DUPONT E I DE NEMOURS & CO
Form 8-K
October 28, 2014

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

FORM 8-K

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

Date of Report (Date of Earliest Event Reported) October 28, 2014

E. I. du Pont de Nemours and Company
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction Of Incorporation)	1-815 (Commission File Number)	51-0014090 (I.R.S. Employer Identification No.)

1007 Market Street
Wilmington, Delaware 19898
(Address of principal executive offices)

Registrant's telephone number, including area code: (302) 774-1000

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

o Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

o Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

o Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

o Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Item 7.01 Regulation FD Disclosure

On October 28, 2014, DuPont issued a letter to shareholders. A copy of the letter is furnished herewith as Exhibit 99.1. Also attached is a presentation which DuPont plans to use in whole or in part during interactions with its investors. It is furnished herewith as Exhibit 99.2. The letter to shareholders and the presentation will be available on the investor center at www.dupont.com.

The information contained in Item 7.01, including Exhibits 99.1 and 99.2, of this report on Form 8-K shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), or otherwise subject to the liability of that section, and it will not be incorporated by reference into any registration statement or other document filed by the Registrant under the Securities Act of 1933, as amended, or the Exchange Act except as expressly set forth by specific reference in such a filing.

Item 9.01 Financial Statements and Exhibits.

(d) Exhibits

99.1 Letter to Shareholders dated October 28, 2014

99.2 DuPont Shareholder Update October 2014

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

E. I. DU PONT DE NEMOURS AND COMPANY
(Registrant)

/s/ Barry J. Niziolek
Barry J. Niziolek
Vice President and Controller

October 28, 2014

EXHIBIT INDEX

Exhibit Number	Description
99.1	Letter to Shareholders dated October 28, 2014
99.2	DuPont Shareholder Update October 2014

4
top:2px;padding-bottom:2px;padding-right:2px;">
General and administrative expenses
6,670

6,818

Insurance taxes, licenses and fees
2,237

2,005

Total Expenses
$
56,888

$
52,752

INCOME BEFORE INCOME TAXES
$
483

$
5,446

Year Ended December 31, 2017 Compared to Year Ended December 31, 2016:
Premium revenue in the P&C segment is primarily driven by our dwelling fire and homeowner lines of business. The following table provides premiums earned by line of business:

(dollars in thousands)	2017		2016		
Line of Business	Premium Earned	% of NPE	Premium Earned	% of NPE	2017 Increase (Decrease)

										over 2016
Dwelling Fire/Allied Lines	$38,485	69.9	%	$37,399	67.8	%	2.9	%		
Homeowners	22,831	41.5	%	23,595	42.8	%	(3.2	)%		
Catastrophe Reinsurance Premium	(6,272)	(11.4	)%	(5,830)	(10.6	)%	7.6	%		
Net Premium Earned	$55,044	100.0	%	$55,164	100.0	%	(0.2	)%		

Property and casualty segment net premium earned for 2017 was $55,044,000 compared to $55,164,000 for the same period in 2016. The primary reason for the moderate decline in 2017 compared to 2016 was a 3.2% decrease in gross premium revenue in our homeowners program. An increase in catastrophe reinsurance cost (ceded premium) of 7.6% also contributed to our 0.2% decrease in net premium earned.

Table of Contents

The primary source of premium revenue growth in the P&C segment was in our non-coastal states; primarily the states of Georgia and Oklahoma. Premium revenue in Georgia increased 16.2% in 2017 with policy counts up 7.1% compared to December 31, 2016. Increased rates were implemented in Georgia, along with growth in policy count, which lead to the year over year increase in premium revenue in the state. In addition, Oklahoma premium revenue increased 4.0% in 2017, with policy counts up 3.5%. An increase in new business production coupled with the implementation of increased rates were the primary reasons for the increase in premium revenue in Oklahoma in 2017 compared to the same period last year. We expect to continue to look for opportunities to increase premium revenue in non-coastal and less hurricane prone regions of the states in which we operate in order to create more geographic diversification and seek appropriate risk adjusted rates in coastal areas.

The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. Our catastrophe retention remained unchanged at $4 million in 2017 and we maintain catastrophe reinsurance coverage with an upper limit of $72.5 million. Our catastrophe reinsurance also covers the cost of a second event up to the same $72.5 million upper limit, again with a $4 million retention.

Under the catastrophe reinsurance program in 2017, the Company retained the first $4,000,000 in losses from each event. Reinsurance coverage for 2017 was maintained in three layers as follows:

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

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

We use the results of the Risk Management Solutions (RMS) and AIR Worldwide (AIR) models in our review of exposure to hurricane risk. Each of these third party vendors provides two views of the modeled results as follows: (i) a long-term view that closely relates modeled event frequency to historical hurricane activity; and (ii) a shorter-term view that adjusts historical frequencies to reflect expectations of elevated hurricane activity in the near future. We believe that modeled estimates provide a range of potential outcomes and we review multiple estimates for purposes of understanding our catastrophic risk and variability. However, due to regulatory and competitive limitations, we generally utilize long-term model output in the development of our product pricing.

The following table provides severe thunderstorm and hurricane single event model estimates for a range of return periods based on a blended view of the RMS and AIR long-term models utilizing our actual in-force P&C segment policy data as of August 31, 2017:

		Gross Losses		Net Losses [1]		Net Losses as a Percent Equity [2]	
Loss Return Period	Yearly Probability of Exceeding	Severe Thunderstorm	Hurricane	Severe Thunderstorm	Hurricane	Severe Thunderstorm	Hurricane
20 Years	5 %	$3,102	$ 17,110	$2,451	$ 3,160	5.15 %	6.64 %
50 Years	2 %	$4,656	$ 30,773	$3,160	$ 3,160	6.64 %	6.64 %
100 Years	1 %	$6,049	$ 43,569	$3,160	$ 3,160	6.64 %	6.64 %
250 Years	0.4 %	$8,327	$ 65,956	$3,160	$ 3,160	6.64 %	6.64 %
500 Years	0.2 %	$10,786	$ 81,420	$3,160	$ 10,207	6.64 %	21.43 %

1 - Net losses are net of reinsurance and after a 21% Federal income tax benefit.
2 - Equity as of December 31, 2017
In addition to the risk of single large catastrophe events, we also have risk associated with multiple smaller catastrophe events that individually may not exceed our $4 million retention. We experienced such a year in 2017 with incurred losses from 26 catastrophe events totaling $14,280,000 with none exceeding our reinsurance retention. This lead to a record year for retained catastrophe losses for the Company and adversely impacted our underwriting results. While

Table of Contents

we have sought reinsurance coverage to reduce the impact of smaller serial events, it has been challenging to obtain cost effective coverage and structure. However, through improvement in our rate structure and implementation of more adequate risk adjusted rates over the past four years, we were able to limit the adverse impact of the record year for retained catastrophe losses in 2017 on our capital position and expect to achieve higher margins in future years with reduced storm activity.

Additional details regarding the structure of our 2017 catastrophe reinsurance program can be found in Note 10 to the Consolidated Financial Statements.

Net investment income totaled $1,571,000 in 2017 compared to $1,706,000 in 2016; a decrease of $135,000. The primary reason for the decrease in net investment income was a $1,341,000 decrease in P&C segment invested assets in 2017, compared to the same period last year, along with moderate erosion in book yields. While overall market interest rates trended higher in 2017, reinvestment rates were still typically below the interest rates earned on maturing investments, leading to lower reinvestment rates on new investments.

The P&C segment ended 2017 with realized capital gains of $163,000, compared to realized capital gains totaling $725,000 for the same period in 2016; a decrease of $562,000. The realized capital gains were primarily from sales of fixed income and equity investments. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and, therefore, can vary significantly from year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to year. The P&C segment was not impacted by the write-down of other-than-temporary impairments of fixed income or equity investments in 2017 or 2016.

Other income was $593,000 in 2017 compared to $603,000 for the same period in 2016; a $10,000 decrease. Other income consists primarily of fees related to the issuance of our property insurance policies as well as other miscellaneous income. As a percent of net earned premium, other income was 1.1% in both 2017 and 2016.

Policyholder benefits and settlement expenses in the property and casualty segment were $37,824,000 in 2017 compared to $33,562,000 for the same period in 2016; an increase of $4,262,000 or 12.7%. The P&C segment ended 2017 with a loss ratio of 68.0% compared to 60.2% for the same period in 2016. The primary reason for the increase in claims and the loss ratio in 2017 compared to 2016 was reported losses and loss adjustment expenses (LAE) from Hurricane Irma coupled with an active spring storm season in 2017.

Table of Contents

The table below provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the year ended December, 2017 and 2016 (dollars in thousands):

For the year ended December 31, 2017			For the year ended December 31, 2016		
Cat event	Reported Losses & LAE	Claim Count	Cat event	Reported Losses & LAE	Claim Count
Cat 11 (Jan 1-3)	$ 800	181	Cat 16 (Feb 22-24)	$ 1,043	241
Cat 13 (Jan 18-22)	2,162	371	Cat 17 (Mar 5-11)	321	102
Cat 19 (Feb 28-Mar 2)	562	146	Cat 19 (Mar 13-14)	129	38
Cat 20 (Mar 6-9)	127	44	Cat 21 (Mar 23)	113	23
Cat 21 (Mar 21-22)	304	76	Cat 22 (Mar 30-Apr 1)	213	58
Cat 22 (Mar 26-28)	440	80	Cat 27 (Apr 25-28)	173	45
Cat 24 (Apr 2-3)	775	154	Cat 28 (Apr 29-May 3)	596	124
Cat 25 (Apr 4-6)	673	167	Cat 29 (May 7-10)	251	31
Cat 28 (Apr 21-25)	433	68	Cat 31 (May 16-19)	163	31
Cat 30 (Apr 28-May 1)	799	182	Cat 32 (May 26-28)	162	16
Cat 31 (May 3-5)	498	104	Cat 35 (Jun 16-18)	446	102
Cat 32 (May 8-11)	314	61	Cat 40 (July 13-15)	345	93
Cat 33 (May 15-18)	323	57	Cat 44 (Aug 11-13)	667	270
Cat 34 (May 27-28)	628	84	Cat 46 (Aug 31-Sept 4)	374	126
Cat 38 (June 2-4)	154	52	Cat 50 (Oct 6-9) GROSS	8,386	1,925
T.S. Cindy (June 21-25)	555	105	Cat 53 (Nov 28-Dec 1)	538	104
Cat 42 (Aug 5-8)	120	42			
Cat 43 (Aug 25-31)	309	77			
Cat 44 (Sept 11-15)	3,622	992			
Cat 46 (Oct 7-9)	292	103			
Cat 51 (Oct 23-24)	147	19			
Misc cats less than $100k	243	51	Misc cats less than $100k	208	76
Total Cat losses	$ 14,280	3,216	Total Before Reinsurance	$ 14,128	3,405
			Less: Reinsurance (Cat 50)	(4,386)	
			Total Net Cat Losses	9,742	
Non-cat wind & hail	$ 5,649	1,596	Non-cat wind & hail	$ 5,575	1,784

To add some perspective to our record year for retained catastrophe losses, on a countrywide basis in the United States, 2017 will go down as one of the costliest years on record. According to the National Oceanic and Atmospheric Administration (NOAA), in 2017, there were 16 weather and climate events with losses exceeding $1 billion each across the U.S. Cumulatively these events generated $306 billion in damages and shattered the previous CPI adjusted record set in 2005 in the aftermath of Hurricanes Dennis, Katrina, Rita and Wilma. Also notable, these 16 events significantly exceeded the 1980-2017 annual average of 5.8 events and the 11.6 annual event average of the last five years. (Source: NOAA National Centers for Environmental Information (2018). https://www.ncdc.noaa.gov/billions/)

During 2017, we were impacted by 26 catastrophe events producing 3,216 policyholder claims totaling $14,280,000, a Company record for retained catastrophe losses. Net of tax, these losses reduced 2017 net income by $9,425,000 or $3.74 per share. In comparison, the P&C segment was impacted by 20 catastrophe events in 2016, from 3,405 claims totaling $14,128,000 ($9,742,000 net of reinsurance recoveries). Net of tax, 2016 catastrophe losses reduced net income by $6,430,000 or $2.55 per share.

The single largest catastrophe event in 2017 was Hurricane Irma, which caused $3,622,000 in reported losses in 2017 from 992 claims. Hurricane Irma impacted our policyholders in Alabama, Georgia, South Carolina and Tennessee.

Table of Contents

Georgia was the primary state in our coverage area impacted by Hurricane Irma comprising approximately 85% of reported claims to date.

Hurricane Matthew was the largest catastrophe event in 2016. Hurricane Matthew caused $8,386,000 in gross reported losses ($4,000,000 net of reinsurance) from 1,925 claims. This storm struck the Atlantic coast during early October 2016; primarily impacting our policyholders in the states of South Carolina and Georgia. In addition to Hurricane Matthew, 2016 also had an active spring storm season with reported non-hurricane catastrophe event losses totaling $5,742,000 from 1,480 claims.

As mentioned previously, during the current year, the P&C segment was heavily impacted by numerous catastrophic storms with $14,280,000 in total cat event claims reported in 2017. Georgia and Alabama were the primary source of the reported cat losses in the current year accounting for 38.1% and 21.6%; respectively. South Carolina and Georgia were the primary source of the reported cat losses in the prior year accounting for 49.7% and 18.5%, respectively.

Non-catastrophe wind and hail claims reported in 2017 totaled $5,649,000 compared to non-catastrophe wind and hail claims reported in 2016 totaling $5,575,000; an increase of $74,000 or 1.3%. During 2017, the P&C segment had 1,596 non-cat wind and hail claims reported (an average of $3,500 per claim) compared to 1,784 claims reported during 2016 (an average of $3,100 per claim). Non-cat wind and hail claims reported during 2017 accounted for 14.9% of total P&C segment incurred losses and LAE in the current year. Non-cat wind and hail claims reported during 2016 accounted for 16.6% of total P&C segment incurred losses and LAE in the prior year.
Year to date policyholder benefit payments were up in the property and casualty segment due to an increase in frequency of reported losses from catastrophe events; however, reported fire losses were down in 2017 compared to 2016. Reported fire losses were down $1,338,000 or 8.7% in 2017 compared to fire losses reported during 2016. The P&C segment had 486 fire losses reported for the year ended December 31, 2017, totaling $13,975,000 compared to 510 fire claims reported for the same period in 2016 totaling $15,313,000. The average cost per claim was $28,800 for fire losses reported in 2017 compared to $30,000 for fire losses reported in 2016.
Deferred policy acquisition costs totaled $2,777,000 in 2017 compared to $2,783,000 in 2016. Deferred policy acquisition costs were 5.0% of net earned premium revenue for 2017 and 2016. Deferred policy acquisition costs consist of amortization of previously capitalized distribution costs, primarily commissions.

Commission expense for 2017 was $7,380,000 (13.4% of premium revenue) compared to $7,584,000 (13.7% of premium revenue) for the same period in 2016. The primary reason for the $204,000 decrease in commission expense was a reduction in bonus commissions to agents in 2017 compared to 2016.

General and administrative expenses in the property and casualty segment totaled $6,670,000 in 2017 compared to $6,818,000 in 2016; a decrease of $148,000 or 2.2%. General and administrative expenses were comparable at $12.1% of premium revenue in 2017 and 12.4% of premium revenue in 2016. The $148,000 decline in general and administrative expenses is primarily due to a reduction in employee bonus payments in 2017 due to weather related underwriting losses in the P&C subsidiary.

Insurance taxes, licenses and fees were $2,237,000 through December 31, 2017 compared to $2,005,000 for the same period in 2016. Insurance taxes, licenses and fees were 4.1% of premium revenue in 2017 compared to 3.6% of premium in 2016. The primary reason for the increase in taxes, licenses and fees in 2017 compared to 2016 was a one time charge for state taxes in the P&C segment totaling $185,000.

The P&C segment ended 2017 with pretax income of $483,000 compared to pretax income of $5,446,000 for the same period in 2016. The $4,963,000 decrease in pretax income was primarily due to the negative impact of claims incurred from Hurricane Irma and the increase in overall catastrophe losses as discussed previously.

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

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

Table of Contents

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

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

	2017	2016
Loss and LAE Ratio (Non-Cat)	42.32 %	42.71%
Loss and LAE Ratio (Cat)	25.67 %	17.47%
Underwriting Expense Ratio	34.26 %	34.41%
Combined Ratio	102.25%	94.59%

Maintaining a combined ratio below 100%, which indicates that the company is making an underwriting profit, depends upon many factors including hurricane activity in the Gulf of Mexico and the southern Atlantic coast, strict underwriting of risks, catastrophe reinsurance costs, severe thunderstorm frequency and the ability to obtain adequate and timely premium rates. A major hurricane hitting the coast of Alabama, Georgia, South Carolina, Mississippi or Louisiana could cause the combined ratio to fluctuate materially from year to year. In addition, most of the states that we write business are prone to severe thunderstorm and tornado activity with significant variations in the level of activity from year to year. The property and casualty subsidiaries maintain catastrophe reinsurance to minimize the effect of a major catastrophe; however, the geography of our coverage area, frequency of smaller catastrophe events and prohibitive cost of maintaining lower catastrophe deductibles and/or catastrophe aggregate coverage prevents us from further mitigating catastrophe risks.

During 2017, the P&C segment experienced an increase of 7.66 percentage points in the combined ratio compared to 2016. As noted in the table above, catastrophe loss is the primary source of variability in our combined ratio over the past two years and is generally the primary driver of variability in our earnings. While catastrophe events are unpredictable and often occur in cycles, management has sought to increase margins through efficiency measures and improved rate optimization. These efforts helped limit the impact of 2017 catastrophe events on our capital position. We believe that these efforts, while not eliminating earnings volatility, will improve our ability to better absorb the impact of a major catastrophe or increased frequency of smaller catastrophe events and improve our long term average returns on equity. Management also continues to improve rate adequacy, reduce significant exposure concentrations and implement other risk management strategies in order to further improve underwriting profitability and mitigate earnings volatility.

Non-insurance Operations:

The non-insurance operations of the Company consist of our parent company, The National Security Group, Inc. (NSG). The National Security Group has no material sources of revenue and relies on dividends and management service fees from our insurance subsidiaries to pay expenses. Dividends from subsidiaries are subject to insurance department approval and are subject to statutory restrictions. Subsidiary dividends and service fees are eliminated upon consolidation of the subsidiaries in the audited financial statements included herein and thus are not included in the table below. Revenues and expense for non-insurance operations for the year ended December 31, 2017 and 2016 are summarized as follows (amounts in thousands):

(dollars in thousands)	2017	2016
REVENUE		
Net investment income	$65	$64
Total Revenues	$65	$64
EXPENSES		
General and administrative expenses	$838	$669
Interest expense	1,234	1,274
Total Expenses	$2,072	$1,943

INCOME (LOSS) BEFORE INCOME TAXES	$(2,007)	$(1,879)

Table of Contents

Year Ended December 31, 2017 Compared to Year Ended December 31, 2016:
Revenue for non-insurance operations primarily consists of interest on investments. General and administrative expenses totaled $838,000 in 2017 compared to $669,000 for the same period last year; a 25.2% increase. The expenses of NSG are primarily associated with the public listing of our stock, taxes and fees, and directors' fees. The most significant item impacting the increase in general expenses were increases in interest costs related to deferred compensation plans. Total interest expense associated with short-term and long-term borrowings of NSG was $1,234,000 for the year ended December 31, 2017 and $1,274,000 for the same period last year. The decline in interest expense is related to a reduction in debt outstanding.

Investments:
The life insurance and property/casualty subsidiaries primarily invest in highly liquid investment grade debt and equity securities. The types of assets in which the Company can invest are influenced by various state insurance laws which prescribe qualified investment assets. While working within the parameters of these regulatory requirements and further considering liquidity and capital needs, the Company considers investment quality, investment return, asset/liability matching and composition of the investment portfolio when making investment decisions.

At December 31, 2017, the Company's holdings in debt securities amounted to 84.9% of total investments and 66.5% of total assets. The Company utilizes the ratings of various Nationally Recognized Statistical Rating Organizations when classifying fixed maturity investments by quality rating.

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

	% of Total Bond Portfolio	
S&P or Equivalent Ratings	2017	2016
AAA/AA+	38.08%	39.15%
AA	6.29%	7.09%
AA-	2.88%	3.45%
A+	2.47%	3.61%
A	5.57%	4.68%
A-	6.11%	5.91%
BBB+	8.39%	9.26%
BBB	18.46%	13.49%
BBB-	5.14%	7.38%
Below Investment Grade	6.61%	5.98%

There have been no material shifts in credit quality in the Company's fixed income portfolio.

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

Table of Contents

The amortized cost and aggregate fair values of investments in securities at December 31, 2017 and December 31, 2016 are as follows (dollars in thousands):

December 31, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
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
Held-to-maturity securities:				
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

December 31, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	$ 40,533	$ 748	$ 878	$40,403
Mortgage backed securities	10,970	134	173	10,931
Private label asset backed securities	7,910	29	165	7,774
Obligations of states and political subdivisions	14,806	507	147	15,166
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,618	208	308	18,518
Total fixed maturities	92,837	1,626	1,671	92,792
Equity securities	2,343	2,628	28	4,943
Total	$ 95,180	$ 4,254	$ 1,699	$97,735
Held-to-maturity securities:				
Mortgage backed securities	$ 1,863	$ 38	$ —	$1,901
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	27	2	—	29
Total	$ 1,890	$ 40	$ —	$1,930

As shown in the tables above, the Company experienced an increase in fair value of fixed maturity investments in 2017 compared to the portfolio composition at December 31, 2016. The increase in fixed maturity investments was driven by both increases in fair value of holdings and investment of positive cash flow from insurance operations.

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

duration. In order to match the longer duration of liabilities, investments in the life insurance portfolio tend to have longer maturities and higher average book yields. Also, less emphasis is placed upon short term liquidity in the life subsidiary due to more predictable cash needs.

A downside of investing in longer duration securities in the life segment is that the portfolio is exposed to more significant price volatility as market interest rates rise. This exposure to sudden interest rate changes can lead to declines in market value of fixed income securities in a rising interest rate environment. Management currently maintains the life insurance portfolio in the intermediate duration range of 6.0 to guard against the adverse impact of rising rates. However,

Table of Contents

due to the necessity of matching the duration of liabilities as closely as possible in order to pass regulatory cash flow testing, some volatility in market value of the portfolio in a rising rate environment cannot be avoided.

At December 31, 2017, 6.61% of total investments in the fixed income portfolio were classified as below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, management evaluated financial information on each company and, where available, reviewed analyst reports from independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the securities in an accumulated loss position in the portfolio were temporary impairments. Management has evaluated each security in a significant unrealized loss position. For the year ended December 31, 2017, the Company realized no other-than-temporary impairments related to fixed maturities or equity securities.

The amortized cost and aggregate fair value of debt securities at December 31, 2017, by contractual maturity, are as follows (dollars in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$ 1,076	$1,075
Due after one year through five years	17,789	18,171
Due after five years through ten years	29,280	29,832
Due after ten years	46,322	46,680
Total	$ 94,467	$95,758
Held-to-maturity securities:		
Due in one year or less	$ 2	$2
Due after one year through five years	—	—
Due after five years through ten years	60	65
Due after ten years	1,554	1,578
Total	$ 1,616	$1,645

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

Investment portfolio income

Investment returns with respect to the investment portfolio for the years ended December 31, 2017 and 2016 follows:

	Year Ended December 31,	
	2017	2016
Net investment income	$3,647	$3,892
Average current yield on investments	3.2 %	3.4 %
Total return on investments	4.6 %	4.6 %
Net realized gains on investments (before taxes)	$234	$998
Change in accumulated net unrealized gains (before income taxes)	$1,403	$343

Average current yield on investments declined to 3.2% due to lower average yields on reinvestments.

The total return on investments in 2017 remained unchanged at 4.6%. Prior year total return was negatively impacted by a combination of interest rate driven declines in fixed income investments and declines in market value of our energy sector bond holdings. During 2017, market values of our energy sector bonds recovered and our equity investments increased in value leading to an increase in net unrealized capital gains. Also, realized capital gains were higher due to sales of both fixed income and equity investments.

Table of Contents

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

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

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

Virtually all invested assets of the Company are held in the insurance subsidiaries. As of December 31, 2017, 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	$ 1,076	$ 2	$1,078	1.12 %
Maturity in 1-5 years	17,789	—	17,789	18.51 %
Maturity in 5-10 years	29,280	60	29,340	30.54 %
Maturity after 10 years	46,322	1,554	47,876	49.83 %
	$ 94,467	$ 1,616	$96,083	100.00 %

It should be noted that the above table represents maturities based on stated/contractual maturity. Due to call and prepayment features inherent in some debt securities and principal pay-downs on mortgage backed securities, actual repayment, or effective maturities, will differ from stated maturities. The Company routinely evaluates the impact of changing interest rates on the projected maturities of bonds in the portfolio and actively manages the portfolio in order to minimize the impact of interest rate risk. However, due to other factors, both regulatory and those associated with good investment management practices associated with asset/liability matching, we do have exposure to changes in market values of securities due to changes in interest rates. Currently, a 100 basis point immediate increase in interest rates would generate approximately a $5,376,000, or 5.7%, decline in the market value of fixed maturity investments. Alternatively, a 100 basis point decrease in interest rates will generate approximately $5,301,000, or 5.6%, 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 December 31, 2017, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of $47,625,000, down $427,000 compared to $48,052,000 at December 31, 2016. Components of the change in equity were a net loss of $1,203,000, increase in accumulated unrealized gains on investments of $926,000, a net unrealized gain of $278,000 related to interest rate swaps, common stock issued of $5,000, additional paid-in-capital of $71,000 and cash dividends paid totaling $504,000.

Table of Contents

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 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 4% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.

The Company, primarily through its insurance subsidiaries, had $6,644,000 in cash and cash equivalents at December 31, 2017, compared to $7,368,000 at December 31, 2016. Cash provided by operating activities increased cash by $2,316,000 during the year ended December 31, 2017. The increase in cash from operating activities was primarily related to collections of reinsurance recoverable balances associated with Hurricane Matthew. Positive cash flow from operations in 2017 was primarily used to increase fixed maturity investments and reduce debt outstanding. Cash provided by operating activities increased cash by $1,148,000 for the year ended December 31, 2016. The increase in cash provided by operations in 2016 was primarily driven by net income from operations.

Net cash used in investing activities totaled $1,113,000 for the year ended December 31, 2017, compared to cash provided of $684,000 in 2016. Cash used in investing activities in 2017 primarily consisted of investment of positive cash flow from operations.

Net cash used in financing activities totaled $1,927,000 for the year ended December 31, 2017, compared to $1,227,000 for the same period last year. During the year ended December 31, 2017, the Company repaid $2,000,000 in long-term debt and drew down $500,000 from an operating line of credit. The Company maintains a $1,000,000 operating line of credit which matures in September 2018, as well as a $700,000 line of credit which matures in March of 2018. We had $1,200,000 available on revolving line of credit at December 31, 2017.

The Company had a total of $14,339,000 of long-term debt outstanding as of December 31, 2017, compared to $15,326,000 at December 31, 2016, 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, $233,000 and $246,000, respectively.

The following table reflects the anticipated cash flows associated with our short- and long-term contractual obligations and commitments as of December 31, 2017 (dollars in thousands):

	Payments due by period				
Contractual Obligations	Total	Less than 1 year	Years 1 through 3	Years 4 through 5	More than 5 years
Notes payable	$1,300	$1,300	$—	$—	$—
Debt obligations[1]	$14,339	$—	$2,200	$—	$12,139
Interest on debt obligations[1]	$13,143	$1,180	$2,456	$1,324	$8,183
Property and casualty claim reserves[2]	$7,075	$6,205	$778	$71	$21
Future life insurance obligations3	$71,843	$4,576	$12,253	$7,099	$47,915

[1] Long-term debt, consisting of two separate issues of trust preferred securities, a line of credit and the long-term portion of an installment note is assumed to be

settled at contractual maturity. Interest on long-term debt is calculated using the interest rates in effect at December 31, 2017 for each issue. Interest on long-term debt is accrued and settled quarterly on the trust preferred securities, monthly on the line of credit and annually on the installment note. Therefore, the timing and amount of interest payments may vary from the calculated value included in the table above. These calculations do not take into account any potential prepayments. For additional information regarding long-term debt and interest on long-term debt, please see Note 8, Notes Payable and Long-term Debt, in the notes to Consolidated Financial Statements.

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

[3] Future life insurance obligations consist primarily of estimated future contingent benefit payments and surrender benefits on policies in force at December 31, 2017. These estimated payments are computed using assumptions for future mortality, morbidity and persistency. In contrast to this table, the majority of NSIC's obligations is recorded on the balance sheet at the current account values and do not incorporate an expectation of future market growth, interest crediting or future deposits. Therefore, the estimated future life insurance obligations presented in this table significantly exceed the liabilities recorded in the Company's consolidated balance sheet. Due to the significance of the assumptions used, the actual amount and timing of such payments may differ significantly from the estimated amounts. Management believes that current assets, future premiums and investment income will be sufficient to fund all future life insurance obligations.

Table of Contents

Contractual obligations reflected in the table above include the issuance of $9,111,000 in subordinated debentures completed on December 15, 2005. The subordinated debentures mature December 15, 2035. It is anticipated that principal payments will not be made before maturity. Also included in long-term debt is the issuance of $3,028,000 in subordinated debentures on June 21, 2007. This issue matures June 15, 2037 and may be prepaid at any time. Also reflected in the table above is a $3,000,000 unsecured loan obtained in December 2016. The current portion of this loan is $800,000 and the long term portion is $2,200,000. The unsecured loan matures in November 2019. The Company drew down $500,000 on a line of credit which is Included in notes payable above.

In estimating the time interval for payment of property and casualty claim reserves, the Company utilized historical payment patterns. By the nature of the insurance contracts under which these liabilities exist, there can be no certainty that actual payments will fall in the periods indicated above. However, management believes that current liquidity and capital resources are sufficient to pay these obligations as they come due. Also, due to the relatively short-tail nature of the majority of the Company's property and casualty claim liabilities, management can conclude with a reasonable level of confidence that historical patterns indicate that approximately 97.2% of claim liabilities at the end of a given year are settled within the following two year period. See Note 9 for additional details on payout patterns.

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

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

Our P&C segment is the primary source of dividends to the holding company. Consideration of insurance subsidiary growth opportunities, regulatory capital adequacy, rating agency impact and holding company debt reduction, among other items, are factors that influence our subsidiary dividend requirements. While we have made significant progress over the past five 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 2017 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 2018 is statutorily limited to $1,646,000 in the life insurance subsidiary and $3,419,000 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 $900,000 in dividends from its subsidiaries during the year ended December 31, 2017.

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

Table of Contents

The Company continues to monitor liquidity and subsidiary capital closely. Improved underwriting results over the past five years stemming from the discontinuation of unprofitable lines of business, generally favorable tropical weather patterns over this period, streamlining of products offered combined with enhancements to the Company's rate development process and improvements in the Company's catastrophe reinsurance structure have reduced the pressure on subsidiary capital levels. However, continuing to strengthen subsidiary capital continues to be a top priority for management.

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

Statutory Risk-Based Capital of Insurance Subsidiaries

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

The levels and ratios are as follows:

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

The ratios of Total Adjusted Capital to Authorized Control Level RBC for The National Security Group's life/health and property/casualty insurance subsidiaries are all in excess of 4 to 1 at December 31, 2017.

National Security Insurance Company (life insurer) has regulatory adjusted capital of $15.7 million and $15.1 million at December 31, 2017 and 2016, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 17.6 and 15.2 at December 31, 2017 and 2016, respectively. Accordingly, National Security Insurance Company exceeds the minimum RBC requirements.

National Security Fire & Casualty Company (property/casualty insurer) has regulatory adjusted capital of $34.2 million and $35.2 million at December 31, 2017 and 2016, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 4.7 and 5.1 at December 31, 2017 and 2016, respectively. Accordingly, National Security Fire & Casualty Company exceeds the minimum RBC requirements.

Omega One Insurance Company (property/casualty insurer), which began writing business in late 1995, has regulatory adjusted capital of $10.9 million and $10.7 million at December 31, 2017 and 2016, and a ratio of regulatory total adjusted capital to authorized control level RBC of 19.6 and 43.7 at December 31, 2017 and 2016, respectively. Accordingly, Omega One Insurance Company exceeds the minimum RBC requirements.

Application of Critical Accounting Policies

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

- Reinsurance

Table of Contents

- Deferred Policy Acquisition Costs
- Income Taxes
- Fair Values of Financial Instruments
- Claim Liabilities
- Recognition of Revenue
- Contingencies

Reinsurance

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

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

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

During 2017, the property and casualty segment maintained a catastrophe contract, which covered losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeded the $4 million company retention stated in the contract, reinsurers would reimburse the company 100% of gross losses up to the upper limits of the reinsurance agreement, which was $72.5 million in 2017 and 2016. Any losses above the $72.5 million upper limit are the responsibility of our Company. The contract in place during 2017 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed.

The property and casualty subsidiaries utilize our actual in force policy data modeled utilizing two different industry accepted catastrophe models to structure catastrophe reinsurance and determine upper limits of catastrophe reinsurance agreements. Based on modeling results utilized in 2017 and 2016, the Company was reinsured at approximately a 250 year event level. While this estimate is subject to some uncertainty and model risk, the models indicate that we maintain catastrophe reinsurance upper limits to cover an event that has less than a 0.5% probability of occurring in a given year.

At December 31, 2017, the estimated reinsurance recoverable recorded was $366,000 compared to $1,780,000 for the same period last year. The Company does not anticipate any issues with collection of the recorded amount. In 2017, catastrophe reinsurance premiums ceded totaled $5,431,000 compared to $5,185,000 ceded in 2016. Catastrophe reinsurance premiums are based on a premium calculation applying the agreed upon rate to the total insured value of the covered lines of business. The increase in ceded premium in 2017 is attributable to a 5.5% increase in the rate applied. In addition to catastrophe reinsurance, the Company placed reinstatement premium protection (RPP) reinsurance during 2017 and 2016 totaling $824,000 and $734,000, respectively.

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

There is a possibility that the actual amounts recovered from reinsurers could be materially less than the estimates recorded. This possibility could result in a material adverse impact on our financial condition and results of operations. Reinsurers may dispute claims under reinsurance treaties, such as the calculated amount of reinsurance recoverable. Management does not anticipate any issues with recoverability of reinsurance balances based on current evaluations of collectability. For more information regarding reinsurance, see the Notes to our Consolidated Financial Statements.

Deferred Policy Acquisition Costs

Deferred policy acquisition costs (DAC) are those costs incurred in connection with acquiring new business or renewing existing business. DAC is primarily comprised of commissions, premium taxes, and underwriting costs associated

Table of Contents

with issuing new policies. In accordance with generally accepted accounting principles, these costs are not expensed in their entirety at policy inception; rather, they are recorded as an asset and amortized over the lives of the policies. A reduction in DAC is recognized if the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums and projected investment income. Management reviews DAC calculations throughout the year to establish and assess their recoverability. Changes in management's assumptions, estimates or judgment with respect to calculating DAC could materially impact our financial statements and financial condition. Changes in loss ratios, projected investment income, premium rates or overall expense levels could negatively impact the recoverability of DAC.

At December 31, 2017 and 2016, the Company recorded $8,124,000 and $8,351,000, respectively, as an asset for DAC in the Consolidated Financial Statements. We do not foresee any issues related to recoverability of these capitalized costs. For more information regarding deferred policy acquisition costs, see Note 1 to our Consolidated Financial Statements.

Income Taxes

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

At December 31, 2017, there is no evidence to suggest to management that any deferred tax asset is unrealizable. For more information regarding deferred income taxes, see Note 7 to our Consolidated Financial Statements.

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

Fair Values of Financial Instruments

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

Claim Liabilities

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

final comprehensive review performed at year-end.

At December 31, 2017 and 2016, the recorded liability for loss and loss adjustment expense was $7,075,000 and $7,531,000, respectively, a $456,000 decrease. The decrease in claim and claim adjustment expense reserves is primarily due to a reduction in non-catastrophe reported claims in the fourth quarter of 2017 compared to last year. We believe the estimate of unpaid losses and loss adjustment expenses to be sufficient based on currently available information and a review of our historical reserving practices. For more information regarding loss and loss adjustment expense, see Note 9 to our Consolidated Financial Statements.

Table of Contents

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

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

Item 7A. Quantitative and Qualitative Disclosures About Market Risk
Under smaller reporting company rules we are not required to disclose information required under Item 7A. 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 $4,509,000. Our portfolio has historically been highly correlated to the S&P 500 with regard to market risk. Based on an evaluation of the historical risk measure of our portfolio relative to the S&P 500, if the market value of the S&P 500 Index decreased 10% from its December 31, 2017 value, the fair value of the Company's common stock investments would decrease by approximately $451,000.

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 5 in the consolidated financial statements present additional disclosures concerning fair values of Financial Assets and Financial Liabilities and are incorporated by reference herein.

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

The Company's investment approach in the equity markets is based primarily on a fundamental analysis of value. This approach requires the investment committee to invest in well managed, primarily dividend paying companies, which have a low debt to capital ratio, above average return on capital for a sustained period of time, and low volatility rating (beta) relative to the market. The dividends provide a steady cash flow to help pay current claim liabilities, and it has been the Company's experience that by following this investment strategy, long term investment results have been superior to those offered by bonds, while keeping the risk of loss of capital to a minimum relative to the overall equity market.

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

Table of Contents

Item 8. Financial Statements and Supplementary Data
Index to Financial Statements

Consolidated Financial Statements:

Report of Independent Registered Public Accounting Firm	43
Consolidated Balance Sheets – December 31, 2017 and 2016	44
Consolidated Statements of Operations – Years Ended December 31, 2017 and 2016	45
Consolidated Statements of Comprehensive Income – Years Ended December 31, 2017 and 2016	46
Consolidated Statements of Changes in Shareholders' Equity – Years Ended December 31, 2017 and 2016	47
Consolidated Statements of Cash Flows – Years Ended December 31, 2017 and 2016	48
Notes to Consolidated Financial Statements – December 31, 2017	49

Financial Statement Schedules:

Schedule I. Summary of Investments Other Than Investments in Related Parties – December 31, 2017 and 2016	80
Schedule II. Condensed Financial Information of Registrant – December 31, 2017 and 2016	81
Schedule III. Supplementary Insurance Information – December 31, 2017 and 2016	83
Schedule IV. Reinsurance – Years Ended December 31, 2017 and 2016	83
Schedule V. Valuation and Qualifying Accounts – Years Ended December 31, 2017 and 2016	84

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

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

Opinion on the Financial Statements
We have audited the accompanying consolidated balance sheets of The National Security Group, Inc. as of December 31, 2017 and 2016 and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes and financial statement schedules I, II, III, IV and V (collectively referred to as the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of The National Security Group, Inc. as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

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

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

/s/ Warren Averett, LLC
We have served as The National Group, Inc.'s auditor since 2009.

Birmingham, Alabama
March 16, 2018

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED BALANCE SHEETS
(In thousands)

	December 31, 2017	December 31, 2016
ASSETS		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2017 - $1,645; 2016 - $1,930)	$ 1,616	$1,890
Fixed maturities available-for-sale, at estimated fair value (cost: 2017 - $94,467; 2016 - $92,837)	95,758	92,792
Equity securities available-for-sale, at estimated fair value (cost: 2017 - $1,842; 2016 - $2,343)	4,509	4,943
Trading securities	107	107
Receivable for securities sold	—	499
Mortgage loans on real estate, at cost	162	174
Investment real estate, at book value	3,221	3,221
Policy loans	1,810	1,708
Company owned life insurance	4,974	4,864
Other invested assets	2,574	2,958
Total Investments	114,731	113,156
Cash and cash equivalents	6,644	7,368
Accrued investment income	768	776
Policy receivables and agents' balances, net	11,653	11,434
Reinsurance recoverable	366	1,780
Deferred policy acquisition costs	8,124	8,351
Property and equipment, net	1,781	1,880
Income tax recoverable	393	941
Deferred income tax asset, net	1,487	2,402
Other assets	491	491
Total Assets	$ 146,438	$148,579
LIABILITIES AND SHAREHOLDERS' EQUITY		
Property and casualty benefit and loss reserves	$ 7,075	$7,531
Accident and health benefit and loss reserves	3,595	3,405
Life and annuity benefit and loss reserves	33,283	32,633
Unearned premiums	30,112	29,968
Policy and contract claims	903	1,008
Other policyholder funds	1,706	1,629
Short-term notes payable and current portion of long-term debt	1,300	1,800
Long-term debt	14,339	15,326
Other liabilities	6,500	7,227
Total Liabilities	98,813	100,527
Contingencies		
Shareholders' equity		
Common stock	2,522	2,517
Additional paid-in capital	5,483	5,412
Accumulated other comprehensive income	2,646	1,007

Retained earnings	36,974	39,116
Total Shareholders' Equity	47,625	48,052
Total Liabilities and Shareholders' Equity	$ 146,438	$ 148,579

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

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

	Year ended December 31,	
	2017	2016
REVENUES		
Net premiums earned	$61,163	$61,398
Net investment income	3,647	3,892
Net realized investment gains	234	998
Other income	596	605
Total Revenues	65,640	66,893
BENEFITS, LOSSES AND EXPENSES		
Policyholder benefits and settlement expenses	42,869	38,847
Amortization of deferred policy acquisition costs	3,589	3,506
Commissions	7,723	7,894
General and administrative expenses	8,821	8,996
Taxes, licenses and fees	2,445	2,204
Interest expense	1,307	1,352
Total Benefits, Losses and Expenses	66,754	62,799
Income (Loss) Before Income Taxes	(1,114)	4,094
INCOME TAX EXPENSE (BENEFIT)		
Current	(206)	(142)
Deferred	295	1,173
	89	1,031
Net Income (Loss)	$(1,203)	$3,063
INCOME (LOSS) PER COMMON SHARE BASIC AND DILUTED	$(0.48)	$1.22
DIVIDENDS DECLARED PER SHARE	$0.20	$0.18

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Year ended December 31,	
	2017	2016
Net income (loss)	$(1,203)	$3,063
Other comprehensive income, net of tax		
Changes in:		
Unrealized gains on securities, net of reclassification adjustment of $153 and $549 for 2017 and 2016, respectively	926	226
Unrealized gain on interest rate swap	278	256
Other comprehensive income, net of tax	1,204	482
Comprehensive income	$1	$3,545

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

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

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital
Balance at December 31, 2015	$44,883	$36,505	$ 525	$ 2,512	$ 5,341
Comprehensive income:					
Net income for 2016	3,063	3,063	—	—	—
Other comprehensive income (net of tax)	482	—	482	—	—
Common stock issued	76	—	—	5	71
Cash dividends	(452)	(452)	—	—	—
Balance at December 31, 2016	$48,052	$39,116	$ 1,007	$ 2,517	$ 5,412
Comprehensive income:					
Net loss for 2017	(1,203)	(1,203)	—	—	—
Other comprehensive income (net of tax)	1,204	—	1,204	—	—
Reclassification of tax effects to AOCI	—	(435)	435	—	—
Common stock issued	76	—	—	5	71
Cash dividends	(504)	(504)	—	—	—
Balance at December 31, 2017	$47,625	$36,974	$ 2,646	$ 2,522	$ 5,483

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year ended December 31,	
	2017	2016
Cash Flows from Operating Activities		
Net income (loss)	$(1,203)	$3,063
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense and amortization/accretion, net	514	303
(Increase) decrease in cash surrender value of company owned life insurance	(110)	34
Net realized gains on investments	(234)	(998)
Deferred income taxes	295	1,173
Amortization of deferred policy acquisition costs	3,589	3,506
Changes in assets and liabilities:		
Change in receivable for securities sold	499	(499)
Change in accrued investment income	8	21
Change in reinsurance recoverable	1,414	(120)
Policy acquisition costs deferred	(3,362)	(3,372)
Change in accrued income taxes	548	(1,042)
Change in net policy liabilities and claims	200	(1,082)
Change in other assets/liabilities, net	155	152
Other, net	3	9
Net cash provided by operating activities	2,316	1,148
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(18,720)	(26,832)
Property and equipment	(62)	(94)
Proceeds from sale or maturities of:		
Held-to-maturity securities	280	572
Available-for-sale securities	17,477	27,034
Real estate held for investment	—	38
Property and equipment	2	—
Other invested assets, net	(90)	(34)
Net cash provided by (used in) investing activities	(1,113)	684
Cash Flows from Financing Activities		
Change in other policyholder funds	77	68
Proceeds from long-term debt	—	3,900
Repayments of long-term debt	(2,000)	(5,686)
Change in short-term notes payable	500	943
Dividends paid	(504)	(452)
Net cash used in financing activities	(1,927)	(1,227)
Net change in cash and cash equivalents	(724)	605
Cash and cash equivalents, beginning of year	7,368	6,763
Cash and cash equivalents, end of period	$6,644	$7,368

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

Table of Contents

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

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.

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

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

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

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

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

Concentration of Risk

The Company's property and casualty subsidiaries, composing 91% of consolidated direct written premium, produced business during 2017 in eight states. However, 55% of property and casualty segment direct written premium is generated in the states of Alabama, Mississippi and Louisiana, subjecting the Company to significant geographic concentration. Consequently, adverse weather conditions or changes in the legal, regulatory or economic environment could adversely impact the Company.

The Company's life, accident and health insurance subsidiary, composing approximately 9% of consolidated direct written premium, is licensed in seven states. However, over 79% of life segment direct premium is generated in the

Table of Contents

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

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

For the year ended December 31, 2017, one agency individually produced greater than 5% of the Company's direct written premium.

Investments
The Company's securities are classified as follows:

- Securities Held-to-Maturity - Bonds, notes and redeemable preferred stock for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.
- Securities Available-for-Sale - Bonds, notes, common stock and non-redeemable preferred stock, not classified as either held-to-maturity or trading, are reported at fair value and adjusted for other-than-temporary declines in fair value.
- Trading Securities - Mutual funds (primarily) are reported at fair value.

Unrealized gains and losses on investments, net of tax, on securities available-for-sale are reflected directly in shareholders' equity as a component of accumulated other comprehensive income (loss), and accordingly, have no effect on operating results until realized.

Changes in fair value of trading securities are recognized in net income.

Realized gains and losses on the sale of investments available-for-sale are determined using the specific-identification method and include write downs on available-for-sale investments considered to have other-than-temporary declines in market value.

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

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

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

When an equity security has a decline in value, where fair value is below cost, that is deemed to be other-than-temporary, the Company reduces the book value of the security to its current fair value, recognizing the decline as a realized loss in the statement of income. Any future increases in the market value of investments written

down are reflected as changes in unrealized gains as part of accumulated other comprehensive income within shareholders' equity.

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

Table of Contents

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

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

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

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

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

The Company owns life insurance (COLI) contracts on certain management and supervisory employees each having a face amount of approximately $2,000,000 (including cash surrender value at the time of payment). The Company's original investment in currently in-force company owned life insurance was $4,315,000. The primary purpose of the program is to offset future employee benefit expenses through earnings on the cash value of the policies. The Company is the owner and principal beneficiary of these policies. The life insurance contracts are carried at their current cash surrender value. Cash surrender value at December 31, 2017 and December 31, 2016 was $4,974,000 and $4,864,000, respectively. Changes in cash surrender values are included in income in the current period. The change in surrender value included in earnings for the periods ended December 31, 2017 and 2016 was an increase of $110,000 and a decline of $34,000, respectively. Death proceeds from the contracts are recorded when the proceeds become payable under the terms of the policy and proceeds in excess of cash surrender value are recognized as a gain on company owned life insurance.

Cash and short-term investments are carried at cost, which approximates market value.

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

Fair Values of Financial Instruments
The Company uses the following methods and assumptions to estimate fair values:

Investments

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

- Equity security fair values are based on quoted market prices.

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

Policy Liabilities
The liability for future life insurance policy benefits is computed using a net level premium method including the following
assumptions:
Years of Issue Interest Rate

1947 - 1968	4%
1969 - 1978	6% graded to 5%
1979 - 2003	7% graded to 6%
2004 - 2012	5.25%
2013 - 2014	4.25%
2015 - 2017	4%

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

Table of Contents

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

Claim Liabilities
The liability for unpaid claims represents the estimated liability for claims reported plus claims incurred but not yet reported and the related loss adjustment expenses. The liabilities for claims and related adjustment expenses are determined using case-basis evaluations and statistical analysis and represent estimates of the ultimate net cost of all losses incurred through December 31 of each year. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in the period in which they are determined.

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 2,520,431 at December 31, 2017 and 2,515,459 at December 31, 2016. The Company did not have any dilutive securities as of December 31, 2017 and 2016.

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

Income Taxes
The Company files a consolidated U.S. federal income tax return that includes the holding company and its subsidiaries. The Company is currently subject to a statutory rate of 34%. Tax related interest and penalties are reported as components of income tax expense.

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

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

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

Reclassifications
Certain 2016 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2017 presentation.

Advertising
The Company expenses advertising costs as incurred.

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts subject to FDIC insured limits of $250,000 per entity. At December 31, 2017, the net amount exceeding FDIC insured limits was $5,683,000 at three financial institutions. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of financial institutions on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At December 31, 2017, the single largest balance due from one agent totaled $480,000.

Table of Contents

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

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet its obligation could result in losses to the insurance subsidiaries. Allowances for losses on reinsurance recoverables are established if amounts are believed to be uncollectible. At December 31, 2017 and December 31, 2016, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At December 31, 2017, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Accounting Changes Not Yet Adopted

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

Recognition and Measurement of Financial Assets and Financial Liabilities
In January 2016, the FASB issued guidance that requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. The guidance requires entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset. The guidance eliminates the requirement for public companies to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. This guidance is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company does not expect the adoption to have a material impact on its financial position, however, the Company does expect adoption of this guidance to increase variability in our results of operations as changes in unrealized gains and losses on equity investments will be reflected in consolidated statements of operations.

In February 2018, the 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.

Table of Contents

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

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.

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

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.

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 does not expect adoption of this 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 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.

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 $177,000 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

Table of Contents

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

securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase $9,279,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of $9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 8, are reported in the accompanying consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total $279,000 and are included in Other Assets in the accompanying consolidated balance sheets.

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, $3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase $3,093,000 unsecured junior subordinated deferrable interest debentures. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of $2,995,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the Trust. The Subordinated Debentures, disclosed in Note 8, are reported in the accompanying consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total $93,000 and are included in Other Assets in the accompanying consolidated balance sheets.

NOTE 3 – STATUTORY ACCOUNTING PRACTICES

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

Statutory net gains (losses) from operations and capital and surplus, excluding intercompany transactions, are summarized as follows:

	2017	2016
NSIC - including realized capital gains of $71 and $274, respectively	$1,554	$1,709
NSFC - including realized capital gains (losses) of $114 and $254, respectively	$(921)	$2,060
Omega - including realized capital gains of $49 and $471, respectively	$34	$225
Statutory risk-based adjusted capital:		
NSIC - including AVR of $841 and $1,037, respectively	$15,689	$15,144
NSFC - including investment in Omega of $7,482 and $7,222, respectively	$34,188	$35,242
Omega	$10,983	$10,719

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

Table of Contents

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

NOTE 4 – INVESTMENTS

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 values of investments in available-for-sale securities as of December 31, 2016 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	$ 40,533	$ 748	$ 878	$40,403
Mortgage backed securities	10,970	134	173	10,931
Private label asset backed securities	7,910	29	165	7,774
Obligations of states and political subdivisions	14,806	507	147	15,166
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,618	208	308	18,518
Total fixed maturities	92,837	1,626	1,671	92,792
Equity securities	2,343	2,628	28	4,943
Total	$ 95,180	$ 4,254	$ 1,699	$97,735

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2016 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized	Gross Unrealized	Fair Value

		Gains	Losses	
Mortgage backed securities	$ 1,863	$ 38	$ —	$1,901
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	27	2	—	29
Total	$ 1,890	$ 40	$ —	$1,930

The amortized cost and aggregate fair value of debt securities at December 31, 2017, 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.

Table of Contents

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

(Dollars in Thousands)	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$ 1,076	$1,075
Due after one year through five years	17,789	18,171
Due after five years through ten years	29,280	29,832
Due after ten years	46,322	46,680
Total	$ 94,467	$95,758
Held-to-maturity securities:		
Due in one year or less	$ 2	$2
Due after one year through five years	—	—
Due after five years through ten years	60	65
Due after ten years	1,554	1,578
Total	$ 1,616	$1,645

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):

	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 securities held-to-maturity with unrealized losses as of December 31, 2017.

Table of Contents

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

A summary of securities available-for-sale with unrealized losses as of December 31, 2016, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows (dollars in thousands):

	Less than 12 months		12 months or longer		Total		
December 31, 2016	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	$14,036	$ 396	$2,594	$ 482	$16,630	$ 878	33
Mortgage backed securities	4,235	84	847	89	5,082	173	16
Private label asset backed securities	1,774	53	3,261	112	5,035	165	11
Obligations of state and political subdivisions	4,154	147	—	—	4,154	147	9
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	11,421	294	291	14	11,712	308	16
Equity securities	—	—	1,258	28	1,258	28	1
	$35,620	$ 974	$8,251	$ 725	$43,871	$ 1,699	86

There were no securities held-to-maturity with unrealized losses as of December 31, 2016.

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 6.61% 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 years ended December 31, 2017 and December 31, 2016, the Company realized no other-than-temporary impairments. 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. At December 31, 2016, the single largest loss not realized as an impairment was in the bond portfolio and totaled $340,000. The second largest loss position was in the bond portfolio and totaled $85,000. The third largest loss position was in the bond portfolio and totaled $66,000.

Table of Contents

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

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

	Year ended December 31,	
	2017	2016
Fixed maturities	$3,377	$3,686
Equity securities	95	104
Mortgage loans on real estate	9	14
Investment real estate	4	7
Policy loans	130	128
Company owned life insurance change in surrender value	110	(34)
Other	74	161
	3,799	4,066
Less: Investment expenses	152	174
Net investment income	$3,647	$3,892

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

	Year ended December 31,	
	2017	2016
Fixed maturities	$58	$409
Equity securities	174	422
Other, principally real estate	2	167
Net realized investment gains	$234	$998

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

	December 31, 2017	December 31, 2016
Net change in unrealized appreciation on available-for-sale securities before deferred tax	$ 1,402	$ 343
Deferred income tax	(476)	(117)
Net change in unrealized appreciation on available-for-sale securities	$ 926	$ 226

NOTE 5 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

Table of Contents

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

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

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

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

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

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

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

Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 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)

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.

Table of Contents

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

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

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

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

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

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

As of December 31, 2017, Level 3 fair value measurements of assets include $1,073,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of December 31, 2017, Level 3 fair value measurements of liabilities include $608,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party that utilizes financial modeling tools and assumptions on interest and other factors. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 8.
The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the years 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.

Table of Contents

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

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2016 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	$40,403	$—	$40,403	$—
Mortgage backed securities	10,931	—	10,931	—
Private label asset backed securities	7,774	—	7,774	—
Obligations of states and political subdivisions	15,166	—	15,166	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,518	18,518	—	—
Trading securities	107	107	—	—
Equity securities available-for-sale	4,943	3,685	—	1,258
Total Financial Assets	$97,842	$22,310	$74,274	$1,258
Financial Liabilities				
Interest rate swap	$(1,030)	$—	$—	$(1,030)
Total Financial Liabilities	$(1,030)	$—	$—	$(1,030)

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, 2016 (in thousands):

For the year ended December 31, 2016	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	$ 1,173	$(1,419)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	85	389
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	$ 1,258	$(1,030)
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, 2016:	$ —	$—

For the year ended December 31, 2016, 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.

Table of Contents

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

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

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

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

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

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

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

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

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

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

The carrying amount and estimated fair value of the Company's financial instruments as of December 31, 2017 and December 31, 2016 are as follows (in thousands):

	December 31, 2017		December 31, 2016	
Assets and related instruments	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Held-to-maturity securities	$1,616	$ 1,645	$1,890	$ 1,930
Mortgage loans	162	162	174	174
Policy loans	1,810	1,810	1,708	1,708
Company owned life insurance	4,974	4,974	4,864	4,864
Other invested assets	2,574	2,574	2,958	2,958
Liabilities and related instruments				
Other policyholder funds	1,706	1,706	1,629	1,629
Short-term notes payable and current portion of long-term debt	1,300	1,300	1,800	1,800
Long-term debt	14,339	14,339	15,326	15,326

NOTE 6 – PROPERTY AND EQUIPMENT

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

	December 31, 2017	December 31, 2016
Building and improvements	$ 3,378	$ 3,348
Electronic data processing equipment	1,512	1,548

Furniture and fixtures	486	515
	5,376	5,411
Less accumulated depreciation	3,595	3,531
Property and equipment, net	$ 1,781	$ 1,880

Depreciation expense for the years ended December 31, 2017 was $121,000 ($159,000 for the year ended December 31, 2016).

Table of Contents

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

NOTE 7 – INCOME TAXES

On December 22, 2017, the President signed the Tax Cuts and Jobs Act (TCJA), a comprehensive tax legislation which, among other things, will reduce 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. The Company has recognized the tax effects of the TCJA in the fourth quarter of 2017 and the impact to the Company's Consolidated Financial Statements are described within this footnote.

Under pre-1984 life insurance company tax laws, a portion of NSIC's gain from operations was not subject to current income taxation, but was accumulated for tax purposes in a memorandum account designated "policyholder surplus". The Deficit Reduction Act of 1984 eliminated further additions to policyholder's surplus but under special rules, the aggregate balance in this account ($2,520,000 at December 31, 2017) would be taxed at current rates only if distributed to shareholders or if the account exceeded a prescribed minimum. Due to the special rules, the Company did not previously recognize the deferred tax liability on amounts designated as policyholder surplus. The TCJA repealed the previously enacted special rules and imposed tax on the remaining accumulated balance of the account as of December 31, 2017 to be paid over eight years at 21% beginning in 2018. Due to enactment of the TCJA the Company established a deferred tax liability at December 31, 2017 on the pre-1984 surplus account in the amount of $529,000.

Deferred tax assets and liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Due to the enactment of the TCJA, the Company revalued its deferred tax assets and liabilities at December 31, 2017. As a result, the Company recognized $857,000 in income tax expense due to the repeal of a special provision on pre-1984 surplus and a $54,000 income tax benefit due to the change in corporate tax rate from 34% to 21%. 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 $1,487,000 at December 31, 2017 and $2,402,000 at December 31, 2016.

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

	As of December 31, 2017 (21% tax rate)	As of December 31, 2016 (34% tax rate)
General expenses	$ 1,069	$ 1,685
Unearned premiums	1,269	2,046
Claims liabilities	484	746
AMT credit	1,575	1,230
Impairment on real estate owned	116	187
Unrealized loss on interest rate swaps	128	350
Deferred tax assets	4,641	6,244
Depreciation	(88)	(135)

Deferred policy acquisition costs	(1,706)	(2,839)
Pre-1984 policyholder surplus account	(529)	—
Unrealized gains on securities available-for-sale	(831)	(868)
Deferred tax liabilities	(3,154)	(3,842)
Net deferred tax asset	$ 1,487	$ 2,402

Table of Contents

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

The appropriate income tax effects of changes in temporary differences are as follows (at 34% with the exception of the impact of the change in tax rate which is calculated at 21%)(dollars in thousands):

	Year ended December 31,	
	2017	2016
Deferred policy acquisition costs	$(77)	$(46)
Unearned premiums	(10)	(7)
General expenses	(45)	(116)
Depreciation	7	24
Claims liabilities	(38)	(16)
Litigation settlement	—	1,748
AMT credit	(345)	(414)
Impact of repeal of special provision on pre-1984 policyholder surplus	857	—
Impact of TCJA change in corporate tax rate	(54)	—
Deferred income tax expense	$295	$1,173

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:

	Year ended December 31,	
	2017	2016
Federal income tax rate applied to pre-tax income/loss	34.0 %	34.0 %
Dividends received deduction and tax-exempt interest	5.8 %	(1.9)%
Company owned life insurance	3.4 %	0.3 %
Small life deduction	30.7 %	(8.6)%
Pre-1984 policyholder surplus account at current statutory rate	(76.9)%	— %
Impact of change in tax rate under TCJA	4.9 %	— %
AMT credit	(6.8)%	— %
Other, net	(3.1)%	1.4 %
Effective federal income tax rate	(8.0)%	25.2 %

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.

Table of Contents

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

NOTE 8 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of December 31, 2017 and December 31, 2016 (dollars in thousands):

	December 31, 2017	December 31, 2016
Current portion of installment note payable due in November with variable interest rate equal to the WSJ prime rate plus 0.5%. Unsecured.	$ 800	$ 1,800
Line of credit, $1,000,000 available, with variable interest rate equal to the WSJ prime rate, subject to a 4.5% floor; maturity September 2018. Interest payments due monthly. Secured.	—	—
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	—
	$ 1,300	$ 1,800

Long-term debt consisted of the following as of December 31, 2017 and December 31, 2016 (dollars in thousands):

	December 31, 2017	December 31, 2016
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	$ 3,200
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.	9,111	9,101
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.	3,028	3,025
	$ 14,339	$ 15,326

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

2018	2019	2020	2021	2022	Thereafter
$1,300	$2,200	$ —	$ —	$ —	$ 12,139

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 $65,000 (liability) and $543,000 (liability), respectively, for a total liability of $608,000 at December 31, 2017 ($1,030,000 at December 31, 2016). The swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of $278,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements at December 31, 2017. A

Table of Contents

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

net valuation gain of $256,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2016.

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

The Company’s interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. At December 31, 2017, the Company has securities on deposit with fair market values of $1,446,000 (all of which is posted as collateral). At December 31, 2016, the Company had securities on deposit with fair market values of $1,466,000 and cash of $231,000 (all of which is posted as collateral). See Note 5 for additional information about the interest rate swaps.

NOTE 9 – POLICY AND CLAIM RESERVES

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

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

	Year ended December 31,	
	2017	2016
Summary of claims and claim adjustment expense reserves		
Balance, beginning of year	$7,531	$9,645
Less reinsurance recoverable on unpaid losses	1,184	1,380
Net balances at beginning of year	6,347	8,265
Net losses:		
Provision for claims and claim adjustment expenses for claims arising in current year	39,604	35,659
Estimated claims and claim adjustment expenses for claims arising in prior years	(1,213)	(1,460)
Total increases	38,391	34,199
Claims and claim adjustment expense payments for claims arising in:		
Current year	34,609	31,265
Prior years	3,381	4,852
Total payments	37,990	36,117
Net balance at end of period	6,748	6,347
Plus reinsurance recoverable on unpaid losses	327	1,184
Claims and claim adjustment expense reserves at end of period	$7,075	$7,531

The increase in claim and claim adjustment expense reserves before reinsurance recoverable is primarily due to the increase in catastrophe losses during the period. The estimate for claims arising in prior years was reduced $1,213,000 in 2017 (reduced $1,460,000 in 2016) due to favorable loss development during the year on claims arising in prior

years.

The Company has a geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather, explosions and fires, and the incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a

Table of Contents

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

catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophe losses are restricted to small geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. The Company generally seeks to reduce its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance. At December 31, 2017, the Company's estimate of unpaid losses and adjustment expenses for claims incurred in prior years related to catastrophes that exceeded our retention totaled $115,000 before reinsurance ($462,000 in 2016). Because the Company has exhausted its catastrophe coverage limits available for Hurricane Katrina any additional development will not be covered by reinsurance.

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

Homeowners, Dwelling Fire and Other Liability

For the Years Ended December 31,

Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance
Unaudited

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	IBNR Reserves Dec. 31, 2017	Cumulative Number of Reported Claims
2008	$40,544	$38,807	$38,639	$38,912	$39,327	$39,069	$39,420	$39,180	$39,117	$39,115	$ —	13,609
2009		31,425	30,236	30,442	30,432	30,484	30,362	30,306	30,280	30,280	—	7,992
2010			30,610	29,918	29,805	29,718	29,687	29,672	29,641	29,660	—	5,886
2011				35,203	33,957	34,233	34,711	34,806	34,650	34,658	8	8,125
2012					29,959	30,190	30,402	30,091	29,948	29,885	28	5,190
2013						27,436	27,147	27,076	27,023	27,191	277	5,198
2014							25,929	26,422	26,290	26,225	105	4,744
2015								31,484	30,861	30,360	120	5,836
2016									36,287	35,343	384	5,178
2017										40,210	2,990	5,087
									Total	$322,927		

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

2008	$34,664	$37,986	$38,312	$38,498	$38,617	$38,935	$39,090	$39,105	$39,108	$39,111
2009		25,245	29,281	29,869	29,847	30,004	30,265	30,274	30,280	30,280
2010			26,064	29,201	29,404	29,507	29,639	29,640	29,640	29,660
2011				31,488	33,080	33,484	34,167	34,622	34,621	34,641
2012					26,162	29,135	29,614	29,765	29,834	29,835
2013						24,157	26,114	26,487	26,661	26,788
2014							22,844	25,461	25,800	26,033
2015								25,923	30,066	30,190
2016									31,893	34,722
2017										35,209

Total	$316,469
All outstanding liabilities before 2008, net of reinsurance	188
Liabilities for claims and claim adjustment expenses, net of reinsurance	$6,646

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

Table of Contents

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

Average Annual Percentage Payout of Incurred Claims by Age (in Years), Net of Reinsurance
Unaudited

Years	1	2	3	4	5	6	7	8	9	10
	87.7%	9.5%	1.0%	0.5%	0.5%	0.5%	0.1%	0.04%	%	%

The tables presented above represent homeowners, dwelling fire and other liability lines of business. The Company combined the data for these lines of business because the policy coverage and payout pattern for homeowners and dwelling fire are not materially different. Also, other liability is combined with dwelling fire because liability coverage is only sold as an additional coverage offered only with the dwelling fire policy. The Company offers no stand alone liability products.

Management periodically estimates the liability for claims that have been reported but not paid and for claims incurred but not reported (IBNR). Management utilizes expected losses along with historical data analysis of paid and incurred loss development patterns over the past ten years to aide in establishing the claims liability. Management also separately evaluates any recent large events in establishing claim reserves. The Company also engages a consulting actuary to review managements' estimates of claim liabilities each year. There has been no material change in reserving methodology in 2017 compared to prior years.

As shown in the table above depicting average annual payout of incurred claims, 87.7% of claims are settled within twelve months of the date of loss and cumulatively, 97.2% of claims are settled within two years of the date of loss. While reserves for reported but unpaid and incurred but not reported claims can ultimately prove to be excessive or deficient, the short duration of the Company's claim liabilities serves to lesson the uncertainty compared to longer tail lines of insurance. The Company has no material exposure to difficult to estimate long tail liabilities such as toxic waste cleanup, asbestos related illness or other environmental remediation exposures.

Table of Contents

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

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

	December 31, 2017	December 31, 2016
Net outstanding liabilities		
Homeowners' insurance	$ 2,384	$ 1,972
Dwelling fire insurance	2,799	2,938
Other Liability insurance	1,463	1,382
Other short-duration insurance lines	102	55
Liabilities for unpaid claims and claim adjustment expenses, net of reinsurance	6,748	6,347
Reinsurance recoverable on unpaid claims		
Homeowners' insurance	327	889
Dwelling fire insurance	—	295
Other Liability insurance	—	—
Other short-duration insurance lines	—	—
Total reinsurance recoverable on unpaid claims	327	1,184
Insurance lines other than short-duration	—	—
Unallocated claims adjustment expenses	—	—
Other	—	—
	—	—
Total gross liability for unpaid claims and claim adjustment expense	$ 7,075	$ 7,531

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 $367,000 at December 31, 2017 ($391,000 at December 31, 2016). These claims are a component of policy and contract claims which totaled $903,000 at December 31, 2017 ($1,008,000 at December 31, 2016).

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

	For the Years Ended December 31,				
	2015	2016	2017		
Incurred Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance Unaudited				IBNR	Cumulative

				Reserves Dec. 31, 2017	Number of Reported Claims
2015	$765	$813	$736	$ —	1,122
2016		960	962	—	1,175
2017			1,008	367	1,266

71

Table of Contents

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

	Cumulative Paid Claims and Allocated Claims Adjustment Expenses, Net of Reinsurance Unaudited		
2015	$568	$724	$736
2016		658	874
2017			725

	Average Annual Percentage Payout of Incurred Claims by Age Unaudited		
Years	1	2	3
	72.5%	22.1%	5.4%

NOTE 10 – REINSURANCE

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

Table of Contents

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

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

At December 31, 2017, the largest reinsurance recoverable of a single reinsurer was $322,000 ($332,000 at December 31, 2016). Amounts reported as ceded incurred losses were related to development of losses from prior year catastrophes.

NOTE 11 – EMPLOYEE BENEFIT PLANS

The Company and its subsidiaries have an established retirement savings plan (401K Plan). All full-time employees are eligible to participate, and all employer contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for the years ended December 31, 2017 and 2016 amounted to $187,000 and $196,000, 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 credited to the non-qualified deferred compensation plans for the years ended December 31, 2017 and 2016 amounted to approximately $303,000 and $245,000, 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 $268,000 costs incurred during the year ended December 31, 2017 and $250,000 costs incurred during the year ended December 31, 2016 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 12 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

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

The amount of dividends paid from NSIC to the Company in any year may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2017, NSIC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to $1,646,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. At December 31, 2017, NSFC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to $3,419,000.

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

At December 31, 2017, securities with market values of $2,928,000 ($3,026,000 at December 31, 2016) were deposited with various states pursuant to statutory requirements.

Table of Contents

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

NOTE 13 – SHAREHOLDERS' EQUITY

During the years ended December 31, 2017 and December 31, 2016, changes in shareholders' equity consisted of net loss of $1,203,000 and net income of $3,063,000, respectively; dividends paid of $504,000 in 2017 and $452,000 in 2016; increases in accumulated other comprehensive income, net of applicable taxes, of $1,204,000 in 2017 and increases in accumulated other comprehensive income, net of applicable taxes, of $482,000 in 2016. 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 December 31, 2017 and December 31, 2016:

	December 31, 2017			December 31, 2016		
	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	2,522,312	2,522,312	3,000,000	2,517,339	2,517,339

On May 19, 2017, 4,973 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

Table of Contents

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

NOTE 14 – ACCUMULATED OTHER COMPREHENSIVE INCOME

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

	Year ended December 31,	
	2017	2016
Gains and Losses on Cash Flow Hedges		
Balance at beginning of period	$(679)	$(935)
Other comprehensive loss for period:		
Other comprehensive gain before reclassifications	278	256
Reclassification adjustment - legislative tax rate change	(79)	—
Amounts reclassified from accumulated other comprehensive income	—	—
Net current period other comprehensive income	199	256
Balance at end of period	$(480)	$(679)
Unrealized Gains and Losses on Available-for-Sale Securities		
Balance at beginning of period	$1,686	$1,460
Other comprehensive income for period:		
Other comprehensive income before reclassifications	1,079	775
Reclassification adjustment - legislative tax rate change	514	—
Amounts reclassified from accumulated other comprehensive income	(153)	(549)
Net current period other comprehensive income	1,440	226
Balance at end of period	$3,126	$1,686
Total Accumulated Other Comprehensive Income at end of period	$2,646	$1,007

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

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	$ 232	Net realized investment gains
	232	Total before tax
	(79)	Tax (expense) or benefit
	$ 153	Net of Tax

Table of Contents

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

The following table presents the amounts reclassified out of AOCI for the years months ended December 31, 2016 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	$ 832	Net realized investment gains
	832	Total before tax
	(283)	Tax (expense) or benefit
	$ 549	Net of Tax

NOTE 15 – SEGMENTS

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

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

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

Total assets by industry segment at December 31, 2017 and at December 31, 2016 are summarized below (dollars in thousands):

Assets by industry segment	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
December 31, 2017	$146,438	$ 80,241	$ 60,709	$ 5,488
December 31, 2016	$148,579	$ 82,647	$ 58,689	$ 7,243

Table of Contents

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

Premium revenues and operating income by business segment for the years ended December 31, 2017 and 2016 are summarized below (dollars in thousands):

Year ended December 31, 2017	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	$61,163	$ 55,044	$ 6,119	$ —
Net investment income	3,647	1,571	2,011	65
Net realized investment gains (losses)	234	163	71	—
Other income	596	593	3	—
	65,640	57,371	8,204	65
BENEFITS AND EXPENSES				
Policyholder benefits paid	42,869	37,824	5,045	—
Amortization of deferred policy acquisition costs	3,589	2,777	812	—
Commissions	7,723	7,380	343	—
General and administrative expenses	8,821	6,670	1,313	838
Taxes, licenses and fees	2,445	2,237	208	—
Interest expense	1,307	—	73	1,234
	66,754	56,888	7,794	2,072
Income (Loss) Before Income Taxes	$(1,114)	$ 483	$ 410	$ (2,007)

Year ended December 31, 2016	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	$61,398	$ 55,164	$ 6,234	$ —
Net investment income	3,892	1,706	2,122	64
Net realized investment gains	998	725	273	—
Other income	605	603	2	—
	66,893	58,198	8,631	64
BENEFITS AND EXPENSES				
Policyholder benefits paid	38,847	33,562	5,285	—
Amortization of deferred policy acquisition costs	3,506	2,783	723	—
Commissions	7,894	7,584	310	—
General and administrative expenses	8,996	6,818	1,509	669
Taxes, licenses and fees	2,204	2,005	199	—
Interest expense	1,352	—	78	1,274
	62,799	52,752	8,104	1,943
Income (Loss) Before Income Taxes	$4,094	$ 5,446	$ 527	$ (1,879)

Table of Contents

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

The following table presents the Company's gross and net premiums written for the property and casualty segment and the life and accident and health segment for the years ended December 31, 2017 and 2016, respectively:

	Year ended December 31,	
	2017	2016
Life, accident and health operations premiums written:		
Traditional life insurance	$4,411	$4,459
Accident and health insurance	1,828	1,851
Gross life, accident and health	6,239	6,310
Reinsurance premium ceded	(77)	(69)
Net life, accident and health premiums written	$6,162	$6,241
Property and Casualty operations premiums written:		
Dwelling fire & extended coverage	$37,034	$35,783
Homeowners (Including mobile homeowners)	22,319	23,250
Other liability	2,145	2,081
Gross property and casualty	61,498	61,114
Reinsurance premium ceded	(6,272)	(5,830)
Net property and casualty written	$55,226	$55,284
Consolidated gross premiums written	$67,737	$67,424
Reinsurance premium ceded	(6,349)	(5,899)
Consolidated net premiums written	$61,388	$61,525

The following table presents the Company's gross and net premiums earned for the property and casualty segment and the life and accident and health segment for the years ended December 31, 2017 and 2016, respectively:

	Year ended December 31,	
	2017	2016
Life, accident and health operations premiums earned:		
Traditional life insurance	$4,368	$4,451
Accident and health insurance	1,828	1,852
Gross life, accident and health	6,196	6,303
Reinsurance premium ceded	(77)	(69)
Net life, accident and health premiums earned	$6,119	$6,234
Property and Casualty operations premiums earned:		
Dwelling fire & extended coverage	$36,373	$35,367
Homeowners (Including mobile homeowners)	22,831	23,595
Other liability	2,112	2,032
Gross property and casualty	61,316	60,994
Reinsurance premium ceded	(6,272)	(5,830)
Net property and casualty earned	$55,044	$55,164
Consolidated gross premiums earned	$67,512	$67,297

Reinsurance premium ceded	(6,349)	(5,899)
Consolidated net premiums earned	$61,163	$61,398

Table of Contents

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

NOTE 16 – CONTINGENCIES

In the ordinary course of business, the Company and its subsidiaries are routinely a defendant in or party to pending or threatened legal actions and proceedings related to the conduct of their insurance operations. These suits can involve alleged breaches of contracts, torts, including bad faith and fraud claims based on alleged wrongful or fraudulent acts of the Company's subsidiaries, and other miscellaneous causes of action. It is inherently difficult to predict the outcome of such matters, particularly when the claimant seeks very large or indeterminate damages or when the matters present novel legal theories or involve multiple parties. An accrued liability is established when loss contingencies are both 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 17 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the years ended December 31, 2017 was $1,285,000 ($1,360,000 in 2016). The Company received refunds of $754,000 from income taxes during the year ended December 31, 2017. Cash paid for income taxes during the year ended December 31, 2016 was $750,000.

During the year ended December 31, 2017, non-cash changes in equity included $5,000 in common stock issued to Directors in lieu of cash compensation along with a corresponding $71,000 increase in additional paid-in capital.

NOTE 18 – SUBSEQUENT EVENTS

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
FINANCIAL STATEMENT SCHEDULES

Schedule I. Summary of Investments Other Than Investments in Related Parties
THE NATIONAL SECURITY GROUP, INC.
(dollars in thousands)

	December 31, 2017			December 31, 2016		
	Cost	Fair Value	Amount per the Balance Sheet	Cost	Fair Value	Amount per the Balance Sheet
Securities Held-to-Maturity:						
United States government	$1	$1	$1	$27	$29	$27
Mortgage backed securities	1,615	1,644	1,615	1,863	1,901	1,863
Total Securities Held-to-Maturity	1,616	1,645	1,616	1,890	1,930	1,890
Securities Available-for-Sale:						
Equity Securities:						
Banks and insurance companies	1,064	1,966	1,966	1,363	1,991	1,991
Industrial and all other	778	2,543	2,543	980	2,952	2,952
Total equity securities	1,842	4,509	4,509	2,343	4,943	4,943
Debt Securities:						
United States government	18,562	18,451	18,451	18,618	18,518	18,518
States, municipalities and political subdivisions	13,758	14,093	14,093	14,806	15,166	15,166
Mortgage backed securities	12,892	12,795	12,795	10,970	10,931	10,931
Private label asset backed securities	10,128	10,510	10,510	7,910	7,774	7,774
Industrial and Miscellaneous	39,127	39,909	39,909	40,533	40,403	40,403
Total Debt Securities	94,467	95,758	95,758	92,837	92,792	92,792
Total Available-for-Sale	96,309	100,267	100,267	95,180	97,735	97,735
Total Securities	97,925	101,912	101,883	97,070	99,665	99,625
Trading securities	107	107	107	107	107	107
Mortgage loans on real estate	162	162	162	174	174	174
Investment real estate	3,221	3,221	3,221	3,221	3,221	3,221
Policy loans	1,810	1,810	1,810	1,708	1,708	1,708
Company owned life insurance	4,315	4,974	4,974	4,315	4,864	4,864
Other invested assets	2,574	2,574	2,574	3,457	3,457	3,457
Total investments	$110,114	$114,760	$114,731	$110,052	$113,196	$113,156

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
FINANCIAL STATEMENT SCHEDULES

Schedule II. Condensed Financial Information of Registrant
THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)
BALANCE SHEETS
(dollars in thousands)

	December 31,	
	2017	2016
Assets		
Fixed maturities available-for-sale, at estimated fair value	$1,446	$1,466
Investment real estate, at book value	356	356
Cash	1,753	1,690
Investment in subsidiaries (equity method) eliminated upon consolidation	61,001	61,108
Deferred income tax asset	1,745	1,826
Other assets	494	2,058
Total Assets	$66,795	$68,504
Liabilities and Shareholders' Equity		
Liabilities		
Accrued general expenses	$2,923	$2,296
Interest rate swaps	608	1,030
Short-term notes payable	1,300	1,800
Long-term debt	14,339	15,326
Total Liabilities	19,170	20,452
Total Shareholders' Equity	47,625	48,052
Total Liabilities and Shareholders' Equity	$66,795	$68,504

THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)
STATEMENTS OF INCOME
(dollars in thousands)

	Years Ended December 31,	
	2017	2016
Income		
Dividends (eliminated upon consolidation)	$900	$1,750
Holding company management service fees	1,019	1,011
Other income	65	64
	1,984	2,825
Expenses		
State taxes	43	43
Interest	1,234	1,274
Other expenses	792	626
	2,069	1,943
Income (loss) before income taxes and equity in undistributed earnings of subsidiaries	(85)	882
Income tax expense (benefit)	74	(274)
Income (loss) before equity in undistributed earnings of subsidiaries	(159)	1,156
Equity in undistributed earnings of subsidiaries	(1,044)	1,907
Net income (loss)	$(1,203)	$3,063

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
FINANCIAL STATEMENT SCHEDULES

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

	Years Ended December 31,	
	2017	2016
Cash Flows from Operating Activities:		
Net income	$(1,203)	$3,063
Adjustments to reconcile net income to net cash provided by (used in)operating activities:		
Equity in undistributed earnings of subsidiaries	1,044	(1,907)
Deferred income tax expense	210	1,481
Other, net	2,016	(643)
Net cash provided by operating activities	2,067	1,994
Cash Flows from Investing Activities:		
Net sales (purchases) of investments	—	—
Net cash provided by investing activities	—	—
Cash Flows from Financing Activities:		
Net (repayments) proceeds from debt	(1,500)	(843)
Cash dividends	(504)	(452)
Net cash used in financing activities	(2,004)	(1,295)
Net change in cash and cash equivalents	63	699
Cash and cash equivalents, at beginning of year	1,690	991
Cash and cash equivalents, at end of year	$1,753	$1,690

Notes to Condensed Financial Information of Registrant

Note 1 - Basis of Presentation

Pursuant to the rules and regulations of the Securities and Exchange Commission, the Condensed Financial Information of the Registrant does not include all of the information and notes normally included with financial statements prepared in accordance with generally accepted accounting principles. It is, therefore, suggested that this Condensed Financial Information be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Registrant's Annual Report as referenced in Form 10-K, Part II, Item 8, page 44.

Note 2 - Cash Dividends and Asset Transfers from Insurance Subsidiaries

In 2017, cash dividends of $900,000 were paid to the Registrant by its subsidiaries ($1,750,000 in 2015).

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
FINANCIAL STATEMENT SCHEDULES

Schedule III. Supplementary Insurance Information
THE NATIONAL SECURITY GROUP, INC.

(dollars in thousands)	Deferred Acquisition Costs	Future Policy Benefits	Unearned Premiums	Unpaid Losses
At December 31, 2017:				
Life and accident and health insurance	$ 4,690	$ 36,878	$ 10	$ 903
Property and casualty insurance	3,434	—	30,102	7,075
Total	$ 8,124	$ 36,878	$ 30,112	$ 7,978
At December 31, 2016:				
Life and accident and health insurance	$ 4,907	$ 36,038	$ 13	$ 1,008
Property and casualty insurance	3,444	—	29,955	7,531
Total	$ 8,351	$ 36,038	$ 29,968	$ 8,539

	Premium Revenue	Net Investment Income	Other Income	Benefits, Claims, Losses and Settlement Expenses	Commissions, Amortization of Policy Acquisition Costs	General Expenses, Taxes, Licenses and Fees
For the year ended December 31, 2017:						
Life and accident and health insurance	$6,119	$ 2,011	$ 3	$ 5,045	$ 1,155	$ 1,521
Property and casualty insurance	55,044	1,571	593	37,824	10,157	8,907
Other	—	65	—	—	—	838
Total	$61,163	$ 3,647	$ 596	$ 42,869	$ 11,312	$ 11,266
For the year ended December 31, 2016:						
Life and accident and health insurance	$6,234	$ 2,122	$ 2	$ 5,285	$ 1,033	$ 1,708
Property and casualty insurance	55,164	1,706	603	33,562	10,367	8,823
Other	—	64	—	—	—	669
Total	$61,398	$ 3,892	$ 605	$ 38,847	$ 11,400	$ 11,200

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

Schedule IV. Reinsurance
THE NATIONAL SECURITY GROUP, INC.

(dollars in thousands)	Gross Amount	Ceded to Other Companies	Assumed from Other Companies	Net Amount	Percentage of Amount Assumed to Net
For the year ended December 31, 2017					
Life insurance in force	$206,826	$ 10,413	$ —	$196,413	— %
Premiums:					
Life insurance and accident and health insurance	$6,196	$ 77	$ —	$6,119	— %
Property and casualty insurance	61,316	6,272	—	55,044	— %
Total premiums	$67,512	$ 6,349	$ —	$61,163	— %
For the year ended December 31, 2016					
Life insurance in force	$208,420	$ 9,825	$ —	$198,595	— %
Premiums:					
Life insurance and accident and health insurance	$6,303	$ 69	$ —	$6,234	— %

Property and casualty insurance	60,994	5,830	—	55,164	— %
Total premiums	$67,297	$ 5,899	$ —	$61,398	— %

83

Table of Contents

THE NATIONAL SECURITY GROUP, INC.
FINANCIAL STATEMENT SCHEDULES

Schedule V. Valuation and Qualifying Accounts
The National Security Group, Inc.
Years ended December 31, 2017 and 2016
(dollars in thousands)

	2017	2016
Balance, January 1 Allowance for Doubtful Accounts	$ 7	$ 6
Additions	1	2
Deletions	4	1
Balance, December 31 Allowance for Doubtful Accounts	$ 4	$ 7

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

Item 9A. Controls and Procedures
Company management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this annual report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

Management's Report on Internal Control over Financial Reporting

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

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

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

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

over financial reporting was effective as of December 31, 2017.

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

Table of Contents

Item 9B. Other Information
None.

Part III

Item 10. Directors, Executive Officers and Corporate Governance
Executive Officers
JACK E. BRUNSON (61) has served as a director since 1999 and as President of NSFC since 1997. He also serves on the Boards of Directors of NSFC and Omega. He joined the Company in 1982. Mr. Brunson is a Chartered Property and Casualty Underwriter.

W. L. BRUNSON, JR. (59) has served as a director since 1999 and as President and Chief Executive Officer of the Company since 2000. He also holds the position of President of NSIC. He joined the Company in 1983. Mr. Brunson is also a director of NSFC, NATSCO, NSIC, and Omega. Mr. Brunson is a member of the Alabama State Bar.

BRIAN R. MCLEOD (49) currently serves as Vice President of Finance & Operations, CFO and Treasurer of the Company. From 1992-2002 he served as Controller. He joined the Company in 1992. Mr. McLeod is a Director of NSIC, NSFC, Omega and NATSCO. Mr. McLeod is also a member of the Board of Directors for Trinity Bank, a community bank in Dothan, Alabama. Mr. McLeod is a Certified Public Accountant.

The information contained in The National Security Group's definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 6, 2018 with respect to directors and executive officers of the Company as well as Corporate Governance, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 6, 2018 with respect to Audit Committee and Audit Committee financial expert, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 6, 2018 with respect to information on the beneficial ownership reporting for directors and executive officers, is incorporated herein by reference in response to this item.

Item 11. Executive Compensation
The information contained in The National Security Group's definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 6, 2018, with respect to executive compensation and transactions, is incorporated herein by reference in response to this item.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters
The information contained in The National Security Group's definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 6, 2018, with respect to security ownership of certain beneficial owners and management is incorporated herein by reference in response to this item.

Item 13. Certain Relationships and Related Transactions and Director Independence
The information contained in The National Security Group's definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 6, 2018, with respect to certain relationships and related transactions, is incorporated herein by reference in response to this item.

Item 14. Principal Accounting Fees and Services

The information contained in The National Security Group's definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 6, 2018, with respect to principal accountant fees and services, is incorporated herein by reference in response to this item.

Table of Contents

PART IV

Item 15. Exhibits and Financial Statement Schedules

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

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

- Report of Independent Registered Public Accounting Firm
- Consolidated Balance Sheets - December 31, 2017 and 2016
- Consolidated Statements of Income (Loss) - Years ended December 31, 2017 and 2016
- Consolidated Statements of Comprehensive Income - Years ended December 31, 2017 and 2016
- Consolidated Statements of Shareholders' Equity - Years ended December 31, 2017 and 2016
- Consolidated Statements of Cash Flows - Years ended December 31, 2017 and 2016
- Consolidated Notes to the Financial Statements

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

The National Security Group, Inc.

Schedule I Summary of Investments Other Than Investments in Related Parties
Schedule II Condensed Financial Information of the Registrant
Schedule III Supplementary Insurance Information
Schedule IV Reinsurance
Schedule V Valuation and Qualifying Accounts

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

11.	Computation of Earnings Per Share filed Herewith, See Note 1 to Consolidated Financial Statements.
14.	Code of Ethics, See Additional Information in Part 1, Item 1 of This Report
21.1	Subsidiaries of the Registrant
31.1	Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.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:

Date of Report	Date Filed	Description
October 20, 2017	October 23, 2017	Press release announcing quarterly dividend.
November 13, 2017	November 13, 2017	Press release announcing financial results for the period ended September 30, 2017.

Table of Contents

SIGNATURE

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

THE NATIONAL SECURITY GROUP, INC.

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

Date: March 16, 2018

POWER OF ATTORNEY

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

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in their capacity as a Director of The National Security Group, Inc. on March 16, 2018:

SIGNATURE

/s/ Charles Arnold	/s/ Brian R. McLeod
/s/ Winfield Baird	/s/ Mickey L. Murdock
/s/ Fleming Brooks	/s/ Frank B. O'Neil
/s/ Jack E. Brunson	/s/ Donald Pittman
/s/ William L. Brunson, Jr.	/s/ Paul C. Wesch
/s/ Fred D. Clark, Jr.	/s/ L. Brunson White

/s/ Elizabeth Crawford /s/ Walter P. Wilkerson

87