NATIONAL SECURITY GROUP INC
Form 10-Q
November 13, 2014
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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 September 30, 2014

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 November 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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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)

	September 30, 2014 (UNAUDITED)	December 31, 2013
ASSETS		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2014 - $1,064; 2013 - $853)	$1,021	$812
Fixed maturities available-for-sale, at estimated fair value (cost: 2014 - $84,541; 2013 - $79,074)	87,207	79,434
Equity securities available-for-sale, at estimated fair value (cost: 2014 - $2,420; 2013 - $2,420)	4,762	4,374
Trading securities	19	19
Mortgage loans on real estate, at cost	227	333
Investment real estate, at book value	4,288	4,218
Policy loans	1,523	1,443
Company owned life insurance	5,494	5,858
Other invested assets	3,509	3,559
Total Investments	108,050	100,050
Cash	8,575	4,987
Accrued investment income	836	817
Policy receivables and agents' balances, net	11,983	10,276
Reinsurance recoverable	814	1,501
Deferred policy acquisition costs	8,900	8,776
Property and equipment, net	1,996	2,077
Accrued income tax recoverable	—	6
Deferred income tax asset, net	3,624	4,654
Other assets	928	836
Total Assets	$145,706	$133,980
LIABILITIES AND SHAREHOLDERS' EQUITY		
Property and casualty benefit and loss reserves	$8,868	$8,734
Accident and health benefit and loss reserves	2,843	2,651
Life and annuity benefit and loss reserves	31,297	30,696
Unearned premiums	31,082	27,301
Policy and contract claims	957	842
Other policyholder funds	1,485	1,447
Short-term notes payable and current portion of long-term debt	1,166	1,866
Long-term debt	20,539	20,889
Accrued income taxes	566	—
Other liabilities	7,139	6,082
Total Liabilities	105,942	100,508
Contingencies		
Shareholders' equity		

Common stock	2,508	2,495
Additional paid-in capital	5,267	5,147
Accumulated other comprehensive income	2,590	936
Retained earnings	29,399	24,894
Total Shareholders' Equity	39,764	33,472
Total Liabilities and Shareholders' Equity	$145,706	$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 September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
REVENUES				
Net premiums earned	$14,374	$13,191	$42,298	$39,163
Net investment income	824	1,007	2,802	2,741
Net realized investment gains	141	3,297	541	4,354
Other income	158	163	2,025	480
Total Revenues	15,497	17,658	47,666	46,738
BENEFITS, LOSSES AND EXPENSES				
Policyholder benefits and settlement expenses	7,172	7,112	24,191	24,923
Amortization of deferred policy acquisition costs	946	894	2,717	2,759
Commissions	2,166	1,800	6,160	5,268
General and administrative expenses	1,719	2,117	6,158	6,082
Taxes, licenses and fees	514	438	1,565	1,398
Interest expense	380	434	1,148	1,311
Total Benefits, Losses and Expenses	12,897	12,795	41,939	41,741
Income Before Income Taxes	2,600	4,863	5,727	4,997
INCOME TAX EXPENSE				
Current	651	332	819	552
Deferred	152	1,192	178	550
	803	1,524	997	1,102
Net Income	$1,797	$3,339	$4,730	$3,895
INCOME PER COMMON SHARE BASIC AND DILUTED	$0.72	$1.35	$1.89	$1.57
DIVIDENDS DECLARED PER SHARE	$0.03	$0.025	$0.09	$0.075

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 (UNAUDITED)
(In thousands)

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Net income	$1,797	$3,339	$4,730	$3,895
Other comprehensive income (loss), net of tax				
Changes in:				
Unrealized gains (losses) on securities, net of reclassification adjustment of $242 and $731 for 2014 and 2013, respectively	(375)	(229)	1,778	(2,185)
Unrealized gain (loss) on interest rate swap	50	(30)	(124)	324
Other comprehensive income (loss), net of tax	(325)	(259)	1,654	(1,861)
Comprehensive income	$1,472	$3,080	$6,384	$2,034

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 nine months ended September 30, 2014	4,730	4,730			
Other comprehensive income (net of tax)	1,654		1,654		
Common stock issued	133			13	120
Cash dividends	(225)	(225)			
Balance at September 30, 2014	$39,764	$29,399	$2,590	$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)

	Nine months ended September 30, 2014	2013
Cash Flows from Operating Activities		
Net income	$4,730	$3,895
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense and amortization/accretion, net	390	563
Decrease in cash surrender value of company owned life insurance	364	100
Net realized gains on investments	(541)	(4,354)
Deferred income taxes	178	550
Amortization of deferred policy acquisition costs	2,717	2,759
Changes in assets and liabilities:		
Change in accrued investment income	(19)	(42)
Change in reinsurance recoverable	687	193
Policy acquisition costs deferred	(2,841)	(2,704)
Change in accrued income taxes	572	358
Change in net policy liabilities and claims	3,101	(791)
Change in other assets/liabilities, net	919	(310)
Other, net	6	235
Net cash provided by operating activities	10,263	452
Cash Flows from Investing Activities		
Purchase of:		
Held-to-maturity securities	(324)	—
Available-for-sale securities	(14,145)	(13,553)
Property and equipment	(214)	(67)
Proceeds from sale or maturities of:		
Held-to-maturity securities	115	623
Available-for-sale securities	8,910	10,485
Real estate held for investment	—	4,847
Property and equipment	253	7
Other invested assets, net	(33)	(54)
Net cash (used in) provided by investing activities	(5,438)	2,288
Cash Flows from Financing Activities		
Change in other policyholder funds	38	22
Change in long-term debt	(350)	(3,634)
Change in short-term notes payable	(700)	(125)
Dividends paid	(225)	(186)
Net cash used in financing activities	(1,237)	(3,923)
Net change in cash and cash equivalents	3,588	(1,183)
Cash and cash equivalents, beginning of year	4,987	6,779
Cash and cash equivalents, end of year	$8,575	$5,596

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 2,499,706 at September 30, 2014 and 2,476,302 at September 30, 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 September 30, 2014, the net amount exceeding FDIC insured limits was $4,859,000 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 September 30, 2014, the single largest balance due from one agent totaled $875,000.

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 September 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 September 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. Although insurance contracts are specifically scoped out of this new guidance, we have 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 our consolidated financial statements.

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

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

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 – INVESTMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of September 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	$38,522	$1,946	$211	$40,257
Mortgage backed securities	11,742	133	230	11,645
Private label mortgage backed securities	1,401	45	3	1,443
Obligations of states and political subdivisions	14,927	913	45	15,795
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	17,949	365	247	18,067
Total fixed maturities	84,541	3,402	736	87,207
Equity securities	2,420	2,530	188	4,762
Total	$86,961	$5,932	$924	$91,969

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of September 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	$624	$48	$—	$672
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	397	4	9	392
Total	$1,021	$52	$9	$1,064

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2013 are as follows (dollars in thousands):

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	$35,831	$1,698	$713	$36,816
Trust preferred securities	538	33	—	571
Mortgage backed securities	7,622	75	557	7,140
Private label mortgage backed securities	2,152	38	4	2,186
Obligations of states and political subdivisions	16,412	524	195	16,741
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	16,519	169	708	15,980
Total fixed maturities	79,074	2,537	2,177	79,434
Equity securities	2,420	2,365	411	4,374
Total	$81,494	$4,902	$2,588	$83,808

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

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2013 are as follows (dollars in thousands):

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	$706	$34	$—	$740
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	106	7	—	113
Total	$812	$41	$—	$853

The amortized cost and aggregate fair value of debt securities at September 30, 2014, by contractual maturity, are presented in the following table (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.

	(Dollars in Thousands)	
	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	$1,780	$1,814
Due after one year through five years	15,706	16,864
Due after five years through ten years	29,716	30,374
Due after ten years	37,339	38,155
Total	$84,541	$87,207
Held-to-maturity securities:		
Due in one year or less	$—	$—
Due after one year through five years	179	188
Due after five years through ten years	145	157
Due after ten years	697	719
Total	$1,021	$1,064

A summary of securities available-for-sale with unrealized losses as of September 30, 2014, 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		
September 30, 2014	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	$6,967	$117	$3,790	$94	$10,757	$211	22
Mortgage backed securities	2,396	20	2,618	210	5,014	230	17
Private label mortgage backed securities	—	—	109	3	109	3	1
	224	1	1,207	44	1,431	45	4

Obligations of state and political subdivisions							
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	3,435	64	4,256	183	7,691	247	15
Equity securities	—	—	1,098	188	1,098	188	1
	$13,022	$202	$13,078	$722	$26,100	$924	60

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

A summary of securities held-to-maturity with unrealized losses as of September 30, 2014, 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		
September 30, 2014	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Securities in a Loss Position
Fixed maturities							
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	$315	$9	—	—	$315	$9	1

A summary of securities available-for-sale with unrealized losses as of December 31, 2013, 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, 2013	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	$10,589	$600	$1,548	$113	$12,137	$713	26
Mortgage backed securities	3,215	427	1,796	130	5,011	557	18
Private label mortgage backed securities	472	4	—	—	472	4	3
Obligations of state and political subdivisions	3,545	165	325	30	3,870	195	11
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	11,534	600	390	108	11,924	708	21
Equity securities	—	—	875	411	875	411	1
	$29,355	$1,796	$4,934	$792	$34,289	$2,588	80

There were no securities held-to-maturity with unrealized losses as of December 31, 2013.

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.

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Management has evaluated each security in a significant unrealized loss position. The Company has no material exposure to sub-prime mortgage loans and less than 2.1% 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 nine months ended September 30, 2014 and 2013, the Company realized no additional other-than-temporary impairments.

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

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Fixed maturities	$855	$846	$2,571	$2,486
Equity securities	29	34	87	107
Mortgage loans on real estate	5	5	12	17
Investment real estate	1	2	4	6
Policy loans	29	27	84	77
Company owned life insurance change in surrender value	(89)	48	49	(100)
Other, principally short-term investments	56	98	184	306
	886	1,060	2,991	2,899
Less: Investment expenses	62	53	189	158
Net investment income	$824	$1,007	$2,802	$2,741

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

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Fixed maturities	$117	$(17)	$366	$110
Equity securities	—	—	—	928
Trading securities	—	—	—	—
Other, principally real estate	24	3,314	175	3,316
Other-than-temporary impairments	—	—	—	—
Net realized investment gains	$141	$3,297	$541	$4,354

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

	September 30, 2014	December 31, 2013
Net change in unrealized appreciation on available-for-sale securities before deferred tax	$2,694	$(4,243)
Deferred income tax	(916)	1,442
Net change in unrealized appreciation on available-for-sale securities	$1,778	$(2,801)

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NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

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

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

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

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

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

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

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

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

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Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2014 are summarized in the following table by the type of inputs applicable to the fair value measurements (unaudited) (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	$40,257	$—	$40,257	$—
Trust preferred securities	—	—	—	—
Mortgage backed securities	11,645	—	11,645	—
Private label mortgage backed securities	1,443	—	1,443	—
Obligations of states and political subdivisions	15,795	—	15,795	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	18,067	18,067	—	—
Trading securities	19	19	—	—
Equity securities available-for-sale	4,762	3,664	—	1,098
Total Financial Assets	$91,988	$21,750	$69,140	$1,098
Financial Liabilities				
Interest rate swap	$(1,085)	$—	$—	$(1,085)
Total Financial Liabilities	$(1,085)	$—	$—	$(1,085)

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

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

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

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

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

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

As of September 30, 2014, Level 3 fair value measurements of assets include $1,098,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of September 30, 2014, Level 3 fair value measurements of liabilities include $1,085,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party broker who utilizes financial

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

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2014 (in thousands):

For the nine months ended September 30, 2014	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	$875	$(897)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	223	(188)
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	$1,098	$(1,085)
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of September 30, 2014:	$—	$—

For the nine months ended September 30, 2014, there were no assets or liabilities measured at fair values on a nonrecurring basis.

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2013 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	$36,816	$—	$36,816	$—
Trust preferred securities	571	—	571	—
Mortgage backed securities	7,140	—	7,140	—
Private label mortgage backed securities	2,186	—	2,186	—
Obligations of states and political subdivisions	16,741	—	16,741	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	15,980	15,980	—	—
Trading securities	19	19	—	—
Equity securities available-for-sale	4,374	3,499	—	875
Total Financial Assets	$83,827	$19,498	$63,454	$875
Financial Liabilities				
Interest rate swap	$897	$—	$—	$897
Total Financial Liabilities	$897	$—	$—	$897

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The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2013 (in thousands):

For the year ended December 31, 2013	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	$829	$(1,521)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	46	624
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	$875	$(897)
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, 2013:	$—	$—

For the year ended December 31, 2013, there were no assets or liabilities measured at fair values on a nonrecurring basis.

The Company is exposed to certain risks in the normal course of its business operations. The primary risk that is managed through the use of derivatives is interest rate risk on floating rate borrowings. This risk is managed through the use of interest rate swap agreements which are designated as cash flow hedges. For cash flow hedges, the effective portion of the gain or loss on the interest rate swap is included as a component of other comprehensive income and reclassified into earnings in the same period during which the hedged transaction is recognized in earnings. The Company does not hold or issue derivatives that are not designated as hedging instruments. See Note 7 for additional information about the interest rate swap agreements.

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

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

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

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

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

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

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

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

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The carrying amount and estimated fair value of the Company's financial instruments as of September 30, 2014 and December 31, 2013 are as follows (in thousands):

	September 30, 2014		December 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related instruments				
Mortgage loans	$227	$227	$333	$333
Policy loans	1,523	1,523	1,443	1,443
Company owned life insurance	5,494	5,494	5,858	5,858
Other invested assets	3,509	3,509	3,559	3,559
Liabilities and related instruments				
Other policyholder funds	1,485	1,485	1,447	1,447
Short-term notes payable and current portion of long-term debt	1,166	1,166	1,866	1,866
Long-term debt	20,539	20,539	20,889	20,889

NOTE 5 – PROPERTY AND EQUIPMENT

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

	September 30, 2014	December 31, 2013
Building and improvements	$3,299	$3,185
Electronic data processing equipment	1,865	1,822
Furniture and fixtures	811	874
	5,975	5,881
Less accumulated depreciation	3,979	3,804
Property and equipment, net	$1,996	$2,077

Depreciation expense for the nine months ended September 30, 2014 was $257,000 ($386,000 for the year ended December 31, 2013).

NOTE 6 – INCOME TAXES

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 2013.

Net deferred tax 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. 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 $3,624,000 at

September 30, 2014 and $4,654,000 at December 31, 2013.

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

	As of September 30, 2014	As of December 31, 2013
General expenses	$1,349	$1,326
Unearned premiums	2,112	1,855
Claims liabilities	975	700
Litigation settlement	3,173	3,173
AMT credit	479	335
NOL carryforward	—	849
Unrealized loss on interest rate swaps	369	305
Deferred tax assets	8,457	8,543
Depreciation	(105)	(119)
Deferred policy acquisition costs	(3,026)	(2,984)
Unrealized gains on securities available-for-sale	(1,702)	(786)
Deferred tax liabilities	(4,833)	(3,889)
Net deferred tax asset	$3,624	$4,654

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

	Nine months ended September 30,	
	2014	2013
Deferred policy acquisition costs	$42	$(19)
Other-than-temporary impairments	—	96
Trading securities	—	(1)
Unearned premiums	(257)	(216)
General expenses	(23)	(72)
Depreciation	(14)	(23)
Claim liabilities	(275)	(277)
AMT credit	(144)	—
NOL carryforward	849	1,062
Deferred income tax expense (benefit)	$178	$550

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

	Nine months ended September 30,			
	2014		2013	
Federal income tax rate applied to pre-tax income/loss	34.0	%	34.0	%
Dividends received deduction and tax-exempt interest	(1.5	)%	(1.9	)%
Company owned life insurance	(9.9	)%	0.7	%
Small life deduction	(6.6	)%	(5.2	)%
Life reserve tax adjustment	—	%	(6.6	)%
Other, net	1.4	%	1.1	%
Effective federal income tax rate	17.4	%	22.1	%

NOTE 7 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of September 30, 2014 and December 31, 2013 (dollars in thousands):

	2014	2013
Line of credit with variable interest rate equal to the Wall Street Journal (WSJ) prime rate, subject to a 5.0% floor; maturity February 2014. Interest payments due quarterly. Unsecured.	$—	$700
Current portion of installment note payable due November 2014 with variable interest rate equal to the WSJ prime rate plus 1%; Unsecured	1,166	1,166
	$1,166	$1,866

Long-term debt consisted of the following as of September 30, 2014 and December 31, 2013 (dollars in thousands):

	2014	2013
Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 5.0% floor; maturity February 2016. Interest payments due quarterly. Unsecured.	$—	$—
Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 4.5% floor; maturity September 2017. Interest payments due monthly. Secured.	—	350
Long term portion of installment note with variable interest rate equal to the WSJ prime rate plus 1% and adjustable each November; maturity November 2021. Interest payable annually with principal payable in equal annual installments. Next principal installment on long term portion due November 2015. Unsecured.	8,167	8,167
Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-Month LIBOR plus 3.75% applied to the outstanding principal; maturity December 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured.	9,279	9,279

Subordinated debentures issued on June 21, 2007 with a floating interest rate equal to the 3-Month LIBOR plus 3.40% applied to the outstanding principal; maturity June 15, 2037. Interest payments due quarterly. All may be redeemed at any time following the fifth anniversary of issuance. Unsecured.	3,093	3,093
	$20,539	$20,889

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On May 26, 2010, the Company entered into a forward swap with a notional amount of $9,000,000 effective December 15, 2015, which will hedge 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 will pay interest at a fixed rate of 8.49% until March 15, 2020.

The swaps entered into in 2009 and 2010 have fair values of $247,000 (liability) and $838,000 (liability), respectively, for a total liability of $1,085,000 at September 30, 2014 ($897,000 at December 31, 2013). The swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation loss of $124,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements for the nine months ended September 30, 2014. A net valuation gain of $412,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2013.

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 September 30, 2014, the Company has securities on deposit with fair market values of $1,476,000 (all of which is posted as collateral). At December 31, 2013, the Company had securities on deposit with fair market values of $1,422,000 (all of which is posted as collateral). See Note 4 for additional information about the interest rate swaps.

NOTE 8 – REINSURANCE

The Company's insurance operations utilize reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term coverage. Property and casualty reinsurance is placed on both a quota-share and excess of loss basis. 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 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.

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 four layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	100% of $6,000,000 in excess of $4,000,000

Second Layer	100% of $7,500,000 in excess of $10,000,000
Third Layer	100% of $25,000,000 in excess of $17,500,000
Fourth 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.

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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 strengthen the Company's capital position by reducing the modeled 100 year event net cost.

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

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

At September 30, 2014, the largest reinsurance recoverable of a single reinsurer was $22,000 ($214,000 at December 31, 2013). Amounts reported as ceded incurred losses in both 2014 and 2013 were related to the development of losses from prior year catastrophes.

NOTE 9 – EMPLOYEE BENEFIT PLANS

The Company and its subsidiaries have an established retirement savings plan (401K Plan). All full-time employees are eligible to participate, and all employer contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for the nine months ended September 30, 2014 and 2013 amounted to $160,000 and $144,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limitations.

In January 2006, the Company established a non-qualified plan under which directors are allowed to defer all or a portion of directors' fees into various investment options.

The supplemental executive retirement plan (SERP) became effective March 1, 2008 and 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 of the non-qualified deferred compensation plans for the nine months ended September 30, 2014 and 2013 amounted to approximately $76,000 and $178,000, respectively.

The Company and its subsidiaries established an Employee Stock Ownership Plan (ESOP) in January 2010, to enable its 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 $150,000 in costs incurred during the first nine months of 2014 and $50,000 costs incurred for the first nine months of 2013 related to the ESOP. All contributions were made in cash for purchase of Company shares in the open market. The Company has not allocated shares directly to the plan and the plan has no debt.

NOTE 10 – SHAREHOLDERS' EQUITY

During the nine months ended September 30, 2014, and year ended December 31, 2013, changes in shareholders' equity consisted of net income of $4,730,000 and $5,658,000, respectively; dividends paid of $225,000 in 2014 and

$248,000 in 2013; changes in accumulated other comprehensive income, net of applicable taxes, of $1,654,000 in 2014 and other comprehensive loss, net of applicable taxes, of $2,389,000 in 2013. Other comprehensive loss consists of accumulated unrealized gains and losses on securities and unrealized gains and losses on interest rate swaps.

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The table below provides information regarding the Company's preferred and common stock as of September 30, 2014 and December 31, 2013:

	September 30, 2014			December 31, 2013		
	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	2,507,452	2,507,452	3,000,000	2,494,480	2,494,480

On June 13, 2014, 12,972 shares of common stock were issued to directors as compensation under the 2009 Equity Incentive Plan previously approved by shareholders.

NOTE 11 – 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):

	Nine Months Ended September 30,	
	2014	2013
Gains and Losses on Cash Flow Hedges		
Balance at beginning of period	$(591)	$(1,003)
Other comprehensive income (loss) for period:		
Other comprehensive income (loss) before reclassifications	(124)	324
Amounts reclassified from accumulated other comprehensive income	—	—
Net current period other comprehensive income (loss)	(124)	324
Balance at end of period	$(715)	$(679)
Unrealized Gains and Losses on Available-for-Sale Securities		
Balance at beginning of period	$1,527	$4,328
Other comprehensive income (loss) for period:		
Other comprehensive income before reclassifications	2,020	(1,454)
Amounts reclassified from accumulated other comprehensive income	(242)	(731)
Net current period other comprehensive income	1,778	(2,185)
Balance at end of period	$3,305	$2,143
Total Accumulated Other Comprehensive Income (loss) at end of period	$2,590	$1,464

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The following table presents the amounts reclassified out of AOCI for nine months ended September 30, 2014 (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	$366	Net realized investment gains
	366	Total before tax
	(124)	Tax (expense) or benefit
	$242	Net of Tax

The following table presents the amounts reclassified out of AOCI for the nine months ended September 30, 2013 (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	$1,108	Net realized investment gains
	1,108	Total before tax
	(377)	Tax (expense) or benefit
	$731	Net of Tax

NOTE 12 – 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. The Company has ceased writing ocean marine, private passenger auto liability, commercial auto liability and auto physical damage coverages over the past two years with no policies remaining in-force at December 31, 2013 in the lines of business.

Management organizes the business utilizing a niche strategy focusing on lower valued dwellings. 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 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 accident and health insurance.

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Total assets by industry segment at September 30, 2014 and at December 31, 2013 are summarized below (dollars in thousands):

	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
September 30, 2014	$145,706	$80,534	$56,924	$8,248
December 31, 2013	$133,980	$71,003	$53,831	$9,146

Premium revenues and operating income by business segment for the three and nine months ended September 30, 2014 and 2013 are summarized below (dollars in thousands):

Three months ended September 30, 2014	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	$14,374	$12,757	$1,617	$—
Net investment income	824	333	472	19
Net realized investment gains	141	23	117	1
Other income	158	156	2	—
	15,497	13,269	2,208	20
BENEFITS, LOSSES AND EXPENSES				
Policyholder benefits paid	7,172	5,876	1,296	—
Amortization of deferred policy acquisition costs	946	642	304	—
Commissions	2,166	2,073	93	—
General and administrative expenses	1,719	1,296	385	38
Taxes, licenses and fees	514	441	73	—
Interest expense	380	—	16	364
	12,897	10,328	2,167	402
Income (Loss) Before Income Taxes	$2,600	$2,941	$41	$(382)

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Three months ended September 30, 2013	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	$13,191	$11,446	$1,745	$—
Net investment income	1,007	474	514	19
Net realized investment gains	3,297	8	(19)	3,308
Other income	163	152	11	—
	17,658	12,080	2,251	3,327
BENEFITS, LOSSES AND EXPENSES				
Policyholder benefits paid	7,112	5,845	1,267	—
Amortization of deferred policy acquisition costs	894	639	255	—
Commissions	1,800	1,704	96	—
General and administrative expenses	2,117	1,444	543	130
Taxes, licenses and fees	438	385	53	—
Interest expense	434	—	34	400
	12,795	10,017	2,248	530
Income Before Income Taxes	$4,863	$2,063	$3	$2,797

Nine months ended September 30, 2014	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	$42,298	$37,397	$4,901	$—
Net investment income	2,802	1,296	1,449	57
Net realized investment gains	541	72	467	2
Other income	2,025	2,022	3	—
	47,666	40,787	6,820	59
BENEFITS AND EXPENSES				
Policyholder benefits paid	24,191	20,106	4,085	—
Amortization of deferred policy acquisition costs	2,717	1,924	793	—
Commissions	6,160	5,908	252	—
General and administrative expenses	6,158	4,285	1,443	430
Taxes, licenses and fees	1,565	1,362	203	—
Interest expense	1,148	—	47	1,101
	41,939	33,585	6,823	1,531
Income (Loss) Before Income Taxes	$5,727	$7,202	$(3)	$(1,472)

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Nine months ended September 30, 2013	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	$39,163	$34,010	$5,153	$—
Net investment income	2,741	1,170	1,514	57
Net realized investment gains	4,354	1,038	8	3,308
Other income	480	467	13	—
	46,738	36,685	6,688	3,365
BENEFITS AND EXPENSES				
Policyholder benefits paid	24,923	21,474	3,449	—
Amortization of deferred policy acquisition costs	2,759	1,938	821	—
Commissions	5,268	4,986	282	—
General and administrative expenses	6,082	4,052	1,455	575
Taxes, licenses and fees	1,398	1,220	178	—
Interest expense	1,311	—	72	1,239
	41,741	33,670	6,257	1,814
Income Before Income Taxes	$4,997	$3,015	$431	$1,551

The following table presents the Company’s gross and net premiums written for the property and casualty segment and the life and accident and health segment for the three and nine months ended September 30, 2014 and 2013, respectively:

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Life, accident and health operations premiums written:				
Traditional life insurance	$1,156	$1,184	$3,472	$3,586
Accident and health insurance	564	604	1,439	1,485
Gross life, accident and health	1,720	1,788	4,911	5,071
Reinsurance premium ceded	(23)	(22)	(58)	(52)
Net life, accident and health premiums written	$1,697	$1,766	$4,853	$5,019
Property and Casualty operations premiums written:				
Dwelling fire & extended coverage	$8,340	$7,630	$25,888	$23,595
Homeowners (Including mobile homeowners)	6,261	6,245	18,889	18,422
Ocean marine	—	—	—	75
Other liability	475	429	1,465	1,311
Gross property and casualty	15,076	14,304	46,242	43,403
Reinsurance premium ceded	(1,762)	(2,081)	(5,319)	(6,401)
Net property and casualty written	$13,314	$12,223	$40,923	$37,002
Gross premiums written	$16,796	$16,092	$51,153	$48,474
Reinsurance premium ceded	(1,785)	(2,103)	(5,377)	(6,453)
Net premiums written	$15,011	$13,989	$45,776	$42,021

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The following table presents the Company’s gross and net premiums earned for the property and casualty segment and the life and accident and health segment for the three and nine months ended September 30, 2014 and 2013, respectively:

	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
Life, accident and health operations premiums earned:				
Traditional life insurance	$1,080	$1,159	$3,537	$3,715
Accident and health insurance	560	608	1,422	1,490
Gross life, accident and health	1,640	1,767	4,959	5,205
Reinsurance premium ceded	(23)	(22)	(58)	(52)
Net life, accident and health premiums earned	$1,617	$1,745	$4,901	$5,153
Property and Casualty operations premiums earned:				
Dwelling fire & extended coverage	$8,147	$7,446	$23,727	$21,720
Homeowners (Including mobile homeowners)	5,914	5,674	17,661	17,007
Ocean marine	—	—	—	524
Other liability	458	408	1,328	1,172
Gross property and casualty	14,519	13,528	42,716	40,423
Reinsurance premium ceded	(1,762)	(2,082)	(5,319)	(6,413)
Net property and casualty earned	$12,757	$11,446	$37,397	$34,010
Gross premiums earned	$16,159	$15,295	$47,675	$45,628
Reinsurance premium ceded	(1,785)	(2,104)	(5,377)	(6,465)
Net premiums earned	$14,374	$13,191	$42,298	$39,163

NOTE 13 – CONTINGENCIES

The Company and its subsidiaries continue to be named individually as parties to litigation related to the conduct of their insurance operations. These suits 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.

The Company's property & casualty subsidiaries are defending a limited number of matters filed in the aftermath of Gustav and Ike in Texas. These actions include individual lawsuits with allegations of underpayment of hurricane-related claims.

The various suits seek a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief. The Company has reserves set up on litigated claims and the reserves are included in benefit and loss reserves.

NOTE 14 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the nine months ended September 30, 2014 was $847,000 ($976,000 in 2013). Cash paid for income taxes during the nine months ended September 30, 2014 was $248,000 ($195,000 in 2013).

During the nine months ended September 30, 2014, non-cash changes in equity included $13,000 in common stock issued to Directors in lieu of cash compensation along with a corresponding $120,000 increase in additional paid in capital.

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NOTE 15 – SUBSEQUENT EVENTS

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

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REVIEW REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the accompanying condensed consolidated balance sheet of The National Security Group, Inc. as of September 30, 2014, and the related condensed consolidated statements of income and comprehensive income for the three-months and nine-months ended September 30, 2014 and 2013, the condensed consolidated statement of shareholders' equity for the nine-months ended September 30, 2014 and the condensed consolidated statements of cash flows for the nine-months ended September 30, 2014 and 2013. These condensed consolidated financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The National Security Group, Inc. as of December 31, 2013, and the related consolidated statements of income (loss), comprehensive income (loss), shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 21, 2014, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2013, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Warren Averett, LLC

Birmingham, Alabama
November 13, 2014

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

Overview
The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) and its subsidiaries. We are a “smaller reporting company” under Securities and Exchange Commission (SEC) regulations and therefore qualify for the scaled disclosure of smaller reporting companies. In general, the same information is required to be disclosed in the management discussion and analysis by smaller reporting companies except that the discussion need only cover the latest two year period and disclosures relating to contractual obligations are not required. In accordance with the scaled disclosure requirements, this discussion covers the three-month and nine-month periods ended September 30, 2014 and 2013.

The National Security Group, Inc. is made up of two segments: the Life segment and the P&C segment. The Company's life, accident and health insurance business is conducted through National Security Insurance Company (NSIC), a wholly owned subsidiary of the Company organized in 1947. The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992.

This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part I, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2013.

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

The National Security Group operates in the property and casualty and life, accident and supplemental health insurance businesses and markets products primarily through independent agents. The Company operates in ten states with 50.4% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment, accounting for 89.6% of gross earned insurance premium revenue in the first nine months of 2014. Revenue generated from the life segment accounted for 10.4% of gross insurance premium revenue in the first nine months of 2014.

National Security Insurance Company (NSIC) is a life, accident and health insurance company founded in 1947. All references to NSIC in the remainder of this management discussion and analysis will refer to the combined life, accident and health insurance operations and will compose the life segment of the Company. NSIC is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

The property and casualty segment consists of the consolidated operations of two subsidiaries, National Security Fire and Casualty Company and its wholly owned subsidiary, Omega One Insurance Company. There is no material differentiation between the products underwritten by NSFC and Omega as both underwrite primarily dwelling personal lines coverage. The Property and Casualty segment has premium in-force in the states of Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, and Tennessee.

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

All of our insurance companies have been assigned ratings by A.M. Best Co (Best). On November 13, 2014, Best revised the outlook to stable from negative and affirmed the financial strength rating (FSR) of B++ (Good) and the issuer credit rating (ICR) of "bbb" of NSFC. In addition, Best affirmed the FSR of B+(Good) and ICR of "bbb-" of Omega and NSIC. The outlook for these ratings remained stable. Best also revised the outlook to stable from negative and affirmed the ICR of "bb" of the parent holding company, NSEC.

The property and casualty subsidiaries have been assigned ratings by Demotech, Inc. On August 12, 2014, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

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The two primary segments in which we report insurance operations are the personal lines property and casualty segment (NSFC) and the life, accident and health insurance segment (NSIC). Due to the small amount of earned premium revenue produced by Omega and the fact that Omega is a wholly owned subsidiary of NSFC, underwriting similar lines of business, all references to NSFC in the remainder of this management discussion and analysis will include the insurance operations of both NSFC and Omega. Our income is principally derived from net underwriting profits and investment income. Net underwriting profit is principally derived from earned premiums received less claims paid, sales commissions to agents, costs of underwriting and insurance taxes and fees. Investment income includes interest and dividend income and gains and losses on investment holdings.

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

Summary of Consolidated Results of Operations

Financial results for the three months and nine months ended September 30, 2014 and 2013 were as follows:

(dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2014	2013	2014	2013
REVENUES				
Net premiums earned	$14,374	$13,191	$42,298	$39,163
Net investment income	824	1,007	2,802	2,741
Net realized investment gains	141	3,297	541	4,354
Other income	158	163	2,025	480
Total Revenues	15,497	17,658	47,666	46,738
BENEFITS, LOSSES AND EXPENSES				
Policyholder benefits and settlement expenses	7,172	7,112	24,191	24,923
Amortization of deferred policy acquisition costs	946	894	2,717	2,759
Commissions	2,166	1,800	6,160	5,268
General and administrative expenses	1,719	2,117	6,158	6,082
Taxes, licenses and fees	514	438	1,565	1,398
Interest expense	380	434	1,148	1,311
Total Benefits, Losses and Expenses	12,897	12,795	41,939	41,741
Income Before Income Taxes	2,600	4,863	5,727	4,997
INCOME TAX EXPENSE				
Current	651	332	819	552
Deferred	152	1,192	178	550
	803	1,524	997	1,102
Net Income	$1,797	$3,339	$4,730	$3,895
INCOME PER COMMON SHARE	$0.72	$1.35	$1.89	$1.57
DIVIDENDS DECLARED PER SHARE	$0.03	$0.025	$0.09	$0.075
Reconciliation of Net Income to non-GAAP Measurement				
Net income	$1,797	$3,339	$4,730	$3,895
Income tax expense	803	1,524	997	1,102
Realized investment gains, net	(141)	(3,297)	(541)	(4,354)
Operating Income	$2,459	$1,566	$5,186	$643

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Three months ended September 30, 2014 compared to three months ended September 30, 2013:

For the three months ended September 30, 2014, the Company had net income of $1,797,000, $0.72 per share, compared to $3,339,000, $1.35 per share, for the same period last year. On a pretax basis, for the three months ended September 30, 2014, we had income of $2,600,000 compared to $4,863,000 for the three months ended September 30, 2013. Our pretax income for the three months ended September 30, 2014, consisted of income from operations of $2,459,000 and realized investment gains of $141,000. The pretax income for the three months ended September 30, 2013, consisted of income from operations of $1,566,000 and realized investment gains of $3,297,000. The primary component of the realized investment gains during the three months ended September 30, 2013 was a pretax gain of $3.3 million from the sale of 2,739 acres of investment real estate consisting of timber property in Alabama.

Pretax operating income, which excludes capital gains, was $2,459,000 for the three month period ended September 30, 2014, compared to $1,566,000 for the same period last year. Favorable weather patterns, leading to lower property and casualty insurance claims, coupled with a 9% increase in revenue for the quarter, were the primary contributing factors to the improved operating income.

Nine months ended September 30, 2014 compared to nine months ended September 30, 2013:

The Company ended the first nine months of 2014 with net income of $4,730,000, $1.89 per share, compared to net income of $3,895,000, $1.57 per share, for the same period last year. On a pretax basis, for the nine months ended September 30, 2014, we had income of $5,727,000 compared to $4,997,000 for the nine months ended September 30, 2013. Our pretax income for the nine months ended September 30, 2014, consisted of income from operations of $5,186,000 and realized investment gains of $541,000. The pretax income for the nine months ended September 30, 2013, consisted of net income from operations of $643,000 and realized investment gains of $4,354,000. As mentioned previously, the primary component of the realized investment gains in 2013 was the sale of timber property creating a $3.3 million pretax gain.

Our 2014 operating income improved due to a combination of increased revenue, a reduction in claims activity and a non-recurring $1,621,000 gain from company owned life insurance (reported as a component of "other income" in the table above).

Net premium earned increased 8.0% in the first nine months of 2014 compared to the same period last year. A combination of increased direct premium revenue and a decrease in reinsurance cost (ceded premium) were the two primary factors contributing to the increase in net premium earned for the nine months ended September 30, 2014. Increases in premium were driven by a combination of rate increases implemented in our core dwelling and homeowners programs along with a moderate increase in policy issuance. The decrease in reinsurance cost, reducing ceded premium, was due to an 18% year over year reduction in our catastrophe reinsurance rate in our 2014 contact.

Year to date claims were down $732,000 in 2014 compared to 2013. The primary reason for the year to date decrease in 2014 compared to 2013 was a reduction in claims related to both cat events and non-catastrophe wind losses in our P&C segment due to a lower frequency of reported claims. Through September 30, 2014, the P&C segment had a $1,689,000 reduction in cat event losses compared to the same period last year. During 2014, the P&C segment was impacted by six cat events totaling $2,572,000 compared to ten cat events in 2013 totaling $4,261,000. In addition, non-catastrophe wind loses were down $636,000 in 2014 compared to 2013. Offsetting these decreases were a $786,000 increase in claims from fire related losses as well as $600,000 in adverse loss development from the settlement of a claim in a discontinued commercial insurance program.

Shareholders' equity as of September 30, 2014 was $39,764,000 up $6,292,000 from our December 31, 2013 Shareholders' equity of $33,472,000. Book value per share was $15.85 per share at September 30, 2014 compared to

$13.42 per share at December 31, 2013, an increase of $2.43. The primary factors contributing to the increase in Shareholders' equity in the first nine months of 2014 was net income of $4,730,000 and other comprehensive income of $1,654,000. The increase in other comprehensive income was primarily driven by the declining interest rate environment, which increased the market value of our investments in fixed income securities, and an increase in value of our equity investments.

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Three months ended September 30, 2014 compared to three months ended September 30, 2013:

Premium revenue:
The table below provides earned premium revenue by segment for the three months ended September 30, 2014 and 2013:

	Three months ended September 30,		Percent
	2014	2013	increase (decrease)
Life, accident and health operations premiums earned:			
Traditional life insurance	$ 1,080	$ 1,159	(6.8)%
Accident and health insurance	560	608	(7.9)%
Gross life, accident and health	1,640	1,767	(7.2)%
Reinsurance premium ceded	(23)	(22)	4.5 %
Net life, accident and health premiums earned	$ 1,617	$ 1,745	(7.3)%
Property and Casualty operations premiums earned:			
Dwelling fire & extended coverage	$ 8,147	$ 7,446	9.4 %
Homeowners (Including mobile homeowners)	5,914	5,674	4.2 %
Ocean marine	—	—	— %
Other liability	458	408	12.3 %
Gross property and casualty	14,519	13,528	7.3 %
Reinsurance premium ceded	(1,762)	(2,082)	(15.4)%
Net property and casualty premiums earned	$ 12,757	$ 11,446	11.5 %
Gross premiums earned	$ 16,159	$ 15,295	5.6 %
Reinsurance premium ceded	(1,785)	(2,104)	(15.2)%
Net premiums earned	$ 14,374	$ 13,191	9.0 %

Consolidated net premium earned was up 9.0% for the quarter ended September 30, 2014, at $14,374,000 compared to $13,191,000 for the quarter ended September 30, 2013. The growth in net premium earned was due to an 11.5% increase in net premium earned in the P&C segment which was driven by increases in direct premium due to rate adjustments and a moderate rise in production. A 15.4% reduction in catastrophe reinsurance cost also contributed to the increase in net premium earned in the P&C segment. The reduction in catastrophe reinsurance cost was due to a catastrophe reinsurance rate reduction in our 2014 calendar year contract renewal.

Investment income:
For the three months ended September 30, 2014, net investment income totaled $824,000 compared to $1,007,000 for the same period last year; a decrease of $183,000. The primary reason for the decline in 2014 was primarily due to a reduction in cash value of company owned life insurance.

Realized investment gains and losses:
For the three months ended September 30, 2014, the Company had realized capital gains totaling $141,000 compared to $3,297,000 for the same period last year. The $3,156,000 decline was due to a $3.3 million pretax gain realized in the third quarter of 2013 from the sale of 2,739 acres of investment real estate consisting of timber property in Alabama. The realized capital gains in the third quarter of 2014 were primarily the result of the sale of securities in our investment portfolio. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and therefore can vary significantly from quarter to quarter and year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from

year to year.

Other income:
Other income was $158,000 for the three months ended September 30, 2014, compared to $163,000 for the same period last year; a decrease of $5,000. Other income consists primarily of fees related to the issuance of our property insurance policies as well as other miscellaneous income.

Policyholder benefits:
Policyholder claims were $7,172,000 for the three months ended September 30, 2014, compared to $7,112,000 for the same period last year; an increase of $60,000 or 0.8%. Claims as a percentage of premium earned was 49.9%

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in the third quarter of 2014 compared to 53.9% in the third quarter of 2013. Favorable weather patterns, which reduced windstorm related claims, positively impacted underwriting results in the third quarter of both years.

Policy acquisition cost (commissions and amortization of deferred acquisition cost):
For the three months ended September 30, 2014, policy acquisition costs were $3,112,000 compared to $2,694,000 for the same period last year; an increase of $418,000. Policy acquisition costs consist of amortization of previously capitalized distribution costs and current commission payments to agents. As a percentage of premium revenue, policy acquisition costs were 21.7% in the third quarter of 2014 compared to 20.4% for the same period last year. The 1.3 percentage point increase in acquisition cost as a percent of premium revenue is primarily associated with increases in our accrual for contingent commission payments to agents in 2014 due to improved year to date underwriting results.

General Expenses:
General and administrative expenses totaled $1,719,000 in the third quarter of 2014 compared to $2,117,000 in the third quarter of 2013; an 18.8% decrease. The primary reason for the $398,000 decline was a reduction in holding company related expenses as well as an overall reduction in general and administrative expenses in both the P&C and life segments.

Taxes, licenses and fees:
Insurance taxes, licenses and fees were $514,000 for the three months ended September 30, 2014, compared to $438,000 for the same period last year. The primary reason for the increase was the 5.4% increase in gross premium written in the third quarter of 2014 compared to the same period last year. As a percentage of net premiums earned, insurance taxes, licenses and fees were 3.6% for the three months ended September 30, 2014 compared to 3.3% for the three months ended September 30, 2013.

Interest expense:
Interest expense for the third quarter of 2014 was $380,000 compared to $434,000 for the same period last year; a decrease of 12.4%. The primary reason for the $54,000 decline was a decrease in interest expense at the holding company level due to a reduction in long term debt during 2013.

Income taxes:
For the three month period ended September 30, 2014, the Company had pretax income of $2,600,000 compared to$4,863,000 for the same period last year. The $803,000 tax expense for the third quarter 2014 consisted of current tax expense of $651,000 and deferred tax expense of $152,000. Tax expense for the third quarter of 2013 consisted of current tax expense of $332,000 and deferred tax expense of $1,192,000. The effective tax rate was comparable for the three month period ended September 30, 2014 and 2013 at 30.9% and 31.3%, respectively.

Net income:
The Company ended the third quarter of 2014 with net income of $1,797,000 compared to net income of $3,339,000 for the same period last year. Net income in the third quarter of 2013 was favorably impacted by an increase in capital gains from the sale of timber property. This gain increased third quarter 2013 pretax income by $3.3 million ($2.2 million net of tax). Net income in the third quarter of 2014 was not materially impacted by capital gains. However, improved underwriting results led to an improvement in operating income for the quarter in 2014 compared to the third quarter of last year.

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Nine months ended September 30, 2014 compared to nine months ended September 30, 2013:

Premium revenue:
The table below provides earned premium revenue by segment for the nine months ended September 30, 2014 and 2013:

	Nine months ended September 30,		Percent
	2014	2013	increase (decrease)
Life, accident and health operations premiums earned:			
Traditional life insurance	$ 3,537	$ 3,715	(4.8)%
Accident and health insurance	1,422	1,490	(4.6)%
Gross life, accident and health	4,959	5,205	(4.7)%
Reinsurance premium ceded	(58)	(52)	11.5 %
Net life, accident and health premiums earned	$ 4,901	$ 5,153	(4.9)%
Property and Casualty operations premiums earned:			
Dwelling fire & extended coverage	$ 23,727	$ 21,720	9.2 %
Homeowners (Including mobile homeowners)	17,661	17,007	3.8 %
Ocean marine	—	524	(100.0)%
Other liability	1,328	1,172	13.3 %
Gross property and casualty	42,716	40,423	5.7 %
Reinsurance premium ceded	(5,319)	(6,413)	(17.1)%
Net property and casualty premiums earned	$ 37,397	$ 34,010	10.0 %
Gross premiums earned	$ 47,675	$ 45,628	4.5 %
Reinsurance premium ceded	(5,377)	(6,465)	(16.8)%
Net premiums earned	$ 42,298	$ 39,163	8.0 %

Consolidated net premium revenue was up 8.0% for the nine months ended September 30, 2014, at $42,298,000 compared to $39,163,000 for the nine months ended September 30, 2013. The primary reason was a 5.7% increase in gross premium earned in the P&C segment from growth in the dwelling fire and homeowners property programs.

P&C segment net premium earned was also impacted by a 17.1% decline in ceded premium associated with a reduction in our catastrophe reinsurance rate under our January 1, 2014 catastrophe contract renewal. The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. Under our 2014 catastrophe contract renewal terms, our retention remained unchanged at $4 million and we maintain catastrophe reinsurance covering the cost incurred in a single catastrophe event up to $72.5 million after exceeding a $4 million per event retention.

Under the catastrophe reinsurance program for 2014, the Company retains the first $4,000,000 in losses from each event. Reinsurance coverage is maintained in four layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	100% of $6,000,000 in excess of $4,000,000
Second Layer	100% of $7,500,000 in excess of $10,000,000
Third Layer	100% of $25,000,000 in excess of $17,500,000
Fourth Layer	100% of $30,000,000 in excess of $42,500,000

Additional details regarding the structure of the current year agreement can be found in Note 10 to the consolidated financial statements.

Investment income:
For the nine months ended September 30, 2014, net investment income totaled $2,802,000 compared to $2,741,000 for the same period last year; an increase of $61,000. Investment income is up for the year to date primarily due to an increase in invested assets. Invested assets has increased due to an increase in cash flow from insurance operations.

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Realized investment gains and losses:
Realized capital gains for the nine months ended September 30, 2014 totaled $541,000 compared to $4,354,000 for the same period last year. The $3,813,000 year over year decline was primarily due to the $3.3 million pretax gain we received in 2013 from the sale of 2,739 acres of investment real estate consisting of timber property in Alabama. Without the timber sale in 2013, realized capital gains would have been $541,000 in 2014 and $1,054,000 in 2013. The realized capital gains in 2014 as well as the remainder of the capital gains received in 2013 were primarily the result of the sale of securities in our investment portfolio. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and therefore can vary significantly from quarter to quarter and year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to year.

Other income:
Other income was $2,025,000 in 2014 compared to $480,000 in 2013; a $1,545,000 increase. The primary reason for the year over year increase was a $1,621,000 non-recurring net gain on company owned life insurance. The remainder of other income consists primarily of fees related to the issuance of our property insurance policies as well as miscellaneous income.

Policyholder benefits:
Claims were $24,191,000 for the nine months ended September 30, 2014, compared to $24,923,000 for the same period last year; a decrease of $732,000 or 2.9%. As a percentage of premium income, policyholder benefits were 57.2% in the first nine months of 2014 compared to 63.6% for the same period last year, an improvement of 6.4 percentage points. The primary reason for the decrease in claims was a reduction in reported losses and LAE in the P&C segment from cat events as well as a reduction in reported losses and LAE in the P&C segment from non-catastrophe wind and hail claims in the current year compared to the same period last year. Offsetting the decline in claims from weather related events was a $786,000 increase in P&C segment reported fire losses for the nine months ended September 30, 2014, compared to the same period last year.

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 nine months ended September 30, 2014 and 2013:

Nine months ended September 30, 2014			Nine months ended September 30, 2013		
Cat event	Reported Losses & LAE	Claim Count	Cat event	Reported Losses & LAE	Claim Count
Cat 32 (Jan 5-8)	$3,000	2	Cat 91 (Jan 29-31)	$354,000	85
Cat 34 (Feb 11-14)	589,000	342	Cat 92 (Feb 24-25)	188,000	63
Cat 37 (Mar 27-29)	13,000	5	Cat 93 (Mar 18-19)	3,000,000	896
Cat 40 (Apr 27-May1)	1,714,000	373	Cat 94 (Mar 29-31)	75,000	20
Cat 43 (May 18-23)	220,000	81	Cat 95 (Apr 1-3)	43,000	10
Cat 45 (Jun 3-5)	33,000	14	Cat 99 (Apr 26-28)	79,000	19
			Cat 14 (May 18-22)	283,000	83
			Cat 15 (May 28-31)	176,000	55
			Cat 17 (Jun 12-14)	42,000	20
			Cat 22 (Jul 23-24)	21,000	6
Total	$2,572,000	817	Total	$4,261,000	1,257
Non-cat wind & hail	$4,623,000	1,642	Non-cat wind & hail	$5,259,000	1,934

During the nine months ended September 30, 2014, the P&C segment was impacted by six cat events totaling $2,572,000. The P&C subsidiaries incurred 817 claims from these cat events. These claims contributed 6.9 percentage points to the 2014 P&C segment loss ratio and had an average cost per claim of $3,100. During the nine months ended September 30, 2013, the P&C segment was impacted by ten cat events totaling $4,261,000 resulting in 1,257 claims with an average per claim of $3,400. The cat events during the first nine months of 2013 increased the prior year P&C segment loss ratio by 12.5 percentage points.

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The largest 2014 cat event was Cat 40, occurring in the second quarter, with reported losses totaling $1,714,000 from 373 claims. Cat 40 added 4.6 percentage points to the 2014 P&C segment loss ratio. In comparison, the largest 2013 cat event was Cat 93, occurring in the first quarter of 2013, with reported losses totaling $3,000,000 from 896 claims. Cat 93 increased the 2013 P&C segment loss ratio 8.8 percentage points.

Non-catastrophe wind and hail claims reported in 2014 totaled $4,623,000 compared to non-catastrophe wind and hail claims reported in 2013 totaling $5,259,000; a decline of $636,000 or 12.1%. During 2014, the P&C segment had 1,642 non-catastrophe wind and hail claims reported (an average of $2,800 per claim) compared to 1,934 claims reported during 2013 (an average of $2,700 per claim). Non-cat wind and hail claims reported during 2014 accounted for 19.1% of total incurred losses and LAE in the current year. Non-cat wind and hail claims reported during 2013 accounted for 21.1% of total incurred losses and LAE in the prior year.

Fire losses reported during 2014 were up $786,000 or 8.8% compared to fire losses reported during 2013. The P&C segment had 394 fire losses reported in 2014 totaling $9,672,000 compared to 391 fire losses reported during the same period last year totaling $8,886,000. The average cost per claim was $24,600 for fire losses reported in 2014 compared to $22,700 for fire losses reported in 2013.

Policy acquisition cost (commissions and amortization of deferred acquisition cost):

For the nine months ended September 30, 2014, policy acquisition costs were $8,877,000 compared to $8,027,000 for the same period last year; an increase of $850,000. Policy acquisition costs consist of amortization of previously capitalized distribution costs and current commission payments to agents. Policy acquisition costs were 21% of earned premium for the first nine months of 2014 compared to 20.5% for the same period last year. The primary reason for the 0.5 percentage point increase in policy acquisition costs was a $400,000 increase in contingent commission accruals in 2014 compared to the same period last year. Contingent commission increased as a results of improved underwriting results in 2014 compared to 2013.

General Expenses:

General and administrative expenses totaled $6,158,000 in 2014 compared to $6,082,000 in 2013. A primary reason for the $76,000 increase in general and administrative expenses was the payout of employee incentive compensation in 2014 not incurred in 2013. Management continues to implement changes to improve efficiency of insurance operations. These changes contributed to the decline in year to date general expenses as a percentage of premium revenue from 15.5% in 2013 to 14.6% in 2014.

Taxes, licenses and fees:

Insurance taxes, licenses and fees were $1,565,000 through September 30, 2014, compared to $1,398,000 for the same period last year. As a percentage of net premiums earned, insurance taxes, licenses and fees were comparable at 3.7% for the nine months ended September 30, 2014 compared to 3.6% for the nine months ended September 30, 2013.

Interest expense:

Interest expense for the first nine months of 2014 was $1,148,000 compared to $1,311,000 for the same period last year; a decrease of 12.4%. The primary reason for the $163,000 decline was a decrease in interest expense at the holding company level due to a reduction in long term debt during 2013.

Income taxes:

For the period ended September 30, 2014, the Company had pretax income of $5,727,000 compared to pretax income of $4,997,000 for the same period last year. Income tax expense as a percent of pretax income totaled 17.4% for the nine months ended September 30, 2014, compared to 22.1% for the nine months ended September 30, 2013. Our pretax income in 2014 included a tax free gain from company owned life insurance totaling $1,621,000, which was the primary factor reducing our effective tax rate.

Net income:
The Company ended the first nine months of 2014 with net income of $4,730,000 compared to net income of $3,895,000 for the same period last year. As discussed above, a primary component of current year net income was $1,621,000 in tax-free life insurance benefit received from our company owned life insurance. In addition, the P&C segment had much improved operating results with net premiums earned up 10.0% and claims down 6.4% in 2014 compared to the same period last year. The primary contributors to 2013 net income was a $3.3 million capital gain ($2.2 million net of tax) and improved underwriting results in the third quarter of 2013.

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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. The liabilities of the life insurance subsidiary are typically of a longer duration, and therefore, a higher percentage of securities in the life insurance subsidiary are invested for periods exceeding 10 years.

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

Virtually all invested assets of the Company are held in the insurance subsidiaries. As of September 30, 2014, 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	$1,780	$—	$1,780	2.08	%
Maturity in 1-5 years	15,706	179	15,885	18.57	%
Maturity in 5-10 years	29,716	145	29,861	34.90	%
Maturity after 10 years	37,339	697	38,036	44.45	%
	$84,541	$1,021	$85,562	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 $4,300,000 decline in the market value of fixed income investment. Alternatively, a 100 basis point decrease in interest rates will generate approximately $4,800,000 in increases in market value of fixed income investments.

At September 30, 2014, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of $39,764,000, up $6,292,000 compared to $33,472,000 at December 31, 2013. Components of the change in equity were net income of $4,730,000, increase in accumulated unrealized gains on investments of $1,778,000, a net unrealized loss of $124,000 related to interest rate swaps and cash dividends paid totaling $225,000.

As discussed above, changing interest rates can have a significant impact on the market value of fixed income securities. Fixed income 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 6.4% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.

The Company, primarily through its insurance subsidiaries, had $8,575,000 in cash and cash equivalents at September 30, 2014, compared to $5,596,000 at September 30, 2013. Significantly improved performance in our insurance operations for the period ended September 30, 2014 contributed to the $10,263,000 in cash provided by operations compared to cash provided by operations the same period last year totaling $452,000. Cash flows from operations in the prior year were negatively impacted by insured losses from spring storms incurred during the first quarter.

Net cash used in investing activities totaled $5,438,000 for the period ended September 30, 2014, compared to cash provided of $2,288,000 for the same period last year. At September 30, 2014, invested assets were up $8,000,000, or 8% compared to December 31, 2013. This increase was primarily the result of increases in market values of available for sale securities coupled with the reinvestment of proceeds from maturities of investments and the utilization of positive cash flows from operations to increase investment holdings. Cash provided by investing activities in the prior year was primarily related to the sale of investment real estate, the proceeds of which were used to reduce long term debt.

Net cash used in financing activities totaled $1,237,000 for the period ended September 30, 2014, compared to $3,923,000 for the same period last year. During the nine months ended September 30, 2014, the Company repaid a $700,000 short-term note payable which was renewed with a two-year term. Also during this period, the Company utilized $275,000 from long-term lines of credit and repaid $625,000 in long-term debt. As of September 30, 2014, a total of $9,333,000 remained outstanding on the note associated with the Mobile Attic settlement with the next installment due in November of 2014. This installment is $1,166,000 and is included in short-term notes payable. The Company maintains a $1,000,000 operating line of credit which matures in September 2017 as well as a $700,000 line of credit which matures in February of 2016, all of which was available at September 30, 2014.

The Company had a total of $20,539,000 of long-term debt outstanding as of September 30, 2014, compared to $20,889,000 at December 31, 2013, which includes $12,372,000 in trust preferred securities issued by the Company in addition to the installment note.

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. Due to a combination of growth opportunities and continued risk of capital exposure to weather related events, management is maintaining a conservative stance with regard to paying of dividends to the holding company. Strengthening capital levels in the insurance subsidiaries remains a 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 2013 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 2014 is statutorily limited to $1,463,000 in the life insurance subsidiary and $2,632,000 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 previous adverse impacts on regulatory surplus, will likely lead to dividend payments to NSG substantially below the above referenced regulatory maximums. The Company received $1,000,000 in dividends from its subsidiaries during the nine months ended September 30, 2014.

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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.

The Company continues to monitor liquidity and subsidiary capital closely. Improved underwriting results stemming from the discontinuation of unprofitable lines of business and 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, due to modest levels of growth in premium revenue, it is still necessary to remain cautious and protect subsidiary capital.

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.

We have taken and will continue to take corrective action as necessary to improve our capital position. Over the past decade we have experienced a significant reduction in equity capital due to the adverse effects of six major hurricanes, the financial market meltdown in 2008, continued historically low interest rates, an unprecedented tornado outbreak in April of 2011 and the Mobile Attic litigation. While we are experiencing improvement and have put some major obstacles behind us, we are in a position where we believe it necessary to continue to increase retained capital and reduce debt levels in the near term in order to put our Company in the best position to be successful moving forward. In order to maintain and improve our capital position, we will continue to monitor our dividend policy on a quarterly basis. As has been stated previously, should we encounter a significant adverse capital event, such as a major hurricane, we could take action which could include the suspension of shareholder dividends. Due to various factors discussed herein, we must remain flexible in our dividend policy until we sufficiently increase capital and reduce debt levels.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Under smaller reporting company rules we are not required to disclose information required under Item 3. However, in order to provide information to our investors, we have elected to provide information related to market risk.

The Company's primary objectives in managing its investment portfolio are to maximize investment income and total investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including changes in interest rates, overall market conditions, underwriting results, regulatory requirements and tax position. Investment decisions are made by management and reviewed by the Board of Directors. Market risk represents the potential for loss due to adverse changes in fair value of securities. The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk and default risk. The primary risk related to the Company's equity portfolio is equity price risk.

Since the Company's assets and liabilities are largely monetary in nature, the Company's financial position and earnings are subject to risks resulting from changes in interest rates at varying maturities, changes in spreads over U.S. Treasuries on new investment opportunities and changes in the yield curve and equity pricing risks.

The Company is exposed to equity price risk on its equity securities. The Company holds common stock with a fair value of $4.8 million. Our portfolio has historically been highly correlated to the S&P 500 with regard to market risk. Based on an evaluation of the historical risk measure of our portfolio relative to the S&P 500, if the market value of the S&P 500 Index decreased 10% from its September 30, 2014 value, the fair value of the Company's common stock investments would decrease by approximately $480,000.

Certain fixed interest rate market risk sensitive instruments may not give rise to incremental income or loss during the period illustrated but may be subject to changes in fair values. Note 4 in the 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

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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 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.

Item 4. Controls and Procedures

Our management carried out an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as of September 30, 2014. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There has not been any change in our internal control over financial reporting in connection with the evaluation required by Rule 13A-15(d) under the Exchange Act that occurred during the nine month period ended September 30, 2014, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. Other Information

Item 1. Legal Proceedings
Please refer to Note 13 to the consolidated financial statements included herein, and the 2013 Annual Report filed on Form 10-K.

Item 1A. Risk Factors
There has been no material change in risk factors previously disclosed under Item 1A. of the Company’s Annual Report for 2013 on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
None

Item 3. Defaults Upon Senior Securities
None

Item 4. Mine Safety Disclosures
None

Item 5. Other Information
None

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Item 6. Exhibits

a. Exhibits

31.1	Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

b. Reports on Form 8-K during the quarter ended September 30, 2014:

Date of Report	Date Filed	Description
July 25, 2014	August 4, 2014	Item 8.01 - announcement of quarterly dividend.
August 13, 2014	August 13, 2014	Press release, dated August 13, 2014, issued by The National Security Group, Inc.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed by the undersigned duly authorized officer, on its behalf and in the capacity indicated.

The National Security Group, Inc.

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

Date: November 13, 2014