hail claims reported (an average of \$2,900 per claim) compared to 528 claims reported during the third quarter of 2015 (an average of \$2,900 per claim). Non-cat wind and hail claims reported during the third quarter of 2016 accounted for 18.6% of total P&C segment incurred losses and LAE in the current year. Non-cat wind and hail claims reported during the third quarter of 2015 accounted for 23.9% of total P&C segment incurred losses and LAE in 2015.

During the third quarter of 2016, the P&C segment was impacted by five catastrophe events and development on 13 catastrophe events from the first half of the year totaling \$1,642,000 from 534 claims compared to reported losses and LAE from one cat event in the third quarter of 2015 and development on 15 cat events from the first half of 2015 totaling \$402,000 from 129 claims. The largest cat impacting third quarter 2016 was Cat 44, impacting our policyholders in Louisiana and totaling \$647,000. This cat accounted for 45.2% of all third quarter 2016 reported cat event losses and LAE. Claims reported from third quarter 2016 cat events contributed 11.7 percentage points to the third quarter 2016 P&C segment loss ratio. In comparison, during the third quarter of 2015, only one cat was reported and contributed less than \$100,000 in reported losses and LAE. Claims reported during the third quarter of 2015 from cat events contributed 3.0 percentage points to the third quarter 2015 P&C segment loss ratio. In the third quarter of both 2016, our catastrophe and non-cat wind and hail losses were above normal driven by a high frequency of isolated severe thunderstorm events across the Southeastern US.

Policyholder benefit payments were up in the property and casualty segment primarily due to an increase in reported fire losses during the third quarter of 2016 compared to the same period last year. Fire losses reported in the third quarter of 2016 were up \$1,029,000 or 31.3% compared to fire losses reported during the third quarter of 2015. The P&C segment had 138 fire losses reported in the third quarter of 2016 totaling \$4,314,000 compared to 121 claims reported in the third quarter of 2015 totaling \$3,285,000. The average cost per claim was \$31,300 for fire losses reported in the third quarter of 2016 compared to \$27,100 for fire losses reported in the third quarter of 2015. Fire claim frequency is generally correlated with the pace of new business production. While fire losses were up significantly for the quarter, year to date fire losses are comparable to prior year.

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

For the three months ended September 30, 2016, policy acquisition costs were \$2,846,000 compared to \$2,991,000 for the same period in 2015; a decrease of \$145,000. Policy acquisition costs consist of amortization of previously capitalized distribution costs and current commission payments to agents. As a percentage of premium revenue, policy acquisition costs were 18.2% in the third quarter of 2016 compared to 19.8% for the same period in 2015.

General Expenses:

General and administrative expenses totaled \$2,026,000 in the third quarter of 2016 compared to \$1,726,000 in the third quarter of 2015; a 17.4% increase. The primary reasons for the increase in general expenses in the third quarter of 2016 compared to the third quarter of 2015 were increases in values associated with holding company unfunded deferred compensation plans. Once holding company debt associated with Mobile Attic is repaid, the company intends to match this non-qualified deferred compensation liability with similar investments in order to reduce financial statement volatility in the future.

Taxes, Licenses and Fees:

Insurance taxes, licenses and fees were \$529,000 for the three months ended September 30, 2016, compared to \$468,000 for the same period in 2015. As a percentage of net premiums earned, insurance taxes, licenses and fees were relatively unchanged at 3.4% for the three months ended September 30, 2016 compared to 3.1% for the three months ended September 30, 2015.

Interest Expense:

Interest expense for the third quarter of 2016 was \$339,000 compared to \$350,000 for the same period in 2015. A reduction in total debt outstanding over the past twelve months is the primary factor contributing to the \$11,000 decrease.

Income taxes:

For the three month period ended September 30, 2016, the Company had pretax income of \$1,297,000 compared to \$2,420,000 for the same period in 2015. The \$367,000 tax expense for the third quarter 2016 consisted of current tax expense of \$238,000 and deferred tax expense \$129,000. Tax expense of \$804,000 for the third quarter of 2015 consisted of current tax expense of \$446,000 and deferred tax expense of \$358,000.

Net Income:

The Company ended the third quarter of 2016 with net income of \$930,000 compared to net income of \$1,616,000 for the same period in 2015. As discussed in detail above, the primary reason for the decrease in third quarter 2016 earnings compared to third quarter 2015 was a 23.4% increase in claims. The increase in claims was primarily due to an increase in frequency of catastrophe events, primarily severe thunderstorm activity in the southeastern US.

Nine months ended September 30, 2016 compared to nine months ended September 30, 2015:
Premium Revenue:

The table below provides earned premium revenue by segment for the nine months ended September 30, 2016 and 2015:

| | Nine months ended September 30, | | Percent increase (decrease) |
|---|------------------------------------|-----------|-----------------------------------|
| | 2016 | 2015 | |
| <i>(dollars in thousands)</i> | | | |
| Life, accident and health operations premiums earned: | | | |
| Traditional life insurance | \$ 3,475 | \$ 3,488 | (0.4)% |
| Accident and health insurance | 1,387 | 1,439 | (3.6)% |
| Gross life, accident and health | 4,862 | 4,927 | (1.3)% |
| Reinsurance premium ceded | (58) | (49) | 18.4 % |
| Net life, accident and health premiums earned | \$ 4,804 | \$ 4,878 | (1.5)% |
| Property and Casualty operations premiums earned: | | | |
| Dwelling fire & extended coverage | \$ 26,410 | \$ 25,150 | 5.0 % |
| Homeowners (Including mobile homeowners) | 17,710 | 17,860 | (0.8)% |
| Other liability | 1,511 | 1,433 | 5.4 % |
| Gross property and casualty | 45,631 | 44,443 | 2.7 % |
| Reinsurance premium ceded | (4,368) | (4,631) | (5.7)% |
| Net property and casualty premiums earned | \$ 41,263 | \$ 39,812 | 3.6 % |
| Consolidated gross premiums earned | \$ 50,493 | \$ 49,370 | 2.3 % |
| Reinsurance premium ceded | (4,426) | (4,680) | (5.4)% |
| Consolidated net premiums earned | \$ 46,067 | \$ 44,690 | 3.1 % |

Consolidated net premium earned was up 3.1% for the year ended September 30, 2016, at \$46,067,000 compared to \$44,690,000 for the year ended September 30, 2015. The growth in net premium earned was due to a 3.6% increase in net premium earned in the P&C segment which was driven by a moderate increase in direct premium. A 5.7% reduction in catastrophe reinsurance cost also contributed to the increase in net premium earned in the P&C segment. The reduction in catastrophe reinsurance cost was due to a catastrophe reinsurance rate reduction in our 2016 calendar year contract renewal.

The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. Our catastrophe retention remained unchanged at \$4 million and we maintain catastrophe reinsurance covering incurred claims of a single catastrophe event up to \$72.5 million after exceeding the retention. Our catastrophe reinsurance also covers the cost of a second event up to the same \$72.5 million upper limit. In our reinsurance structure, management attempts to limit the impact on pretax earnings of a single modeled 100 year cat event to no more than \$4 million. It is noted, however, that hurricane models are subject to significant risk and are only a tool to estimate the impact of catastrophe events. The Company also has risk associated with more frequent smaller catastrophe events that individually may not exceed our \$4 million retention.

Under the catastrophe reinsurance program in 2016, the Company retained the first \$4,000,000 in losses from each event. Reinsurance coverage is maintained in three layers as follows:

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

Investment Income:

For the nine months ended September 30, 2016, net investment income was \$3,025,000 compared to \$2,552,000 for the same period in 2015; an increase of \$473,000. The primary reason for the increase in net investment income in

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the first nine months of 2016 compared to the same period in 2015 was an increase in the value of company owned life insurance. The change in value of the COLI increased investment income \$80,000 during the nine months ended September 30, 2016, while the change decreased investment income \$208,000 during the same period in 2015.

Realized Investment Gains and Losses:

For the nine months ended September 30, 2016, the Company had net realized capital gains totaling \$536,000 compared to \$517,000 for the same period in 2015. The \$19,000 change was primarily associated with sales of fixed income investments. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and therefore can vary significantly from quarter to quarter and year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to year.

Other Income:

Other income was \$456,000 for the nine months ended September 30, 2016, compared to \$468,000 for the same period in 2015; a decrease of \$12,000. Other income consists primarily of fees related to the issuance of our property insurance policies as well as other miscellaneous income.

Policyholder Benefits:

Policyholder claims were \$27,991,000 for the nine months ended September 30, 2016, compared to \$25,867,000 for the nine months ended September 30, 2015; an increase of \$2,124,000 or 8.2%. Claims as a percentage of premium earned was 60.8% through the nine months ended September 30, 2016 compared to 57.9% through the nine months ended September 30, 2015. Policyholder benefits were up due to an increase in P&C segment claims in the first nine months of 2016 compared to the same period in 2015. The primary components of the increase in P&C segment claims were \$1,033,000 from reported non-cat wind and hail losses as well as \$2,105,000 from reported claims from cat events. However, offsetting the increases were a decline in reported fire claims totaling \$159,000 in the P&C segment and prior year reserve savings is discontinued programs.

The table below provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the nine months ended September 30, 2016 and 2015 (dollars in thousands):

| For the nine months ended September 30, 2016 | | | For the nine months ended September 30, 2015 | | |
|--|-----------------------|--------------|--|-----------------------|--------------|
| Cat event | Reported Losses & LAE | Claim Count | Cat event | Reported Losses & LAE | Claim Count |
| Cat 16 (Feb 22-24) | \$ 1,042 | 240 | Cat 70 (Mar 25-26) | \$ 489 | 88 |
| Cat 17 (Mar 5-11) | 323 | 101 | Cat 71 (Mar 31-Apr 1) | 238 | 56 |
| Cat 22 (Mar 30-Apr 1) | 209 | 57 | Cat 75 (Apr 18-21) | 380 | 102 |
| Cat 27 (Apr 25-28) | 189 | 47 | Cat 76 (Apr 24-28) | 616 | 190 |
| Cat 28 (Apr 29-May 3) | 593 | 120 | Cat 79 (May 6-13) | 500 | 100 |
| Cat 29 (May 7-10) | 255 | 28 | Cat 81 (May 23-28) | 378 | 94 |
| Cat 31 (May 16-19) | 170 | 31 | | | |
| Cat 32 (May 26-28) | 143 | 15 | | | |
| Cat 35 (Jun 16-18) | 438 | 99 | | | |
| Cat 40 (Jul 13-15) | 311 | 87 | | | |
| Cat 44 (Aug 11-13) | 647 | 262 | | | |
| Cat 46 (Aug 31-Sept 4) | 357 | 114 | | | |
| Misc cats less than \$100k | 448 | 135 | Misc cats less than \$100k | 419 | 148 |
| Total Cat losses | \$ 5,125 | 1,336 | Total Cat losses | \$ 3,020 | 778 |
| Non-cat wind & hail | \$ 4,833 | 1,513 | Non-cat wind & hail | \$ 3,800 | 1,310 |

Non-catastrophe wind and hail claims reported in the first nine months of 2016 totaled \$4,833,000 compared to non-catastrophe wind and hail claims reported in the first nine of 2015 totaling \$3,800,000; an increase of \$1,033,000 or 27.2%. During the first nine months of 2016, the P&C segment had 1,513 non-cat wind and hail claims reported (an

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average of \$3,200 per claim) compared to 1,310 claims reported during the first nine months of 2015 (an average of \$2,900 per claim). Non-cat wind and hail claims reported during the first nine months of 2016 accounted for 20.2% of total P&C segment incurred losses and LAE in the current year. Non-cat wind and hail claims reported during the first nine months of 2015 accounted for 17.5% of total P&C segment incurred losses and LAE in 2015. The P&C segment has experienced a higher frequency of severe thunderstorm activity in 2016 than for the same period in 2015. While the most of these individual thunderstorms were isolated to small geographic areas, the frequency of these weather events drove a significant increase in both catastrophe and non-cat wind and hail claims.

During the first nine months of 2016, the P&C segment was impacted by 18 catastrophe events totaling \$5,125,000 from 1,336 claims compared to reported losses and LAE from 16 cat events totaling \$3,020,000 from 778 claims in the first nine months of 2015. Claims reported from year to date 2016 cat events contributed 12.4 percentage points to the 2016 P&C segment loss ratio. In comparison, claims reported during the first nine months of 2015 from prior year cat events contributed 7.6 percentage points to the year to date 2015 P&C segment loss ratio. In both 2016 and 2015, the P&C segment was impacted by only one cat event exceeding \$1,000,000. However, the claims associated with these cats were the result of frequent but less severe thunderstorms and isolated tornado and hail events which impacted all states in which we do business. During the current year, southern Louisiana was the primary source of the reported cat claims, which is not typical in the spring in this region, while Oklahoma was the primary source of the reported cat event claims during 2015. The claims reported in Louisiana from cat events accounted for 24.3% of all reported cat event claims in 2016. In 2015, the cat event claims reported in Oklahoma accounted for 46.4% of all reported cat event claims.

Year to date policyholder benefit payments were up in the property and casualty segment due to an increase in frequency of wind related losses; however, reported fire losses helped offset this increase. Reported fire losses were down \$159,000 or 1.4% in 2016 compared to fire losses reported during the first nine months of 2015. The P&C segment had 380 fire losses reported for the period ended September 30, 2016, totaling \$11,299,000 compared to 414 fire claims reported for the same period in 2015 totaling \$11,458,000. The average cost per claim was \$29,700 for fire losses reported in 2016 compared to \$27,700 for fire losses reported in 2015.

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

For the nine months ended September 30, 2016, policy acquisition costs were \$8,764,000 compared to \$8,952,000 for the same period in 2015; a decrease of \$188,000. Policy acquisition costs consist of amortization of previously capitalized distribution costs and current commission payments to agents. As a percentage of premium revenue, policy acquisition costs were 19.0% in the first half of 2016 compared to 20.0% for the same period in 2015.

General Expenses:

Year to date general and administrative expenses totaled \$6,313,000 in 2016 compared to \$5,876,000 in 2015; a 7.4% increase. The increase is primarily associated with increase in value of unfunded deferred compensation plans of the holding company totaling \$319,000 and a \$47,000 increase in actuarial fees in the P&C segment associated with insurance rate development work. Once holding company debt associated with Mobile Attic is repaid, we intend to match the liability associated with unfunded non-qualified deferred compensation plans with similar investments in order to reduce financial statement liability in the future.

Taxes, licenses and fees:

Insurance taxes, licenses and fees were comparable at \$1,703,000 for the nine months ended September 30, 2016, compared to \$1,641,000 for the same period in 2015. As a percentage of net premiums earned, insurance taxes, licenses and fees were 3.7% for the nine months ended September 30, 2016 and 2015.

Interest expense:

Interest expense for the first nine months of 2016 was \$1,017,000, virtually unchanged to \$1,018,000 for the same period in 2015; a decrease of 0.1%. The primary reason for the \$1,000 decrease was due to an outstanding balance in a revolving line of credit.

Income taxes:

For the nine month period ended September 30, 2016, the Company had pretax income of \$4,296,000 compared to \$4,873,000 for the same period in 2015. The \$1,129,000 tax expense for the first nine months 2016 consisted of current tax expense of \$858,000 and deferred tax benefit of \$271,000. Tax expense of \$1,326,000 for the first nine months of 2015 consisted of current tax expense of \$1,078,000 and deferred tax expense of \$248,000. The effective tax rate for the nine month period ended September 30, 2016 and 2015 was 26.3% and 27.2%, respectively. The lower effective tax rate was primarily due to a higher percentage of net income from our life segment which has a lower effective tax rate.

Net income:

The Company ended the first nine months of 2016 with net income of \$3,167,000 compared to net income of \$3,547,000 for the same period in 2015. The primary factor contributing to the \$380,000 decrease in net income was a 8.2% increase in 2016 claims compared to 2015.

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 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 September 30, 2016, the contractual maturity schedule for all bonds and notes held by the Company, stated at amortized cost, was as follows (dollars in thousands):

| <u>Maturity</u> | <u>Available- for- Sale</u> | <u>Held-to- Maturity</u> | <u>Total</u> | <u>Percentage of Total</u> |
|------------------------------|---------------------------------|------------------------------|------------------|--------------------------------|
| Maturity in less than 1 year | \$ 3,232 | \$ 1 | \$ 3,233 | 3.25% |
| Maturity in 1-5 years | 15,624 | 39 | 15,663 | 15.74% |
| Maturity in 5-10 years | 34,761 | 86 | 34,847 | 35.01% |
| Maturity after 10 years | 43,837 | 1,946 | 45,783 | 46.00% |
| | <u>\$ 97,454</u> | <u>\$ 2,072</u> | <u>\$ 99,526</u> | <u>100.00%</u> |

It should be noted that the above table represents maturities based on stated/contractual maturity. Due to call and prepayment features inherent in some debt securities and principal pay-downs on mortgage backed securities, actual repayment, or effective maturities, will differ from stated maturities. The Company routinely evaluates the impact of changing interest rates on the projected maturities of bonds in the portfolio and actively manages the portfolio in order to minimize the impact of interest rate risk. However, due to other factors, both regulatory and those associated with good investment management practices associated with asset/liability matching, we do have exposure to changes in market values of securities due to changes in interest rates. Currently, a 100 basis point immediate increase in interest rates would generate approximately a \$5,048,000, or 5.7%, decline in the market value of fixed income investments. Alternatively, a 100 basis point decrease in interest rates will generate approximately \$4,732,000, or 4.8%, 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 company book value.

At September 30, 2016, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$50,197,000, up \$5,314,000 compared to \$44,883,000 at December 31, 2015. Components of the change in equity were net income of \$3,167,000, increase in accumulated unrealized gains on investments of \$2,357,000, a net unrealized gain of \$53,000 related to interest rate swaps and cash dividends paid totaling \$339,000.

As discussed above, changing interest rates can have a significant impact on the market value of fixed income securities. Fixed income securities classified as available-for-sale increase the liquidity resources of the Company as they can be sold at any time to pay claims or meet other Company obligations. However, these securities are required to be carried at market value with net of tax accumulated unrealized gains and losses directly impacting shareholder's equity.

While the increase in interest rates causes near term declines in the value of fixed income securities, we are able to reap the benefit of reinvesting at higher rates as current fixed income investments are called, amortized (mortgage

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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 8.3% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.

The Company, primarily through its insurance subsidiaries, had \$5,525,000 in cash and cash equivalents at September 30, 2016, compared to \$10,644,000 at September 30, 2015. Cash provided by operating activities increased cash by \$4,456,000 during the quarter ended September 30, 2016. The increase in cash provided by operations was primarily driven by net income from operations and recovery of reinsurance balances receivable. For the nine months ended September 30, 2015, cash provided by operating activities totaled \$6,882,000. Operating cash flow generated in the property and casualty segment was the primary contributor to cash provided by operating activities in the prior year.

Net cash used in investing activities totaled \$4,708,000 for the period ended September 30, 2016, compared to cash used of \$1,198,000 for the same period last year. The investment of cash generated from operations and reinvestment of maturing fixed income securities was the primary cash related investment activities during the nine months ended September 30, 2016. For the period ended September 30, 2015, cash used in investing activities totaled \$1,198,000 the reinvestment of maturities of fixed income securities and investment of cash from operations was the primary cash related investment activity during the period.

Net cash used in financing activities totaled \$986,000 for the period ended September 30, 2016, compared to \$1,466,000 for the same period last year. During the nine months ended September 30, 2016, the Company repaid a \$700,00 long-term note payable. During the nine months ended September 30, 2015, the Company repaid a \$500,000 long-term note and a \$700,000 short-term note payable. As of September 30, 2016, a total of \$5,143,000 remained outstanding on the note associated with the Mobile Attic settlement with the next installment due in November of 2016. This installment is \$857,000 and is included in short-term notes payable. The Company maintains a \$1,000,000 operating line of credit which matures in September 2017, as well as a \$700,000 line of credit which was renewed in February of 2016. Between the two lines of credit, \$1,700,000 was available at September 30, 2016.

The Company had a total of \$16,409,000 of long-term debt outstanding as of September 30, 2016, compared to \$17,100,000 at December 31, 2015, 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, \$249,000 and \$258,000, respectively.

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 over the past three years, 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 2015 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 2016 is statutorily limited to \$1,510,000 in the life insurance

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subsidiary and \$3,445,000 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 previous 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 in dividends from its subsidiaries during the nine months ended September 30, 2016.

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.

The Company continues to monitor liquidity and subsidiary capital closely. Improved underwriting results stemming from the discontinuation of unprofitable lines of business, favorable tropical weather patterns, streamlining of products offered combined with enhancements to the Company's rate development process and improvements in the Company's catastrophe reinsurance structure have reduced the pressure on subsidiary capital levels. However, continuing to strengthen 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.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

The Company's primary objectives in managing its investment portfolio are to maximize investment income and total investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including changes in interest rates, overall market conditions, underwriting results, regulatory requirements and tax position. Investment decisions are made by management and reviewed by the Board of Directors. Market risk represents the potential for loss due to adverse changes in fair value of securities. The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk and default risk. The 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 \$5.3 million. 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 September 30, 2016 value, the fair value of the Company's common stock investments would decrease by approximately \$520,000.

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 condensed 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

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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.

Item 4. Controls and Procedures

Our management carried out an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as of September 30, 2016. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There has not been any change in our internal control over financial reporting in connection with the evaluation required by Rule 13A-15 (d) under the Exchange Act that occurred during the nine month period ended September 30, 2016, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings

Please refer to Note 13 to the condensed consolidated financial statements included herein, and the 2015 Annual Report filed on Form 10-K.

Item 1A. Risk Factors

There has been no material change in risk factors previously disclosed under Item 1A. of the Company's Annual Report for 2015 on Form 10-K.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

None

Item 5. Other Information

None

Item 6. Exhibits

a. Exhibits

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

b. Reports on Form 8-K during the quarter ended September 30, 2016:

| <u>Date of Report</u> | <u>Date Filed</u> | <u>Description</u> |
|-----------------------|-------------------|---|
| July 16, 2016 | July 18, 2016 | Press release, dated July 18, 2016, issued by The National Security Group, Inc. |
| August 12, 2016 | August 12, 2016 | Press release, dated August 12, 2016, issued by The National Security Group, Inc. |

SIGNATURE

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

The National Security Group, Inc.

/s/ Brian R. McLeod

Brian R. McLeod
Chief Financial Officer and Treasurer

/s/ William L. Brunson, Jr.

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

Date: November 11, 2016

Section 2: EX-31.1 (EXHIBIT 31.1)

Exhibit 31.1

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, William L. Brunson, Jr., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of The National Security Group, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with

respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 11, 2016

/s/ William L. Brunson, Jr.

William L. Brunson, Jr.

President and Chief Executive Officer

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Section 3: EX-31.2 (EXHIBIT 31.2)

Exhibit 31.2

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Brian R. McLeod, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of The National Security Group, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 11, 2016

/s/ Brian R. McLeod

Brian R. McLeod
Chief Financial Officer

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Section 4: EX-32.1 (EXHIBIT 32.1)

EXHIBIT 32.1

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

Exhibit 32.1 Certification of Chief Executive Officer and Chief Financial Officer

Pursuant to 18 U.S.C. § 1350, the undersigned officer of the National Security Group, Inc. (the "Company"), hereby certifies, to such officer's knowledge, that the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2016 (the "Report") fully complies with the requirements of Section 13(a) or 15 (d), as applicable, of the Securities Exchange Act of 1934 and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 11, 2016

/s/ William L. Brunson, Jr.

Name: William L. Brunson, Jr.
Title: Chief Executive Officer

/s/ Brian R. McLeod

Name: Brian R. McLeod, CPA
Title: Chief Financial Officer

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