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National Interstate CORP
Form 10-Q
October 31, 2014

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

Form 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2014
OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____
Commission File Number: 000-51130

National Interstate Corporation
(Exact name of registrant as specified in its charter)

| | |
|--|--------------------------------------|
| Ohio | 34-1607394 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 3250 Interstate Drive, Richfield, OH | 44286-9000 |
| (Address of principal executives offices) | (Zip Code) |

(330) 659-8900
(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

| | |
|--|--|
| Large Accelerated Filer <input type="checkbox"/> | Accelerated Filer <input type="checkbox"/> |
| Non-Accelerated Filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller Reporting Company <input type="checkbox"/> |

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

The number of shares outstanding of the registrant's sole class of common shares as of October 28, 2014 was 19,781,073.

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PART I—FINANCIAL INFORMATION

ITEM 1. Financial Statements

National Interstate Corporation and Subsidiaries

Consolidated Balance Sheets

(In thousands, except per share data)

| | September 30, 2014 (Unaudited) | December 31, 2013 |
|---|--------------------------------------|----------------------|
| ASSETS | | |
| Investments: | | |
| Fixed maturities available-for-sale, at fair value (amortized cost – \$918,711 and \$914,149, respectively) | \$947,843 | \$933,579 |
| Equity securities available-for-sale, at fair value (amortized cost – \$70,433 and \$55,537, respectively) | 78,885 | 65,770 |
| Other invested assets | 45,625 | 40,395 |
| Total investments | 1,072,353 | 1,039,744 |
| Cash and cash equivalents | 72,982 | 35,684 |
| Accrued investment income | 8,293 | 8,644 |
| Premiums receivable, net of allowance for doubtful accounts of \$2,861 and \$3,225, respectively | 238,862 | 244,934 |
| Reinsurance recoverable on paid and unpaid losses | 159,858 | 169,210 |
| Prepaid reinsurance premiums | 47,703 | 37,867 |
| Deferred policy acquisition costs | 23,239 | 23,025 |
| Deferred federal income taxes | 20,403 | 25,826 |
| Property and equipment, net | 24,616 | 24,753 |
| Funds held by reinsurer | 4,178 | 3,780 |
| Intangible assets, net | 7,862 | 8,073 |
| Prepaid expenses and other assets | 7,193 | 2,287 |
| Total assets | \$1,687,542 | \$1,623,827 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Unpaid losses and loss adjustment expenses | \$851,433 | \$803,782 |
| Unearned premiums and service fees | 284,575 | 283,582 |
| Long-term debt | 12,000 | 12,000 |
| Amounts withheld or retained for accounts of others | 92,985 | 80,999 |
| Reinsurance balances payable | 32,173 | 26,317 |
| Accounts payable and other liabilities | 35,471 | 44,516 |
| Commissions payable | 15,284 | 13,934 |
| Assessments and fees payable | 4,586 | 6,413 |
| Total liabilities | 1,328,507 | 1,271,543 |
| Shareholders' equity: | | |
| Preferred shares – no par value | | |
| Authorized – 10,000 shares | | |
| Issued – 0 shares | — | — |
| Common shares – \$0.01 par value | | |
| Authorized – 50,000 shares | | |
| Issued – 23,350 shares, including 3,570 and 3,689 shares, respectively, in treasury | 234 | 234 |
| Additional paid-in capital | 58,943 | 56,481 |
| Retained earnings | 280,491 | 281,518 |

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| | | |
|--|-------------|-------------|
| Accumulated other comprehensive income | 24,430 | 19,281 |
| Treasury shares | (5,063 |) (5,230 |
| Total shareholders' equity | 359,035 | 352,284 |
| Total liabilities and shareholders' equity | \$1,687,542 | \$1,623,827 |

See notes to consolidated financial statements.

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National Interstate Corporation and Subsidiaries
Consolidated Statements of Income
(Unaudited)
(In thousands, except per share data)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Revenues: | | | | |
| Premiums earned | \$ 140,009 | \$ 132,748 | \$ 412,651 | \$ 388,521 |
| Net investment income | 9,130 | 8,302 | 26,615 | 24,190 |
| Net realized gains on investments (*) | 2,622 | 1,353 | 6,294 | 5,433 |
| Other | 941 | 877 | 2,487 | 2,559 |
| Total revenues | 152,702 | 143,280 | 448,047 | 420,703 |
| Expenses: | | | | |
| Losses and loss adjustment expenses | 110,755 | 104,530 | 346,920 | 320,098 |
| Commissions and other underwriting expenses | 24,058 | 23,555 | 70,482 | 69,847 |
| Other operating and general expenses | 4,912 | 4,625 | 15,797 | 15,240 |
| Transaction expenses | — | — | 2,163 | — |
| Expense on amounts withheld | 1,971 | 1,080 | 4,952 | 3,548 |
| Interest expense | 59 | 184 | 191 | 486 |
| Total expenses | 141,755 | 133,974 | 440,505 | 409,219 |
| Income before income taxes | 10,947 | 9,306 | 7,542 | 11,484 |
| Provision for income taxes | 2,154 | 2,028 | 1,437 | 2,469 |
| Net income | \$8,793 | \$7,278 | \$6,105 | \$9,015 |
| Net income per share – basic | \$0.44 | \$0.37 | \$0.31 | \$0.46 |
| Net income per share – diluted | \$0.44 | \$0.37 | \$0.31 | \$0.46 |
| Weighted average of common shares outstanding – basic | 19,780 | 19,657 | 19,746 | 19,640 |
| Weighted average of common shares outstanding – diluted | 19,853 | 19,766 | 19,823 | 19,770 |
| Cash dividends per common share | \$0.12 | \$0.11 | \$0.36 | \$0.33 |

(*) Consists of the following:

| | | | | |
|---|---------|---------|---------|---------|
| Net realized gains before impairment losses | \$2,942 | \$1,491 | \$6,979 | \$5,588 |
| Total losses on securities with impairment charges | (320) |) (138) |) (455) |) (155) |
| Non-credit portion recognized in other comprehensive income | — | — | (230) |) — |
| Net impairment charges recognized in earnings | (320) |) (138) |) (685) |) (155) |
| Net realized gains on investments | \$2,622 | \$1,353 | \$6,294 | \$5,433 |

See notes to consolidated financial statements.

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National Interstate Corporation and Subsidiaries
 Consolidated Statements of Comprehensive Income (Loss)
 (Unaudited)
 (Dollars in thousands)

| | Three Months Ended | | Nine Months Ended September | | |
|---|--------------------|---------|-----------------------------|----------|---|
| | September 30, | | 30, | | |
| | 2014 | 2013 | 2014 | 2013 | |
| Net income | \$8,793 | \$7,278 | \$6,105 | \$9,015 | |
| Other comprehensive (loss) income, before tax: | | | | | |
| Net unrealized gains on available-for-sale securities: | | | | | |
| Net unrealized holding (losses) gains on securities arising during the period | (6,947 |) 1,052 | 10,647 | (14,820 |) |
| Reclassification adjustment for net realized gains included in net income | (1,570 |) (800 |) (2,726 |) (2,984 |) |
| Total other comprehensive (loss) income, before tax | (8,517 |) 252 | 7,921 | (17,804 |) |
| Deferred income tax (benefit) expense on other comprehensive (loss) income | (2,981 |) 89 | 2,772 | (6,231 |) |
| Other comprehensive (loss) income, net of tax | (5,536 |) 163 | 5,149 | (11,573 |) |
| Total comprehensive income (loss) | \$3,257 | \$7,441 | \$11,254 | \$(2,558 |) |
| See notes to consolidated financial statements. | | | | | |

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National Interstate Corporation and Subsidiaries
Consolidated Statements of Shareholders' Equity
(Unaudited)
(Dollars in thousands)

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total |
|--|-----------------|----------------------------------|----------------------|---|-------------------|-----------|
| Balance at January 1, 2014 | \$234 | \$56,481 | \$281,518 | \$ 19,281 | \$(5,230) | \$352,284 |
| Net income | | | 6,105 | | | 6,105 |
| Other comprehensive income, net of tax | | | | 5,149 | | 5,149 |
| Dividends on common stock | | | (7,132) | | | (7,132) |
| Issuance of 119,651 treasury shares upon exercise of options and restricted stock issued, net of forfeitures | | 1,976 | | | 167 | 2,143 |
| Net tax effect from exercise/vesting of stock compensation | | 50 | | | | 50 |
| Stock-based compensation expense | | 436 | | | | 436 |
| Balance at September 30, 2014 | \$234 | \$58,943 | \$280,491 | \$ 24,430 | \$(5,063) | \$359,035 |
| Balance at January 1, 2013 | \$234 | \$54,788 | \$272,618 | \$ 31,634 | \$(5,326) | \$353,948 |
| Net income | | | 9,015 | | | 9,015 |
| Other comprehensive loss, net of tax | | | | (11,573) | | (11,573) |
| Dividends on common stock | | | (6,503) | | | (6,503) |
| Issuance of 65,483 treasury shares upon exercise of options and restricted stock issued, net of forfeitures | | 944 | | | 91 | 1,035 |
| Net tax effect from exercise/vesting of stock compensation | | 21 | | | | 21 |
| Stock-based compensation expense | | 515 | | | | 515 |
| Balance at September 30, 2013 | \$234 | \$56,268 | \$275,130 | \$ 20,061 | \$(5,235) | \$346,458 |

See notes to consolidated financial statements.

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National Interstate Corporation and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)
(Dollars in thousands)

| | Nine Months Ended September | |
|--|-----------------------------|-----------|
| | 30, | |
| | 2014 | 2013 |
| Operating activities | | |
| Net income | \$6,105 | \$9,015 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net amortization of bond premiums and discounts | 2,990 | 5,175 |
| Provision for depreciation and amortization | 3,254 | 2,751 |
| Net realized gains on investment securities | (6,294) | (5,433) |
| Deferred federal income taxes | 2,651 | 456 |
| Stock-based compensation expense | 436 | 515 |
| (Increase) decrease in deferred policy acquisition costs, net | (214) | 2,078 |
| Increase in reserves for losses and loss adjustment expenses | 47,651 | 28,317 |
| Increase in premiums receivable | 6,072 | 690 |
| Increase (decrease) in unearned premiums and service fees | 993 | (1,556) |
| (Increase) decrease in interest receivable and other assets | (4,953) | 303 |
| Increase in prepaid reinsurance premiums | (9,836) | (5,318) |
| Increase in accounts payable, commissions and other liabilities and assessments and fees payable | (9,522) | (11,654) |
| Increase in amounts withheld or retained for accounts of others | 11,986 | 7,819 |
| Decrease in reinsurance recoverable | 9,352 | 4,921 |
| Increase in reinsurance balances payable | 5,856 | 5,231 |
| Other | 39 | (122) |
| Net cash provided by operating activities | 66,566 | 43,188 |
| Investing activities | | |
| Purchases of fixed maturities | (125,325) | (184,673) |
| Purchases of equity securities | (21,678) | (28,422) |
| Proceeds from sale of fixed maturities | 19,985 | 35,023 |
| Proceeds from sale of equity securities | 8,428 | 6,747 |
| Proceeds from maturities and redemptions of investments | 99,344 | 135,109 |
| Change in other invested assets, net | (2,138) | (1,820) |
| Capital expenditures | (2,945) | (2,391) |
| Net cash used in investing activities | (24,329) | (40,427) |
| Financing activities | | |
| Net tax effect from exercise/vesting of stock-based compensation | 50 | 21 |
| Issuance of common shares from treasury upon exercise of stock options or stock award grants | 2,143 | 1,035 |
| Cash dividends paid on common shares | (7,132) | (6,503) |
| Net cash used in financing activities | (4,939) | (5,447) |
| Net increase (decrease) in cash and cash equivalents | 37,298 | (2,686) |
| Cash and cash equivalents at beginning of period | 35,684 | 41,981 |
| Cash and cash equivalents at end of period | \$72,982 | \$39,295 |
| See notes to consolidated financial statements. | | |

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NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of National Interstate Corporation (the “Company”) and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) and the instructions to Form 10-Q.

The unaudited consolidated financial statements include the accounts of the Company and its subsidiaries, National Interstate Insurance Company (“NIIC”), Hudson Indemnity, Ltd., National Interstate Insurance Company of Hawaii, Inc. (“NIIC-HI”), Triumphe Casualty Company (“TCC”), National Interstate Insurance Agency, Inc. (“NIIA”), Hudson Management Group, Ltd., Vanliner Insurance Company (“VIC”), Vanliner Reinsurance Limited, American Highways Insurance Agency, Inc., Explorer RV Insurance Agency, Inc., Safety, Claims and Litigation Services, LLC and TransProtection Service Company. Significant intercompany transactions have been eliminated.

These interim unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013. The interim financial statements reflect all adjustments which are, in the opinion of management, necessary for the fair presentation of the results for the periods presented. Such adjustments are of a normal recurring nature. Operating results for the three and nine month periods ended September 30, 2014 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2014.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates.

2. Fair Value Measurements

The Company must determine the appropriate level in the fair value hierarchy for each applicable measurement. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company’s management is responsible for the valuation process and uses data from outside sources (including nationally recognized pricing services and broker/dealers) in establishing fair value.

Pricing services use a variety of observable inputs to estimate the fair value of fixed maturities that do not trade on a daily basis. These inputs include, but are not limited to, recent reported trades, benchmark yields, issuer spreads, bids or offers, reference data and measures of volatility. Included in the pricing of mortgage-backed securities are estimates of the rate of future prepayments and defaults of principal over the remaining life of the underlying collateral. Inputs from brokers and independent financial institutions include, but are not limited to, yields or spreads of comparable investments which have recent trading activity, credit quality, duration, credit enhancements, collateral value and estimated cash flows based on inputs including delinquency rates, estimated defaults and losses and estimates of the rate of future prepayments. Valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by the Company’s internal and affiliated investment professionals who are familiar with the securities being priced and the markets in which they trade to ensure the fair value determination is representative of an exit price. To validate the appropriateness of the prices obtained, the Company’s internal investment professionals, who report to the Chief Investment Officer, compare the valuation received to independent third party pricing sources and consider widely published indices (as benchmarks), recent trades, changes in interest rates, general economic conditions and the credit quality of the specific issuers. If the Company believes that significant discrepancies exist, the Company will perform additional procedures, which may include specific inquiry of the pricing source, to resolve the discrepancies.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical securities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the security, either directly or indirectly. Level 2 inputs include quoted prices for similar securities in active markets, quoted prices for identical or similar securities that are not active and observable inputs other than quoted prices, such as interest rate and yield curves. Level 3 inputs are unobservable inputs for the asset or liability. Level 1 consists of publicly traded equity securities and highly liquid, direct obligations of the U.S. Government whose fair value is based on quoted prices that are readily and regularly available in an active market. Level 2 primarily consists of financial

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instruments whose fair value is based on quoted prices in markets that are not active and include U.S. government agency securities, fixed maturity investments and nonredeemable preferred stocks that are not actively traded. Included in Level 2 are \$145.4 million of securities, which are valued based upon a non-binding broker quote and validated with other observable market data by management. Level 3 consists of financial instruments that are not traded in an active market, whose fair value is estimated by management based on inputs from independent financial institutions, which include non-binding broker quotes. The Company believes these estimates reflect fair value, but the Company is unable to verify inputs to the valuation methodology. The Company obtained at least one quote or price per instrument from its brokers and pricing services for all Level 3 securities and did not adjust any quotes or prices that it obtained. The Company's internal and affiliated investment professionals review these broker quotes using any recent trades, if such information is available, or market prices of similar investments. The Company primarily uses the market approach valuation technique for all investments.

The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fall as of September 30, 2014:

| | Level 1 | Level 2 | Level 3 | Total |
|---|------------------------|-----------|----------|-------------|
| | (Dollars in thousands) | | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$1,709 | \$103,410 | \$— | \$105,119 |
| Foreign government obligations | — | — | — | — |
| State and local government obligations | — | 347,659 | 887 | 348,546 |
| Residential mortgage-backed securities | — | 196,262 | — | 196,262 |
| Commercial mortgage-backed securities | — | 20,703 | — | 20,703 |
| Corporate obligations | — | 183,330 | 7,103 | 190,433 |
| Other debt obligations | — | 79,982 | 2,503 | 82,485 |
| Redeemable preferred stocks | 3,801 | — | 494 | 4,295 |
| Total fixed maturities | 5,510 | 931,346 | 10,987 | 947,843 |
| Equity securities: | | | | |
| Common stocks | 53,165 | — | 3,778 | 56,943 |
| Nonredeemable preferred stocks | 18,318 | 3,624 | — | 21,942 |
| Total equity securities | 71,483 | 3,624 | 3,778 | 78,885 |
| Total fixed maturities and equity securities | 76,993 | 934,970 | 14,765 | 1,026,728 |
| Cash and cash equivalents | 72,982 | — | — | 72,982 |
| Total fixed maturities, equity securities and cash and cash equivalents at fair value | \$149,975 | \$934,970 | \$14,765 | \$1,099,710 |

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The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fell as of December 31, 2013:

| | Level 1 | Level 2 | Level 3 | Total |
|---|------------------------|-----------|----------|-------------|
| | (Dollars in thousands) | | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$1,486 | \$92,871 | \$— | \$94,357 |
| Foreign government obligations | — | 3,553 | — | 3,553 |
| State and local government obligations | — | 355,944 | 859 | 356,803 |
| Residential mortgage-backed securities | — | 202,225 | — | 202,225 |
| Commercial mortgage-backed securities | — | 34,963 | — | 34,963 |
| Corporate obligations | — | 187,481 | 4,969 | 192,450 |
| Other debt obligations | — | 41,805 | 3,311 | 45,116 |
| Redeemable preferred stocks | 3,625 | — | 487 | 4,112 |
| Total fixed maturities | 5,111 | 918,842 | 9,626 | 933,579 |
| Equity securities: | | | | |
| Common stocks | 48,145 | — | 1,500 | 49,645 |
| Nonredeemable preferred stocks | 11,972 | 3,570 | 583 | 16,125 |
| Total equity securities | 60,117 | 3,570 | 2,083 | 65,770 |
| Total fixed maturities and equity securities | 65,228 | 922,412 | 11,709 | 999,349 |
| Cash and cash equivalents | 35,684 | — | — | 35,684 |
| Total fixed maturities, equity securities and cash and cash equivalents at fair value | \$100,912 | \$922,412 | \$11,709 | \$1,035,033 |

The tables above exclude other invested assets of \$45.6 million and \$40.4 million at September 30, 2014 and December 31, 2013, respectively. Other invested assets include investments in limited partnerships which are accounted for under the equity method. Equity method investments are not reported at fair value.

The Company uses the end of the reporting period as its policy for determining transfers into and out of each level. During the three and nine months ended September 30, 2014, the Company transferred seven nonredeemable preferred stocks, with an aggregate value of \$6.1 million, from Level 2 to Level 1 due to increases in trading activity. Conversely, during the same nine month period, the Company transferred six other nonredeemable preferred stocks, with an aggregate value of \$5.0 million, from Level 1 to Level 2 due to decreases in trading activity. There were no transfers from Level 1 to Level 2 during the three months ended September 30, 2014.

During the nine months ended September 30, 2013, the Company transferred \$3.8 million of nonredeemable preferred stocks and \$1.0 million of redeemable preferred stocks from Level 2 to Level 1 due to increases in trading activity. Of these transfers, \$3.5 million of the nonredeemable preferred stocks were transferred in the third quarter of 2013. There were no transfers from Level 1 to Level 2 during the three or nine months ended September 30, 2013.

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The following tables present a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the three and nine months ended September 30, 2014 and 2013. The transfers into Level 3 during the three and nine months ended September 30, 2014 and 2013 were due to decreases in the availability of market observable inputs. All transfers are reflected in the table at fair value as of the end of the reporting period.

| | Three Months Ended September 30, 2014 | | | | | |
|--|---|--------------------------|---------------------------|----------------------------------|-----------------|-------------------------------------|
| | State and Local Government Obligations | Corporate Obligations | Other Debt Obligations | Redeemable Preferred Stock | Common Stock | |
| Beginning balance at July 1, 2014 | \$887 | \$6,019 | \$2,510 | \$493 | | \$3,844 |
| Total gains or (losses): | | | | | | |
| Included in earnings | — | — | — | — | | — |
| Included in other comprehensive income | — | 128 | (7 |) 1 | | (66) |
| Purchases and issuances | — | — | — | — | | — |
| Sales, settlements and redemptions | — | (59 |) — | — | | — |
| Transfers in and/or (out) of Level 3 | — | 1,015 | — | — | | — |
| Ending balance at September 30, 2014 | \$887 | \$7,103 | \$2,503 | \$494 | | \$3,778 |
| The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date | \$— | \$— | \$— | \$— | | \$— |
| | Nine Months Ended September 30, 2014 | | | | | |
| | State and Local Government Obligations | Corporate Obligations | Other Debt Obligations | Redeemable Preferred Stock | Common Stock | Nonredeemable Preferred Stock |
| | (Dollars in thousands) | | | | | |
| Beginning balance at January 1, 2014 | \$859 | \$4,969 | \$3,311 | \$487 | \$1,500 | \$ 583 |
| Total gains or (losses): | | | | | | |
| Included in earnings | — | — | 24 | — | — | — |
| Included in other comprehensive income | 28 | 280 | (21 |) 7 | 12 | — |
| Purchases and issuances | — | 1,000 | — | — | 2,266 | — |
| Sales, settlements and redemptions | — | (161 |) (811 |) — | — | (583 |
| Transfers in and/or (out) of Level 3 | — | 1,015 | — | — | — | — |
| Ending balance at September 30, 2014 | \$887 | \$7,103 | \$2,503 | \$494 | \$3,778 | \$ — |
| The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating | \$— | \$— | \$— | \$— | \$— | \$ — |

to assets still held at the reporting
date

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| | Three Months Ended September 30, 2013 | | | | |
|--|---|--------------------------|---------------------------|----------------------------------|-------------------------------------|
| | State and Local Government Obligations | Corporate Obligations | Other Debt Obligations | Redeemable Preferred Stock | Nonredeemable Preferred Stock |
| | (Dollars in thousands) | | | | |
| Beginning balance at July 1, 2013 | \$844 | \$8,617 | \$— | \$481 | \$ 963 |
| Total gains or (losses): | | | | | |
| Included in earnings | — | — | — | — | — |
| Included in other comprehensive income | 13 | (240) | — | 4 | 12 |
| Purchases and issuances | — | — | — | — | — |
| Sales, settlements and redemptions | — | (55) | — | — | — |
| Transfers in and/or (out) of Level 3 | — | — | 2,510 | — | — |
| Ending balance at September 30, 2013 | \$857 | \$8,322 | \$2,510 | \$485 | \$ 975 |
| The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date | \$— | \$— | \$— | \$— | \$ — |

| | Nine Months Ended September 30, 2013 | | | | |
|--|---|--------------------------|---------------------------|----------------------------------|-------------------------------------|
| | State and Local Government Obligations | Corporate Obligations | Other Debt Obligations | Redeemable Preferred Stock | Nonredeemable Preferred Stock |
| | (Dollars in thousands) | | | | |
| Beginning balance at January 1, 2013 | \$837 | \$7,658 | \$— | \$483 | \$ — |
| Total gains or (losses): | | | | | |
| Included in earnings | — | — | — | — | — |
| Included in other comprehensive income | 20 | (189) | — | 2 | 6 |
| Purchases and issuances | — | 1,000 | — | — | 969 |
| Sales, settlements and redemptions | — | (147) | — | — | — |
| Transfers in and/or (out) of Level 3 | — | — | 2,510 | — | — |
| Ending balance at September 30, 2013 | \$857 | \$8,322 | \$2,510 | \$485 | \$ 975 |
| The amount of total gains or (losses) for the period included in earnings and attributable to the change in unrealized gains or (losses) relating to assets still held at the reporting date | \$— | \$— | \$— | \$— | \$ — |

At September 30, 2014, the Company had 14 securities with a fair value of \$14.8 million that are included in Level 3, which represented 1.4% of its total investments reported at fair value. The significant unobservable inputs used by the brokers and pricing services in establishing fair values of the Company's Level 3 securities are primarily spreads to U.S. Treasury rates and discounts to comparable securities. The specifics of such spreads and discounts were not made available to the Company. Significant increases (decreases) on spreads to U.S. Treasury rates and discount spreads to comparable securities would result in lower (higher) fair value measurements. Generally, a change in the assumption used for determining a spread is accompanied by market factors that warrant an adjustment for the credit risk and liquidity premium of the security. As the total fair value of Level 3 securities is 4.1% of the Company's shareholders'

equity at September 30, 2014, any change in unobservable inputs would not have a material impact on the Company's financial position.

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3. Investments

Under other-than-temporary impairment accounting guidance, if management can assert that it does not intend to sell an impaired fixed maturity security and it is not more likely than not that it will be required to sell the security before recovery of its amortized cost basis, then an entity may separate the other-than-temporary impairments into two components: 1) the amount related to credit losses (recorded in earnings) and 2) the amount related to all other factors (recorded in other comprehensive income (loss)). The credit related portion of an other-than-temporary impairment is measured by comparing a security's amortized cost to the present value of its current expected cash flows discounted at its effective yield prior to the impairment charge. If management intends to sell an impaired security, or it is more likely than not that it will be required to sell the security before recovery, an impairment charge recorded in earnings is required to reduce the amortized cost of that security to fair value.

The cost or amortized cost and fair value of investments in fixed maturities and equity securities are as follows:

| | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|------------------------------|------------------------------|-------------------------------|----------------|
| | (Dollars in thousands) | | | |
| September 30, 2014 | | | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$ 102,225 | \$ 2,952 | \$(58) |) \$ 105,119 |
| State and local government obligations | 336,897 | 12,130 | (481) |) 348,546 |
| Residential mortgage-backed securities | 189,788 | 8,221 | (1,747) |) 196,262 |
| Commercial mortgage-backed securities | 19,672 | 1,036 | (5) |) 20,703 |
| Corporate obligations | 183,142 | 7,793 | (502) |) 190,433 |
| Other debt obligations | 82,819 | 219 | (553) |) 82,485 |
| Redeemable preferred stocks | 4,168 | 133 | (6) |) 4,295 |
| Total fixed maturities | 918,711 | 32,484 | (3,352) |) 947,843 |
| Equity securities: | | | | |
| Common stocks | 49,743 | 9,290 | (2,090) |) 56,943 |
| Nonredeemable preferred stocks | 20,690 | 1,505 | (253) |) 21,942 |
| Total equity securities | 70,433 | 10,795 | (2,343) |) 78,885 |
| Total fixed maturities and equity securities | \$ 989,144 | \$ 43,279 | \$(5,695) |) \$ 1,026,728 |
| December 31, 2013 | | | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$ 91,360 | \$ 3,282 | \$(285) |) \$ 94,357 |
| Foreign government obligations | 3,529 | 24 | — |) 3,553 |
| State and local government obligations | 351,866 | 8,155 | (3,218) |) 356,803 |
| Residential mortgage-backed securities | 197,376 | 8,034 | (3,185) |) 202,225 |
| Commercial mortgage-backed securities | 33,503 | 1,483 | (23) |) 34,963 |
| Corporate obligations | 186,899 | 7,060 | (1,509) |) 192,450 |
| Other debt obligations | 45,448 | 146 | (478) |) 45,116 |
| Redeemable preferred stocks | 4,168 | 72 | (128) |) 4,112 |
| Total fixed maturities | 914,149 | 28,256 | (8,826) |) 933,579 |
| Equity securities: | | | | |
| Common stocks | 39,755 | 10,842 | (952) |) 49,645 |
| Nonredeemable preferred stocks | 15,782 | 1,047 | (704) |) 16,125 |
| Total equity securities | 55,537 | 11,889 | (1,656) |) 65,770 |
| Total fixed maturities and equity securities | \$ 969,686 | \$ 40,145 | \$(10,482) |) \$ 999,349 |

The table above excludes other invested assets of \$45.6 million and \$40.4 million at September 30, 2014 and December 31, 2013, respectively. Other invested assets include investments in limited partnerships which are accounted for under the equity method. Equity method investments are not reported at fair value.

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State and local government obligations represented approximately 36.8% of the Company's fixed maturity portfolio at September 30, 2014, with approximately \$286.5 million, or 82.2%, of the Company's state and local government obligations held in special revenue obligations, and the remaining amount held in general obligations. The Company's state and local government obligations portfolio is high quality, as 98.8% of such securities were rated investment grade (as determined by nationally recognized agencies) at September 30, 2014. The Company had no state and local government obligations for any state, municipality or political subdivision that comprised 10% or more of the total amortized cost or fair value of such obligations at September 30, 2014.

The non-credit portion of other-than-temporary impairment charges is included in other comprehensive income. Cumulative non-credit charges taken for securities still owned at September 30, 2014 and December 31, 2013 were \$3.3 million and \$3.5 million, respectively.

The amortized cost and fair value of fixed maturities at September 30, 2014, by contractual maturity, are shown below. Other debt obligations, which are primarily comprised of asset-backed securities other than mortgage-backed securities are categorized based on their average maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The average life of mortgage-backed securities is 4.0 years in the Company's investment portfolio.

Amortized cost and fair value of the fixed maturities in the Company's investment portfolio were as follows:

| | Amortized Cost | Fair Value |
|--|------------------------|------------|
| | (Dollars in thousands) | |
| Due in one year or less | \$22,206 | \$22,458 |
| Due after one year through five years | 291,379 | 301,098 |
| Due after five years through ten years | 300,223 | 308,683 |
| Due after ten years | 95,443 | 98,639 |
| | 709,251 | 730,878 |
| Mortgage-backed securities | 209,460 | 216,965 |
| Total | \$918,711 | \$947,843 |

Gains and losses on the sale of investments, including other-than-temporary impairment charges and other invested assets' gains or losses, were as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------|-------------------------------------|---------|------------------------------------|---------|
| | 2014 | 2013 | 2014 | 2013 |
| | (Dollars in thousands) | | | |
| Fixed maturity gains | \$172 | \$405 | \$1,079 | \$2,104 |
| Fixed maturity losses | (32) | (33) | (262) | (38) |
| Equity security gains | 1,827 | 625 | 2,766 | 1,835 |
| Equity security losses | (319) | (147) | (530) | (216) |
| Other invested assets, net gains | 974 | 503 | 3,241 | 1,748 |
| Net realized gains on investments | \$2,622 | \$1,353 | \$6,294 | \$5,433 |

Pre-tax net realized gains on investments of \$2.6 million and \$6.3 million for the three and nine months ended September 30, 2014 were partially generated from net realized gains associated with the sales or redemptions of securities of \$1.9 million and \$3.8 million, respectively. The gains on equity and fixed maturity securities were primarily due to favorable market conditions that increased the value of securities over book value. Other invested assets generated net gains of \$1.0 million and \$3.2 million for the three and nine months ended September 30, 2014, respectively. Offsetting these gains for the three and nine months ended September 30, 2014, were other-than-temporary impairment charges of \$0.3 million and \$0.7 million, respectively, related to several securities due to the uncertainty surrounding the timing and extent of recovery.

Pre-tax net realized gains on investments of \$1.4 million and \$5.4 million for the three and nine months ended September 30, 2013 were primarily generated from net realized gains associated with the sales or redemptions of securities of \$1.0 million and \$3.8 million, respectively. The gains on equity and fixed maturity securities were

primarily due to favorable market conditions that increased the value of securities over book value. Other invested assets generated net gains of \$0.5 million and \$1.8 million for the three and nine months ended September 30, 2013, respectively. Offsetting these gains were other-than-temporary impairment

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charges of \$0.1 million and \$0.2 million for the three and nine months ended September 30, 2013 on several equity securities due to the uncertainty surrounding the timing and extent of recovery.

The following table summarizes the Company's gross unrealized losses on fixed maturities and equity securities and the length of time that individual securities have been in a continuous unrealized loss position:

| | Less than Twelve Months | | | | Twelve Months or More | | | |
|---|-------------------------|-------------------|-------------------------|--------------------|-----------------------|-------------------|-------------------------|--------------------|
| | Fair Value | Unrealized Losses | Fair Value as % of Cost | Number of Holdings | Fair Value | Unrealized Losses | Fair Value as % of Cost | Number of Holdings |
| (Dollars in thousands) | | | | | | | | |
| September 30, 2014 | | | | | | | | |
| Fixed maturities: | | | | | | | | |
| U.S. Government and government agency obligations | | | | | | | | |
| | \$9,195 | \$(57) | 99.4 % | 11 | \$48 | \$(1) | 98.0 % | 1 |
| State and local government obligations | | | | | | | | |
| | 22,208 | (205) | 99.1 % | 18 | 12,151 | (276) | 97.8 % | 10 |
| Residential mortgage-backed securities | | | | | | | | |
| | 36,520 | (321) | 99.1 % | 31 | 39,568 | (1,426) | 96.5 % | 34 |
| Commercial mortgage-backed securities | | | | | | | | |
| | 1,055 | (2) | 99.8 % | 1 | 1,048 | (3) | 99.7 % | 1 |
| Corporate obligations | | | | | | | | |
| | 16,834 | (151) | 99.1 % | 20 | 13,161 | (351) | 97.4 % | 11 |
| Other debt obligations | | | | | | | | |
| | 47,713 | (374) | 99.2 % | 51 | 10,863 | (179) | 98.4 % | 11 |
| Redeemable preferred stocks | | | | | | | | |
| | 999 | (1) | 99.9 % | 1 | 494 | (5) | 99.0 % | 1 |
| Total fixed maturities | | | | | | | | |
| | 134,524 | (1,111) | 99.2 % | 133 | 77,333 | (2,241) | 97.2 % | 69 |
| Equity securities: | | | | | | | | |
| Common stocks | | | | | | | | |
| | 20,707 | (2,090) | 90.8 % | 35 | — | — | 0.0 % | — |
| Nonredeemable preferred stocks | | | | | | | | |
| | 5,521 | (84) | 98.5 % | 11 | 2,832 | (169) | 94.4 % | 3 |
| Total equity securities | | | | | | | | |
| | 26,228 | (2,174) | 92.3 % | 46 | 2,832 | (169) | 94.4 % | 3 |
| Total fixed maturities and equity securities | | | | | | | | |
| | \$160,752 | \$(3,285) | 98.0 % | 179 | \$80,165 | \$(2,410) | 97.1 % | 72 |
| December 31, 2013 | | | | | | | | |
| Fixed maturities: | | | | | | | | |
| U.S. Government and government agency obligations | | | | | | | | |
| | \$19,307 | \$(285) | 98.5 % | 19 | \$— | \$— | 0.0 % | — |
| State and local government obligations | | | | | | | | |
| | 110,694 | (3,077) | 97.3 % | 81 | 859 | (141) | 85.9 % | 1 |
| Residential mortgage-backed securities | | | | | | | | |
| | 64,858 | (2,286) | 96.6 % | 55 | 12,445 | (899) | 93.3 % | 9 |
| Commercial mortgage-backed securities | | | | | | | | |
| | 2,773 | (23) | | | | | | |