NATIONAL SECURITY GROUP INC
Form 10-Q
May 14, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For Quarterly Period Ended March 31, 2015

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

Commission File Number 0-18649

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

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

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

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

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

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

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

As of May 14, 2015, there were 2,507,452 shares, $1.00 par value, of the registrant’s common stock outstanding.

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THE NATIONAL SECURITY GROUP, INC.

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PART I. FINANCIAL INFORMATION

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Cautionary Statement Regarding Forward-Looking Statements

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

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

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

The Company is subject to regulation by state governments for each of the states in which it conducts business. The Company cannot predict the subject of any future regulatory initiative(s) or its (their) impact on the Company's business.

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

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

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

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

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

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

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

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PART I. Financial Information

Item 1. Financial Statements

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (In thousands)

	March 31, 2015 (UNAUDITED)	December 31, 2014
ASSETS		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2015 - $2,905; 2014 - $3,182)	$2,767	$3,108
Fixed maturities available-for-sale, at estimated fair value (cost: 2015 - $86,454; 2014 - $84,024)	89,901	86,886
Equity securities available-for-sale, at estimated fair value (cost: 2015 - $2,420; 2014 - $2,420)	4,964	4,995
Trading securities	19	19
Mortgage loans on real estate, at cost	208	210
Investment real estate, at book value	3,735	3,735
Policy loans	1,556	1,530
Company owned life insurance	5,161	5,513
Other invested assets	3,484	3,553
Total Investments	111,795	109,549
Cash	7,108	6,426
Accrued investment income	842	797
Policy receivables and agents' balances, net	11,285	10,948
Reinsurance recoverable	1,510	939
Deferred policy acquisition costs	8,586	8,592
Property and equipment, net	2,035	2,013
Deferred income tax asset, net	3,055	3,189
Other assets	800	2,412
Total Assets	$147,016	$144,865
LIABILITIES AND SHAREHOLDERS' EQUITY		
Property and casualty benefit and loss reserves	$8,876	$8,321
Accident and health benefit and loss reserves	2,991	3,017
Life and annuity benefit and loss reserves	31,482	31,418
Unearned premiums	29,564	28,853
Policy and contract claims	1,113	996
Other policyholder funds	1,525	1,510
Short-term notes payable and current portion of long-term debt	1,557	857
Long-term debt	17,515	18,715
Accrued income taxes	492	487
Other liabilities	7,688	7,934
Total Liabilities	102,803	102,108
Contingencies		
Shareholders' equity		
Common stock	2,508	2,508

Additional paid-in capital	5,267	5,267
Accumulated other comprehensive income	3,020	2,772
Retained earnings	33,418	32,210
Total Shareholders' Equity	44,213	42,757
Total Liabilities and Shareholders' Equity	$147,016	$144,865

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

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THE NATIONAL SECURITY GROUP, INC.

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

	Three Months Ended March 31,	
	2015	2014
REVENUES		
Net premiums earned	$14,706	$13,824
Net investment income	974	948
Net realized investment gains	142	88
Other income	158	154
Total Revenues	15,980	15,014
BENEFITS, LOSSES AND EXPENSES		
Policyholder benefits and settlement expenses	8,262	7,864
Amortization of deferred policy acquisition costs	899	898
Commissions	2,055	2,027
General and administrative expenses	2,006	2,026
Taxes, licenses and fees	655	530
Interest expense	317	386
Total Benefits, Losses and Expenses	14,194	13,731
Income Before Income Taxes	1,786	1,283
INCOME TAX EXPENSE		
Current	471	88
Deferred	7	196
	478	284
Net Income	$1,308	$999
INCOME PER COMMON SHARE BASIC AND DILUTED	$0.52	$0.40
DIVIDENDS DECLARED PER SHARE	$0.04	$0.03

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

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THE NATIONAL SECURITY GROUP, INC.

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

	Three Months Ended March 31,	
	2015	2014
Net income	$1,308	$999
Other comprehensive income (loss), net of tax		
Changes in:		
Unrealized gains on securities, net of reclassification adjustment of $94 and $59 for 2015 and 2014, respectively	365	1,073
Unrealized loss on interest rate swap	(117)	(76)
Other comprehensive income, net of tax	248	997
Comprehensive income	$1,556	$1,996

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

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THE NATIONAL SECURITY GROUP, INC.

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

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital
Balance at December 31, 2014 (AUDITED)	$42,757	$32,210	$2,772	$2,508	$5,267
Net income for the three months ended March 31, 2015	1,308	1,308			
Other comprehensive income (net of tax)	248		248		
Cash dividends	(100)	(100)			
Balance at March 31, 2015	$44,213	$33,418	$3,020	$2,508	$5,267

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

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THE NATIONAL SECURITY GROUP, INC.

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

	Three months ended March 31, 2015	2014
Cash Flows from Operating Activities		
Net income	$1,308	$999
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense and amortization/accretion, net	79	134
Increase in cash surrender value of company owned life insurance	(44)	(30)
Net realized gains on investments	(142)	(88)
Deferred income taxes	7	196
Amortization of deferred policy acquisition costs	899	898
Changes in assets and liabilities:		
Change in accrued investment income	(45)	(19)
Change in reinsurance recoverable	(571)	223
Policy acquisition costs deferred	(893)	(856)
Change in accrued income taxes	5	38
Change in net policy liabilities and claims	1,075	1,066
Change in other assets/liabilities, net	1,247	(71)
Other, net	8	8
Net cash provided by operating activities	2,933	2,498
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(7,582)	(2,707)
Property and equipment	(69)	(4)
Proceeds from sale or maturities of:		
Held-to-maturity securities	346	39
Available-for-sale securities	5,256	2,370
Property and equipment	—	3
Other invested assets, net	383	34
Net cash used in investing activities	(1,666)	(265)
Cash Flows from Financing Activities		
Change in other policyholder funds	15	19
Proceeds from long-term debt	—	275
Repayments of long-term debt	(500)	—
Change in short-term notes payable	—	(700)
Dividends paid	(100)	(75)
Net cash used in financing activities	(585)	(481)
Net change in cash and cash equivalents	682	1,752
Cash and cash equivalents, beginning of year	6,426	4,987
Cash and cash equivalents, end of year	$7,108	$6,739

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

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED EXCEPT FOR DECEMBER 31, 2014 AMOUNTS)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation
The accompanying condensed consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary, Omega One Insurance Company (Omega). The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). In the opinion of management, all adjustments, consisting of normal and recurring items, necessary for the fair presentation of the condensed consolidated financial statements have been included. All significant intercompany transactions and accounts have been eliminated. The financial information presented herein should be read in conjunction with the Company’s Annual
Report on Form 10-K for the year ended December 31, 2014, which includes information and disclosures not presented
herein.

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

Earnings Per Share
Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,507,452 in 2015 and 2,494,480 in 2014.

Reclassifications
Certain 2014 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2015 presentation.

Concentration of Credit Risk
The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts subject to FDIC insured limits of $250,000 per entity. At March 31, 2015, the net amount exceeding FDIC insured limits was $3,924,000 at one financial institution. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of financial institutions on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At March 31, 2015, the single largest balance due from one agent totaled $937,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At March 31, 2015 and December 31, 2014, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At March 31, 2015, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED EXCEPT FOR DECEMBER 31, 2014 AMOUNTS)

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. This guidance is effective retrospectively for fiscal years beginning after December 15, 2016 and interim periods within those years. Early adoption of this standard is not permitted. Although insurance contracts are specifically scoped out of this new guidance, the Company has minor services that may be subject to the new revenue recognition guidance and are still in the process of evaluating the impact, if any, the guidance may have on its consolidated financial statements.

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

Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items
In January 2015, the FASB issued guidance that eliminates from GAAP the concept of extraordinary items. The guidance is effective for fiscal periods ending after December 15, 2015 and interim periods thereafter. Early adoption is permitted. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Amendments to the Consolidation Analysis
In February 2015, the FASB issued additional guidance regarding the consolidation of certain legal entities. The guidance modifies the evaluation of whether or not limited partnerships and similar legal entities are variable interest entities (VIEs) and the consolidation analysis of entities involved with VIEs, particularly those that have fee arrangements and related party relationships. This guidance is effective for fiscal years beginning after December 15, 2015. The Company does not expect the adoption to have a material impact on its financial position or results of operations.

Recently Adopted Accounting Standards

Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures
In June 2014, the FASB issued guidance requiring secured borrowing accounting treatment for repurchase-to-maturity transactions and provides guidance on accounting for repurchase financing arrangements. This ASU is effective for interim and annual reporting periods beginning after December 15, 2014. The Company adopted this standard on

January 1, 2015. The Company is the counter party to repurchase agreements and as such, the adoption did not have a material impact on its financial position or results of operations.

Reporting Discontinued Operations and Disclosure of Disposals of components of an Entity

In April 2014, the FASB issued guidance which modifies the definition of discontinued operations by limiting discontinued operations reporting to disposals of components of an entity that represent strategic shifts that have (or will have) a major effect on an entity's operations and financial results. Also, this update requires additional financial statement disclosures about discontinued operations, as well as disposals of an individually significant component of an entity that do not qualify for discontinued operations presentation. This ASC update is effective for all disposals (or classifications as held for sale) of components of an entity that occur within annual and interim periods beginning on or after December 15, 2014 and for all businesses that, on acquisition, are classified as held for sale that also occur within interim and annual periods beginning on or after December 15, 2014. The Company adopted this standard on

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED EXCEPT FOR DECEMBER 31, 2014 AMOUNTS)

January 1, 2015. The Company has no discontinued operations, and the adoption of this standard did not have a material impact on its financial position or results of operations.

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 $294,000 and is included as a component of Other Invested Assets in the accompanying condensed consolidated balance sheets.

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, $9,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase $9,279,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of $9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 8, are reported in the accompanying condensed consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total $279,000 and are included in Other Assets in the accompanying condensed consolidated balance sheets.

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

NOTE 3 – INVESTMENTS

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

Available-for-sale securities:	Amortized Cost	Gross Unrealized	Gross Unrealized	Fair Value

		Gains	Losses	
Corporate debt securities	$36,570	$1,904	$311	$38,163
Mortgage backed securities	11,998	297	132	12,163
Private label mortgage backed securities	5,111	42	73	5,080
Obligations of states and political subdivisions	14,885	1,043	4	15,924
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	17,890	727	46	18,571
Total fixed maturities	86,454	4,013	566	89,901
Equity securities	2,420	2,690	146	4,964
Total	$88,874	$6,703	$712	$94,865

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THE NATIONAL SECURITY GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED EXCEPT FOR DECEMBER 31, 2014 AMOUNTS)

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

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	$2,708	$134	$—	$2,842
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	59	4	—	63
Total	$2,767	$138	$—	$2,905

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2014 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	$37,299	$1,773	$405	$38,667
Mortgage backed securities	12,691	214	153	12,752
Private label mortgage backed securities	1,261	38	3	1,296
Obligations of states and political subdivisions	14,919	993	13	15,899
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	17,854	525	107	18,272
Total fixed maturities	84,024	3,543	681	86,886
Equity securities	2,420	2,745	170	4,995
Total	$86,444	$6,288	$851	$91,881

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2014 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	$2,818	$69	$—	$2,887
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	290	5	—	295
Total	$3,108	$74	$—	$3,182

The amortized cost and aggregate fair value of debt securities at March 31, 2015, by contractual maturity, are presented in the following table (