

NATIONAL SECURITY GROUP INC
Form 10-Q
August 13, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For Quarterly Period Ended June 30, 2014

or

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

For the transition period from _____ to _____.

Commission File Number 0-18649

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

Delaware (State or Other Jurisdiction of Incorporation or Organization)	63-1020300 (IRS Employer Identification No.)
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661 East Davis Street Elba, Alabama (Address of principal executive offices)	36323 (Zip-Code)
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Registrant's Telephone Number including Area Code (334) 897-2273

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

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

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

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

As of August 13, 2014, 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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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)

	June 30, 2014 (UNAUDITED)	December 31, 2013
ASSETS		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2014 - \$783; 2013 - \$853)	\$728	\$812
Fixed maturities available-for-sale, at estimated fair value (cost: 2014 - \$81,984; 2013 - \$79,074)	85,092	79,434
Equity securities available-for-sale, at estimated fair value (cost: 2014 - \$2,420; 2013 - \$2,420)	4,888	4,374
Trading securities	19	19
Mortgage loans on real estate, at cost	229	333
Investment real estate, at book value	4,288	4,218
Policy loans	1,480	1,443
Company owned life insurance	5,996	5,858
Other invested assets	3,478	3,559
Total Investments	106,198	100,050
Cash	6,179	4,987
Accrued investment income	802	817
Policy receivables and agents' balances, net	12,176	10,276
Reinsurance recoverable	789	1,501
Deferred policy acquisition costs	8,960	8,776
Property and equipment, net	1,991	2,077
Accrued income tax recoverable	—	6
Deferred income tax asset, net	3,609	4,654
Other assets	2,563	836
Total Assets	\$143,267	\$133,980
LIABILITIES AND SHAREHOLDERS' EQUITY		
Property and casualty benefit and loss reserves	\$9,328	\$8,734
Accident and health benefit and loss reserves	2,694	2,651
Life and annuity benefit and loss reserves	31,163	30,696
Unearned premiums	30,512	27,301
Policy and contract claims	896	842
Other policyholder funds	1,483	1,447
Short-term notes payable and current portion of long-term debt	1,166	1,866
Long-term debt	21,164	20,889
Accrued income taxes	52	—
Other liabilities	6,441	6,082
Total Liabilities	104,899	100,508
Contingencies		
Shareholders' equity		

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Common stock	2,508	2,495
Additional paid-in capital	5,267	5,147
Accumulated other comprehensive income	2,915	936
Retained earnings	27,678	24,894
Total Shareholders' Equity	38,368	33,472
Total Liabilities and Shareholders' Equity	\$143,267	\$133,980

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 June 30,		Six months ended June 30,	
	2014	2013	2014	2013
REVENUES				
Net premiums earned	\$14,100	\$13,038	\$27,924	\$25,972
Net investment income	1,030	689	1,978	1,734
Net realized investment gains	312	1,030	400	1,057
Other income	1,713	145	1,867	317
Total Revenues	17,155	14,902	32,169	29,080
BENEFITS, LOSSES AND EXPENSES				
Policyholder benefits and settlement expenses	9,155	8,260	17,019	17,811
Amortization of deferred policy acquisition costs	873	923	1,771	1,865
Commissions	1,967	1,486	3,994	3,468
General and administrative expenses	2,413	2,162	4,439	3,965
Taxes, licenses and fees	521	474	1,051	960
Interest expense	382	435	768	877
Total Benefits, Losses and Expenses	15,311	13,740	29,042	28,946
Income Before Income Taxes	1,844	1,162	3,127	134
INCOME TAX EXPENSE (BENEFIT)				
Current	80	88	168	220
Deferred	(170)	) 109	26	(642)
	(90)	) 197	194	(422)
Net Income	\$1,934	\$965	\$2,933	\$556
INCOME PER COMMON SHARE BASIC AND DILUTED	\$0.77	\$0.39	\$1.18	\$0.23
DIVIDENDS DECLARED PER SHARE	\$0.03	\$0.025	\$0.06	\$0.05

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

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THE NATIONAL SECURITY GROUP, INC.

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

	Three months ended June 30, 2014		Six months ended June 30, 2014	
	2013		2013	
Net income	\$1,934	\$965	\$2,933	\$556
Other comprehensive income (loss), net of tax				
Changes in:				
Unrealized gains (losses) on securities, net of reclassification adjustment of \$264 and \$698 for 2014 and 2013, respectively	1,080	(2,482)	2,153	(1,956)
Unrealized gain (loss) on interest rate swap	(98 )	) 302	(174 )	) 354
Other comprehensive income (loss), net of tax	982	(2,180)	1,979	(1,602)
Comprehensive income (loss)	\$2,916	\$(1,215)	\$4,912	\$(1,046)

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, 2013 (AUDITED)	\$33,472	\$24,894	\$936	\$2,495	\$5,147
Net income for the six months ended June 30, 2014	2,933	2,933			
Other comprehensive income (net of tax)	1,979		1,979		
Common stock issued	133			13	120
Cash dividends	(149)	(149)			
Balance at June 30, 2014	\$38,368	\$27,678	\$2,915	\$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)

	Six months ended	
	June 30,	
	2014	2013
Cash Flows from Operating Activities		
Net income	\$2,933	\$556
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation expense and amortization/accretion, net	262	398
Increase (decrease) in cash surrender value of company owned life insurance	(138)	) 148
Net realized gains on investments	(400)	) (1,057)
Deferred income taxes	26	) (642)
Amortization of deferred policy acquisition costs	1,771	1,865
Changes in assets and liabilities:		
Change in accrued investment income	15	(24)
Change in reinsurance recoverable	712	8
Policy acquisition costs deferred	(1,955)	) (1,812)
Change in accrued income taxes	58	120
Change in net policy liabilities and claims	2,459	(1,614)
Change in other assets/liabilities, net	(1,459)	) (587)
Other, net	13	233
Net cash provided by (used in) operating activities	4,297	(2,408)
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(8,619)	) (9,619)
Property and equipment	(123)	) (67)
Proceeds from sale or maturities of:		
Held-to-maturity securities	83	364
Available-for-sale securities	5,865	8,319
Real estate held for investment	—	207
Property and equipment	219	6
Other invested assets, net	8	3
Net cash used in investing activities	(2,567)	) (787)
Cash Flows from Financing Activities		
Change in other policyholder funds	36	5
Change in long-term debt	275	300
Change in short-term notes payable	(700)	) 75
Dividends paid	(149)	) (123)
Net cash (used in) provided by financing activities	(538)	) 257
Net change in cash and cash equivalents	1,192	(2,938)
Cash and cash equivalents, beginning of year	4,987	6,779
Cash and cash equivalents, end of year	\$6,179	\$3,841

The Notes to 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, 2013 AMOUNTS)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary, Omega One Insurance Company (Omega). The accompanying 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 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, 2013, which includes information and disclosures not presented herein.

Use of Estimates

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

Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,495,770 in 2014 and 2,467,062 in 2013.

Reclassifications

Certain 2013 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2014 presentation.

Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts. Through December 31, 2012, these balances were insured by the FDIC with no balance limits. On January 1, 2013, \$250,000 per entity account balance limits were reinstated. At June 30, 2014, the net amount exceeding FDIC insured limits was \$3,769,000 at one financial institution. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of the financial institution 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 June 30, 2014, the single largest balance due from one agent totaled \$1,407,000.

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 June 30, 2014 and 2013, 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 June 30, 2014, 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, 2013 AMOUNTS)

Recently Adopted Accounting Standards

Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists

In July 2013, the FASB issued guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss ("NOL") carryforward, a similar tax loss, or a tax credit carryforward exists. This guidance applies to all entities with unrecognized tax benefits that also have tax loss or tax credit carryforwards in the same tax jurisdiction as of the reporting date. This guidance is effective for fiscal years beginning after December 15, 2013. The Company adopted this standard on January 1, 2014. This guidance did not have a material effect on results of operations or financial position.

Revenue from Contracts with Customers

In May 2014, the 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. The Company is currently evaluating the impact of this guidance on its consolidated financial statement.

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 \$325,000 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 securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$9,279,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 7, are reported in the accompanying consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$279,000 and are included in Other Assets in the accompanying consolidated balance sheets.

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

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THE NATIONAL SECURITY GROUP, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (UNAUDITED EXCEPT FOR DECEMBER 31, 2013 AMOUNTS)

NOTE 3 – INVESTMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of June 30, 2014 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$37,728	\$2,315	\$127	\$39,916
Mortgage backed securities	10,146	169	194	10,121
Private label mortgage backed securities	1,626	60	1	1,685
Obligations of states and political subdivisions	15,410	820	60	16,170
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	17,074	375	249	17,200
Total fixed maturities	81,984	3,739	631	85,092
Equity securities	2,420	2,688	220	4,888
Total	\$84,404	\$6,427	\$851	\$89,980

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of June 30, 2014 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$648	\$51	\$—	\$699
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	80			