NATIONAL SECURITY GROUP INC
Form 10-Q
May 14, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For Quarterly Period Ended March 31, 2018

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .

Commission File Number 0-18649

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

Delaware (State or Other Jurisdiction of Incorporation or Organization)	63-1020300 (IRS Employer Identification No.)
661 East Davis Street Elba, Alabama (Address of principal executive offices)	36323 (Zip-Code)

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

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

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). þ Yes o No

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

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

As of May 14, 2018, there were 2,522,312 shares, $1.00 par value, of the registrant's common stock outstanding.

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Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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

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

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

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

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

The Company's ability to continue to pay dividends to shareholders is contingent upon profitability and capital adequacy of the insurance subsidiaries. The insurance subsidiaries operate under regulatory restrictions that could limit the ability to fund future dividend payments of the Company. An adverse event or series of events could materially impact the ability of the insurance subsidiaries to fund future dividends, and consequently, the Board of Directors would have to suspend the declaration of dividends to shareholders.

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

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PART I. Financial Information
Item 1. Financial Statements

THE NATIONAL SECURITY GROUP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

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

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

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

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THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share amounts)

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

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THE NATIONAL SECURITY GROUP, INC.

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

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

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THE NATIONAL SECURITY GROUP, INC.

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

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

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

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THE NATIONAL SECURITY GROUP, INC.

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

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

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

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

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

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

Use of Estimates

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

Earnings Per Share

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

Reclassifications

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

Concentration of Credit Risk

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

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

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

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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Accounting Changes Not Yet Adopted

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

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

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

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

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

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

Recently Adopted Accounting Standards

Income Statement - Reporting Comprehensive Income

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

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

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

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

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

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

NOTE 2 – VARIABLE INTEREST ENTITIES

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

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

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

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

NOTE 3 – INVESTMENTS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Management has evaluated each security in a significant unrealized loss position in both the debt and equity investment portfolios. The Company has no material exposure to sub-prime mortgage loans and approximately 5.94% of the fixed income investment portfolio is rated below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, Management evaluated financial information on each company and where available, reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company’s intent and ability to hold the securities until market values recovered, it was determined that the securities in an accumulated loss position in the portfolio were temporary impairments.

For the three months ended March 31, 2018 and year ended December 31, 2017, the Company realized no other-than-temporary impairments. At March 31, 2018, the single largest loss not realized as an impairment was in the bond portfolio and totaled $88,000. The second largest loss position was in the bond portfolio and totaled $87,000. The third largest loss position was in the bond portfolio and totaled $81,000. At December 31, 2017, the single largest loss not realized as an impairment was in the bond portfolio and totaled $75,000. The second largest loss position was in the bond portfolio and totaled $60,000. The third largest loss position was in the bond portfolio and totaled $53,000.

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

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

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

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

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

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

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NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

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

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

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

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

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

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

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

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

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Assets/Liabilities Measured at Fair Value on a Recurring Basis

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

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

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

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

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

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

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

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

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

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

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

For the three months ended March 31, 2018	Equity Securities	Interest Rate Swap
Beginning balance	$ 1,073	$(608)
Total gains or losses (realized and unrealized):		
Included in earnings	29	—
Included in other comprehensive income	—	167
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	$ 1,102	$(441)
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of March 31, 2018:	$ —	$—

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

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

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

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

For the year ended December 31, 2017	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	$ 1,258	$(1,030)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	114	422
Purchases:	46	—
Sales:	(345)	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	$ 1,073	$(608)
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of December 31, 2017:	$ —	$—

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

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 5 – PROPERTY AND EQUIPMENT

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

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

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

NOTE 6 – INCOME TAXES

On December 22, 2017, the President signed the Tax Cuts and Jobs Act (TCJA), a comprehensive tax legislation which, among other things, reduced the Company's statutory federal income tax rate from 34% to 21% effective January 1, 2018. In addition to the reduction in tax rates, the TCJA makes broad and complex changes to the Internal Revenue Code that will introduce changes to many tax related exclusions, deductions and credits. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax assets. The Company recognized net deferred tax asset positions of $1,123,000 at March 31, 2018 and $1,487,000 at December 31, 2017.

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

	As of March 31, 2018	As of December 31, 2017
General expenses	$1,068	$ 1,069
Unearned premiums	1,295	1,269
Claims liabilities	469	484
AMT credit	788	1,575
Impairment on real estate owned	116	116
Unrealized losses on securities available-for-sale	95	—
Unrealized loss on interest rate swaps	93	128
Deferred tax assets	3,924	4,641
Depreciation	(85)	(88)
Deferred policy acquisition costs	(1,686)	(1,706)
Pre-1984 policyholder surplus account	(513)	(529)
Unrealized gains on securities available-for-sale	—	(831)
Unrealized gains on equity securities	(517)	—
Deferred tax liabilities	(2,801)	(3,154)
Net deferred tax asset	$1,123	$ 1,487

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

	Three months ended March 31,	
	2018	2017
Deferred policy acquisition costs	$(20)	$(3)
Unearned premiums	(26)	(62)
General expenses	1	62
Depreciation	(3)	(4)
Claims liabilities	15	(44)
AMT credit	787	(23)
Impact of repeal of special provision on pre-1984 policyholder surplus	(16)	—
Unrealized gains on equity securities	(43)	—
Deferred income tax expense (benefit)	$695	$(74)

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

	Three months ended March 31,	
	2018	2017
Federal income tax rate applied to pre-tax income/loss	21.0 %	34.0 %
Dividends received deduction and tax-exempt interest	(1.2)%	2.6 %

Company owned life insurance	4.6 %	2.0 %
Small life deduction	— %	19.3 %
Other, net	1.1 %	(2.1)%
Effective federal income tax rate	25.5 %	55.8 %

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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 2011. Tax returns have been filed through the year 2016.

NOTE 7 – NOTES PAYABLE AND LONG-TERM DEBT

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

	March 31, 2018	December 31, 2017
Current portion of installment note payable due in November with variable interest rate equal to the WSJ prime rate plus 0.5%. Unsecured.	$ 800	$ 800
Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 5.0% floor; maturity March 2018. Interest payments due quarterly. Unsecured.	—	500
	$ 800	$ 1,300

Long-term debt consisted of the following as of March 31, 2018 and December 31, 2017 (dollars in thousands):

	March 31, 2018	December 31, 2017
Promissory note with variable interest rate equal to the WSJ prime rate plus 0.5%; maturity November 2019. Annual installment payments beginning November 2017 with final balloon payment due November 30, 2019. Unsecured.	$2,200	$ 2,200
Subordinated debentures issued on December 15, 2005 with floating rate interest equal to 3-Month LIBOR plus 375 basis points; net of $168,000 in debt issuance cost ($178,000 in 2016); maturity December 2035. Interest payable quarterly. Redeemable prior to maturity. Unsecured.	9,113	9,111
Subordinated debentures issued on June 21, 2007 with floating rate interest equal to 3-Month LIBOR plus 340 basis points; net of $65,000 in debt issuance cost ($68,000 in 2016); maturity June 15, 2037. Interest payable quarterly. Redeemable prior to maturity. Unsecured.	3,029	3,028
	$14,342	$ 14,339

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

The swaps entered into in 2009 and 2010 have fair values of $39,000 (liability) and $402,000 (liability), respectively, for a total liability of $441,000 at March 31, 2018 ($608,000 at December 31, 2017). The swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of $132,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements at March 31, 2018. A net valuation gain of $278,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2017.

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

The Company’s interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. At March 31, 2018, the Company has securities on deposit with fair market values of $1,425,000 ($926,000 of which is posted as collateral). At December 31, 2017, the Company had securities on deposit with fair market values of $1,446,000 (all of which is posted as collateral). See Note 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 reserves estimates can be revised up or down depending on changes in circumstances. Changes in prior years' reserve estimates are reflected in the results of operations in the year such changes are determined.

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

	Three months ended March 31,	
	2018	2017
Summary of claims and claim adjustment expense reserves		
Balance, beginning of year	$7,075	$7,531
Less reinsurance recoverable on unpaid losses	327	1,184
Net balances at beginning of year	6,748	6,347
Net losses:		
Provision for claims and claim adjustment expenses for claims arising in current year	9,185	10,786
Estimated claims and claim adjustment expenses for claims arising in prior years	(1,097)	(751)
Total increases	8,088	10,035
Claims and claim adjustment expense payments for claims arising in:		
Current year	5,527	7,090
Prior years	2,567	2,006
Total payments	8,094	9,096
Net balance at end of period	6,742	7,286
Plus reinsurance recoverable on unpaid losses	185	526
Claims and claim adjustment expense reserves at end of period	$6,927	$7,812

The decline in claim and claim adjustment expense reserves before reinsurance recoverable is primarily due to the decrease in catastrophe losses during the period. The estimate for claims arising in prior years was reduced $1,097,000 in 2018 (reduced $751,000 in 2017) 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 $430,000 at March 31, 2018 ($367,000 at December 31, 2017). These claims are a component of policy and contract claims which totaled $913,000 at March 31, 2018 ($903,000 at December 31, 2017).

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

In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other individually significant large loss events that cause unfavorable underwriting results 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 each catastrophe event. Catastrophe reinsurance coverage is maintained in three layers as follows:

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

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

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

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

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

At March 31, 2018, the largest reinsurance recoverable of a single reinsurer was $340,000 ($322,000 at December 31, 2017). 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 three months ended March 31, 2018 and 2017 amounted to $45,000 and $57,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limits.

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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 three months ended March 31, 2018 and 2017 amounted to an approximate $48,000 decrease and $83,000 increase 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 $232,000 costs incurred during the three months ended March 31, 2018 and $268,000 costs incurred during the three months ended March 31, 2017 related to ESOP plan contributions. All contributions were made in cash for purchase of Company shares in the open market. The Company has not allocated newly issued shares directly to the plan and the plan has no debt.

NOTE 11 – SHAREHOLDERS' EQUITY

During the three months ended March 31, 2018 and year ended December 31, 2017, changes in shareholders' equity consisted of net income of $471,000 and net loss of $1,203,000, respectively; dividends paid of $126,000 in 2018 and $504,000 in 2017; decreases in accumulated other comprehensive income, net of applicable taxes, of $1,244,000 in 2018 and increases in accumulated other comprehensive income, net of applicable taxes, of $1,204,000 in 2017. Other comprehensive gains and losses consisted of accumulated unrealized gains and losses on securities available-for-sale and unrealized loss on interest rate swaps.

Preferred Stock
Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference. 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 March 31, 2018 and December 31, 2017:

	Authorized	Issued	Outstanding

Preferred Stock, $1 par value	500,000	—	—
Class A Common Stock, $1 par value	2,000,000	—	—
Common Stock, $1 par value	3,000,000	2,522,312	2,522,312

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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):

	Three months ended March 31, 2018	Three months ended March 31, 2017
Gains and Losses on Cash Flow Hedges		
Balance at beginning of period	$(480)	$(679)
Other comprehensive income for period:		
Other comprehensive gain before reclassifications	132	70
Net current period other comprehensive income	132	70
Balance at end of period	$(348)	$(609)
Unrealized Gains and Losses on Available-for-Sale Securities		
Balance at beginning of period	$3,126	$1,686
Other comprehensive income (loss) for period:		
Other comprehensive income (loss) before reclassifications	(1,308)	450
Reclassification adjustment - gains on equity securities	(2,107)	—
Amounts reclassified from accumulated other comprehensive income	(68)	(106)
Net current period other comprehensive income (loss)	(3,483)	344
Balance at end of period	$(357)	$2,030
Total Accumulated Other Comprehensive Income (Loss) at end of period	$(705)	$1,421

The following table presents the amounts reclassified out of AOCI for the three months ended March 31, 2018 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	$ 86	Net realized investment gains
	86	Total before tax
	(18)	Tax (expense) or benefit
	$ 68	Net of Tax

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The following table presents the amounts reclassified out of AOCI for the three months ended March 31, 2017 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	$ 160	Net realized investment gains
	160	Total before tax
	(54)	Tax (expense) or benefit
	$ 106	Net of Tax

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 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 March 31, 2018 and at December 31, 2017 are summarized below (dollars in thousands):

Assets by industry segment	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
March 31, 2018	$146,074	$ 81,397	$ 59,972	$ 4,705
December 31, 2017	$146,438	$ 80,241	$ 60,709	$ 5,488

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

Three months ended March 31, 2018	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	$15,059	$ 13,531	$ 1,528	$ —
Net investment income	781	251	516	14
Net realized investment gains (losses)	(125)	(174)	49	—
Other income	161	160	1	—
	15,876	13,768	2,094	14
BENEFITS AND EXPENSES				
Policyholder benefits paid	9,427	7,978	1,449	—
Amortization of deferred policy acquisition costs	803	690	113	—
Commissions	2,060	2,012	48	—
General and administrative expenses	2,003	1,452	507	44
Taxes, licenses and fees	649	553	96	—
Interest expense	302	—	12	290
	15,244	12,685	2,225	334
Income (Loss) Before Income Taxes	$632	$ 1,083	$ (131)	$ (320)

Three months ended March 31, 2017	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	$15,040	$ 13,489	$ 1,551	$ —
Net investment income	926	392	519	15
Net realized investment gains	160	—	160	—
Other income	152	150	2	—
	16,278	14,031	2,232	15
BENEFITS AND EXPENSES				
Policyholder benefits paid	11,146	9,918	1,228	—
Amortization of deferred policy acquisition costs	945	694	251	—
Commissions	2,093	2,024	69	—
General and administrative expenses	1,797	1,275	279	243
Taxes, licenses and fees	689	592	97	—
Interest expense	323	—	19	304
	16,993	14,503	1,943	547
Income (Loss) Before Income Taxes	$(715)	$ (472)	$ 289	$ (532)

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The following table presents the Company’s gross and net premiums written for the property and casualty segment and the life and accident and health segment for the three months ended March 31, 2018 and 2017, respectively:

	Three months ended March 31,	
	2018	2017
Life, accident and health operations premiums written:		
Traditional life insurance	$1,120	$1,145
Accident and health insurance	415	423
Gross life, accident and health	1,535	1,568
Reinsurance premium ceded	(31)	(29)
Net life, accident and health premiums written	$1,504	$1,539
Property and Casualty operations premiums written:		
Dwelling fire & extended coverage	$9,553	$9,431
Homeowners (Including mobile homeowners)	5,312	5,627
Other liability	565	543
Gross property and casualty	15,430	15,601
Reinsurance premium ceded	(1,154)	(1,102)
Net property and casualty written	$14,276	$14,499
Consolidated gross premiums written	$16,965	$17,169
Reinsurance premium ceded	(1,185)	(1,131)
Consolidated net premiums written	$15,780	$16,038

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 months ended March 31, 2018 and 2017, respectively:

	Three months ended March 31,	
	2018	2017
Life, accident and health operations premiums earned:		
Traditional life insurance	$1,144	$1,158
Accident and health insurance	415	422
Gross life, accident and health	1,559	1,580
Reinsurance premium ceded	(31)	(29)
Net life, accident and health premiums earned	$1,528	$1,551
Property and Casualty operations premiums earned:		
Dwelling fire & extended coverage	$9,116	$8,816
Homeowners (Including mobile homeowners)	5,497	5,720
Other liability	530	513
Gross property and casualty	15,143	15,049
Reinsurance premium ceded	(1,612)	(1,560)
Net property and casualty earned	$13,531	$13,489
Consolidated gross premiums earned	$16,702	$16,629
Reinsurance premium ceded	(1,643)	(1,589)

Consolidated net premiums earned	$15,059	$15,040

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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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 probably 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 two actions remaining in Texas filed in the aftermath of Hurricane Ike at December 31, 2017. These actions include individual lawsuits with allegations of underpayment of hurricane-related claims. The suits seek a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief. In March of 2018 the Company was notified that the Texas Supreme Court denied a Writ of Application to review an unfavorable decision handed down by the Court of Appeals on one of the two remaining Ike claims. This claim was 95% reinsured by the Company's catastrophe reinsurance coverage and the amount of the settlement, net of reinsurance, did not have a material impact on these consolidated financial statements.

The Company has reserves set up on litigated claims and the reserves are included in benefit and loss reserves.

NOTE 15 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the three months ended March 31, 2018 was $266,000 ($269,000 in 2017). There was no cash paid for income taxes during the three months ended March 31, 2018 or 2017.

NOTE 16 – SUBSEQUENT EVENTS

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

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REVIEW OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. as of March 31, 2018, and the related condensed consolidated statements of operations and comprehensive income (loss) for the three-month periods ended March 31, 2018 and 2017 and the condensed consolidated statement of changes in shareholders' equity for the three-month period ended March 31, 2018 and the statement of cash flows for the three-month periods ended March 31, 2018 and 2017. These condensed consolidated financial statements are the responsibility of the company's management.

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

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

We have previously audited, in accordance with auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The National Security Group, Inc. as of December 31, 2017, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 16, 2018, 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, 2017, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Warren Averett, LLC

Birmingham, Alabama
May 14, 2018

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

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) and its subsidiaries. We are a “smaller reporting company” under Securities and Exchange Commission (SEC) regulations and therefore qualify for the scaled disclosure of smaller reporting companies. In general, the same information is required to be disclosed in the management discussion and analysis by smaller reporting companies except that the discussion need only cover the latest two year period and disclosures relating to contractual obligations are not required. In accordance with the scaled disclosure requirements, this discussion covers the three month periods ended March 31, 2018 and 2017.

The National Security Group, Inc. operates in ten states with 46.9% 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 90.7% of gross earned premium in 2018. The P&C segment has insurance in-force in the states of Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, and Tennessee.

- The Life segment accounted for 9.3% of gross premium revenue in 2018. The Life segment is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

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

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

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

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

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

The property and casualty subsidiaries have been assigned ratings by Demotech, Inc. On March 8, 2018, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

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

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