

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, 2019

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

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

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, par value \$1.00 per share	NSEC	The NASDAQ Stock Market LLC

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, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 12(a) of the Exchange Act.

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

As of November 13, 2019, there were 2,531,552 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. Company insurance rates are also subject to approval by state insurance departments in each of these states. We are often limited in the level of rate increases we can obtain.
- The Company is rated by various insurance rating agencies. If a rating is downgraded from its current level by one of these agencies, sales of the Company's products and stock price could be adversely impacted.
- The Company's financial results are adversely affected by increases in policy claims received by the Company. While a manageable risk, this fluctuation is often unpredictable.
- The Company's investments are subject to a variety of risks. Investments are subject to defaults and changes in market value. Market value can be affected by changes in interest rates, market performance and the economy.
- The Company mitigates risk associated with life policies through implementing effective underwriting and reinsurance strategies. These factors mitigate, not eliminate, risk related to mortality and morbidity exposure. The Company has established reserves for claims and future policy benefits based on amounts determined by independent actuaries. There is no assurance that these estimated reserves will prove to be sufficient or that the Company will not incur claims exceeding reserves, which could result in operating losses and loss of capital.
- The Company mitigates risk associated with property and casualty policies through implementing effective underwriting and reinsurance strategies. The Company obtains reinsurance which increases underwriting capacity and limits the risk associated with policy claims. The Company is subject to credit risk with regard to reinsurers as reinsurance does not alleviate the Company's liability to its insured's for the ceded risks. The Company utilizes a third-party to develop a reinsurance treaty with reinsurers who are reliable and financially stable. However, there is no guarantee that booked reinsurance recoverable will actually be recovered. A reinsurer's insolvency or inability to make payments due could have a material adverse impact on the financial condition of the Company.
- The Company's ability to continue to pay dividends to shareholders is contingent upon profitability and capital adequacy of the insurance subsidiaries. The insurance subsidiaries operate under regulatory restrictions that could limit the ability to fund future dividend payments of the Company. An adverse event or series of events could materially impact the ability of the insurance subsidiaries to fund future dividends, and consequently, the Board of Directors would have to suspend the declaration of dividends to shareholders.
- The Company is subject to the risk of adverse settlements or judgments resulting from litigation of contested claims. It is difficult to predict or quantify the expected results of litigation because the outcome depends on decisions of the court and jury that are based on facts and legal arguments presented at the trial.

PART I. Financial Information

Item 1. Financial Statements

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

	September 30, 2019	December 31, 2018
	(UNAUDITED)	
ASSETS		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2019 - \$1,430; 2018 - \$1,443)	\$ 1,349	\$ 1,449
Fixed maturities available-for-sale, at estimated fair value (cost: 2019 - \$98,445; 2018 - \$96,877)	102,036	95,125
Equity securities, at estimated fair value (cost: 2019 - \$1,849; 2018 - \$1,842)	4,385	4,306
Trading securities	142	107
Receivable for securities sold	41	—
Mortgage loans on real estate, at cost	148	156
Investment real estate, at book value	2,934	2,945
Policy loans	1,854	1,854
Company owned life insurance	4,617	4,600
Other invested assets	2,286	2,148
Total Investments	119,792	112,690
Cash and cash equivalents	9,085	5,676
Accrued investment income	776	774
Policy receivables and agents' balances, net	12,907	11,185
Reinsurance recoverable	316	1,772
Deferred policy acquisition costs	7,915	7,834
Property and equipment, net	1,612	1,649
Income tax recoverable	802	1,463
Deferred income tax asset, net	—	716
Other assets	907	472
Total Assets	\$ 154,112	\$ 144,231
LIABILITIES AND SHAREHOLDERS' EQUITY		
Property and casualty benefit and loss reserves	\$ 6,957	\$ 8,208
Accident and health benefit and loss reserves	3,931	3,803
Life and annuity benefit and loss reserves	34,106	33,671
Unearned premiums	32,695	29,999
Policy and contract claims	956	792
Other policyholder funds	1,493	1,515
Short-term notes payable and current portion of long-term debt	2,200	2,200
Long-term debt	12,161	12,152
Deferred income tax liability	186	—
Other liabilities	7,288	6,025
Total Liabilities	101,973	98,365
Contingencies		
Shareholders' equity		
Common stock	2,532	2,527
Additional paid-in capital	5,602	5,554
Accumulated other comprehensive income (loss)	2,743	(1,570)
Retained earnings	41,262	39,355

Total Shareholders' Equity	52,139	45,866
Total Liabilities and Shareholders' Equity	\$ 154,112	\$ 144,231

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

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THE NATIONAL SECURITY GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
REVENUES				
Net premiums earned	\$ 15,209	\$ 15,445	\$ 44,917	\$ 45,764
Net investment income	989	1,017	2,908	2,932
Investment gains (losses)	(117)	456	2,120	(8)
Other income	148	148	440	457
Total Revenues	16,229	17,066	50,385	49,145
BENEFITS, LOSSES AND EXPENSES				
Policyholder benefits and settlement expenses	9,750	9,825	29,673	29,024
Amortization of deferred policy acquisition costs	805	782	2,624	2,372
Commissions	2,006	2,003	6,017	5,795
General and administrative expenses	2,226	2,404	6,974	7,075
Taxes, licenses and fees	604	567	1,890	1,565
Interest expense	293	306	879	917
Total Benefits, Losses and Expenses	15,684	15,887	48,057	46,748
Income Before Income Taxes	545	1,179	2,328	2,397
INCOME TAX EXPENSE (BENEFIT)				
Current	190	235	287	(83)
Deferred	(75)	37	(245)	645
	<u>115</u>	<u>272</u>	<u>42</u>	<u>562</u>
Net Income	\$ 430	\$ 907	\$ 2,286	\$ 1,835
INCOME PER COMMON SHARE BASIC AND DILUTED	\$ 0.17	\$ 0.36	\$ 0.90	\$ 0.73
DIVIDENDS DECLARED PER SHARE	\$ 0.05	\$ 0.05	\$ 0.15	\$ 0.15

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,	
	2019	2018	2019	2018
Net income	<u>\$ 430</u>	<u>\$ 907</u>	<u>\$ 2,286</u>	<u>\$ 1,835</u>
Other comprehensive income (loss), net of tax				
Changes in:				
Unrealized gains (losses) on securities, net of reclassification adjustment of \$(7) and \$123 for 2019 and 2018, respectively	735	(395)	4,221	(2,582)
Unrealized gain on interest rate swap	47	58	92	265
Other comprehensive income (loss), net of tax	<u>782</u>	<u>(337)</u>	<u>4,313</u>	<u>(2,317)</u>
Comprehensive income (loss)	<u>\$ 1,212</u>	<u>\$ 570</u>	<u>\$ 6,599</u>	<u>\$ (482)</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)

For the nine months ended September 30, 2019

	Total	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock	Additional Paid-in Capital
Balance at December 31, 2018	\$ 45,866	\$ 39,355	\$ (1,570)	\$ 2,527	\$ 5,554
Comprehensive income:					
Net income for September 30, 2019	2,286	2,286	—	—	—
Other comprehensive income (net of tax)	4,313	—	4,313	—	—
Common stock issued	53	—	—	5	48
Cash dividends	(379)	(379)	—	—	—
Balance at September 30, 2019	<u>\$ 52,139</u>	<u>\$ 41,262</u>	<u>\$ 2,743</u>	<u>\$ 2,532</u>	<u>\$ 5,602</u>

For the three months ended September 30, 2019

	Total	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock	Additional Paid-in Capital
Balance at June 30, 2019	\$ 51,053	\$ 40,958	\$ 1,961	\$ 2,532	\$ 5,602
Comprehensive income:					
Net income for September 30, 2019	430	430	—	—	—
Other comprehensive income (net of tax)	782	—	782	—	—
Cash dividends	(126)	(126)	—	—	—
Balance at September 30, 2019	<u>\$ 52,139</u>	<u>\$ 41,262</u>	<u>\$ 2,743</u>	<u>\$ 2,532</u>	<u>\$ 5,602</u>

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THE NATIONAL SECURITY GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)
(In thousands)

For the nine months ended September 30, 2018

	Total	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock	Additional Paid-in Capital
Balance at December 31, 2017	\$ 47,625	\$ 36,974	\$ 2,646	\$ 2,522	\$ 5,483
Cumulative effect of change in accounting principle	—	2,107	(2,107)	—	—
Comprehensive income:					
Net income for September 30, 2018	1,835	1,835	—	—	—
Other comprehensive income (net of tax)	(2,317)	—	(2,317)	—	—
Common stock issued	76	—	—	5	71
Cash dividends	(379)	(379)	—	—	—
Balance at September 30, 2018	<u>\$ 46,840</u>	<u>\$ 40,537</u>	<u>\$ (1,778)</u>	<u>\$ 2,527</u>	<u>\$ 5,554</u>

For the three months ended September 30, 2018

	Total	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Common Stock	Additional Paid-in Capital
Balance at June 30, 2018	\$ 46,397	\$ 39,757	\$ (1,441)	\$ 2,527	\$ 5,554
Comprehensive income:					
Net income for September 30, 2018	907	907	—	—	—
Other comprehensive income (net of tax)	(337)	—	(337)	—	—
Cash dividends	(127)	(127)	—	—	—
Balance at September 30, 2018	<u>\$ 46,840</u>	<u>\$ 40,537</u>	<u>\$ (1,778)</u>	<u>\$ 2,527</u>	<u>\$ 5,554</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 CASH FLOWS (UNAUDITED)
(In thousands)

	Nine months ended September 30,	
	2019	2018
Cash Flows from Operating Activities		
Net income	\$ 2,286	\$ 1,835
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense and amortization/accretion, net	201	218
Net (gains) losses on investments	(2,120)	8
Deferred income taxes	(245)	645
Amortization of deferred policy acquisition costs	2,624	2,372
Changes in assets and liabilities:		
Change in receivable for securities sold	(41)	—
Change in accrued investment income	(2)	(96)
Change in reinsurance recoverable	1,456	154
Policy acquisition costs deferred	(2,705)	(2,333)
Change in accrued income taxes	661	(83)
Change in net policy liabilities and claims	442	2,016
Change in other assets/liabilities, net	859	227
Other, net	9	11
Net cash provided by operating activities	<u>3,425</u>	<u>4,974</u>
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(12,198)	(14,741)
Trading securities and short-term investments	(26)	—
Property and equipment	(56)	(9)
Proceeds from sale or maturities of:		
Held-to-maturity securities	105	141
Available-for-sale securities	10,510	9,071
Real estate held for investment	11	188
Other invested assets, net	2,039	(23)
Net cash provided by (used in) investing activities	<u>385</u>	<u>(5,373)</u>
Cash Flows from Financing Activities		
Change in other policyholder funds	(22)	(212)
Change in short-term notes payable	—	(500)
Dividends paid	(379)	(379)
Net cash used in financing activities	<u>(401)</u>	<u>(1,091)</u>
Net change in cash and cash equivalents	3,409	(1,490)
Cash and cash equivalents, beginning of year	5,676	6,644
Cash and cash equivalents, end of period	<u>\$ 9,085</u>	<u>\$ 5,154</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, 2018 AMOUNTS)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES AND PRACTICES

Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary, Omega One Insurance Company (Omega). The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). In the opinion of management, all adjustments, consisting of normal and recurring items, necessary for the fair presentation of the consolidated financial statements have been included. All significant intercompany transactions and accounts have been eliminated in the consolidated financial statements. The financial information presented herein should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2018, which includes information and disclosures not presented herein.

Use of Estimates

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

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 2,529,352 at September 30, 2019 and 2,524,715 at September 30, 2018. The Company did not have any dilutive securities as of September 30, 2019 and 2018.

Reclassifications

Certain 2018 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2019 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, 2019, the net amount exceeding FDIC insured limits was \$5,655,000 at three financial institutions. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of financial institutions on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At September 30, 2019, the single largest balance due from one agent totaled \$539,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet its obligation could result in losses to the insurance subsidiaries. Allowances for losses on reinsurance recoverables are established if amounts are believed to be uncollectible. At September 30, 2019 and December 31, 2018, 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, 2019, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2018 AMOUNTS)

Accounting Changes Not Yet Adopted

Changes to the Disclosure Requirements for Fair Value Measurement

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

Targeted Improvements to the Accounting for Long-Duration Contracts

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

Contingent Put and Call Options in Debt Instruments

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

Financial Instruments - Credit Losses

In June 2016, the FASB issued guidance that replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The FASB released additional guidance in November 2018 that provides scope clarification. This guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within those years. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Recently Adopted Accounting Standards

Improvements to Nonemployee Share-Based Payment Accounting

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

Derivatives and Hedging

In August 2017, the FASB issued guidance that amends and simplifies hedge accounting guidance in order to enable entities to better portray the economic results of their risk management activities. The guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those periods. Early adoption is permitted. The Company adopted this guidance on January 1, 2019 and had two swaps designated as cash flow hedges. One expired March 15, 2019 and one expires March 15, 2020. The adoption of this guidance did not have a significant impact on our financial position, results of operations, cash flows or related disclosures.

THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2018 AMOUNTS)

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 (ROU) asset at the commencement date of the lease. Additional transition guidance was issued in 2018 and 2019. This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those years.

The Company adopted this guidance on January 1, 2019 and recorded a ROU asset of \$299,000 and corresponding lease liability of \$306,000. The ROU asset and operating lease liability are included in other assets and other liabilities, respectively, on our Condensed Consolidated Balance Sheets as of January 1, 2019. The Company elected the package of practical expedients permitted under the guidance, which allowed the Company to account for existing leases under their current classification, as well as omit any new costs classified as initial direct costs, under the new guidance. Based on this election, the Company kept existing agreements as operating leases. The Company also elected the practical expedient allowing an accounting policy election by class of underlying asset, to account for separate lease and nonlease components as a single lease component.

The Company leases automobiles and some office equipment. These leases are not considered material. Adoption of this guidance had no material impact on the Company's financial position, results of operations, cash flows or related disclosures.

NOTE 2 – VARIABLE INTEREST ENTITIES

The Company holds passive interests in limited partnerships that are considered to be Variable Interest Entities (VIE) under the provisions of ASC 810 *Consolidation*. The Company is not the primary beneficiary of the entities and is not required to consolidate under ASC 810. The entities are private placement investment funds formed for the purpose of investing in private equity investments. The Company owns less than 1% of the limited partnerships. The carrying value of the investments totals \$291,000 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 condensed consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$93,000 and are included in Other Assets in the accompanying condensed consolidated balance sheets.

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THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED AMOUNTS EXCEPT FOR DECEMBER 31, 2018 AMOUNTS)

NOTE 3 – INVESTMENTS

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

The amortized cost and aggregate fair values of investments in available-for-sale securities as of September 30, 2019 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government corporations and agencies	\$ 4,134	\$ 183	\$ —	\$ 4,317
Agency mortgage backed securities	30,665	1,182	127	31,720
Asset backed securities	10,002	66	101	9,967
Private label mortgage backed securities	7,019	587	—	7,606
Corporate bonds	38,261	1,715	119	39,857
States, municipalities and political subdivisions	7,546	144	—	7,690
Foreign governments	818	61	—	879
Total fixed maturities	98,445	3,938	347	102,036
Equity securities	1,849	2,536	—	4,385
Total	\$ 100,294	\$ 6,474	\$ 347	\$ 106,421

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of September 30, 2019 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Agency mortgage backed securities	\$ 1,349	\$ 81	\$ —	\$ 1,430
Total	\$ 1,349	\$ 81	\$ —	\$ 1,430

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

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

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

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

The amortized cost and aggregate fair value of debt securities at September 30, 2019, by contractual maturity, are presented in the following table (*dollars in thousands*). Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in Thousands)	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	\$ 2,424	\$ 2,423
Due after one year through five years	17,437	17,930
Due after five years through ten years	26,308	27,071
Due after ten years	52,276	54,612
Total	\$ 98,445	\$ 102,036
Held-to-maturity securities:		
Due after one year through five years	\$ 32	\$ 34
Due after five years through ten years	4	5
Due after ten years	1,313	1,391
Total	\$ 1,349	\$ 1,430

A summary of securities available-for-sale with unrealized losses as of September 30, 2019, 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*):

September 30, 2019	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	
Agency mortgage backed securities	\$ 3,534	\$ 71	\$ 1,921	\$ 56	\$ 5,455	\$ 127	16
Asset backed securities	5,243	89	1,809	12	7,052	101	10
Corporate bonds	6,467	67	2,447	52	8,914	119	16
	\$ 15,244	\$ 227	\$ 6,177	\$ 120	\$ 21,421	\$ 347	42

There were no securities held-to-maturity with unrealized losses as of September 30, 2019.

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

	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
December 31, 2018							
U.S. Government corporations and agencies	\$ —	\$ —	\$ 3,209	\$ 107	\$ 3,209	\$ 107	6
Agency mortgage backed securities	5,504	45	10,969	500	16,473	545	38
Asset backed securities	5,824	146	2,741	102	8,565	248	12
Private label mortgage backed securities	1,348	27	—	—	1,348	27	2
Corporate bonds	16,583	709	9,823	842	26,406	1,551	51
States, municipalities and political subdivisions	1,242	10	4,420	81	5,662	91	11
	<u>\$ 30,501</u>	<u>\$ 937</u>	<u>\$ 31,162</u>	<u>\$ 1,632</u>	<u>\$ 61,663</u>	<u>\$ 2,569</u>	<u>120</u>

A summary of securities held-to-maturity with unrealized losses as of December 31, 2018 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows (*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	
December 31, 2018							
Agency mortgage backed securities	\$ 1,026	\$ 22	\$ —	\$ —	\$ 1,026	\$ 22	2
	<u>\$ 1,026</u>	<u>\$ 22</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 1,026</u>	<u>\$ 22</u>	<u>2</u>

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

Management has evaluated each security in a significant unrealized loss position in the fixed maturity investment portfolio. The Company has no material exposure to sub-prime mortgage loans and approximately 5% of the fixed income investment portfolio is rated below investment grade. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the

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securities until market values recovered, it was determined that, other than the impairment described below, the securities in an accumulated loss position in the portfolio were temporary impairments.

For the nine months ended September 30, 2019, the Company realized no other-than-temporary impairments. For the year ended December 31, 2018, the Company realized \$16,000 other-than-temporary impairments. At September 30, 2019, the three largest losses not realized as an impairment in the fixed maturity portfolio totaled \$40,000, \$27,000 and \$25,000. Each of these losses were driven by changes in market interest rates. At December 31, 2018, the three largest losses not realized as an impairment was in the fixed maturity portfolio totaled \$145,000, \$99,000 and \$94,000.

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

	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
Fixed maturities	\$ 960	\$ 989	\$ 2,831	\$ 2,843
Equity securities	19	21	66	61
Mortgage loans on real estate	2	2	6	6
Investment real estate	—	1	3	2
Policy loans	37	35	106	105
Other	6	6	13	21
	<u>1,024</u>	<u>1,054</u>	<u>3,025</u>	<u>3,038</u>
Less: Investment expenses	35	37	117	106
Net investment income	<u>\$ 989</u>	<u>\$ 1,017</u>	<u>\$ 2,908</u>	<u>\$ 2,932</u>

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

	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
Realized gains (losses) on fixed maturities	\$ (24)	\$ 27	\$ (9)	\$ 156
Gains on trading securities	1	—	9	—
Change in fair value of equity securities	(80)	426	72	57
Change in surrender value of company owned life insurance	(14)	3	256	(133)
Realized gain on company owned life insurance	—	—	1,792	—
Other, principally real estate	—	—	—	(88)
Net investment gains (losses)	<u>\$ (117)</u>	<u>\$ 456</u>	<u>\$ 2,120</u>	<u>\$ (8)</u>

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

	September 30, 2019	December 31, 2018
Fixed maturities	\$ 5,343	\$ (3,042)
Deferred income tax	(1,122)	638
Change in net unrealized gains (losses) on available-for-sale securities	<u>\$ 4,221</u>	<u>\$ (2,404)</u>

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NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

Level 1 – Quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date. Level 1 assets and liabilities consist of money market fund deposits and certain of our marketable debt and equity instruments, including equity instruments offsetting deferred compensation, that are traded in an active market with sufficient volume and frequency of transactions.

Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets include certain of our marketable debt and equity instruments with quoted market prices that are traded in less active markets or priced using a quoted market price for similar instruments. Level 2 assets also include marketable equity instruments with security-specific restrictions that would transfer to the buyer, marketable debt instruments priced using indicator prices which represent non-binding market consensus prices that can be corroborated by observable market quotes, as well as derivative contracts and debt instruments priced using inputs that are observable in the market or can be derived principally from or corroborated by observable market data. Marketable debt instruments in this category generally include commercial paper, bank time deposits, repurchase agreements for fixed-income instruments, and a majority of floating-rate notes, corporate bonds, and municipal bonds.

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

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

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Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2019 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
U.S. Government corporations and agencies	\$ 4,317	\$ 4,317	\$ —	\$ —
Agency mortgage backed securities	31,720	18,154	13,566	—
Asset backed securities	9,967	2,728	7,239	—
Corporate bonds	39,857	—	39,857	—
Private label asset backed securities	7,606	1,240	6,366	—
States, municipalities and political subdivisions	7,690	—	7,690	—
Foreign governments	879	879	—	—
Trading securities	142	142	—	—
Equity securities	4,385	3,195	—	1,190
Total Financial Assets	\$ 106,563	\$ 30,655	\$ 74,718	\$ 1,190
Financial Liabilities				
Interest rate swap	\$ (118)	\$ —	\$ —	\$ (118)
Total Financial Liabilities	\$ (118)	\$ —	\$ —	\$ (118)

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 quoted market prices in active markets for identical assets are reflected within Level 1 while 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, 2019, Level 3 fair value measurements of assets include \$1,190,000 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, 2019, Level 3 fair value measurements of liabilities include \$118,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party that utilizes financial modeling

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tools and assumptions on interest and other factors. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 7.

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2019 (in thousands):

For the nine months September 30, 2019	Equity Securities	Interest Rate Swap
Beginning balance	\$ 1,125	\$ (234)
Total gains or losses (realized and unrealized):		
Included in earnings	65	—
Included in other comprehensive income	—	116
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	<u>\$ 1,190</u>	<u>\$ (118)</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, 2019:	<u>\$ —</u>	<u>\$ —</u>

For the nine months ended September 30, 2019, 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, 2018 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
U.S. Government corporations and agencies	\$ 4,744	\$ 4,147	\$ 597	\$ —
Agency mortgage backed securities	27,106	11,756	15,350	—
Asset backed securities	10,660	2,939	7,721	—
Corporate bonds	35,791	—	35,791	—
Private label asset backed securities	5,947	—	5,947	—
States, municipalities and political subdivisions	10,073	—	10,073	—
Foreign governments	804	804	—	—
Trading securities	107	107	—	—
Equity securities available-for-sale	4,306	3,181	—	1,125
Total Financial Assets	<u>\$ 99,538</u>	<u>\$ 22,934</u>	<u>\$ 75,479</u>	<u>\$ 1,125</u>
Financial Liabilities				
Interest rate swap	\$ (234)	\$ —	\$ —	\$ (234)
Total Financial Liabilities	<u>\$ (234)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (234)</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, 2018 (in thousands):

For the year ended December 31, 2018	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$ 1,073	\$ (608)
Total gains or losses (realized and unrealized):		
Included in earnings	52	—
Included in other comprehensive income	—	374
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$ 1,125	\$ (234)
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of December 31, 2018:		
	\$ —	\$ —

For the year ended December 31, 2018, 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, 2019 and December 31, 2018 are as follows (in thousands):

	September 30, 2019		December 31, 2018	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related instruments				
Held-to-maturity securities	\$ 1,349	\$ 1,430	\$ 1,449	\$ 1,443
Mortgage loans	148	148	156	156
Policy loans	1,854	1,854	1,854	1,854
Company owned life insurance	4,617	4,617	4,600	4,600
Other invested assets	2,286	2,286	2,148	2,148
Liabilities and related instruments				
Other policyholder funds	1,493	1,493	1,515	1,515
Short-term notes payable and current portion of long-term debt	2,200	2,200	2,200	2,200
Long-term debt	12,161	12,161	12,152	12,152

NOTE 5 – PROPERTY AND EQUIPMENT

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

	September 30, 2019	December 31, 2018
Building and improvements	\$ 3,431	\$ 3,378
Electronic data processing equipment	1,508	1,504
Furniture and fixtures	477	477
	5,416	5,359
Less accumulated depreciation	3,804	3,710
Property and equipment, net	\$ 1,612	\$ 1,649

Depreciation expense for the nine months ended September 30, 2019 was \$94,000 (\$161,000 for the year ended December 31, 2018).

NOTE 6 – INCOME TAXES

On December 22, 2017, the President signed the Tax Cuts and Jobs Act (TCJA), a comprehensive tax legislation which, among other things, reduced the Company's statutory federal income tax rate from 34% to 21% effective January 1, 2018. In addition to the reduction in tax rates, the TCJA made broad and complex changes to the Internal Revenue Code that introduced changes to many tax related exclusions, deductions and credits. At December 31, 2017, \$1,575,000 in AMT credit was booked as a deferred tax asset. Effective December 31, 2018, the Company recognized the AMT credit in federal income tax recoverable of which \$1,074,000 was recovered with the 2018 return and Management anticipates the remainder will be recovered by 2021 pursuant to allowable amounts under the TCJA. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax assets. The Company recognized a net deferred tax liability position of \$186,000 at September 30, 2019 and a net deferred tax asset position of \$716,000 at December 31, 2018.

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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, 2019	As of December 31, 2018
General expenses	\$ 1,152	\$ 1,067
Unearned premiums	1,379	1,265
Claims liabilities	582	552
Impairment on real estate owned	119	119
Unrealized losses on securities available-for-sale	—	368
Unrealized loss on interest rate swaps	25	49
Deferred tax assets	<u>3,257</u>	<u>3,420</u>
Trading securities	(2)	—
Depreciation	(79)	(79)
Deferred policy acquisition costs	(1,662)	(1,645)
Pre-1984 policyholder surplus account	(413)	(463)
Unrealized gains on securities available-for-sale	(533)	—
Unrealized gains on equity securities	(754)	(517)
Deferred tax liabilities	<u>(3,443)</u>	<u>(2,704)</u>
Net deferred tax asset (liability)	<u>\$ (186)</u>	<u>\$ 716</u>

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

	Nine months ended September 30,	
	2019	2018
Deferred policy acquisition costs	\$ 17	\$ (8)
Trading securities	2	—
Unearned premiums	(114)	(88)
General expenses	(85)	(27)
Depreciation	—	(9)
Claims liabilities	(30)	5
AMT credit	—	809
Impact of repeal of special provision on pre-1984 policyholder surplus	(50)	(49)
Unrealized gains on equity securities	15	12
Deferred income tax expense (benefit)	<u>\$ (245)</u>	<u>\$ 645</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,	
	2019	2018
Federal income tax rate applied to pre-tax income/loss	21.0 %	21.0 %
Dividends received deduction and tax-exempt interest	(0.5)%	(0.9)%
Company owned life insurance	(18.5)%	1.2 %
Other, net	(0.2)%	2.2 %
Effective federal income tax rate	<u>1.8 %</u>	<u>23.5 %</u>

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The Company recognizes tax-related interest and penalties as a component of tax expense. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2014. Tax returns have been filed through the year 2017.

NOTE 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, 2019 and December 31, 2018 (*dollars in thousands*):

	September 30, 2019	December 31, 2018
Current portion of installment note payable due in November with variable interest rate equal to the WSJ prime rate plus 0.5%. Unsecured.	\$ 2,200	\$ 2,200
	<u>\$ 2,200</u>	<u>\$ 2,200</u>

Long-term debt consisted of the following as of September 30, 2019 and December 31, 2018 (*dollars in thousands*):

	September 30, 2019	December 31, 2018
Subordinated debentures issued on December 15, 2005 with floating rate interest equal to 3-Month LIBOR plus 375 basis points; net of \$152,000 in debt issuance cost (\$159,000 in 2018); maturity December 2035. Interest payable quarterly. Redeemable prior to maturity. Unsecured.	\$ 9,127	\$ 9,120
Subordinated debentures issued on June 21, 2007 with floating rate interest equal to 3-Month LIBOR plus 340 basis points; net of \$59,000 in debt issuance cost (\$61,000 in 2018); maturity June 15, 2037. Interest payable quarterly. Redeemable prior to maturity. Unsecured.	3,034	3,032
	<u>\$ 12,161</u>	<u>\$ 12,152</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, which expired on March 15, 2019, the Company paid 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 \$0 and \$118,000 (liability), respectively, for a total liability of \$118,000 at September 30, 2019 (\$234,000 at December 31, 2018). The swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of \$92,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements at September 30, 2019. A net valuation gain of \$295,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2018.

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.

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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, 2019, the Company has securities on deposit with fair market values of \$296,000 (\$296,000 all of which is posted as collateral). At December 31, 2018, the Company had securities on deposit with fair market values of \$932,000 (all of which is posted as collateral). See Note 4 for additional information about the interest rate swaps.

NOTE 8 – POLICY AND CLAIM RESERVES

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

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

	Nine months ended September 30,	
	2019	2018
Summary of claims and claim adjustment expense reserves		
Balance, beginning of year	\$ 8,208	\$ 7,075
Less reinsurance recoverable on unpaid losses	1,384	327
Net balances at beginning of year	6,824	6,748
Net losses:		
Provision for claims and claim adjustment expenses for claims arising in current year	27,126	25,460
Estimated claims and claim adjustment expenses for claims arising in prior years	(1,014)	(250)
Total increases	26,112	25,210
Claims and claim adjustment expense payments for claims arising in:		
Current year	22,694	20,906
Prior years	3,496	3,592
Total payments	26,190	24,498
Net balance at end of period	6,746	7,460
Plus reinsurance recoverable on unpaid losses	211	184
Claims and claim adjustment expense reserves at end of period	\$ 6,957	\$ 7,644

Claim and claim adjustment expense reserves before reinsurance recoverable at September 30, 2019 was comparable to the same period last year. Reinsurance recoverable on unpaid losses was higher due to amounts recoverable on unpaid losses associated with Hurricane Michael. The estimate for claims arising in prior years was reduced \$1,014,000 in 2019 (reduced \$250,000 in 2018) due to favorable loss development during the year on claims arising in prior years.

Accident and Health Claim Reserves

The Company, through its life insurance subsidiary, underwrites a limited number of short duration accident and health contracts. These claims are typically settled in three years or less and the reserve for unpaid claims totaled \$403,000 at September 30, 2019 (\$358,000 at December 31, 2018). These claims are a component of policy and contract claims which totaled \$956,000 at September 30, 2019 (\$792,000 at December 31, 2018).

NOTE 9 – REINSURANCE

The Company's insurance operations utilize reinsurance in the risk management process in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is placed through yearly renewable term coverage. Property and casualty reinsurance

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is placed on an excess of loss basis to cover losses from catastrophe events. Reinsurance contracts do not relieve the insurance subsidiaries of the obligation indemnify policyholders with respect to the underlying insurance contracts. Failure of re-insurers to honor their obligations could result in credit related losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurance companies and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the companies to minimize their exposure to significant losses from reinsurance insolvencies.

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

Under the catastrophe reinsurance program, the Company retains the first \$4,000,000 in losses from the first catastrophe event and \$2,000,000 from a second 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
Underlying 2nd Event	100% of \$2,000,000 in excess of \$2,000,000 retention

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

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

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

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

At September 30, 2019, the largest reinsurance recoverable of a single reinsurer was \$12,000 (\$125,000 at December 31, 2018). Amounts reported as ceded incurred losses were related to development of losses from prior year catastrophes.

NOTE 10 – 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, 2019 and 2018 amounted to \$136,000 and \$135,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limits.

The Company established a non-qualified plan under which Company directors are allowed to defer all or a portion of directors' fees into various investment options. A supplemental executive retirement plan (SERP) covers named executive officers, with the Company contributing 15% of executive compensation to the plan. Contributions to the plan are fully vested upon the earlier of death, disability, change in control, or ten years of participation in the plan. Costs for amounts related to the non-qualified deferred compensation plans for the nine months ended September 30,

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2019 and 2018 amounted to an approximate increase of \$412,000 and \$128,000 in employee benefit related expenses, respectively.

The Company and its subsidiaries established an Employee Stock Ownership Plan (ESOP) in January 2010, to enable eligible employees to acquire a proprietary interest in the Company's common stock and to provide retirement and other benefits to such employees. There were no contributions during the nine months ended September 30, 2019 and contributions of \$232,000 during the nine months ended September 30, 2018. All contributions were made in cash for purchase of Company shares in the open market. The Company has not allocated newly issued shares directly to the plan and the plan has no debt.

NOTE 11 – SHAREHOLDERS' EQUITY

During the nine months ended September 30, 2019 and year ended December 31, 2018, changes in shareholders' equity consisted of net income of \$2,286,000 and net income of \$779,000, respectively; dividends paid of \$379,000 in 2019 and \$505,000 in 2018; other comprehensive income of \$4,313,000 in 2019 and other comprehensive loss of \$2,109,000 in 2018. Other comprehensive income/loss consisted of changes in accumulated unrealized gains/losses on securities available-for-sale and changes in accumulated unrealized losses on interest rate swaps.

Preferred Stock

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

Common Stock

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

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

The table below provides information regarding the Company's preferred and common stock as of September 30, 2019 and December 31, 2018:

	September 30, 2019			December 31, 2018		
	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	2,531,552	2,531,552	3,000,000	2,527,136	2,527,136

On May 17, 2019, 4,416 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

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NOTE 12 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

	Nine months ended September 30,	
	2019	2018
Gains and Losses on Cash Flow Hedges		
Balance at beginning of period	\$ (185)	\$ (480)
Other comprehensive income for period:		
Other comprehensive gain before reclassifications	92	265
Net current period other comprehensive income	92	265
Balance at end of period	<u>\$ (93)</u>	<u>\$ (215)</u>
Unrealized Gains and Losses on Available-for-Sale Securities		
Balance at beginning of period	\$ (1,385)	\$ 3,126
Other comprehensive income (loss) for period:		
Other comprehensive income (loss) before reclassifications	4,228	(2,459)
Reclassification adjustment - gains on equity securities	—	(2,107)
Amounts reclassified from accumulated other comprehensive income (loss)	(7)	(123)
Net current period other comprehensive income (loss)	4,221	(4,689)
Balance at end of period	<u>\$ 2,836</u>	<u>\$ (1,563)</u>
Total Accumulated Other Comprehensive Income (Loss) at end of period	<u>\$ 2,743</u>	<u>\$ (1,778)</u>

The following table presents the amounts reclassified out of AOCI for the nine months ended September 30, 2019 (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	\$ (9)	Net investment losses
	(9)	Total before tax
	2	Tax (expense) or benefit
	<u>\$ (7)</u>	Net of Tax

The following table presents the amounts reclassified out of AOCI for the nine months ended September 30, 2018 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	\$ 156	Net investment gains
	156	Total before tax
	(33)	Tax (expense) or benefit
	<u>\$ 123</u>	Net of Tax

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NOTE 13 – SEGMENTS

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

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

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

Total assets by industry segment at September 30, 2019 and December 31, 2018 are summarized below (*dollars in thousands*):

<i>Assets by industry segment</i>	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
<i>September 30, 2019</i>	\$ 154,112	\$ 85,083	\$ 64,809	\$ 4,220
<i>December 31, 2018</i>	\$ 144,231	\$ 80,994	\$ 59,479	\$ 3,758

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Premium revenues and operating income by business segment for the three and nine months ended September 30, 2019 and 2018 are summarized below (*dollars in thousands*):

Three months ended September 30, 2019	P&C Insurance Operations	Life Insurance Operations	Non- Insurance Operations	Inter-company Eliminations	Total
REVENUE					
Net premiums earned	\$ 13,628	\$ 1,581	\$ —	\$ —	\$ 15,209
Net investment income	404	708	12	(135)	989
Investment gains (losses)	(50)	(68)	1	—	(117)
Other income	148	226	266	(492)	148
	<u>14,130</u>	<u>2,447</u>	<u>279</u>	<u>(627)</u>	<u>16,229</u>
BENEFITS AND EXPENSES					
Policyholder benefits paid	8,564	1,303	—	(117)	9,750
Amortization of deferred policy acquisition costs	681	124	—	—	805
Commissions	1,919	87	—	—	2,006
General and administrative expenses	2,070	531	135	(510)	2,226
Taxes, licenses and fees	528	76	—	—	604
Interest expense	—	13	280	—	293
	<u>13,762</u>	<u>2,134</u>	<u>415</u>	<u>(627)</u>	<u>15,684</u>
Income (Loss) Before Income Taxes	368	313	(136)	—	545
INCOME TAX EXPENSE (BENEFIT)	76	67	(28)	—	115
Net Income (Loss)	\$ 292	\$ 246	\$ (108)	\$ —	\$ 430

Three months ended September 30, 2018	P&C Insurance Operations	Life Insurance Operations	Non- Insurance Operations	Inter-company Eliminations	Total
REVENUE					
Net premiums earned	\$ 13,818	\$ 1,627	\$ —	\$ —	\$ 15,445
Net investment income	428	710	14	(135)	1,017
Investment gains	270	186	—	—	456
Other income	146	250	266	(514)	148
	<u>14,662</u>	<u>2,773</u>	<u>280</u>	<u>(649)</u>	<u>17,066</u>
BENEFITS AND EXPENSES					
Policyholder benefits paid	8,731	1,215	—	(121)	9,825
Amortization of deferred policy acquisition costs	689	93	—	—	782
Commissions	1,932	71	—	—	2,003
General and administrative expenses	2,085	676	171	(528)	2,404
Taxes, licenses and fees	516	51	—	—	567
Interest expense	—	10	296	—	306
	<u>13,953</u>	<u>2,116</u>	<u>467</u>	<u>(649)</u>	<u>15,887</u>
Income (Loss) Before Income Taxes	709	657	(187)	—	1,179
INCOME TAX EXPENSE (BENEFIT)	144	168	(40)	—	272
Net Income (Loss)	\$ 565	\$ 489	\$ (147)	\$ —	\$ 907

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Nine months ended September 30, 2019	P&C Insurance Operations	Life Insurance Operations	Non- Insurance Operations	Inter- company Eliminations	Total
REVENUE					
Net premiums earned	\$ 40,356	\$ 4,561	\$ —	\$ —	\$ 44,917
Net investment income	1,255	2,022	36	(405)	2,908
Investment gains	1,991	109	20	—	2,120
Other income	430	689	785	(1,464)	440
	<u>44,032</u>	<u>7,381</u>	<u>841</u>	<u>(1,869)</u>	<u>50,385</u>
BENEFITS AND EXPENSES					
Policyholder benefits paid	26,112	3,916	—	(355)	29,673
Amortization of deferred policy acquisition costs	2,043	581	—	—	2,624
Commissions	5,795	222	—	—	6,017
General and administrative expenses	6,200	1,471	817	(1,514)	6,974
Taxes, licenses and fees	1,659	231	—	—	1,890
Interest expense	—	34	845	—	879
	<u>41,809</u>	<u>6,455</u>	<u>1,662</u>	<u>(1,869)</u>	<u>48,057</u>
Income (Loss) Before Income Taxes	2,223	926	(821)	—	2,328
INCOME TAX EXPENSE (BENEFIT)	33	186	(177)	—	42
Net Income (Loss)	\$ 2,190	\$ 740	\$ (644)	\$ —	\$ 2,286

Nine months ended September 30, 2018	P&C Insurance Operations	Life Insurance Operations	Non- Insurance Operations	Inter- company Eliminations	Total
REVENUE					
Net premiums earned	\$ 41,060	\$ 4,704	\$ —	\$ —	\$ 45,764
Net investment income	1,253	2,042	42	(405)	2,932
Investment gains (losses)	(101)	93	—	—	(8)
Other income	454	713	772	(1,482)	457
	<u>42,666</u>	<u>7,552</u>	<u>814</u>	<u>(1,887)</u>	<u>49,145</u>
BENEFITS AND EXPENSES					
Policyholder benefits paid	25,210	4,187	—	(373)	29,024
Amortization of deferred policy acquisition costs	2,069	303	—	—	2,372
Commissions	5,609	186	—	—	5,795
General and administrative expenses	6,198	1,907	484	(1,514)	7,075
Taxes, licenses and fees	1,382	183	—	—	1,565
Interest expense	—	35	882	—	917
	<u>40,468</u>	<u>6,801</u>	<u>1,366</u>	<u>(1,887)</u>	<u>46,748</u>
Income (Loss) Before Income Taxes	2,198	751	(552)	—	2,397
INCOME TAX EXPENSE (BENEFIT)	477	201	(116)	—	562
Net Income (Loss)	\$ 1,721	\$ 550	\$ (436)	\$ —	\$ 1,835

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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, 2019 and 2018, respectively:

	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
Life, accident and health operations premiums written:				
Traditional life insurance	\$ 1,062	\$ 1,083	\$ 3,151	\$ 3,280
Accident and health insurance	623	617	1,376	1,428
Gross life, accident and health	1,685	1,700	4,527	4,708
Reinsurance premium ceded	(11)	(11)	(64)	(70)
Net life, accident and health premiums written	\$ 1,674	\$ 1,689	\$ 4,463	\$ 4,638
Property and Casualty operations premiums written:				
Dwelling fire & extended coverage	\$ 9,927	\$ 9,515	\$ 30,266	\$ 29,181
Homeowners (Including mobile homeowners)	5,235	5,406	16,098	16,782
Other liability	561	557	1,743	1,716
Gross property and casualty	15,723	15,478	48,107	47,679
Reinsurance premium ceded	(1,930)	(1,738)	(5,155)	(4,627)
Net property and casualty written	\$ 13,793	\$ 13,740	\$ 42,952	\$ 43,052
Consolidated gross premiums written	\$ 17,408	\$ 17,178	\$ 52,634	\$ 52,387
Reinsurance premium ceded	(1,941)	(1,749)	(5,219)	(4,697)
Consolidated net premiums written	\$ 15,467	\$ 15,429	\$ 47,415	\$ 47,690

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, 2019 and 2018, respectively:

	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
Life, accident and health operations premiums earned:				
Traditional life insurance	\$ 1,008	\$ 1,021	\$ 3,249	\$ 3,347
Accident and health insurance	584	617	1,376	1,427
Gross life, accident and health	1,592	1,638	4,625	4,774
Reinsurance premium ceded	(11)	(11)	(64)	(70)
Net life, accident and health premiums earned	\$ 1,581	\$ 1,627	\$ 4,561	\$ 4,704
Property and Casualty operations premiums earned:				
Dwelling fire & extended coverage	\$ 9,644	\$ 9,403	\$ 28,401	\$ 27,792
Homeowners (Including mobile homeowners)	5,178	5,449	15,585	16,420
Other liability	560	552	1,654	1,628
Gross property and casualty	15,382	15,404	45,640	45,840
Reinsurance premium ceded	(1,754)	(1,586)	(5,284)	(4,780)
Net property and casualty earned	\$ 13,628	\$ 13,818	\$ 40,356	\$ 41,060
Consolidated gross premiums earned	\$ 16,974	\$ 17,042	\$ 50,265	\$ 50,614
Reinsurance premium ceded	(1,765)	(1,597)	(5,348)	(4,850)
Consolidated net premiums earned	\$ 15,209	\$ 15,445	\$ 44,917	\$ 45,764

THE NATIONAL SECURITY GROUP, INC.
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NOTE 14 – CONTINGENCIES

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

The Company's property & casualty subsidiaries had one action remaining in Texas filed in the aftermath of Hurricane Ike at September 30, 2019. This is an individual action with allegations of underpayment of a hurricane-related claim. The suit seeks a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief.

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

NOTE 15 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the nine months ended September 30, 2019 was \$774,000 (\$804,000 in 2018). Cash received from income taxes during the nine months ended September 30, 2019 was \$373,000. There was no cash received from or paid for income taxes during the nine months ended September 30, 2018.

During the nine months ended September 30, 2019, non-cash changes in equity included \$5,000 in common stock issued to Directors in lieu of cash compensation along with a corresponding \$48,000 increase in additional paid-in capital.

NOTE 16 – SUBSEQUENT EVENTS

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

REVIEW OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

Results of Review of Interim Financial Information

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. (the Company) as of September 30, 2019, and the related condensed consolidated statements of operations and comprehensive income (loss) for the three-month and nine-month periods ended September 30, 2019 and 2018, the condensed consolidated statements of changes in shareholders' equity and cash flows for the nine-month periods ended September 30, 2019 and 2018, and the related notes (collectively referred to as the interim financial statements). Based on our reviews, we are not aware of any material modifications that should be made to the accompanying interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheet of the Company as of December 31, 2018, and the related consolidated statements of operations, comprehensive income (loss), changes in shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 15, 2019, 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, 2018, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Basis for Review Results

These interim financial statements are the responsibility of the Company's management. We conducted our review in accordance with the standards of the PCAOB. 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 PCAOB, 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. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB

/s/ Warren Averett, LLC
Birmingham, Alabama

November 13, 2019

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 and nine month periods ended September 30, 2019 and 2018.

The National Security Group, Inc. operates in ten states with 46.0% of total premium revenue generated in the states of Alabama and Mississippi. The Company is made up of the following two segments:

- The Property and Casualty (P&C) segment is the most significant segment, accounting for 90.8% of gross earned premium in 2019. The P&C segment has insurance policies in-force in the states of Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, and Tennessee.
- The Life segment accounted for 9.2% of gross premium revenue in 2019. The Life segment is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

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

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

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

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

All of our insurance companies have been assigned ratings by A.M. Best Co (Best). On April 11, 2019, A. M. Best affirmed the Financial Strength Rating (FSR) of B++ (Good) and the Long-Term Issuer Credit Rating (Long-Term ICR) of "bbb" of NSFC. In addition, A.M. Best affirmed the FSR of B+ (Good) and Long-Term ICR of "bbb-" of Omega. The A.M. Best outlook for the ratings is "stable" for NSFC and Omega. A.M. Best upgraded the FSR to B++ (Good) and the Long-Term ICR to "bbb" for NSIC. The outlook for the ratings of NSIC is "stable". A.M. Best also affirmed the Long-Term ICR of "bb" of the parent holding company, NSEC, with a "stable" outlook.

The property and casualty subsidiaries have been assigned ratings by Demotech, Inc. On September 30, 2019, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

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

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A primary process management utilizes to review financial information of the Company is evaluating the operating performance of each segment before intercompany eliminations. By performing the evaluation in this manner, management can assess the profitability of each segment on a standalone basis. We have altered the presentation of our Management Discussion and Analysis related to industry segment data to provide pretax income by segment before eliminations. We have restated prior year to follow the same format. Note 13 to the condensed consolidated financial statements in this Form 10-Q contains a reconciliation of net income by segment to consolidated net income.

This discussion and analysis of the consolidated results of operations and financial condition of the Company should be read in conjunction with the Selected Financial Data and Consolidated Financial Statements and related notes included in our Form 10-K for the period ended December 31, 2018. Please refer to our note regarding forward-looking statements on page 4 of this report.

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

Summary:

For the three months ended September 30, 2019, the Company had net income of \$430,000, \$0.17 income per share, compared to net income of \$907,000, \$0.36 income per share, for the three months ended September 30, 2018; a quarterly decline of \$477,000. The decrease in net income was driven by a 1.5% decline in net premiums earned coupled with investment losses for the third quarter of 2019 compared to investment gains in the third quarter of 2018. Pretax income from operations for the third quarter of 2019 totaled \$662,000 compared to a pretax income from operations of \$723,000 in the third quarter of 2018. The primary reason for the \$61,000 decline in pretax income from operations in the third quarter of 2019, compared to the same period in 2018, was a \$236,000 decrease in net premiums earned. The decline in net premiums earned was due to an increase in ceded premium related to higher cost of catastrophe reinsurance in our P&C segment.

For the nine months ended September 30, 2019, the Company had net income of \$2,286,000, \$0.90 income per share, compared to a net income of \$1,835,000, \$0.73 income per share, for the nine months ended September 30, 2018. The year to date pretax income from operations in 2019 totaled \$208,000 compared to a pretax income from operations of \$2,405,000 in 2018. The primary reason for the \$2,197,000 decrease in pretax income from operations in 2019, compared to the same period in 2018, was a \$649,000 increase in policyholder benefits (primarily driven by an increase in claims in the P&C segment) coupled with a \$847,000 decrease in net premiums earned. The decline in net premiums earned was due to an 10.3% increase in ceded premium related to higher cost of catastrophe reinsurance in our P&C segment.

Financial results for the three and nine months ended September 30, 2019 and 2018 were as follows:

Unaudited Consolidated Financial Summary <i>(dollars in thousands, except per share)</i>	Three months ended September 30,		Nine months ended September 30,	
	2019	2018	2019	2018
Gross premiums written	\$ 17,408	\$ 17,178	\$ 52,634	\$ 52,387
Net premiums written	\$ 15,467	\$ 15,429	\$ 47,415	\$ 47,690
Net premiums earned	\$ 15,209	\$ 15,445	\$ 44,917	\$ 45,764
Net investment income	989	1,017	2,908	2,932
Net investment gains (losses)	(117)	456	2,120	(8)
Other income	148	148	440	457
Total Revenues	16,229	17,066	50,385	49,145
Policyholder benefits and settlement expenses	9,750	9,825	29,673	29,024
Amortization of deferred policy acquisition costs	805	782	2,624	2,372
Commissions	2,006	2,003	6,017	5,795
General and administrative expenses	2,226	2,404	6,974	7,075
Taxes, licenses and fees	604	567	1,890	1,565
Interest expense	293	306	879	917
Total Benefits, Losses and Expenses	15,684	15,887	48,057	46,748
Income Before Income Taxes	545	1,179	2,328	2,397
Income tax expense	115	272	42	562
Net Income	\$ 430	\$ 907	\$ 2,286	\$ 1,835
Income Per Common Share	\$ 0.17	\$ 0.36	\$ 0.90	\$ 0.73
Reconciliation of Net Income to non-GAAP Measurement				
Net income	\$ 430	\$ 907	\$ 2,286	\$ 1,835
Income tax expense	115	272	42	562
Investment (gains) losses, net	117	(456)	(2,120)	8
Pretax Income From Operations	\$ 662	\$ 723	\$ 208	\$ 2,405

Three-month period ended September 30, 2019 compared to three-month period ended September 30, 2018

Premium Revenue:

For the three-month period ended September 30, 2019, net premiums earned were down \$236,000 at \$15,209,000 compared to \$15,445,000 during the same period in 2018. The decrease in premium revenue was primarily attributable to a 1.4% decrease in net premiums earned in the P&C segment coupled with a 2.8% decrease in net premiums earned in the Life segment.

Investment Gains (Losses):

Investment losses for the three-month period ended September 30, 2019 were \$117,000 compared to investment gains of \$456,000 for the three-month period ended September 30, 2018. The primary reason for the \$573,000 decrease in third quarter investment losses compared to the third quarter of 2018 investment gains was a decrease in value of equity investments held for sale.

In January of 2016, the FASB issued guidance that requires equity investments to be measured at fair value with changes in fair value recognized in net income through investment gains and losses. For us, this guidance became effective January 1, 2018 and is a decrease in market value of our equity securities of \$80,000 and was the primary factor contributing to the investment losses in third quarter 2019. In addition, we had a \$24,000 realized loss on the sale of fixed income securities.

Net Income:

For the quarter ended September 30, 2019, the Company had net income of \$430,000, \$0.17 income per share, compared to net income of \$907,000, \$0.36 income per share, for the same period in 2018; a decline of \$477,000. As discussed above, a \$236,000 decline in net premiums earned coupled with a \$573,000 change in investment losses were the primary factors contributing to the decrease in net income in the third quarter of the current year compared to the same period last year.

Pretax Income from Operations:

For the three months ended September 30, 2019, our pretax income from operations was \$662,000 compared to pretax income from operations of \$723,000 for the three months ended September 30, 2018; a decrease of \$61,000. A 1.5% decrease in net premiums earned was the primary reason for the decrease in pretax income from operations in the third quarter of 2019 compared to the third quarter of 2018.

P&C Segment Combined Ratio:

In order to present information as analyzed by Company management, the P&C segment combined ratio in this Management Discussion and Analysis is presented before certain intercompany eliminations. These intercompany eliminations, which are presented in Note 13 to the Condensed Consolidated Financial Statements, primarily include management and service fees paid by each subsidiary to NSEC, along with fees and expenses of the Company's employee claims adjusters. Claims adjusters are employees of NSIC but provide claim adjustment services to NSFC at rates comparable to those paid to independent (non-employee) adjusters utilized by NSFC. Management believes that the analysis of the P&C segment combined ratio prior to elimination of the intercompany transactions provides a more realistic view of performance.

The P&C segment ended the third quarter of 2019 with a GAAP basis combined ratio of 99.9%. Reported catastrophe losses totaled \$1,942,000 for the quarter and added 14.1 percentage points to the combined ratio. In comparison, the P&C segment ended the third quarter of 2018 with a GAAP basis combined ratio of 99.9% with catastrophe losses increasing the combined ratio by 13.6 percentage points. Partially offsetting the increase in reported catastrophe losses in the third quarter of 2019 was a reduction in reported non-catastrophe wind and hail losses of \$227,000 in the third quarter of 2019 compared to the third quarter of 2018. Reported non-catastrophe wind and hail losses for the third quarter of 2019 totaled \$1,607,000 and added 11.7 percentage points to the third quarter 2019 combined ratio. In comparison, third quarter 2018 reported non-catastrophe wind and hail losses totaled \$1,834,000 and added 13.1 percentage points to the third quarter 2018 combined ratio.

Nine-month period ended September 30, 2019 compared to nine-month period ended September 30, 2018

Premium Revenue:

For the nine-month period ended September 30, 2019, net premiums earned were down \$847,000 at \$44,917,000 compared to \$45,764,000 during the same period in 2018. The decrease in premium revenue was primarily driven by a decline in net earned premium in the P&C segment of \$704,000. The decline in gross earned premium was primarily

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attributable to a decrease in our surplus lines business in coastal Louisiana. In addition, P&C segment ceded premium was up \$504,000 or 10.5%, in 2019, compared to the same period in 2018 due to an increase in cost of our catastrophe reinsurance.

Investment Gains (Losses):

Investment gains for the nine-month period ended September 30, 2019 were \$2,120,000 compared to investment losses of \$8,000 for the nine-month period ended September 30, 2018. The primary reason for the increase in 2019 investment gains compared to the 2018 investment losses was a gain on our company owned life insurance (COLI) investment of \$1,792,000.

In 2018, due to a change in GAAP, unrealized gains and losses on equity investments are required to be reported as a component of investment gains/losses on the statement of operations. These amounts were previously reported as a component of Other Comprehensive Income. For the nine months ended September 30, 2019, investment gains include a \$72,000 increase in accumulated gains on equity securities held for investment. This increase in accumulated gains was driven by an overall improvement in stock market returns experienced in the third quarter of 2019.

Net Income:

For the nine months ended September 30, 2019, the Company had net income of \$2,286,000, \$0.90 income per share, compared to net income of \$1,835,000, \$0.73 income per share, for the same period in 2018. The primary reason for the increase in 2019 earnings compared to 2018 earnings was the gain on company owned life insurance mentioned previously.

Pretax Income from Operations:

For the nine-month period ended September 30, 2019, our pretax income from operations was \$208,000 compared to a pretax income from operations of \$2,405,000 for the nine-month period ended September 30, 2018; a decrease of \$2,197,000. The primary reasons for the decline in pretax income from operations in the 2019 compared to the pretax income from operations for same period in 2018 was a \$649,000 increase in claims coupled with a decrease of \$847,000 in net premiums earned driven by an increase in ceded premium related to our catastrophe reinsurance cost.

P&C Segment Combined Ratio:

For the nine months ended September 30, 2019, the P&C segment had a GAAP combined ratio of 102.5%. Reported claims from cat events totaling \$4,805,000 combined with reported claims from non-catastrophe wind and hail totaling \$6,791,000 increased the P&C segment combined ratio in 2019 by 28.4 percentage points. In comparison, for the nine months ended September 30, 2018, the P&C segment had a GAAP combined ratio of 97.5%. Reported claims from cat events totaling \$4,378,000 combined with reported claims from non-catastrophe wind and hail totaling \$5,111,000 increased the P&C segment combined ratio in 2018 by 22.9 percentage points. Partially offsetting the increase in catastrophe losses and non-cat wind and hail losses in 2019 was a decrease in reported fire losses of \$804,000 compared to the same period in the prior year.

Overview - Balance Sheet highlights at September 30, 2019 compared to December 31, 2018

Selected Balance Sheet Highlights	September 30, 2019	December 31, 2018
<i>(dollars in thousands)</i>	<i>(UNAUDITED)</i>	
Invested Assets	\$ 119,792	\$ 112,690
Cash	\$ 9,085	\$ 5,676
Total Assets	\$ 154,112	\$ 144,231
Policy Liabilities	\$ 80,138	\$ 77,988
Total Debt	\$ 14,361	\$ 14,352
Accumulated Other Comprehensive Income (Loss)	\$ 2,743	\$ (1,570)
Shareholders' Equity	\$ 52,139	\$ 45,866
Book Value Per Share	\$ 20.59	\$ 18.15

Invested Assets:

Invested assets as of September 30, 2019 were \$119,792,000 compared to \$112,690,000 as of December 31, 2018; an increase of 6.3%. The increase in invested assets was due to reinvestment of \$3,425,000 in positive cash flow from operating activities coupled with a \$5,343,000 increase in market value of fixed income securities available for sale. Significant declines in market interest rates over the past nine months was the primary driver of the increase in market value of fixed income securities.

Cash:

The Company, primarily through its insurance subsidiaries, had \$9,085,000 in cash and cash equivalents at September 30, 2019, compared to \$5,676,000 at December 31, 2018. The primary reason for the increase in cash and cash equivalents compared to last year was timing in reinvestment of positive cash flow from operations coupled with the accumulation of cash at the holding company level in anticipation of the repayment of short term debt in the fourth quarter of 2019.

Total Assets:

Total assets as of September 30, 2019 were \$154,112,000 compared to \$144,231,000 at December 31, 2018. Positive cash flow from insurance operations contributed to an increase in purchases of fixed maturity securities and a \$5,343,000 increase in market value of our portfolio of fixed maturity securities further contributed to the increase in total assets for the first nine months of 2019.

Policy Liabilities:

Policy related liabilities were \$80,138,000 at September 30, 2019, compared to \$77,988,000 at December 31, 2018; an increase of \$2,150,000 or 2.8%. The primary reason for the increase in policy liabilities in 2019 compared to 2018 was a \$2,696,000 increase in unearned premium. This increase in unearned premium is seasonal as we typically issue and renew a larger number of annual insurance contracts during the first half of the year compared to the remainder of the year.

Debt Outstanding:

Total debt at September 30, 2019 was virtually unchanged at \$14,361,000 compared to \$14,352,000 at December 31, 2018.

Shareholders' Equity:

Shareholders' equity as of September 30, 2019 was \$52,139,000, up \$6,273,000 compared to December 31, 2018 Shareholders' equity of \$45,866,000. Book value per share was \$20.59 at September 30, 2019, compared to \$18.15 per share at December 31, 2018; an increase of 13.4% or \$2.44 per share. The primary factors contributing to the increase in both book value per share and Shareholders' equity were net income of \$2,286,000 and accumulated other comprehensive income of \$4,313,000. Offsetting the increase in Shareholders' equity was shareholder dividends paid of \$379,000.

Three Months Ended September 30, 2019 compared to Three Months Ended September 30, 2018

Premium Revenue:

The table below provides earned premium revenue by segment for the three months ended September 30, 2019 and 2018 (*dollars in thousands*):

	Three months ended September 30,		Percent increase (decrease)
	2019	2018	
Life, accident and health operations premiums earned:			
Traditional life insurance	\$ 1,008	\$ 1,021	(1.3)%
Accident and health insurance	584	617	(5.3)%
Gross life, accident and health	1,592	1,638	(2.8)%
Reinsurance premium ceded	(11)	(11)	— %
Net life, accident and health premiums earned	<u>\$ 1,581</u>	<u>\$ 1,627</u>	<u>(2.8)%</u>
Property and Casualty operations premiums earned:			
Dwelling fire & extended coverage	\$ 9,644	\$ 9,403	2.6 %
Homeowners (Including mobile homeowners)	5,178	5,449	(5.0)%
Other liability	560	552	1.4 %
Gross property and casualty	15,382	15,404	(0.1)%
Reinsurance premium ceded	(1,754)	(1,586)	10.6 %
Net property and casualty premiums earned	<u>\$ 13,628</u>	<u>\$ 13,818</u>	<u>(1.4)%</u>
Consolidated gross premiums earned	\$ 16,974	\$ 17,042	(0.4)%
Reinsurance premium ceded	(1,765)	(1,597)	10.5 %
Consolidated net premiums earned	<u>\$ 15,209</u>	<u>\$ 15,445</u>	<u>(1.5)%</u>

Consolidated net premium earned was down 1.5% for the quarter ended September 30, 2019, at \$15,209,000 compared to \$15,445,000 for the quarter ended September 30, 2018. The decrease in net premium earned was due to a 1.4% decrease in net premium earned in the P&C segment coupled with a 2.8% decrease in net premium earned in the Life segment. Premium growth has slowed due to a combination of competitive pressures in some states, particularly Louisiana, and the smaller size of the specialty market in which we operate. We have made modifications to our products and eased some underwriting restrictions in order to remain competitive through the current market cycle. However, we do not intend to sacrifice overall underwriting profitability with significant rate cuts in order to increase top line revenue growth.

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The table below provides the major categories of investment income, primarily dividend and interest income, for the three months ended September 30, 2019 and 2018 (*dollars in thousands*):

	Three months ended September 30,	
	2019	2018
Fixed maturities	\$ 960	\$ 989
Equity securities	19	21
Mortgage loans on real estate	2	2
Investment real estate	—	1
Policy loans	37	35
Other	6	6
	<u>1,024</u>	<u>1,054</u>
Less: Investment expenses	35	37
Net investment income	<u>\$ 989</u>	<u>\$ 1,017</u>

For the three months ended September 30, 2019, net investment income was \$989,000 compared to \$1,017,000 for the same period in 2018; a moderate decrease of \$28,000 or 2.8%.

Investment Gains and Losses:

The table below provides investment gains and losses for the three months ended September 30, 2019 and 2018 (*dollars in thousands*):

	Three months ended September 30,	
	2019	2018
Realized gains (losses) on fixed maturities	\$ (24)	\$ 27
Gains on trading securities	1	—
Change in fair value of equity securities	(80)	426
Change in surrender value of company owned life insurance	(14)	3
Other, principally real estate	—	—
Net investment gains (losses)	<u>\$ (117)</u>	<u>\$ 456</u>

Net investment losses, for the three months ended September 30, 2019, were \$117,000 compared to net investment gains of \$456,000 for the same period in 2018; a decrease of \$573,000. A decrease in value of our company owned life insurance (COLI) contributed to the investment losses for the third quarter of 2019. Changes in cash surrender values during each current period are included in income as an investment gain or loss. The change in surrender value included in earnings for the three-month periods ended September 30, 2019 and 2018 were a decrease of \$14,000 and an increase of \$3,000, respectively.

In January of 2016, the FASB issued guidance that requires equity investments to be measured at fair value with changes in fair value recognized in net income through investment gains and losses. For us, this guidance became effective January 1, 2018 and is reflected in the table above as a decrease in market value of our equity securities of \$80,000 and was the primary factor contributing to the investment losses in third quarter 2019. In addition, we had a \$24,000 realized loss on the sale of fixed income securities.

Other Income:

Other income was \$148,000 for the three months ended September 30, 2019 and 2018. 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 \$9,750,000 for the three months ended September 30, 2019, compared to \$9,825,000 for the three months ended September 30, 2018; a decrease of \$75,000 or 0.8%. Claims as a percentage of premium

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earned was 64.1% in the third quarter of 2019 compared to 63.6% in the third quarter of 2018. The primary reason for the decline in claims was a \$191,000 decrease in P&C segment weather related claims.

Weather related losses consistently create the most significant variability in our loss and loss adjustment expense payments from year to year in our P&C segment and contribute to significant volatility in our earnings. The following table provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the three months ended September 30, 2019 and 2018 (*dollars in thousands*):

For the three months ended September 30, 2019			For the three months ended September 30, 2018		
Catastrophe event	Reported Losses & LAE	Claim Count	Catastrophe event	Reported Losses & LAE	Claim Count
Cat 1916 (Feb 23-26)	\$ (4)	3	Cat 1814 (Feb 24-26)	\$ 4	1
Cat 1918 (Mar 3-4)	22	3	Cat 1817 (Mar 18-21)	36	4
Cat 1920 (Mar 23-25)	72	16	Cat 1821 (Apr 13-17)	3	6
Cat 1923 (Apr 12-15)	7	2	Cat 1824 (May 12-16)	145	35
Cat 1924 (Apr 17-20)	14	6	Cat 1827 (May 29-June 1)	26	7
Cat 1926 (Apr 30-May 2)	36	13	Cat 1835 (June 24-26)	190	14
Cat 1927 (May 7-10)	95	17	Cat 1836 (June 28)	304	31
Cat 1931 (May 20-22)	155	41	Cat 1840 (July 19-22)	318	60
Cat 1943 (July 10-18)	995	242	Cat 1852 (Sept 13-16)	819	243
Cat 1954 (Aug 28-Sept 6)	464	128			
Misc cats less than \$100k	86	23	Misc cats less than \$100k	61	30
Total Cat losses	\$ 1,942	494	Total Cat losses	\$ 1,906	431
Non-cat wind & hail	\$ 1,607	382	Non-cat wind & hail	\$ 1,834	570

During the third quarter of 2019, the P&C segment was impacted by three catastrophe events (as well as development from 16 first and second quarter cat events) which produced 494 policyholder claims totaling \$1,942,000. In comparison, the P&C segment was impacted by three catastrophe events (as well as development from 11 first and second quarter cat events) during the third quarter of 2018 from 431 claims totaling \$1,906,000. During the third quarter of 2019, the P&C segment had reported losses from Cat 1943 (Hurricane Barry) totaling \$995,000 from 242 claims as well as reported losses from Cat 1954 (Hurricane Dorian) totaling \$464,000 from 128 claims. These cat events accounted for 75.1% of total reported losses from cat events during the third quarter of 2019 and added 10.6 percentage points to the third quarter 2019 P&C segment loss ratio. Claims reported from all third quarter 2019 cat events contributed 14.1 percentage points to the third quarter 2019 P&C segment loss ratio. During the third quarter of 2018, the P&C segment had reported losses from Cat 1852 totaling \$819,000 from 243 claims. This cat event accounted for 43.0% of total reported losses from cat events during the third quarter of 2018 and added 5.9 percentage points to the third quarter 2018 P&C segment loss ratio. Claims reported from all third quarter 2018 cat events contributed 13.6 percentage points to the third quarter 2018 P&C segment loss ratio.

Non-catastrophe wind and hail claims reported in the third quarter of 2019 were down and totaled \$1,607,000 compared to non-catastrophe wind and hail claims reported in the third quarter of 2018 totaling \$1,834,000; a decrease of \$227,000. During the third quarter of 2019, the P&C segment had 382 non-cat wind and hail claims reported (an average of \$4,200 per claim) compared to 570 non-cat wind and hail claims reported during the third quarter of 2018 (an average of \$3,200 per claim). Non-cat wind and hail claims reported during the third quarter of 2019 accounted for 18.8% of total P&C segment incurred losses in the current year and added 11.7 percentage points to the 2019 P&C segment combined ratio. Non-cat wind and hail claims reported during the third quarter of 2018 accounted for 21.0% of total P&C segment incurred losses in 2018 and added 13.1 percentage points to the 2018 P&C segment combined ratio.

Reported fire losses in the third quarter of 2019 were up \$592,000 or 21.1% compared to fire losses reported during the third quarter of 2018. The P&C segment had 128 fire losses reported in the third quarter of 2019 totaling \$3,401,000 compared to 92 claims reported in the third quarter of 2018 totaling \$2,809,000. The average cost per claim was \$26,600 for fire losses reported in the third quarter of 2019 compared to \$30,500 for fire losses reported in the third

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quarter of 2018. Fire losses reported during the third quarter of 2019 added 24.7 percentage points to the P&C segment combined ratio while fire losses reported during the third quarter of 2018 added 20.1 percentage points to the P&C segment combined ratio.

Policy Acquisition Cost (Commissions and Amortization of Deferred Acquisition Cost):

For the three months ended September 30, 2019, policy acquisition costs were \$2,811,000 compared to \$2,785,000 for the same period in 2018; an increase of \$26,000. 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 elevated at 18.5% in the third quarter of 2019 compared to 18.0% for the same period in 2018.

General Expenses:

General and administrative expenses totaled \$2,226,000 in the third quarter of 2019 compared to \$2,404,000 in the third quarter of 2018; a 7.4% decrease. The primary factors contributing to the \$178,000 decline in general expenses, in the third quarter of 2019, compared to the same period in 2018, was a decrease in director deferred compensation cost, employee benefits and actuarial fees totaling \$114,000.

Taxes, Licenses and Fees:

Insurance taxes, licenses and fees were \$604,000 for the three months ended September 30, 2019, compared to \$567,000 for the same period in 2018. As a percentage of net premiums earned, insurance taxes, licenses and fees were 4.0% for the three months ended September 30, 2019, compared to 3.7% for the three months ended September 30, 2018. The primary reason for the increase in taxes, licenses and fees, in the third quarter of 2019, compared to the third quarter of 2018, was fees paid associated with our Alabama Department of Insurance periodic examination.

Interest Expense:

Interest expense for the third quarter of 2019 was \$293,000 compared to \$306,000 for the same period in 2018; a decrease of 4.2%. The primary reason for the \$13,000 decrease was a reduction in debt outstanding.

Income Taxes:

For the three-month period ended September 30, 2019, the Company had pretax income of \$545,000 compared to pretax income of \$1,179,000 for the same period in 2018. The \$115,000 tax expense for the third quarter of 2019 consisted of current tax expense of \$190,000 and deferred tax benefit of \$75,000. The \$272,000 tax expense for the third quarter of 2018 consisted of current tax expense of \$235,000 and deferred tax expense of \$37,000. The effective tax rate for the third quarter of 2019 was 21.1% compared to 23.1% in the third quarter of 2018.

Net Income:

The Company ended the third quarter of 2019 with net income of \$430,000 compared to net income of \$907,000 for the same period in 2018. The primary factors contributing to the \$477,000 decrease in net income was the decrease in net premiums earned discussed previously.

Nine Months Ended September 30, 2019 compared to Nine Months Ended September 30, 2018

Premium Revenue:

The table below provides earned premium revenue by segment for the nine months ended September 30, 2019 and 2018 (*dollars in thousands*):

	Nine months ended September 30,		Percent increase (decrease)
	2019	2018	
Life, accident and health operations premiums earned:			
Traditional life insurance	\$ 3,249	\$ 3,347	(2.9)%
Accident and health insurance	1,376	1,427	(3.6)%
Gross life, accident and health	4,625	4,774	(3.1)%
Reinsurance premium ceded	(64)	(70)	(8.6)%
Net life, accident and health premiums earned	\$ 4,561	\$ 4,704	(3.0)%
Property and Casualty operations premiums earned:			
Dwelling fire & extended coverage	\$ 28,401	\$ 27,792	2.2 %
Homeowners (Including mobile homeowners)	15,585	16,420	(5.1)%
Other liability	1,654	1,628	1.6 %
Gross property and casualty	45,640	45,840	(0.4)%
Reinsurance premium ceded	(5,284)	(4,780)	10.5 %
Net property and casualty premiums earned	\$ 40,356	\$ 41,060	(1.7)%
Consolidated gross premiums earned	\$ 50,265	\$ 50,614	(0.7)%
Reinsurance premium ceded	(5,348)	(4,850)	10.3 %
Consolidated net premiums earned	\$ 44,917	\$ 45,764	(1.9)%

Consolidated net premium earned was down 1.9% for the nine months ended September 30, 2019, at \$44,917,000 compared to \$45,764,000 for the same period in 2018. The decrease in net premium earned was due to a 1.7% decrease in net premium earned in the P&C segment coupled with a 3.0% decrease in net premium earned in the Life segment. As mentioned previously, premium growth has slowed due to a combination of competitive pressures in some states, particularly Louisiana, and the smaller size of the specialty market in which we operate. We have made modifications to our products and eased some underwriting restrictions in order to remain competitive through the current market cycle. However, we do not intend to sacrifice overall underwriting profitability with significant rate cuts in order to increase top line revenue growth.

The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. With our 2019 catastrophe contract placement, our single event catastrophe retention remained unchanged from the prior year at \$4 million. However, in our 2019 contract, we added an underlying second event layer of \$2 million in excess of \$2 million. This additional coverage effectively lowers our second event retention to \$2 million. Also unchanged from last year, we maintain catastrophe reinsurance covering incurred claims of a single catastrophe event up to \$72.5 million. Our catastrophe reinsurance has a reinstatement provision for one event and 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 (net of reinsurance). It is noted, however, that hurricane models are subject to significant risk and are only a tool to estimate the impact of catastrophe events. The Company also has risk associated with multiple smaller catastrophe events that individually may not exceed our \$4 million retention and would not be covered under our catastrophe reinsurance contract.

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To summarize our catastrophe reinsurance structure, under the catastrophe reinsurance program in 2019, the Company retains the first \$4,000,000 in losses from a first event and \$2 million in losses from a second 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 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
Underlying 2nd Event	100% of \$2,000,000 in excess of \$2,000,000 retention

Additional details regarding the structure of our 2019 catastrophe reinsurance program can be found in Note 9 to the Consolidated Financial Statements.

Investment Income:

The table below provides the major categories of investment income, primarily dividend and interest income, for the nine months ended September 30, 2019 and 2018 (*dollars in thousands*):

	Nine months ended September 30,	
	2019	2018
Fixed maturities	\$ 2,831	\$ 2,843
Equity securities	66	61
Mortgage loans on real estate	6	6
Investment real estate	3	2
Policy loans	106	105
Other	13	21
	<u>3,025</u>	<u>3,038</u>
Less: Investment expenses	117	106
Net investment income	<u>\$ 2,908</u>	<u>\$ 2,932</u>

For the nine months ended September 30, 2019, net investment income was \$2,908,000 compared to \$2,932,000 for the same period in 2018; a slight decrease of \$24,000 or 0.8%.

Investment Gains and Losses:

The table below provides investment gains and losses for the nine months ended September 30, 2019 and 2018 (*dollars in thousands*):

	Nine months ended September 30,	
	2019	2018
Realized gains (losses) on fixed maturities	\$ (9)	\$ 156
Gains on trading securities	9	—
Change in fair value of equity securities	72	57
Change in surrender value of company owned life insurance	256	(133)
Realized gain on company owned life insurance	1,792	—
Other, principally real estate	—	(88)
Net investment gains (losses)	<u>\$ 2,120</u>	<u>\$ (8)</u>

Net Investment gains, for the nine months ended September 30, 2019, were \$2,120,000 compared to net investment losses of \$8,000 for the same period in 2018; an increase of \$2,128,000. A gain on our company owned life insurance (COLI) investment of \$1,792,000 was the primary reason for the significant increase in net investment gains in 2019. Changes in cash surrender values driven by underlying investment funds in the COLI are included in income as an

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investment gain or loss in the current period. The change in surrender value included in earnings for the periods ended September 30, 2019 and 2018 were an increase of \$256,000 and a decline of \$133,000, respectively.

In January of 2016, the FASB issued guidance that requires equity investments to be measured at fair value with changes in fair value recognized in net income through investment gains and losses. For us, this guidance became effective January 1, 2018 and is reflected in the table above in the change in value of equity securities which was an increase of \$72,000 for the nine months ended September 30, 2019 and an increase of \$57,000 for the same period last year. In addition, we had a \$9,000 realized loss on the sale of fixed income securities for the nine months ended September 30, 2019 compared to a \$156,000 realized gain for the same period last year.

Other Income:

Other income was comparable at \$440,000 for the nine months ended September 30, 2019, compared to \$457,000 for the same period in 2018; a decrease of \$17,000. 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 \$29,673,000 for the nine months ended September 30, 2019, compared to \$29,024,000 for the nine months ended September 30, 2018; an increase of \$649,000 or 2.2%. Claims as a percentage of premium earned was 66.1% in 2019 compared to 63.4% in 2018. The primary reason for the increase in claims was a \$2,107,000 increase in P&C segment weather related claims.

Weather related losses consistently create the most significant variability in our loss and loss adjustment expense payments from year to year in our P&C segment. The following table provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the nine months ended September 30, 2019 and 2018 (*dollars in thousands*):

For the nine months ended September 30, 2019			For the nine months ended September 30, 2018		
Catastrophe event	Reported Losses & LAE	Claim Count	Catastrophe event	Reported Losses & LAE	Claim Count
Cat 1916 (Feb 23-26)	\$ 292	84	Cat 1814 (Feb 24-26)	\$ 162	52
Cat 1918 (Mar 3-4)	741	75	Cat 1817 (Mar 18-21)	1,136	211
Cat 1920 (Mar 23-25)	147	29	Cat 1821 (Apr 13-17)	633	146
Cat 1923 (Apr 12-15)	569	120	Cat 1824 (May 12-16)	145	35
Cat 1924 (Apr 17-20)	317	75	Cat 1827 (May 29-June 1)	251	49
Cat 1926 (Apr 30-May 2)	209	35	Cat 1835 (June 24-26)	279	47
Cat 1927 (May 7-10)	601	102	Cat 1836 (June 28)	415	68
Cat 1931 (May 20-22)	155	41	Cat 1840 (July 19-22)	318	60
Cat 1943 (July 10-18)	995	242	Cat 1852 (Sept 13-16)	819	243
Cat 1954 (Aug 28-Sept 6)	464	128			
Misc cats less than \$100k	315	82	Misc cats less than \$100k	220	80
Total Cat losses	\$ 4,805	1,013	Total Cat losses	\$ 4,378	991
Non-cat wind & hail	\$ 6,791	1,672	Non-cat wind & hail	\$ 5,111	1,539

During the first nine months of 2019, the P&C segment was impacted by 19 catastrophe events producing 1,013 policyholder claims totaling \$4,805,000. Net of tax, these losses reduced 2019 net income by \$3,796,000 or \$1.50 per share. In comparison, in 2018, the P&C segment was impacted by 14 catastrophe events from 991 claims totaling \$4,378,000. Net of tax, 2018 catastrophe losses reduced net income for the nine-month period ended September 30, 2018 by \$3,459,000 or \$1.37 per share. During 2019, the P&C segment had reported losses from Cat 1943 totaling \$995,000 from 242 claims. This cat event accounts for 20.7% of total reported losses from cat events during 2019 and added 2.4 percentage points to the 2019 P&C segment loss ratio. Claims reported from all 2019 cat events contributed 11.8 percentage points to the 2019 P&C segment loss ratio. During 2018, the P&C segment had reported losses from Cat 1817 totaling \$1,136,000 from 211 claims. This cat event accounted for 25.9% of total reported losses

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from cat events during 2018 and added 2.7 percentage points to the 2018 P&C segment loss ratio. Claims reported from all 2018 cat events contributed 10.5 percentage points to the 2018 P&C segment loss ratio.

Non-catastrophe wind and hail claims reported in 2019 were elevated and totaled \$6,791,000 compared to non-catastrophe wind and hail claims reported in 2018 totaling \$5,111,000; an increase of \$1,680,000. During 2019, the P&C segment had 1,672 non-cat wind and hail claims reported (an average of \$4,100 per claim) compared to 1,539 non-cat wind and hail claims reported during 2018 (an average of \$3,300 per claim). Non-cat wind and hail claims reported during 2019 accounted for 26.0% of total P&C segment incurred losses in the current year and added 16.7 percentage points to the 2019 P&C segment combined ratio. Non-cat wind and hail claims reported during 2018 accounted for 20.3% of total P&C segment incurred losses in 2018 and added 12.3 percentage points to the 2018 P&C segment combined ratio.

Reported fire losses in 2019 were down \$804,000 or 7.2% compared to fire losses reported during 2018. The P&C segment had 363 fire losses reported in 2019 totaling \$10,346,000 compared to 353 fire losses reported in 2018 totaling \$11,150,000. The average cost per claim was \$28,500 for fire losses reported in 2019 compared to \$31,600 for fire losses reported in 2018. Fire losses reported during 2019 added 25.4 percentage points to the P&C segment combined ratio while fire losses reported during 2018 added 26.9 percentage points to the P&C segment combined ratio.

Policy Acquisition Cost (Commissions and Amortization of Deferred Acquisition Cost):

For the nine months ended September 30, 2019, policy acquisition costs were \$8,641,000 compared to \$8,167,000 for the same period in 2018; an increase of \$474,000. 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 comparable at 19.2% in the first nine months of 2019 compared to 17.8% for the same period in 2018. The primary reason for the increase in policy acquisition costs was a \$300,000 increase in contingent commissions in the P&C segment in 2019 compared to the same period in 2018. Contingent commissions are estimated over the course of the year and paid after year end based on full year results.

General Expenses:

General and administrative expenses totaled \$6,974,000 in 2019 compared to \$7,075,000 in 2018; a 1.4% decrease. The primary factors contributing to the \$101,000 decrease in general expenses, in 2019, compared to the same period in 2018, was a \$216,000 decline in actuarial fees and employee benefit costs.

Taxes, Licenses and Fees:

Insurance taxes, licenses and fees were \$1,890,000 for the nine months ended September 30, 2019, compared to \$1,565,000 for the same period in 2018. As a percentage of net premiums earned, insurance taxes, licenses and fees were 4.2% for the nine months ended September 30, 2019, compared to 3.4% for the nine months ended September 30, 2018. The primary reason for the increase in taxes, licenses and fees, in 2019, compared to 2018, was due to a slight increase in Mississippi related taxes in addition to the utilization of credits on premium taxes in the state of Mississippi in the prior year that were not applied in 2019.

Interest Expense:

Interest expense for the first nine months of 2019 was \$879,000 compared to \$917,000 for the same period in 2018; a decrease of 4.1%. The primary reason for the \$38,000 decrease was a reduction in debt outstanding in the fourth quarter of 2018.

Income Taxes:

For the nine-month period ended September 30, 2019, the Company had a pretax income of \$2,328,000 compared to pretax income of \$2,397,000 for the same period in 2018. The \$42,000 tax expense for 2019 consisted of current tax expense of \$287,000 and deferred tax benefit of \$245,000. The \$562,000 tax expense for 2018 consisted of current tax benefit of \$83,000 and deferred tax expense of \$645,000. The effective tax rate for 2019 is significantly lower because the gain on COLI benefits is not subject to federal income tax. COLI benefits were previously subject to alternative minimum tax (AMT) but the Tax Cuts and Jobs Act of 2017 eliminated the AMT.

Net Income:

The Company ended the first nine months of 2019 with net income of \$2,286,000 compared to net income of \$1,835,000 for the same period in 2018. The primary factors contributing to the \$451,000 increase in net income was the COLI benefit discussed previously.

Liquidity and capital resources:

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

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

Virtually all invested assets of the Company are held in the insurance subsidiaries. As of September 30, 2019, the contractual maturity schedule for all bonds and notes held by the Company, stated at amortized cost, was as follows (dollars in thousands):

Maturity	Available- for- Sale	Held-to- Maturity	Total	Percentage of Total
Maturity in less than 1 year	\$ 2,424	\$ —	\$ 2,424	2.43%
Maturity in 1-5 years	17,437	32	17,469	17.50%
Maturity in 5-10 years	26,308	4	26,312	26.37%
Maturity after 10 years	52,276	1,313	53,589	53.70%
	<u>\$ 98,445</u>	<u>\$ 1,349</u>	<u>\$ 99,794</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 fixed maturity securities, actual repayment, or effective maturities, will differ from stated maturities. The Company routinely evaluates the impact of changing interest rates on the projected maturities of bonds in the portfolio and actively manages the portfolio in order to minimize the impact of interest rate risk. However, due to other factors, both regulatory and those associated with good investment management practices associated with asset/liability matching, we do have exposure to changes in market values of securities due to changes in interest rates. Currently, a 100 basis point immediate increase in interest rates would generate approximately a \$5,040,000, or 4.9%, decline in the market value of fixed maturity investments. Alternatively, a 100 basis point decrease in interest rates will generate approximately \$5,042,000, or 4.9%, increase in market value of fixed income investments. Management has attempted, to the extent possible, to reduce risk in a rising rate environment. However, due to asset liability matching requirements, particularly in the life subsidiary portfolio, interest rate risk can not be eliminated and exposure to market volatility can cause some variability in our accumulated other comprehensive income, total return on investments, total shareholders' equity and book value per share.

At September 30, 2019, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$52,139,000, up \$6,273,000 compared to \$45,866,000 at December 31, 2018. Components of the change in equity were net income of \$2,286,000, comprehensive income due to changes in value of fixed maturity securities of \$4,221,000, comprehensive income of \$92,000 related to change in value of interest rate swaps and cash dividends paid totaling \$379,000.

As discussed above, changing interest rates can have a significant impact on the market value of fixed maturity investments. Fixed maturity securities classified as available-for-sale increase the liquidity resources of the Company as they can be sold at any time to pay claims or meet other Company obligations. However, these securities are required to be carried at market value with net of tax change in accumulated unrealized gains and losses directly impacting shareholder's equity. While the increase in interest rates causes near term declines in the value of fixed income securities, we are able to reap the benefit of reinvesting at higher rates as current fixed income investments are called, amortized (mortgage backed securities) or reach contractual maturity. Over the next twelve months, based on cash flow projection modeling that considers such factors as anticipated principal payments on mortgage backed securities, likelihood of call provisions being enacted and regular contractual maturities, we expect approximately 9% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.

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The Company, primarily through its insurance subsidiaries, had \$9,085,000 in cash and cash equivalents at September 30, 2019, compared to \$5,154,000 at September 30, 2018. Cash provided by operating activities increased cash by \$3,425,000 during the nine months ended September 30, 2019. The increase in cash from operating activities was driven by refunds of federal income tax overpayment along with changes in other assets and reinsurance recoveries. Cash provided by operating activities increased cash by \$4,974,000 for the nine months ended September 30, 2018. The increase in cash provided by operating activities in 2018 was primarily driven by net income from operations. Net cash provided by investing activities totaled \$385,000 for the nine months ended September 30, 2019, compared to cash used in investing activities of \$5,373,000 in 2018. Net cash provided by investing activities in 2019 primarily consisted of maturities of investments in which reinvestment was delayed in order to increase liquidity during hurricane season. Net cash used in financing activities totaled \$401,000 for the nine months ended September 30, 2019, compared to \$1,091,000 for the same period last year. During the nine months ended September 30, 2019, the Company paid \$379,000 in dividends to shareholders. The Company maintains a \$700,000 line of credit which matures in March of 2020. We had \$700,000 available on our revolving line of credit at September 30, 2019.

The Company had a total of \$12,161,000 of long-term debt outstanding as of September 30, 2019, compared to \$12,152,000 at December 31, 2018, 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, \$211,000 and \$220,000, 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 in recent years, continued strengthening capital levels in the insurance subsidiaries and reduction of debt remains a top priority.

Dividends paid from the insurance subsidiaries are subject to regulatory restrictions and prior approval of the Alabama Department of Insurance. As disclosed in Note 12 to the audited consolidated financial statements included in our 2018 Annual Report on Form 10-K, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company during 2019 is statutorily limited to \$1,583,000 in the life insurance subsidiary and \$3,464,000 in the property/casualty insurance subsidiary. Dividends are limited to the greater of net income (operating income for life subsidiary) or 10% of statutory capital, and regulators consider dividends paid within the preceding twelve months when calculating the available dividend capacity. Therefore, all of the above referenced dividend capacity will not be available for consideration of payment until dividends paid in the preceding twelve months have been considered on a rolling basis. The Company also has to continuously evaluate other factors such as subsidiary operating performance, subsidiary capital requirements and potential impact by rating agencies in making decisions on how much capital can be released from insurance subsidiaries for payment of dividends to NSG. These factors are considered along with the goal of growing year over year statutory surplus in the subsidiaries, and these considerations along with potential adverse impacts on regulatory surplus, will likely lead to dividend payments to NSG substantially below the above referenced regulatory maximums. The Company received \$1,500,000 dividends from its subsidiaries during the nine months ended September 30, 2019.

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,

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

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

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 \$4,385,000. Our portfolio has historically been highly correlated to the S&P 500 with regard to market risk. Based on an evaluation of the historical risk measure of our portfolio relative to the S&P 500, if the market value of the S&P 500 Index decreased 10% from its September 30, 2019 value, the fair value of the Company's common stock investments would decrease by approximately \$439,000.

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".

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 fixed maturity securities in order to limit volatility of statutory capital of the insurance subsidiaries.

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, 2019. Based upon that

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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 months ended September 30, 2019, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II

Item 1. Legal Proceedings

Please refer to Note 14 to the condensed consolidated financial statements included herein, and the 2018 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 2018 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. During the last fiscal quarter of the period covered by this Report, the Company filed the following Current Reports on Form 8-K:

<u>Date of Report</u>	<u>Date Filed</u>	<u>Description</u>
July 26, 2019	July 29, 2019	Press release, dated July 29, 2019, issued by The National Security Group, Inc.
August 13, 2019	August 13, 2019	Press release, dated August 13, 2019, 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 and Director

/s/ William L. Brunson, Jr.

William L. Brunson, Jr.

President, Chief Executive Officer and Director

Date: November 13, 2019

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 13, 2019

/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 13, 2019

/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, 2019 (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 13, 2019

/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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