

Edgar Filing: National Interstate CORP - Form 10-Q

National Interstate CORP
Form 10-Q
November 04, 2015
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, 2015

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 checked="" 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 30, 2015 was 19,901,904.

Table of Contents

National Interstate Corporation
Table of Contents

| | Page |
|--|-----------|
| <u>Part I – Financial Information</u> | <u>3</u> |
| <u>Item 1. Financial Statements</u> | <u>3</u> |
| <u>Consolidated Balance Sheets</u> | <u>3</u> |
| <u>Consolidated Statements of Income</u> | <u>4</u> |
| <u>Consolidated Statements of Comprehensive Income</u> | <u>5</u> |
| <u>Consolidated Statements of Shareholders' Equity</u> | <u>6</u> |
| <u>Consolidated Statements of Cash Flows</u> | <u>7</u> |
| <u>Notes to Consolidated Financial Statements</u> | <u>8</u> |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>24</u> |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u> | <u>38</u> |
| <u>Item 4. Controls and Procedures</u> | <u>38</u> |
| <u>Part II – Other Information</u> | <u>39</u> |
| <u>Item 1. Legal Proceedings</u> | <u>39</u> |
| <u>Item 1A. Risk Factors</u> | <u>39</u> |
| <u>Item 6. Exhibits</u> | <u>39</u> |

Table of Contents

PART I—FINANCIAL INFORMATION

ITEM 1. Financial Statements

National Interstate Corporation and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands, except per share data)

| | September 30, 2015 (Unaudited) | December 31, 2014 |
|---|--------------------------------------|----------------------|
| ASSETS | | |
| Investments: | | |
| Fixed maturities available-for-sale, at fair value (amortized cost – \$1,019,843 and \$945,956, respectively) | \$1,043,555 | \$974,746 |
| Equity securities available-for-sale, at fair value (amortized cost – \$88,956 and \$76,352, respectively) | 90,006 | 85,228 |
| Other invested assets | 48,018 | 46,786 |
| Total investments | 1,181,579 | 1,106,760 |
| Cash and cash equivalents | 81,704 | 53,583 |
| Accrued investment income | 8,744 | 8,724 |
| Premiums receivable, net of allowance for doubtful accounts of \$2,180 and \$2,627, respectively | 284,358 | 271,336 |
| Reinsurance recoverable on paid and unpaid losses | 207,991 | 180,332 |
| Prepaid reinsurance premiums | 51,091 | 47,013 |
| Deferred policy acquisition costs | 22,431 | 22,654 |
| Deferred federal income taxes | 28,382 | 23,150 |
| Property and equipment, net | 23,134 | 24,538 |
| Funds held by reinsurer | 4,776 | 4,335 |
| Intangible assets, net | 7,650 | 7,791 |
| Prepaid expenses and other assets | 2,139 | 4,517 |
| Total assets | \$1,903,979 | \$1,754,733 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Liabilities: | | |
| Unpaid losses and loss adjustment expenses | \$976,237 | \$883,078 |
| Unearned premiums and service fees | 315,656 | 311,255 |
| Long-term debt | 12,000 | 12,000 |
| Amounts withheld or retained for accounts of others | 117,298 | 101,799 |
| Reinsurance balances payable | 45,197 | 31,069 |
| Accounts payable and other liabilities | 49,579 | 33,402 |
| Commissions payable | 16,089 | 15,392 |
| Assessments and fees payable | 4,800 | 4,649 |
| Total liabilities | 1,536,856 | 1,392,644 |
| 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 3,450 and 3,557 shares, respectively, in treasury | 234 | 234 |
| Additional paid-in capital | 61,528 | 59,386 |
| Retained earnings | 294,161 | 283,031 |

Edgar Filing: National Interstate CORP - Form 10-Q

| | | |
|---|-------------|-------------|
| Accumulated other comprehensive income | 16,096 | 24,483 |
| Treasury shares | (4,896 |) (5,045 |
| Total shareholders' equity | 367,123 | 362,089 |
| Total liabilities and shareholders' equity | \$1,903,979 | \$1,754,733 |
| See notes to consolidated financial statements. | | |

3

Table of Contents

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, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| Revenues: | | | | |
| Premiums earned | \$ 151,483 | \$ 140,009 | \$ 433,198 | \$ 412,651 |
| Net investment income | 9,927 | 9,130 | 29,411 | 26,615 |
| Net realized (losses) gains on investments (*) | (3,836 |) 2,622 | (2,336 |) 6,294 |
| Other | 1,046 | 941 | 2,762 | 2,487 |
| Total revenues | 158,620 | 152,702 | 463,035 | 448,047 |
| Expenses: | | | | |
| Losses and loss adjustment expenses | 120,090 | 110,755 | 342,414 | 346,920 |
| Commissions and other underwriting expenses | 24,200 | 24,058 | 70,547 | 70,482 |
| Other operating and general expenses | 6,145 | 4,912 | 19,262 | 15,797 |
| Transaction expenses | — | — | — | 2,163 |
| Expense on amounts withheld | 1,602 | 1,971 | 4,755 | 4,952 |
| Interest expense | 50 | 59 | 146 | 191 |
| Total expenses | 152,087 | 141,755 | 437,124 | 440,505 |
| Income before income taxes | 6,533 | 10,947 | 25,911 | 7,542 |
| Provision for income taxes | 1,388 | 2,154 | 7,015 | 1,437 |
| Net income | \$ 5,145 | \$ 8,793 | \$ 18,896 | \$ 6,105 |
| Net income per share – basic | \$ 0.26 | \$ 0.44 | \$ 0.95 | \$ 0.31 |
| Net income per share – diluted | \$ 0.26 | \$ 0.44 | \$ 0.95 | \$ 0.31 |
| Weighted average of common shares outstanding – basic | 19,868 | 19,780 | 19,847 | 19,746 |
| Weighted average of common shares outstanding – diluted | 19,916 | 19,853 | 19,896 | 19,823 |
| Cash dividends per common share | \$ 0.13 | \$ 0.12 | \$ 0.39 | \$ 0.36 |

(*) Consists of the following:

| | | | | |
|---|-----------|------------|-----------|------------|
| Net realized (losses) gains before impairment losses | \$ (706 |) \$ 2,942 | \$ 2,168 | \$ 6,979 |
| Total losses on securities with impairment charges | (3,133 |) (320 |) (4,492 |) (455 |
| Non-credit portion recognized in other comprehensive income | 3 | — | (12 |) (230 |
| Net impairment charges recognized in earnings | (3,130 |) (320 |) (4,504 |) (685 |
| Net realized (losses) gains on investments | \$ (3,836 |) \$ 2,622 | \$ (2,336 |) \$ 6,294 |

See notes to consolidated financial statements.

Table of Contents

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | |
|---|-------------------------------------|----------|------------------------------------|----------|---|
| | 2015 | 2014 | 2015 | 2014 | |
| Net income | \$5,145 | \$8,793 | \$18,896 | \$6,105 | |
| 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 | (7,890 |) (6,947 |) (11,895 |) 10,647 | |
| Reclassification adjustment for net realized losses (gains) included in net income | 702 | (1,570 |) (1,009 |) (2,726 |) |
| Total other comprehensive (loss) income, before tax | (7,188 |) (8,517 |) (12,904 |) 7,921 | |
| Deferred income tax (benefit) expense on other comprehensive (loss) income | (2,517 |) (2,981 |) (4,517 |) 2,772 | |
| Other comprehensive (loss) income, net of tax | (4,671 |) (5,536 |) (8,387 |) 5,149 | |
| Total comprehensive income | \$474 | \$3,257 | \$10,509 | \$11,254 | |
| See notes to consolidated financial statements. | | | | | |

Table of Contents

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, 2015 | \$234 | \$59,386 | \$283,031 | \$ 24,483 | \$(5,045) | \$362,089 |
| Net income | | | 18,896 | | | 18,896 |
| Other comprehensive loss, net of tax | | | | (8,387) | | (8,387) |
| Dividends on common stock | | | (7,766) | | | (7,766) |
| Issuance of 107,006 treasury shares upon exercise of options and restricted stock issued, net of forfeitures | | 1,598 | | | 149 | 1,747 |
| Net tax effect from exercise/vesting of stock-based compensation | | (48) | | | | (48) |
| Stock-based compensation expense | | 592 | | | | 592 |
| Balance at September 30, 2015 | \$234 | \$61,528 | \$294,161 | \$ 16,096 | \$(4,896) | \$367,123 |
| 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-based 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 |

See notes to consolidated financial statements.

Table of Contents

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

| | Nine Months Ended September | |
|---|-----------------------------|------------|
| | 30, | |
| | 2015 | 2014 |
| Operating activities | | |
| Net income | \$18,896 | \$6,105 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net amortization of bond premiums and discounts | 2,240 | 2,990 |
| Provision for depreciation and amortization | 3,990 | 3,254 |
| Net realized losses (gains) on investment securities | 2,336 | (6,294) |
| Deferred federal income taxes | (715) | 2,651) |
| Stock-based compensation expense | 592 | 436 |
| Decrease (increase) in deferred policy acquisition costs, net | 223 | (214) |
| Increase in reserves for losses and loss adjustment expenses | 93,159 | 47,651 |
| (Increase) decrease in premiums receivable | (13,022) | 6,072) |
| Increase in unearned premiums and service fees | 4,401 | 993 |
| Decrease (increase) in interest receivable and other assets | 1,917 | (4,953) |
| Increase in prepaid reinsurance premiums | (4,078) | (9,836) |
| Increase (decrease) in accounts payable, commissions and other liabilities and assessments and fees payable | 10,654 | (9,522) |
| Increase in amounts withheld or retained for accounts of others | 15,499 | 11,986 |
| (Increase) decrease in reinsurance recoverable | (27,659) | 9,352) |
| Increase in reinsurance balances payable | 14,128 | 5,856 |
| Other | 662 | 39 |
| Net cash provided by operating activities | 123,223 | 66,566 |
| Investing activities | | |
| Purchases of fixed maturities | (202,859) | (125,325) |
| Purchases of equity securities | (21,687) | (21,678) |
| Proceeds from sale of fixed maturities | 8,770 | 19,985 |
| Proceeds from sale of equity securities | 6,933 | 8,428 |
| Proceeds from maturities and redemptions of investments | 124,088 | 99,344 |
| Change in other investments, net | (1,173) | (2,138) |
| Capital expenditures | (3,107) | (2,945) |
| Net cash used in investing activities | (89,035) | (24,329) |
| Financing activities | | |
| Net tax effect from exercise/vesting of stock-based compensation | (48) | 50) |
| Issuance of common shares from treasury | 1,747 | 2,143 |
| Cash dividends paid on common shares | (7,766) | (7,132) |
| Net cash used in financing activities | (6,067) | (4,939) |
| Net increase in cash and cash equivalents | 28,121 | 37,298 |
| Cash and cash equivalents at beginning of period | 53,583 | 35,684 |
| Cash and cash equivalents at end of period | \$81,704 | \$72,982 |
| See notes to consolidated financial statements. | | |

Table of Contents

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”), Vanliner Insurance Company (“VIC”), National Interstate Insurance Company of Hawaii, Inc. (“NIIC-HI”), Hudson Indemnity, Ltd. (“HIL”), Triumphe Casualty Company (“TCC”), Hudson Management Group, Ltd., Vanliner Reinsurance Limited, National Interstate Insurance Agency, Inc. (“NIIA”), American Highways Insurance Agency, Inc., TransProtection Service Company, Explorer RV Insurance Agency, Inc. and Safety, Claims and Litigation Services, LLC. 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, 2014. 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 nine month period ended September 30, 2015 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2015.

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. Recent Accounting Pronouncements

In February 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis (“ASU 2015-02”). The FASB issued ASU 2015-02 to simplify consolidation accounting by reducing the number of consolidation models and to provide more useful information to stakeholders. The Update affects reporting entities that are required to evaluate whether they should consolidate certain entities. The main provisions affect limited partnerships and similar legal entities as variable interest entities or voting interest entities; the evaluation of fees paid to a decision maker as a variable interest; the effect of fee arrangements on the primary beneficiary determination; and a scope exception for certain investment funds. The updated guidance is effective for annual and interim periods beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. The adoption of this guidance is not expected to have a material effect on the Company’s results of operations or financial position.

In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs (“ASU 2015-03”). ASU 2015-03 simplifies the presentation of debt issuance costs by requiring reporting entities to present such costs on the balance sheet as a deduction from the related debt liability, similar to the presentation of debt discounts. Amortization of the costs will continue to be reported as interest expense. The updated guidance is effective for fiscal years beginning after December 15, 2015 and interim periods within those fiscal years. Early adoption is permitted. The adoption of this guidance is not expected to have a material effect on the Company’s results of operations or financial position.

In May 2015, the FASB issued ASU No. 2015-09, Financial Services - Insurance (Topic 944): Disclosures about Short-Duration Contracts (“ASU 2015-09”). The FASB issued ASU 2015-09 to enhance disclosure requirements for short-duration insurance contracts and to increase transparency regarding significant estimates made in measuring liabilities for unpaid claims and claim adjustment expenses. The ASU is also intended to improve comparability by requiring consistent disclosure information as well as provide financial statement users with additional information to facilitate analysis of the amount, timing, and uncertainty of claims cash flows. The new disclosures will be effective for fiscal years beginning after December 15, 2015 and interim periods within annual periods beginning after December 15, 2016. Early adoption is permitted. The Company will incorporate the required disclosures upon

adoption of this guidance. The adoption of this guidance is not expected to have a material effect on the Company's results of operations or financial position.

3. 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,

Table of Contents

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 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. At September 30, 2015, Level 2 included \$209.7 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.

Table of Contents

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 September 30, 2015:

| | Level 1 | Level 2 | Level 3 | Total |
|---|------------------------|-------------|----------|-------------|
| | (Dollars in thousands) | | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$4,239 | \$147,189 | \$— | \$151,428 |
| State and local government obligations | — | 315,841 | 2,909 | 318,750 |
| Residential mortgage-backed securities | — | 167,164 | — | 167,164 |
| Commercial mortgage-backed securities | — | 14,832 | — | 14,832 |
| Corporate obligations | — | 198,950 | 7,037 | 205,987 |
| Other debt obligations | — | 167,902 | 13,203 | 181,105 |
| Redeemable preferred stocks | 3,637 | 153 | 499 | 4,289 |
| Total fixed maturities | 7,876 | 1,012,031 | 23,648 | 1,043,555 |
| Equity securities: | | | | |
| Common stocks | 62,017 | 823 | 2,737 | 65,577 |
| Nonredeemable preferred stocks | 20,230 | 4,199 | — | 24,429 |
| Total equity securities | 82,247 | 5,022 | 2,737 | 90,006 |
| Total fixed maturities and equity securities | 90,123 | 1,017,053 | 26,385 | 1,133,561 |
| Cash and cash equivalents | 81,704 | — | — | 81,704 |
| Total fixed maturities, equity securities and cash and cash equivalents at fair value | \$171,827 | \$1,017,053 | \$26,385 | \$1,215,265 |

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, 2014:

| | Level 1 | Level 2 | Level 3 | Total |
|---|------------------------|-----------|----------|-------------|
| | (Dollars in thousands) | | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$2,911 | \$110,535 | \$— | \$113,446 |
| State and local government obligations | — | 338,694 | 2,887 | 341,581 |
| Residential mortgage-backed securities | — | 192,555 | — | 192,555 |
| Commercial mortgage-backed securities | — | 16,998 | — | 16,998 |
| Corporate obligations | — | 192,314 | 7,100 | 199,414 |
| Other debt obligations | — | 102,454 | 3,995 | 106,449 |
| Redeemable preferred stocks | 3,808 | — | 495 | 4,303 |
| Total fixed maturities | 6,719 | 953,550 | 14,477 | 974,746 |
| Equity securities: | | | | |
| Common stocks | 58,839 | — | 3,988 | 62,827 |
| Nonredeemable preferred stocks | 16,887 | 5,514 | — | 22,401 |
| Total equity securities | 75,726 | 5,514 | 3,988 | 85,228 |
| Total fixed maturities and equity securities | 82,445 | 959,064 | 18,465 | 1,059,974 |
| Cash and cash equivalents | 53,583 | — | — | 53,583 |
| Total fixed maturities, equity securities and cash and cash equivalents at fair value | \$136,028 | \$959,064 | \$18,465 | \$1,113,557 |

Table of Contents

The previous tables exclude other invested assets of \$48.0 million and \$46.8 million at September 30, 2015 and December 31, 2014, 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 nine months ended September 30, 2015, the Company transferred three nonredeemable preferred stocks, totaling \$1.5 million (none in the third quarter) and one common stock at \$19 thousand (transferred in the third quarter) from Level 2 to Level 1 due to increases in trading activity. Conversely, during the same nine month period, the Company transferred one common stock at \$0.9 million (none in the third quarter) and one redeemable preferred stock at \$0.2 million (transferred in the third quarter) and four nonredeemable preferred stocks totaling \$1.2 million (including three in the third quarter totaling \$1.1 million) from Level 1 to Level 2 due to decreases in trading activity. During the nine months ended September 30, 2014, the Company transferred seven nonredeemable preferred stocks, with an aggregate value of \$6.1 million (all in the third quarter), 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 (none in the third quarter), from Level 1 to Level 2 due to decreases in trading activity.

Table of Contents

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, 2015 and 2014. The transfers in and out of Level 3 were due to changes 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, 2015 | | | | |
|--|---|--------------------------|---------------------------|----------------------------------|-----------------|
| | State and Local Government Obligations | Corporate Obligations | Other Debt Obligations | Redeemable Preferred Stock | Common Stock |
| Beginning balance at July 1, 2015 | \$2,919 | \$7,152 | \$6,815 | \$498 | \$2,778 |
| Total gains (losses): | | | | | |
| Included in earnings | — | — | — | — | — |
| Included in other comprehensive income | (10 |) (75 |) 431 | 1 | (199 |
| Purchases and issuances | — | — | 5,001 | — | 158 |
| Sales, settlements and redemptions | — | (40 |) (45 |) — | — |
| Transfers in and/or (out) of Level 3 | — | — | 1,001 | — | — |
| Ending balance at September 30, 2015 | \$2,909 | \$7,037 | \$13,203 | \$499 | \$2,737 |
| The amount of total gains (losses) for the period included in earnings and attributable to the change in unrealized gains (losses) relating to assets still held at the reporting date | \$— | \$— | \$— | \$— | \$— |
| | Nine Months Ended September 30, 2015 | | | | |
| | State and Local Government Obligations | Corporate Obligations | Other Debt Obligations | Redeemable Preferred Stock | Common Stock |
| Beginning balance at January 1, 2015 | \$2,887 | \$7,100 | \$3,995 | \$495 | \$3,988 |
| Total gains (losses): | | | | | |
| Included in earnings | — | — | — | — | (278 |
| Included in other comprehensive income | 22 | 104 | 428 | 4 | (165 |
| Purchases and issuances | — | — | 9,389 | — | 158 |
| Sales, settlements and redemptions | — | (167 |) (2,610 |) — | — |
| Transfers in and/or (out) of Level 3 | — | — | 2,001 | — | (966 |
| Ending balance at September 30, 2015 | \$2,909 | \$7,037 | \$13,203 | \$499 | \$2,737 |
| The amount of total gains (losses) for the period included in earnings and attributable to the change in unrealized gains (losses) relating to assets still held at the reporting date | \$— | \$— | \$— | \$— | \$— |

Table of Contents

| | Three Months Ended September 30, 2014 | | | | | |
|--|---|--------------------------|---------------------------|----------------------------------|-----------------|-------------------------------------|
| | State and Local Government Obligations | Corporate Obligations | Other Debt Obligations | Redeemable Preferred Stock | Common Stock | |
| | (Dollars in thousands) | | | | | |
| Beginning balance at July 1, 2014 | \$887 | \$6,019 | \$2,510 | \$493 | \$3,844 | |
| Total gains (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 (losses) for the period included in earnings and attributable to the change in unrealized gains (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 (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 (losses) for the period included in earnings and attributable to the change in unrealized gains (losses) relating to assets still held at the reporting date | \$— | \$— | \$— | \$— | \$— | \$ — |

At September 30, 2015, the Company had 25 securities with a fair value of \$26.4 million that are included in Level 3, which represented 2.3% 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 approximately 7.0% of the Company's shareholders' equity at September 30, 2015, changes in unobservable inputs would not have a material impact on the Company's financial position.

Table of Contents

4. Investments

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

| | Cost or Amortized Cost (Dollars in thousands) | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|--|------------------------------|-------------------------------|---------------|
| September 30, 2015 | | | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$147,767 | \$3,683 | \$(22) |) \$151,428 |
| State and local government obligations | 307,959 | 11,047 | (256) |) 318,750 |
| Residential mortgage-backed securities | 161,315 | 6,577 | (728) |) 167,164 |
| Commercial mortgage-backed securities | 13,970 | 876 | (14) |) 14,832 |
| Corporate obligations | 204,075 | 5,858 | (3,946) |) 205,987 |
| Other debt obligations | 180,589 | 1,039 | (523) |) 181,105 |
| Redeemable preferred stocks | 4,168 | 123 | (2) |) 4,289 |
| Total fixed maturities | 1,019,843 | 29,203 | (5,491) |) 1,043,555 |
| Equity securities: | | | | |
| Common stocks | 65,269 | 6,045 | (5,737) |) 65,577 |
| Nonredeemable preferred stocks | 23,687 | 1,085 | (343) |) 24,429 |
| Total equity securities | 88,956 | 7,130 | (6,080) |) 90,006 |
| Total fixed maturities and equity securities | \$1,108,799 | \$36,333 | \$(11,571) |) \$1,133,561 |
| December 31, 2014 | | | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$110,254 | \$3,206 | \$(14) |) \$113,446 |
| State and local government obligations | 329,725 | 12,193 | (337) |) 341,581 |
| Residential mortgage-backed securities | 185,346 | 8,435 | (1,226) |) 192,555 |
| Commercial mortgage-backed securities | 16,050 | 953 | (5) |) 16,998 |
| Corporate obligations | 193,702 | 6,965 | (1,253) |) 199,414 |
| Other debt obligations | 106,711 | 278 | (540) |) 106,449 |
| Redeemable preferred stocks | 4,168 | 140 | (5) |) 4,303 |
| Total fixed maturities | 945,956 | 32,170 | (3,380) |) 974,746 |
| Equity securities: | | | | |
| Common stocks | 54,663 | 9,643 | (1,479) |) 62,827 |
| Nonredeemable preferred stocks | 21,689 | 963 | (251) |) 22,401 |
| Total equity securities | 76,352 | 10,606 | (1,730) |) 85,228 |
| Total fixed maturities and equity securities | \$1,022,308 | \$42,776 | \$(5,110) |) \$1,059,974 |

The table above excludes other invested assets of \$48.0 million and \$46.8 million at September 30, 2015 and December 31, 2014, 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.

State and local government obligations represented approximately 30.5% of the Company's fixed maturity portfolio at September 30, 2015, with approximately \$277.6 million, or 87.1%, 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, with 98.8% of such securities rated investment grade (as determined by nationally recognized agencies) at September 30, 2015. 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, 2015.

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 were \$3.3 million at both September 30, 2015 and December 31, 2014.

The amortized cost and fair value of fixed maturities at September 30, 2015, 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

14

Table of Contents

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 3.7 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 | \$30,877 | \$31,199 |
| Due after one year through five years | 351,132 | 358,446 |
| Due after five years through ten years | 386,809 | 393,360 |
| Due after ten years | 75,740 | 78,554 |
| | 844,558 | 861,559 |
| Mortgage-backed securities | 175,285 | 181,996 |
| Total | \$1,019,843 | \$1,043,555 |

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, | |
|---|----------------------------------|---------|---------------------------------|---------|
| | 2015 | 2014 | 2015 | 2014 |
| | (Dollars in thousands) | | | |
| Fixed maturity gains | \$16 | \$172 | \$421 | \$1,079 |
| Fixed maturity losses | (1,198) | (32) | (1,591) | (262) |
| Equity security gains | 868 | 1,827 | 2,033 | 2,766 |
| Equity security losses | (2,176) | (319) | (3,258) | (530) |
| Other invested assets, net (losses) gains | (1,346) | 974 | 59 | 3,241 |
| Net realized (losses) gains on investments | \$(3,836) | \$2,622 | \$(2,336) | \$6,294 |

Pre-tax net realized losses on investments of \$3.8 million and \$2.3 million for the three and nine months ended September 30, 2015, were primarily due to other-than-temporary impairment charges of \$3.1 million and \$4.5 million, respectively. The other-than-temporary impairment charges for both the three and nine months ended September 30, 2015 were primarily on securities related to the energy sector, as well as equity securities within the financial services and, to a lesser extent, other non-energy sectors, where management is uncertain of the timing and the extent of ultimate recovery. In addition, other invested assets produced net losses of \$1.3 million for the third quarter of 2015, which were also impacted by turmoil in the energy sector. For the nine months ended September 30, 2015, other invested assets generated net gains of \$0.1 million. Partially offsetting these losses for the three and nine months ended September 30, 2015, were net realized gains associated with the sales or redemptions of securities of \$0.6 million and \$2.1 million, respectively.

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, respectively, 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.

Table of Contents

Realized gains (losses) and changes in unrealized appreciation related to fixed maturities, equity securities and other invested assets are as follows:

| | Fixed Maturities | Equity Securities | Other Invested Assets | Tax Effects | Total | |
|--|------------------------|----------------------|--------------------------|-------------|------------|---|
| | (Dollars in thousands) | | | | | |
| Three Months Ended September 30, 2015: | | | | | | |
| Realized before impairments | \$ (48 |) \$ 688 | \$ (1,346 |) \$ 247 | \$ (459 |) |
| Realized - impairments | (1,134 |) (1,996 |) — | 1,095 | (2,035 |) |
| Change in unrealized | (340 |) (6,848 |) — | 2,517 | (4,671 |) |
| Three Months Ended September 30, 2014: | | | | | | |
| Realized before impairments | \$ 172 | \$ 1,796 | \$ 974 | \$ (1,030 |) \$ 1,912 | |
| Realized - impairments | (32 |) (288 |) — | 112 | (208 |) |
| Change in unrealized | (3,939 |) (4,578 |) — | 2,981 | (5,536 |) |
| Nine Months Ended September 30, 2015: | | | | | | |
| Realized before impairments | \$ 349 | \$ 1,760 | \$ 59 | \$ (759 |) \$ 1,409 | |
| Realized - impairments | (1,519 |) (2,985 |) — | 1,576 | (2,928 |) |
| Change in unrealized | (5,078 |) (7,826 |) — | 4,517 | (8,387 |) |
| Nine Months Ended September 30, 2014: | | | | | | |
| Realized before impairments | \$ 1,079 | \$ 2,659 | \$ 3,241 | \$ (2,443 |) \$ 4,536 | |
| Realized - impairments | (262 |) (423 |) — | 240 | (445 |) |
| Change in unrealized | 9,702 | (1,781 |) — | (2,772 |) 5,149 | |

Table of Contents

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, 2015 | | | | | | | | |
| Fixed maturities: | | | | | | | | |
| U.S. Government and government agency obligations | \$1,970 | \$(22) | 98.9 % | 1 | \$— | \$— | 0.0 % | — |
| State and local government obligations | 12,036 | (152) | 98.8 % | 13 | 2,840 | (104) | 96.5 % | 4 |
| Residential mortgage-backed securities | 14,984 | (283) | 98.1 % | 20 | 26,845 | (445) | 98.4 % | 26 |
| Commercial mortgage-backed securities | 546 | (1) | 99.8 % | 1 | 591 | (13) | 97.8 % | 1 |
| Corporate obligations | 47,897 | (2,962) | 94.2 % | 74 | 2,800 | (984) | 74.0 % | 3 |
| Other debt obligations | 64,577 | (456) | 99.3 % | 64 | 4,645 | (67) | 98.6 % | 7 |
| Redeemable preferred stocks | — | — | 0.0 % | — | 499 | (2) | 99.6 % | 1 |
| Total fixed maturities | 142,010 | (3,876) | 97.3 % | 173 | 38,220 | (1,615) | 95.9 % | 42 |
| Equity securities: | | | | | | | | |
| Common stocks | 32,572 | (5,737) | 85.0 % | 52 | — | — | 0.0 % | — |
| Nonredeemable preferred stocks | 8,849 | (131) | 98.5 % | 15 | 2,788 | (212) | 92.9 % | 3 |
| Total equity securities | 41,421 | (5,868) | 87.6 % | 67 | 2,788 | (212) | 92.9 % | 3 |
| Total fixed maturities and equity securities | \$183,431 | \$(9,744) | 95.0 % | 240 | \$41,008 | \$(1,827) | 95.7 % | 45 |
| December 31, 2014 | | | | | | | | |
| Fixed maturities: | | | | | | | | |
| U.S. Government and government agency obligations | \$11,750 | \$(13) | 99.9 % | 7 | \$49 | \$(1) | 98.0 % | 1 |
| State and local government obligations | 18,100 | (166) | 99.1 % | 14 | 6,110 | (171) | 97.3 % | 6 |
| Residential mortgage-backed securities | 19,344 | (140) | 99.3 % | 19 | 38,163 | (1,086) | 97.2 % | 34 |
| Commercial mortgage-backed securities | 848 | (4) | 99.5 % | 1 | 776 | (1) | 99.9 % | 1 |
| Corporate obligations | 21,230 | (974) | 95.6 % | 33 | 10,874 | (279) | 97.5 % | 7 |
| Other debt obligations | 50,733 | (273) | 99.5 % | 54 | 13,291 | (267) | 98.0 % | 13 |
| | — | — | 0.0 % | — | 495 | (5) | 99.0 % | 1 |

Edgar Filing: National Interstate CORP - Form 10-Q

Redeemable preferred
stocks

| | | | | | | | | |
|---|-----------|------------|------|-------|----------|------------|------|------|
| Total fixed maturities | 122,005 | (1,570) | 98.7 | % 128 | 69,758 | (1,810) | 97.5 | % 63 |
| Equity securities: | | | | | | | | |
| Common stocks | 13,379 | (1,479) | 90.0 | % 19 | — | — | 0.0 | % — |
| Nonredeemable preferred stocks | 4,921 | (58) | 98.8 | % 9 | 2,807 | (193) | 93.6 | % 3 |
| Total equity securities | 18,300 | (1,537) | 92.3 | % 28 | 2,807 | (193) | 93.6 | % 3 |
| Total fixed maturities and equity securities | \$140,305 | \$(3,107) | 97.8 | % 156 | \$72,565 | \$(2,003) | 97.3 | % 66 |

17

Table of Contents

The gross unrealized losses on the Company's fixed maturities and equity securities portfolios increased from \$5.1 million at December 31, 2014 to \$11.6 million at September 30, 2015 primarily due to declines in the equity markets. The gross unrealized losses on equity securities at September 30, 2015, consist of \$5.7 million of common stocks and \$0.1 million of nonredeemable preferred stock that have been in an unrealized loss position for less than 12 months, as well as \$0.2 million of investment grade nonredeemable preferred stocks that have been in an unrealized loss position for 12 months or more, all of which are considered to be temporary. The gross unrealized losses on fixed maturity securities at September 30, 2015 were \$5.5 million and primarily consist of corporate obligations and to a lesser extent, residential mortgage-backed securities and other debt obligations. Investment grade securities represent 80.2% of all fixed maturity securities with unrealized losses.

At September 30, 2015, corporate obligations, with gross unrealized losses of \$3.9 million, had 74 securities that were in an unrealized loss position of \$2.9 million for less than 12 months and 3 securities with gross unrealized losses of \$1.0 million for 12 months or more. Other debt obligations, with gross unrealized losses of \$0.5 million, had 64 securities that were in an unrealized loss position of \$0.4 million for less than 12 months and 7 securities with gross unrealized losses of \$0.1 million for 12 months or more. Investment grade securities represented 98.6% of other debt obligations with unrealized losses.

At September 30, 2015, residential mortgage-backed securities, with gross unrealized losses of \$0.7 million, included 20 securities that were in an unrealized loss position of \$0.3 million for less than 12 months and 26 securities with gross unrealized losses of \$0.4 million for 12 months or more. Based on historical payment data and analysis of expected future cash flows of the underlying collateral, independent credit ratings and other facts and analysis, management believes that, based upon information currently available, the Company will recover its cost basis in all of these securities.

Management concluded that no additional charges for other-than-temporary impairment were required on the fixed maturity and equity holdings for the nine months ended September 30, 2015 based on several factors, including the Company's ability and current intent to hold these investments for a period of time sufficient to allow for anticipated recovery of its amortized cost, the length of time and the extent to which fair value has been below cost, analysis of company-specific financial data and the outlook for industry sectors and credit ratings. The Company believes these unrealized losses are primarily due to temporary market and sector-related factors and does not consider these securities to be other-than-temporarily impaired. If the Company's strategy was to change or these securities were determined to be other-than-temporarily impaired, the Company would recognize a write-down in accordance with its stated policy.

The following table is a progression of the amount related to credit losses on fixed maturity securities for which the non-credit portion of an other-than-temporary impairment has been recognized in other comprehensive income.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------------------|----------------------------------|---------|---------------------------------|---------|
| | 2015 | 2014 | 2015 | 2014 |
| | (Dollars in thousands) | | | |
| Beginning balance | \$2,370 | \$2,377 | \$2,368 | \$2,183 |
| Additional credit impairments on: | | | | |
| Previously impaired securities | — | — | 15 | 230 |
| Securities without prior impairment | 37 | — | 37 | — |
| Reductions - disposals | (11 |) (9 |) (24 |) (45 |
| Ending balance | \$2,396 | \$2,368 | \$2,396 | \$2,368 |

5. Income Taxes

The Company's provision for income taxes in interim periods is computed by applying its estimated full-year effective tax rate against pre-tax income for the period. The effective tax rate was 21.2% and 27.1% for the three and nine months ended September 30, 2015, respectively, and 19.7% and 19.1% for the three and nine months ended September 30, 2014, respectively. The effective tax rate for the nine months ended September 30, 2015 is lower than the 35% statutory rate primarily due to the tax effect of tax-exempt income earned.

Table of Contents

The tax effects of temporary differences that give rise to significant portions of the net deferred tax assets and liabilities in the Consolidated Balance Sheets were as follows:

| | September 30, 2015 | December 31, 2014 |
|---|------------------------|----------------------|
| | (Dollars in thousands) | |
| Deferred tax assets: | | |
| Unearned premiums | \$ 18,486 | \$ 18,442 |
| Unpaid losses and loss adjustment expenses | 17,942 | 19,609 |
| Assessments and fees payable | 1,502 | 1,491 |
| Realized losses on investments, primarily impairments | 5,639 | 4,138 |
| Accrued compensation | 1,868 | 1,897 |
| Alternative minimum tax credit | 1,103 | — |
| Other, net | 2,140 | 2,548 |
| Total deferred tax assets | 48,680 | 48,125 |
| Deferred tax liabilities: | | |
| Deferred policy acquisition costs | (7,851 |) (7,929 |
| Unrealized gains on investments | (8,666 |) (13,183 |
| Intangible assets | (2,678 |) (2,727 |
| Limited partnership investments | (339 |) (236 |
| Other, net | (764 |) (900 |
| Total deferred tax liabilities | (20,298 |) (24,975 |
| Net deferred tax assets | \$28,382 | \$23,150 |

Management has reviewed the recoverability of the deferred tax assets and believes that the amount will be recoverable against future earnings.

6. Shareholders' Equity and Stock-Based Compensation

The Company grants options and other stock awards to officers and key employees of the Company under the amended and restated Long Term Incentive Plan ("LTIP"). At September 30, 2015, there were options for 187,553 shares outstanding and 754,396 of the Company's common shares reserved for issuance under the LTIP. Treasury shares are used to fulfill the options exercised and other awards granted. Options and restricted shares vest pursuant to the terms of a written grant agreement. Options must be exercised no later than the tenth anniversary of the date of grant. As set forth in the LTIP, the Compensation Committee of the Board of Directors may accelerate vesting and exercisability of options.

For the three months ended September 30, 2015 and 2014, the Company recognized stock-based compensation expense of \$0.2 million and \$46 thousand, respectively, with related income tax benefits of approximately \$0.1 million and \$26 thousand. For the nine months ended September 30, 2015 and 2014, the Company recognized stock-based compensation expense of \$0.6 million and \$0.4 million, respectively, with related income tax benefits of approximately \$0.2 million and \$0.1 million.

Table of Contents

7. Earnings Per Common Share

The following table sets forth the computation of basic and diluted net income per share:

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------------------|---------|-------------------|---------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| | (In thousands, except per share data) | | | |
| Net income | \$5,145 | \$8,793 | \$18,896 | \$6,105 |
| Weighted average shares outstanding during period | 19,868 | 19,780 | 19,847 | 19,746 |
| Additional shares issuable under employee common stock option plans using treasury stock method | 48 | 73 | 49 | 77 |
| Weighted average shares outstanding assuming exercise of stock options | 19,916 | 19,853 | 19,896 | 19,823 |
| Net income per share: | | | | |
| Basic | \$0.26 | \$0.44 | \$0.95 | \$0.31 |
| Diluted | \$0.26 | \$0.44 | \$0.95 | \$0.31 |

For both the three and nine months ended September 30, 2015, there were 97,870 outstanding options and restricted shares excluded from diluted earnings per share because they were anti-dilutive. For the three and nine months ended September 30, 2014, there were 97,870 and 100,000, respectively, outstanding options and restricted shares excluded from diluted earnings per share because they were anti-dilutive.

8. Transactions with Related Parties

The Company's principal insurance subsidiary, NIIC, is involved in both the cession and assumption of reinsurance. NIIC is a party to a reinsurance agreement, and NIIA is a party to an underwriting management agreement with Great American Insurance Company ("Great American"). As of September 30, 2015, Great American owned 51.1% of the outstanding shares of the Company. The reinsurance agreement calls for the assumption by NIIC of all of the risk on Great American's net premiums written for public transportation and recreational vehicle risks underwritten pursuant to the reinsurance agreement. NIIA provides administrative services to Great American in connection with Great American's underwriting of these risks. Historically, the Company also ceded premium through reinsurance agreements with Great American to reduce exposure in certain of its property and casualty insurance programs. Effective November 1, 2014, Great American no longer participates in such reinsurance agreements and settlement activity in 2015 is not expected to be material.

The table below summarizes the reinsurance balance and activity with Great American:

| | Three Months Ended | | Nine Months Ended | |
|---|------------------------|-------|-------------------|-------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| | (Dollars in thousands) | | | |
| Assumed premiums written | \$62 | \$112 | \$241 | \$479 |
| Assumed premiums earned | 91 | 225 | 339 | 852 |
| Assumed losses and loss adjustment expense incurred | 52 | 326 | 192 | 719 |
| Ceded premiums written | — | 19 | — | 60 |
| Ceded premiums earned | 5 | 18 | 28 | 48 |
| Ceded losses and loss adjustment expense recoveries | 237 | 182 | 390 | 738 |

| | September 30, 2015 | December 31, 2014 |
|--|------------------------|-------------------|
| | (Dollars in thousands) | |
| Payable to Great American as of period end | \$2 | \$56 |

The Company is not substantially dependent on any individual reinsurance agreements, including the expired reinsurance agreements with Great American. The Company does not depend on these specific reinsurers to a material extent, as other reinsurers could be obtained for those treaties or the business could be retained.

Table of Contents

During 2014, Minnesota, Virginia, and Washington recreational vehicle risks previously written through Great American were transitioned to TCC, resulting in a decline in assumed premiums written and earned from Great American.

The Company has an agreement with American Money Management Corporation (“AMMC”), a wholly-owned subsidiary of American Financial Group, Inc. (“AFG”), whereby AMMC manages approximately 57% of the Company’s investment portfolio at an annual cost of 15 basis points of the portfolio's fair value. Fees for such services were approximately \$0.2 million and \$0.7 million for the three and nine months ended September 30, 2015 and 2014, respectively.

Great American or its parent, AFG, has performed for many years certain services for the Company without charge including actuarial services and on a consultative basis, as needed and as the Company requests, internal audit, legal, accounting and other support services. If Great American no longer controlled a majority of the Company’s common shares, it is possible that many of these services would cease or, alternatively, be provided at an increased cost to the Company. This could impact the Company’s personnel resources, require the Company to hire additional professional staff and generally increase the Company’s operating expenses. Management believes, based on discussions with Great American, that these services will continue to be provided by the affiliated entity in future periods and the relative impact on operating results is not material.

9. Reinsurance

Premiums and reinsurance activity consisted of the following:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------|----------------------------------|------------|---------------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| | (Dollars in thousands) | | | |
| Direct premiums written | \$179,541 | \$140,432 | \$512,433 | \$480,783 |
| Reinsurance assumed | 3,653 | 3,815 | 11,021 | 9,167 |
| Reinsurance ceded | (24,016) |) (17,422) |) (89,841) |) (86,173) |
| Net premiums written | \$159,178 | \$126,825 | \$433,613 | \$403,777 |
| Direct premiums earned | \$177,657 | \$163,424 | \$508,668 | \$480,135 |
| Reinsurance assumed | 3,389 | 3,407 | 10,294 | 8,853 |
| Reinsurance ceded | (29,563) |) (26,822) |) (85,764) |) (76,337) |
| Premiums earned | \$151,483 | \$140,009 | \$433,198 | \$412,651 |

The Company cedes premiums through reinsurance agreements with reinsurers to reduce exposure in certain of its property and casualty insurance programs. Ceded losses and loss adjustment expense recoveries recorded for the three months ended September 30, 2015 and 2014 were \$11.8 million and \$14.9 million, respectively, and were \$37.7 million and \$40.7 million for the nine months ended September 30, 2015 and 2014, respectively. The Company remains primarily liable as the direct insurer on all risks reinsured and a contingent liability exists to the extent that the reinsurance companies are unable to meet their obligations for losses assumed. To minimize its exposure to significant losses from reinsurer insolvencies, the Company seeks to do business with reinsurers rated “A-” or better by A.M. Best Company and regularly evaluates the financial condition of its reinsurers. If a reinsurer is not rated by A.M. Best Company or their rating falls below “A-”, the contract with them generally requires that they secure outstanding obligations with cash, a trust or a letter of credit that the Company deems acceptable.

10. Commitments and Contingencies

The Company and its subsidiaries are subject at times to various claims, lawsuits and legal proceedings arising in the ordinary course of business. All legal actions relating to claims made under insurance policies are considered in the establishment of the Company’s loss and loss adjustment expense (“LAE”) reserves. In addition, regulatory bodies, such as state insurance departments, the Securities and Exchange Commission, the Department of Labor and other regulatory bodies may make inquiries and conduct examinations or investigations concerning the Company’s compliance with insurance laws, securities laws, labor laws and the Employee Retirement Income Security Act of

1974, as amended.

The Company's subsidiaries also have lawsuits pending in which the plaintiff seeks extra-contractual damages from the Company in addition to damages claimed or in excess of the available limits under an insurance policy. These lawsuits, which are in various stages, generally mirror similar lawsuits filed against other carriers in the industry. Although the Company is vigorously defending these lawsuits, the outcomes of these cases cannot be determined at this time. In accordance with current accounting standards for

21

Table of Contents

loss contingencies and based upon information currently known to the Company, reserves are established for litigation when it is probable that a loss associated with a claim or proceeding has been incurred and the amount of the loss or range of loss can be reasonably estimated. As such, the Company has established loss and LAE reserves for such lawsuits as to which the Company has determined that a loss is both probable and estimable. In addition to these case reserves, the Company also establishes reserves for claims incurred but not reported to cover unknown exposures and adverse development on known exposures. Based on currently available information, the Company believes that reserves for these lawsuits are reasonable and that the amounts reserved did not have a material effect on the Company's financial condition or results of operations. However, if any one or more of these cases results in a judgment against or settlement by the Company for an amount that is significantly greater than the amount so reserved, the resulting liability could have a material effect on the Company's financial condition, cash flows and results of operations.

As a direct writer of insurance, the Company receives assessments by state funds to cover losses to policyholders of insolvent or rehabilitated companies and other authorized fees. These mandatory assessments may be partially recovered through a reduction in future premium taxes in some states over several years. At September 30, 2015 and December 31, 2014, the liability for such assessments was \$4.8 million and \$4.6 million, respectively, and will be paid over several years as assessed by the various state funds.

The Company has investments in limited partnerships which are included in the "Other invested assets" line on the Consolidated Balance Sheets. Relative to such limited partnerships, the Company has contractual agreements to invest up to an additional \$16.7 million. These limited partnership contractual agreements have expiration dates up to ten years whereby the entire amounts or a portion thereof could be required to be funded at any time prior to the expiration dates.

11. Segment Information

The Company operates its business as one segment, property and casualty insurance. The Company manages this segment through a product management structure. The following table shows revenues summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

| | Three Months Ended September 30, 2015 | | Nine Months Ended September 30, 2015 | |
|--|---|-----------|--|-----------|
| | 2014 | | 2014 | |
| | (Dollars in thousands) | | | |
| Revenue: | | | | |
| Premiums earned: | | | | |
| Alternative Risk Transfer | \$85,915 | \$75,476 | \$237,149 | \$222,376 |
| Transportation | 49,163 | 47,999 | 147,604 | 140,939 |
| Specialty Personal Lines | 7,647 | 8,418 | 22,835 | 27,344 |
| Hawaii and Alaska | 5,131 | 4,695 | 14,733 | 13,269 |
| Other | 3,627 | 3,421 | 10,877 | 8,723 |
| Total premiums earned | 151,483 | 140,009 | 433,198 | 412,651 |
| Net investment income | 9,927 | 9,130 | 29,411 | 26,615 |
| Net realized (losses) gains on investments | (3,836) |) 2,622 | (2,336) |) 6,294 |
| Other | 1,046 | 941 | 2,762 | 2,487 |
| Total revenues | \$158,620 | \$152,702 | \$463,035 | \$448,047 |

Table of Contents

12. Accumulated Other Comprehensive Income, Net of Tax ("AOCI")

The following table presents the changes in the Company's AOCI:

| | Three Months Ended September 30, | |
|--|----------------------------------|----------|
| | 2015 | 2014 |
| | (Dollars in thousands) | |
| Beginning balance | \$20,767 | \$29,966 |
| Net unrealized losses on available-for-sale securities: | | |
| Net unrealized holding losses on securities arising during the period, net of tax | (5,128) | (4,516) |
| Reclassification adjustment for net realized losses (gains) included in net income, net of tax | 457 | (1,020) |
| Other comprehensive loss, net of tax | (4,671) | (5,536) |
| Ending balance | \$16,096 | \$24,430 |
| | Nine Months Ended September 30, | |
| | 2015 | 2014 |
| | (Dollars in thousands) | |
| Beginning balance | \$24,483 | \$19,281 |
| Net unrealized (losses) gains on available-for-sale securities: | | |
| Net unrealized holding (losses) gains on securities arising during the period, net of tax | (7,731) | 6,921 |
| Reclassification adjustment for net realized gains included in net income, net of tax | (656) | (1,772) |
| Other comprehensive (loss) income, net of tax | (8,387) | 5,149 |
| Ending balance | \$16,096 | \$24,430 |

The following table presents amounts related to unrealized gains and losses on available-for-sale securities which were reclassified out of AOCI during the three and nine months ended September 30, 2015 and 2014, categorized by the respective affected line items in the Consolidated Statements of Income:

| | Three Months Ended September 30, | |
|---|----------------------------------|---------|
| | 2015 | 2014 |
| | (Dollars in thousands) | |
| (Decrease) increase to net realized (losses) gains on investments | \$(702) | \$1,570 |
| (Decrease) increase to income before income taxes | (702) | 1,570 |
| (Decrease) increase to provision for income taxes | (245) | 550 |
| (Decrease) increase to net income | \$(457) | \$1,020 |
| | Nine Months Ended September 30, | |
| | 2015 | 2014 |
| | (Dollars in thousands) | |
| Increase to net realized gains on investments | \$1,009 | \$2,726 |
| Increase to income before income taxes | 1,009 | 2,726 |
| Increase to provision for income taxes | 353 | 954 |
| Increase to net income | \$656 | \$1,772 |

Table of Contents

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

Forward-Looking Statements

This document, including information incorporated by reference, contains "forward-looking statements" (within the meaning of the Private Securities Litigation Reform Act of 1995). All statements, trend analyses and other information contained in this Form 10-Q relative to markets for our products and trends in our operations or financial results, as well as other statements including words such as "may," "target," "anticipate," "believe," "plan," "estimate," "expect," "intend," "project," and other similar expressions, constitute forward-looking statements. We made these statements based on our plans and current analyses of our business and the insurance industry as a whole. We caution that these statements may and often do vary from actual results and the differences between these statements and actual results can be material. Factors that could contribute to these differences include, among other things:

- general economic conditions, weakness of the financial markets and other factors, including prevailing interest rate levels and stock and credit market performance, which may affect or continue to affect (among other things) our ability to sell our products and to collect amounts due to us, our ability to access capital resources and the costs associated with such access to capital and the market value of our investments;
- our ability to obtain adequate premium rates and manage our growth strategy;
- performance of securities markets;
- our ability to attract and retain independent agents and brokers;
- customer response to new products and marketing initiatives;
- tax law and accounting changes;
- increasing competition in the sale of our insurance products and services and the retention of existing customers;
- changes in legal environment;
- legal actions brought against us;
- regulatory changes or actions, including those relating to the regulation of the sale, underwriting and pricing of insurance products and services and capital requirements;
- damage to our reputation;
- levels of natural catastrophes, terrorist events, incidents of war and other major losses;
- technology or network security disruptions;
- adequacy of insurance reserves; and
- availability of reinsurance and ability of reinsurers to pay their obligations.

The forward-looking statements herein are made only as of the date of this report. We assume no obligation to publicly update any forward-looking statements.

General

We underwrite and sell traditional and alternative risk transfer ("ART") property and casualty insurance products primarily to the passenger transportation industry, the trucking industry and moving and storage transportation companies, general commercial insurance to small businesses in Hawaii and Alaska and personal insurance to owners of recreational vehicles throughout the United States.

We have five property and casualty insurance subsidiaries: National Interstate Insurance Company ("NIIC"), Vanliner Insurance Company ("VIC" or "Vanliner"), National Interstate Insurance Company of Hawaii, Inc. ("NIIC-HI"), Triumpher Casualty Company ("TCC"), Hudson Indemnity, Ltd. ("HIL") and five active agency and service subsidiaries. We write our insurance policies on a direct basis through NIIC, VIC, NIIC-HI and TCC. NIIC and VIC are licensed in all 50 states and the District of Columbia. NIIC-HI is licensed in Ohio, Hawaii, Michigan and New Jersey. TCC holds licenses for multiple lines of authority, including auto-related lines, in 42 states and the District of Columbia. HIL is domiciled in the Cayman Islands and provides reinsurance for NIIC, VIC, NIIC-HI and TCC, primarily for the ART component. Insurance products are marketed through multiple distribution channels, including independent agents and brokers, program administrators, affiliated agencies and agent internet initiatives. We sell and service our insurance business through our active agency and service subsidiaries.

Table of Contents

As of September 30, 2015, Great American Insurance Company (“Great American”) owned 51.1% of our outstanding common shares.

Results of Operations

Overview

Through the operations of our subsidiaries, we are engaged in property and casualty insurance operations. We focus on niche insurance markets where we offer specialized insurance products, services and programs designed to meet the unique needs of targeted insurance buyers that we believe are underserved by the insurance industry. Our underwriting approach is to price our products to attain an underwriting profit even if we forgo volume as a result. We derive our revenues primarily from premiums generated by our insurance policies and income from our investment portfolio. Our expenses consist primarily of losses and loss adjustment expenses (“LAE”), commissions and other underwriting expenses and other operating and general expenses.

Our 2014 results include transaction expenses we incurred related to the February 5, 2014 Great American unsolicited tender offer to acquire all of our remaining outstanding common shares not already owned by Great American. Transaction expenses primarily consisted of financial advisory and legal services incurred in connection with the tender offer and related litigation. Great American withdrew the tender offer on March 16, 2014.

Our net income, determined in accordance with U.S. generally accepted accounting principles (“GAAP”), includes after-tax net realized gains from investments and transaction expenses related to the Great American tender offer that may not be indicative of our ongoing operations. The following tables reconcile net income to net income from operations; a non-GAAP financial measure that we believe is a useful tool for investors and analysts in analyzing ongoing operating trends.

| | Three Months Ended September 30, | | | |
|--|---|-----------|---------|-----------|
| | 2015 | | 2014 | |
| | Amount | Per Share | Amount | Per Share |
| | (Dollars in thousands, except per share data) | | | |
| Net income from operations | \$7,638 | \$0.39 | \$7,089 | \$0.36 |
| After-tax net realized (losses) gains from investments | (2,493 |) (0.13 |) 1,704 | 0.08 |
| Net income | \$5,145 | \$0.26 | \$8,793 | \$0.44 |
| | Nine Months Ended September 30, | | | |
| | 2015 | | 2014 | |
| | Amount | Per Share | Amount | Per Share |
| | (Dollars in thousands, except per share data) | | | |
| Net income from operations | \$20,414 | \$1.03 | \$3,420 | \$0.17 |
| After-tax net realized (losses) gains from investments | (1,518 |) (0.08 |) 4,091 | 0.21 |
| After-tax impact from transaction expenses | — | — | (1,406 |) (0.07 |
| Net income | \$18,896 | \$0.95 | \$6,105 | \$0.31 |

We recorded net income for the three months ended September 30, 2015 of \$5.1 million (\$0.26 per share diluted) compared to net income of \$8.8 million (\$0.44 per share diluted) for the same period in 2014. The decrease in net income during the three month period was due primarily to after-tax net realized losses from investments. Such losses were largely attributable to other-than-temporary impairment charges primarily from securities related to the energy sector, as well as equity securities within the financial services and, to a lesser extent, other non-energy sectors, where management is uncertain of the timing and the extent of ultimate recovery. In addition, other invested assets produced net losses during the third quarter of 2015, which were also impacted by declines in the energy sector and equity markets. Our loss and LAE ratio for the three month periods were comparable at 79.3% and 79.1%, respectively. We recorded net income for the nine months ended September 30, 2015 of \$18.9 million (\$0.95 per share diluted) compared to net income of \$6.1 million (\$0.31 per share diluted) for the same period in 2014. The increase in net income for the nine month period was driven by a decrease in our loss and LAE ratio to 79.0% for the nine months

ended September 30, 2015 compared to 84.1% for the same period in 2014. The elevated 2014 loss ratio was primarily attributable to unfavorable development from prior years' loss reserves, which included \$20 million in prior year loss and loss expense reserve strengthening, primarily for accident years 2011, 2012 and 2013. The majority of such strengthening was concentrated in our commercial auto liability lines of business. Also contributing to the improvement in net income for the nine month period were increases in net investment income due to

Table of Contents

higher average investment balances compared to the prior period. Partially offsetting these increases to the nine month period net income was after-tax other-than-temporary impairment charges and losses from other invested assets primarily concentrated in the energy sector as discussed previously. Net income for the first nine months of 2014 was adversely impacted by after-tax transaction expenses related to the Great American tender offer.

Our net income from operations for the three and nine months ended September 30, 2015 was \$7.6 million (\$0.39 per share diluted) and \$20.4 million (\$1.03 per share diluted), compared to net income of \$7.1 million (\$0.36 per share diluted) and \$3.4 million (\$0.17 per share diluted) for the same periods in 2014. The primary drivers for the period-over-period fluctuations are the same as those discussed above for the change in net income for the respective periods.

Gross Premiums Written

We operate our business as one segment, property and casualty insurance. We manage this segment through a product management structure. The following tables set forth an analysis of gross premiums written by the broader business component description, which were determined based primarily on similar economic characteristics, products, and services:

| | Three Months Ended September 30, | | | | |
|---------------------------|----------------------------------|---------|-------------|---------|---|
| | 2015 | | 2014 | | |
| | Amount | Percent | Amount | Percent | |
| | (Dollars in thousands) | | | | |
| Alternative Risk Transfer | \$101,224 | 55.3 | % \$64,435 | 44.8 | % |
| Transportation | 62,663 | 34.2 | % 60,496 | 41.9 | % |
| Specialty Personal Lines | 8,278 | 4.5 | % 8,717 | 6.0 | % |
| Hawaii and Alaska | 7,067 | 3.9 | % 6,648 | 4.6 | % |
| Other | 3,962 | 2.1 | % 3,951 | 2.7 | % |
| Gross premiums written | \$183,194 | 100.0 | % \$144,247 | 100.0 | % |
| | Nine Months Ended September 30, | | | | |
| | 2015 | | 2014 | | |
| | Amount | Percent | Amount | Percent | |
| | (Dollars in thousands) | | | | |
| Alternative Risk Transfer | \$291,502 | 55.7 | % \$257,382 | 52.6 | % |
| Transportation | 174,911 | 33.4 | % 178,358 | 36.4 | % |
| Specialty Personal Lines | 27,566 | 5.3 | % 28,044 | 5.7 | % |
| Hawaii and Alaska | 17,609 | 3.4 | % 16,667 | 3.4 | % |
| Other | 11,866 | 2.2 | % 9,499 | 1.9 | % |
| Gross premiums written | \$523,454 | 100.0 | % \$489,950 | 100.0 | % |

Three months ended September 30, 2015 compared to September 30, 2014. During the three months ended September 30, 2015, our gross premiums written increased \$38.9 million, or 27.0%, compared to the same period in 2014, primarily attributable to growth in our ART component. Gross premiums written in our ART component increased \$36.8 million, or 57.1%, during the current period compared to the same period last year primarily due to the addition of one large insured to our national account ART product. Additionally, our ART business achieved average rate increases on renewed business of approximately 6% and benefited from an increased exposure base and strong renewal retention. Our transportation component had moderate growth of \$2.2 million, or 3.6%, due primarily to a shift in available renewal premium, as one large account renewed in the third quarter of 2015 that had previously renewed in the second quarter of 2014, as well as new business premium and rate increases on renewed business which averaged approximately 5% in the current period. New business premium was added to several of our traditional products including our passenger transportation, home delivery, crane and heavy haul and paratransit insurance operations. The growth within our transportation component was partially offset by our continued underwriting efforts which have led to rate actions and non-renewals of multiple accounts, primarily from our traditional trucking and tow related products.

Edgar Filing: National Interstate CORP - Form 10-Q

Nine months ended September 30, 2015 compared to September 30, 2014. During the first nine months of 2015, our gross premiums written increased \$33.5 million, or 6.8%, compared to the same period in 2014 primarily due to growth within our ART component. Gross premiums written reflect overall average rate increases on renewed business of approximately 6% in the current period. Gross premiums written in our ART component increased \$34.1 million, or 13.3%, during the first nine months of 2015 compared

Table of Contents

to the same period in 2014 due primarily to the addition of one large insured to our national account ART product and, to a lesser extent, new business written and exposure growth within several of our existing ART products.

Additionally, we achieved average rate increases on renewed business in our ART component of approximately 5% in the current period. Partially offsetting these increases were lower renewals resulting from rate actions taken on several large accounts within our group captive and national account ART products, as well as the loss of one national account insured to aggressive competition. Also, several large group ART insureds changed programs during the first quarter of 2014, resulting in a portion of this business renewing in the fourth quarter of 2014, instead of the first quarter of 2015. Gross premiums written in our transportation component decreased \$3.4 million, or 1.9%, due to lower renewals from rate actions taken on underperforming accounts within our traditional trucking, tow and waste operations products. These decreases were partially offset by average rate increases on renewal business in our transportation component of approximately 7% and new business premium written on our home delivery product.

The other component, which is comprised of premium from assigned risk policies that we receive from involuntary state insurance plans from the states in which our insurance company subsidiaries operate and over which we have no control, increased \$2.4 million, or 24.9%, compared to the same period in 2014.

Our group ART programs, which focus on specialty or niche businesses, provide various services and coverages tailored to meet specific requirements of defined client groups and their members. These services include risk management consulting, claims administration and handling, loss control and prevention and reinsurance placement, along with providing various types of property and casualty insurance coverage. Insurance coverage is provided primarily to companies with similar risk profiles and to specified classes of business of our agent partners.

As part of our ART programs, we analyze, on a quarterly basis, members' loss performance on a policy year basis to determine if there would be an assessment premium (loss results are unfavorable to expectations) or if there would be a return of premium (loss results are favorable to expectations) to participants. Assessment premium and return of premium are recorded as adjustments to premiums written (assessments increase premiums written; returns of premium reduce premiums written). For the three months ended September 30, 2015 and 2014, we recorded net premium assessments of \$0.8 million and \$2.2 million, respectively. For the nine months ended September 30, 2015 and 2014, we recorded net premium assessments of \$6.1 million and \$7.5 million, respectively.

Premiums Earned

We operate our business as one segment, property and casualty insurance. We manage this segment through a product management structure. The following tables show premiums earned summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

| | Three Months Ended | | Change | | |
|---------------------------|------------------------|-----------|----------|---------|----|
| | September 30, 2015 | 2014 | Amount | Percent | |
| | (Dollars in thousands) | | | | |
| Premiums earned: | | | | | |
| Alternative Risk Transfer | \$85,915 | \$75,476 | \$10,439 | 13.8 | % |
| Transportation | 49,163 | 47,999 | 1,164 | 2.4 | % |
| Specialty Personal Lines | 7,647 | 8,418 | (771) | (9.2) |)% |
| Hawaii and Alaska | 5,131 | 4,695 | 436 | 9.3 | % |
| Other | 3,627 | 3,421 | 206 | 6.0 | % |
| Total premiums earned | \$151,483 | \$140,009 | \$11,474 | 8.2 | % |

Table of Contents

| | Nine Months Ended September 30, | | Change | | |
|---------------------------|---------------------------------|-----------|----------|---------|----|
| | 2015 | 2014 | Amount | Percent | |
| | (Dollars in thousands) | | | | |
| Premiums earned: | | | | | |
| Alternative Risk Transfer | \$237,149 | \$222,376 | \$14,773 | 6.6 | % |
| Transportation | 147,604 | 140,939 | 6,665 | 4.7 | % |
| Specialty Personal Lines | 22,835 | 27,344 | (4,509) | (16.5) |)% |
| Hawaii and Alaska | 14,733 | 13,269 | 1,464 | 11.0 | % |
| Other | 10,877 | 8,723 | 2,154 | 24.7 | % |
| Total premiums earned | \$433,198 | \$412,651 | \$20,547 | 5.0 | % |

Three months ended September 30, 2015 compared to September 30, 2014. Our premiums earned increased \$11.5 million, or 8.2%, to \$151.5 million during the three months ended September 30, 2015 compared to \$140.0 million for the same period in 2014. The increase in premiums earned was primarily attributable to our ART component, which grew \$10.4 million, or 13.8%, over 2014. Our ART component growth was primarily from the addition of one large insured to our national account ART product during the third quarter, rate and exposure increases on renewed business and the addition of new participants in our existing ART captive programs. We experienced modest growth within our transportation component which has primarily been due to new business premium and rate increases on renewed business within our passenger transportation and home delivery insurance products. Partially offsetting this component's growth has been rate actions and non-renewals of underperforming accounts within our traditional trucking and tow products. The decrease in our specialty personal lines component of \$0.8 million, or 9.2%, reflects our decision to stop selling our commercial vehicle product in late 2013. The increase in our Hawaii and Alaska component of \$0.4 million, or 9.3%, is due to high retention and rate increases on renewed business, as well as new business written. Our other component, which is comprised of premium from assigned risk plans from the states in which our insurance company subsidiaries operate and over which we have no control, increased \$0.2 million, or 6.0%, compared to the same period in 2014.

Nine months ended September 30, 2015 compared to September 30, 2014. Our premiums earned increased \$20.5 million, or 5.0%, to \$433.2 million during the nine months ended September 30, 2015 compared to \$412.7 million for the same period in 2014. The increase in premiums earned was primarily attributable to our ART and transportation components, which grew \$14.8 million, or 6.6%, and \$6.7 million, or 4.7%, respectively. Such growth was partially offset by our specialty personal lines component which decreased \$4.5 million, 16.5%, compared to 2014. The changes experienced in our ART, transportation and specialty personal lines components, as well as the changes to our Hawaii and Alaska, and other components, are attributable to the same factors as discussed above for the three month period.

Underwriting and Loss Ratio Analysis

Underwriting profitability, as opposed to overall profitability or net earnings, is measured by the combined ratio. The combined ratio is the sum of the loss and LAE ratio and the underwriting expense ratio. A combined ratio under 100% is indicative of a pre-tax underwriting profit.

Losses and LAE are a function of the amount and type of insurance contracts we write and of the loss experience of the underlying risks. We seek to establish case reserves at the maximum probable exposure based on our historical claims experience. Our ability to accurately estimate losses and LAE at the time of pricing our contracts is a critical factor in determining our profitability. The amount reported under losses and LAE in any period includes payments in the period net of the change in reserves for unpaid losses and LAE between the beginning and the end of the period. Our underwriting expense ratio includes commissions and other underwriting expenses and other operating and general expenses, offset by other income. Commissions and other underwriting expenses consist principally of brokerage and agent commissions reduced by ceding commissions received from reinsurers, and vary depending upon the amount and types of contracts written and, to a lesser extent, premium taxes.

Our underwriting approach is to price our products to attain an underwriting profit even if we forgo volume as a result. We continue to achieve rate level increases on renewed business, which have averaged approximately 5% and 6% overall in the current quarter and year, respectively, with several of our products having double digit increases. We apply the same pricing criteria to our new business opportunities. We believe that the current rate level increases we are obtaining on renewal business, along with improved pricing on new business, are at levels that adequately consider industry loss cost trends.

Table of Contents

The table below presents our net premiums earned and combined ratios for the periods indicated:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | |
|---|----------------------------------|-----------|---------------------------------|-----------|---|
| | 2015 | 2014 | 2015 | 2014 | |
| | (Dollars in thousands) | | | | |
| Gross premiums written | \$183,194 | \$144,247 | \$523,454 | \$489,950 | |
| Ceded reinsurance | (24,016) | (17,422) | (89,841) | (86,173) |) |
| Net premiums written | 159,178 | 126,825 | 433,613 | 403,777 | |
| Change in unearned premiums, net of ceded | (7,695) | 13,184 | (415) | 8,874 |) |
| Total premiums earned | \$151,483 | \$140,009 | \$433,198 | \$412,651 | |
| Combined ratios: | | | | | |
| Loss and LAE ratio ⁽¹⁾ | 79.3 | % 79.1 | % 79.0 | % 84.1 | % |
| Underwriting expense ratio ⁽²⁾ | 19.3 | % 20.0 | % 20.1 | % 20.3 | % |
| Combined ratio | 98.6 | % 99.1 | % 99.1 | % 104.4 | % |

(1) The ratio of losses and LAE to premiums earned.

(2) The ratio of the sum of commissions and other underwriting expenses and other operating expenses less other income to premiums earned.

Three months ended September 30, 2015 compared to September 30, 2014. Our loss and LAE ratio for the three months ended September 30, 2015 was relatively flat compared to the same period last year, increasing 0.2 combined ratio points to 79.3% compared to 79.1% in 2014. We experienced no loss development during the current period and development recorded in the prior period was inconsequential. Severe claim activity was comparable for both periods. The underwriting expense ratio for the three months ended September 30, 2015 of 19.3% decreased slightly compared to 20.0% for the same period in 2014 due primarily to changes in our mix of business written.

Nine months ended September 30, 2015 compared to September 30, 2014. Our loss and LAE ratio for the nine months ended September 30, 2015 decreased 5.1 combined ratio points to 79.0% compared to 84.1% during the same period in 2014. This decrease over the prior period is primarily attributable to adverse development on prior years' loss reserves and the related reserve strengthening recorded during the second quarter of 2014. For the nine months ended September 30, 2015, we had unfavorable development from prior years' loss reserves of \$4.7 million, or 1.0 combined ratio points, compared to \$30.0 million, or 7.3 combined ratio points, for the same period last year. The unfavorable development in the current period was concentrated in our commercial auto liability line of business and was primarily attributable to products we no longer offer or customers which we no longer insure, as well as from assigned risk policies that we are obligated to write as part of the involuntary insurance market. The 2014 adverse development primarily consisted of \$20.0 million related to reserve strengthening predominantly in our commercial auto liability line of business for accident years 2011, 2012 and 2013. Excluding development from prior year claims, the loss and LAE ratio reported during the first nine months of 2015 and 2014 was 78.0% and 76.8%, respectively, and reflects an increase in claims severity on our commercial auto line of business. Such increase was concentrated in our moving and storage business and occurred primarily on quality operators with histories of good performance. We have non-renewed one of the accounts and will continue to be diligent in applying our underwriting disciplines on all remaining business.

The underwriting expense ratio for the nine month periods ended September 30, 2015 and 2014 of 20.1% and 20.3%, respectively, is indicative of our continued effectiveness managing operating costs over increased premiums earned. Additionally, our underwriting expense ratio for the current year reflects changes in our mix of business written as discussed above for the three month period.

We continue to be diligent in monitoring and maintaining disciplined underwriting among all lines of business. This has been evidenced through our pricing and risk selection of new and renewal business as we pursue rate increases and take rate actions on or non-renew underperforming accounts. In addition to our stringent underwriting criteria, we continuously seek to enhance our claims management and risk management tools to improve pricing and risk

selection, as well as focusing on being disciplined and well managed in our reserving practices.

Table of Contents

Net Investment Income

2015 compared to 2014. For the three and nine months ended September 30, 2015, net investment income was \$9.9 million and \$29.4 million, respectively, compared to \$9.1 million and \$26.6 million for the same periods in 2014. The increase in net investment income for both the three and nine months ended September 30, 2015 of \$0.8 million, or 8.7%, and \$2.8 million, or 10.5%, respectively, compared to the same periods in 2014, is primarily due to higher average invested assets.

Net Realized (Losses) Gains on Investments

2015 compared to 2014. Pre-tax net realized losses on investments were \$3.8 million and \$2.3 million for the three and nine months ended September 30, 2015, respectively, compared to pre-tax net realized gains of \$2.6 million and \$6.3 million for the same periods in 2014. The pre-tax net realized losses for both the third quarter and the first nine months of 2015 were primarily due to other-than-temporary impairment charges of \$3.1 million and \$4.5 million, respectively, and were primarily from securities related to the energy sector, as well as equity securities within the financial services and, to a lesser extent, other non-energy sectors, where management is uncertain of the timing and the extent of ultimate recovery. In addition, other invested assets produced net losses of \$1.3 million for the third quarter of 2015, which were also impacted by the declines in the energy sector. For the nine months ended September 30, 2015, other invested assets generated net gains of \$0.1 million. Partially offsetting these losses for both the three and nine months ended September 30, 2015, were gains generated from the sales or redemptions of securities of \$0.6 million and \$2.1 million, respectively. The pre-tax net realized gains for both the third quarter and first nine months of 2014 were partially generated from sales of securities totaling \$1.9 million and \$3.8 million, respectively. In addition, other invested assets produced net gains of \$1.0 million and \$3.2 million for the third quarter and first nine months of 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.

Commissions and Other Underwriting Expenses

2015 compared to 2014. For the three and nine months ended September 30, 2015 and 2014, commissions and other underwriting expenses were relatively flat. For the three month periods such expenses were \$24.2 million and \$24.1 million, or 16.0% and 17.2% as a percentage of premiums earned, respectively. For both the nine month periods ended September 30, 2015 and 2014 such expenses were \$70.5 million, or 16.3% and 17.1%, respectively, as a percentage of premiums earned. The improvement in commissions and other underwriting expenses as a percentage of premiums earned reflects changes in our mix of business written.

Other Operating and General Expenses

2015 compared to 2014. For the three months ended September 30, 2015 and 2014, other operating and general expenses were \$6.1 million and \$4.9 million, respectively, while such expenses for the nine month periods were \$19.3 million and \$15.8 million, respectively. The increase in these expenses is primarily attributable to an increase in personnel and information technology resources to support business decisions and to sustain continued growth. As a percentage of premiums earned, such expenses were 4.1% and 3.5% for the three months ended September 30, 2015 and 2014, respectively, and 4.4% and 3.8% for the nine months ended September 30, 2015 and 2014, respectively.

Transaction Expenses

2015 compared to 2014. During the nine month period ended September 30, 2014, we incurred \$2.2 million in transaction expenses related to the Great American tender offer. Transaction expenses primarily consisted of financial advisory and legal services incurred in connection with the tender offer and related litigation. Included in the transaction expenses was \$0.6 million related to a settlement agreement reached with our director, Alan R. Spachman, for a portion of the expenses he incurred personally in connection with the tender offer.

Expense on Amounts Withheld

2015 compared to 2014. We invest funds in the participant loss layer for several of our ART programs. We earn investment income and generate realized gains or losses, and incur an equal expense on the amounts owed to ART participants. "Expense on amounts withheld" represents both investment income and realized gains or losses that we remit back to ART participants. The related investment income and realized gains or losses are included in the "Net investment income" and "Net realized gains on investments"

30

Table of Contents

lines, respectively, on our Consolidated Statements of Income. For the three and nine month periods ended September 30, 2015, expense on amounts withheld were \$1.6 million and \$4.8 million, decreasing 18.7% and 4.0%, respectively, compared to the \$2.0 million and \$5.0 million reported during the same periods in 2014. Such decreases for both the three and nine month periods were primarily due to several securities invested on behalf of certain ART programs that were sold during the three month period ended September 30, 2014, generating net realized gains on investments and thereby increasing the expense on amounts withheld.

Income Taxes

2015 compared to 2014. The income tax provision for the nine months ended September 30, 2015 reflects our full-year effective tax rate of 27.1%, which represents an 8.0 percentage point increase from the 19.1% effective tax rate reported for the same period in 2014. Such increase was primarily driven by an increase in income before taxes over the prior period. As a result of recording our provision for income taxes based on our full-year estimated effective tax rate, our effective tax rate for the third quarter of 2015 increased 1.5 percentage points to 21.2% as compared to 19.7% for the same period in 2014.

Financial Condition**Investments**

At September 30, 2015, our investment portfolio contained \$1.0 billion in fixed maturity securities and \$90.0 million in equity securities, all carried at fair value, with unrealized gains and losses reported as a separate component of shareholders' equity, and \$48.0 million in other invested assets, which are limited partnership investments accounted for in accordance with the equity method. At September 30, 2015, we had pre-tax net unrealized gains of \$23.7 million on fixed maturities and \$1.1 million on equity securities. Our investment portfolio allocation is based on diversification among primarily high quality fixed maturity investments, guidelines in our investment policy and market opportunities.

At September 30, 2015, 90.6% of the fixed maturities in our portfolio were rated "investment grade" (credit rating of AAA to BBB-) by nationally recognized rating agencies. Investment grade securities generally bear lower degrees of risk and corresponding lower yields than those that are unrated or non-investment grade. Although we cannot provide any assurances, we believe that, in normal market conditions, our high quality investment portfolio should generate a stable and predictable investment return.

Included in fixed maturities at September 30, 2015 were \$318.8 million of state and local government obligations, which represented approximately 30.5% of our fixed maturity portfolio, with approximately \$277.6 million, or 87.1%, of our state and local government obligations held in special revenue obligations, and the remaining amount held in general obligations. Our state and local government obligations portfolio is high quality, as 98.8% of such securities were rated investment grade at September 30, 2015. We 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, 2015.

Included in fixed maturities at September 30, 2015 were \$182.0 million of residential and commercial mortgage-backed securities ("MBS"). MBS are subject to significant prepayment risk due to the fact that, in periods of declining interest rates, mortgages may be repaid more rapidly than scheduled as borrowers refinance higher rate mortgages to take advantage of lower rates. Summarized information for our MBS at September 30, 2015 is shown in the table below. Agency-backed securities are those issued by a U.S. government-backed agency; Alt-A mortgages are those with risk profiles between prime and subprime. The majority of the Alt-A securities and substantially all of the subprime securities are backed by fixed-rate mortgages.

| Collateral Type | Amortized Cost (Dollars in thousands) | Fair Value | Fair Value as % of Cost | Unrealized Gain (Loss) |
|-----------------|---|------------|----------------------------|---------------------------|
| Residential: | | | | |
| Agency-backed | \$94,386 | \$95,674 | 101 | % \$1,288 |

Edgar Filing: National Interstate CORP - Form 10-Q

| | | | | |
|------------------|------------|------------|-----|-----------|
| Non-agency prime | 12,666 | 13,669 | 108 | % 1,003 |
| Alt-A | 18,144 | 19,546 | 108 | % 1,402 |
| Subprime | 36,120 | 38,275 | 106 | % 2,155 |
| Commercial | 13,969 | 14,832 | 106 | % 863 |
| | \$ 175,285 | \$ 181,996 | 104 | % \$6,711 |

At September 30, 2015, approximately 66.0% of our MBS, having a fair value of \$120.9 million, were rated investment grade by major rating firms. The National Association of Insurance Commissioners ("NAIC") assigns creditworthiness designations on a

Table of Contents

scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retained third-party investment management firms to assist in the determination of appropriate NAIC designations for MBS based not only on the probability of loss (which is the primary basis of ratings by the major ratings firms), but also on the severity of loss and the statutory carrying value. At September 30, 2015, 99.6% (based on statutory carrying value of \$177.2 million) of our MBS had an NAIC designation of 1 or 2.

Certain European countries, including the so-called "peripheral countries" (Greece, Portugal, Ireland, Italy and Spain) have been experiencing varying degrees of financial stress over the past few years and there remains uncertainty as to future developments and the impact on global financial markets. At September 30, 2015, less than 5% of our investments consisted of European debt and we owned no sovereign debt issued by the peripheral countries.

Summary information for securities with unrealized gains or losses at September 30, 2015 is shown in the following table. Approximately \$8.9 million of fixed maturities and \$3.4 million of equity securities had no unrealized gains or losses at September 30, 2015.

| | Securities with Unrealized Gains | Securities with Unrealized Losses | |
|---|-------------------------------------|--------------------------------------|---|
| | (Dollars in thousands) | | |
| Fixed Maturities: | | | |
| Fair value of securities | \$854,398 | \$ 180,230 | |
| Amortized cost of securities | 825,195 | 185,721 | |
| Gross unrealized gain or (loss) | \$29,203 | \$ (5,491 |) |
| Fair value as a % of amortized cost | 103.5 | % 97.0 | % |
| Number of security positions held | 746 | 215 | |
| Number individually exceeding \$50,000 gain or (loss) | 167 | 28 | |
| Concentration of gains or (losses) by type or industry: | | | |
| U.S. Government and government agencies | \$3,683 | \$ (22 |) |
| State, municipalities and political subdivisions | 11,047 | (256 |) |
| Residential mortgage-backed securities | 6,577 | (728 |) |
| Commercial mortgage-backed securities | 876 | (14 |) |
| Other debt obligations | 1,039 | (523 |) |
| Financial institutions, insurance and real estate | 2,290 | (524 |) |
| Industrial and other | 3,691 | (3,424 |) |
| Percent rated investment grade (a) | 92.8 | % 80.2 | % |
| Equity Securities: | | | |
| Fair value of securities | \$42,398 | \$ 44,209 | |
| Cost of securities | 35,268 | 50,289 | |
| Gross unrealized gain or (loss) | \$7,130 | \$ (6,080 |) |
| Fair value as a % of cost | 120.2 | % 87.9 | % |
| Number individually exceeding \$50,000 gain or (loss) | 33 | 24 | |
| (a) Investment grade of AAA to BBB- by nationally recognized rating agencies. | | | |

Table of Contents

The table below sets forth the scheduled maturities of available for sale fixed maturity securities at September 30, 2015, based on their fair values. Other debt obligations, which are primarily comprised of asset-backed securities other than those related to mortgages, are categorized based on their average maturity. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| | | Securities with Unrealized Gains | Securities with Unrealized Losses | |
|------------------------------------|-------|-------------------------------------|--------------------------------------|---|
| Maturity: | | | | |
| One year or less | 3.4 | % | 1.1 | % |
| After one year through five years | 34.9 | % | 31.7 | % |
| After five years through ten years | 37.5 | % | 37.3 | % |
| After ten years | 7.9 | % | 6.1 | % |
| | 83.7 | % | 76.2 | % |
| Mortgage-backed securities | 16.3 | % | 23.8 | % |
| | 100.0 | % | 100.0 | % |

Table of Contents

The table below summarizes the unrealized gains and losses on fixed maturities and equity securities by dollar amount.

| | At September 30, 2015 | | Fair Value | |
|------------------------------------|------------------------|-------------|------------|---|
| | Aggregate | Aggregate | as % of | |
| | Fair Value | Unrealized | Cost Basis | |
| | | Gain (Loss) | | |
| | (Dollars in thousands) | | | |
| Fixed Maturities: | | | | |
| Securities with unrealized gains: | | | | |
| Exceeding \$50,000 and for: | | | | |
| Less than one year (36 issues) | \$60,564 | \$2,465 | 104.2 | % |
| One year or longer (131 issues) | 261,041 | 17,630 | 107.2 | % |
| \$50,000 or less (579 issues) | 532,793 | 9,108 | 101.7 | % |
| | \$854,398 | \$29,203 | | |
| Securities with unrealized losses: | | | | |
| Exceeding \$50,000 and for: | | | | |
| Less than one year (25 issues) | \$25,709 | \$(3,151) |) 89.1 | % |
| One year or longer (3 issues) | 1,878 | (538) |) 77.7 | % |
| \$50,000 or less (187 issues) | 152,643 | (1,802) |) 98.8 | % |
| | \$180,230 | \$(5,491) |) | |
| Equity Securities: | | | | |
| Securities with unrealized gains: | | | | |
| Exceeding \$50,000 and for: | | | | |
| Less than one year (13 issues) | \$5,546 | \$1,194 | 127.4 | % |
| One year or longer (20 issues) | 15,495 | 4,639 | 142.7 | % |
| \$50,000 or less (56 issues) | 21,357 | 1,297 | 106.5 | % |
| | \$42,398 | \$7,130 | | |
| Securities with unrealized losses: | | | | |
| Exceeding \$50,000 and for: | | | | |
| Less than one year (24 issues) | \$24,000 | \$(5,151) |) 82.3 | % |
| One year or longer (0 issues) | — | — |) 0.0 | % |
| \$50,000 or less (46 issues) | 20,209 | (929) |) 95.6 | % |
| | \$44,209 | \$(6,080) |) | |

When a decline in the value of a specific investment is considered to be other-than-temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective, as well as, objective factors. Factors considered and resources used by management include those discussed in “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Other-Than-Temporary Impairment.”

Table of Contents

Liquidity and Capital Resources

Our cash flows from operating, investing and financing activities as detailed in our Consolidated Statement of Cash Flows are shown below (in thousands):

| | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2015 | 2014 |
| Net cash provided by operating activities | \$123,223 | \$66,566 |
| Net cash used in investing activities | (89,035 |) (24,329 |
| Net cash used in financing activities | (6,067 |) (4,939 |
| Net increase in cash and cash equivalents | \$28,121 | \$37,298 |

The liquidity requirements of our insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and payments of dividends and taxes to us from insurance subsidiaries. Historically, and during the nine months ended September 30, 2015, cash flows from premiums and investment income have provided sufficient funds to meet these requirements without requiring significant liquidation of investments. If our cash flows change dramatically from historical patterns, for example as a result of a decrease in premiums, an increase in claims paid or operating expenses, or financing an acquisition, we may be required to sell securities before their maturity and possibly at a loss. Our insurance subsidiaries generally hold a significant amount of highly liquid, short-term investments or cash and cash equivalents to meet their liquidity needs. Our historic pattern of using receipts from current premium writings for the payment of liabilities incurred in prior periods provides us with the option to extend the maturities of our investment portfolio beyond the estimated settlement date of our loss reserves. Funds received in excess of cash requirements are generally invested in additional marketable securities.

We believe that our insurance subsidiaries maintain sufficient liquidity to pay claims and operating expenses, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies. Our principal sources of liquidity are our existing cash and cash equivalents. Cash and cash equivalents increased \$28.1 million from \$53.6 million at December 31, 2014 to \$81.7 million at September 30, 2015. We generated net cash from operations of \$123.2 million for the nine months ended September 30, 2015, compared to \$66.6 million during the same period in 2014, which is primarily attributable to an increase in premiums collected and a decrease in cash payments made for loss and loss adjustment expenses year-over-year. Additionally, the increase reflects a \$5.9 million cash settlement received in 2015 related to the Vanliner balance sheet guaranty compared to a payment of \$9.1 million under the guaranty in 2014.

Net cash used in investing activities was \$89.0 million and \$24.3 million for the nine months ended September 30, 2015 and 2014, respectively. The increase in net cash used in investing activities was primarily attributable to fixed maturity security purchases exceeding sales, maturities and redemptions. Purchases of and proceeds from the redemption of fixed maturity securities were \$202.9 million and \$124.1 million, respectively, for the period ending September 30, 2015, compared to \$125.3 million and \$99.3 million, respectively, for the same period last year. The increase in purchases of fixed maturity securities was concentrated in U.S. government agency bonds and other debt obligations and was primarily driven by reinvesting funds in excess of cash requirements.

Net cash used in financing activities was \$6.1 million and \$4.9 million for the nine months ended September 30, 2015 and 2014, respectively. Our financing activities include those related to stock option activity and dividends paid on our common shares.

We have continuing cash needs for administrative expenses, the payment of principal and interest on borrowings, shareholder dividends and taxes. Funds to meet these obligations come primarily from parent company cash, dividends and other payments from our insurance company subsidiaries.

We have a \$100.0 million unsecured credit agreement (the "Credit Agreement") that terminates in November 2017, which includes a sublimit of \$10.0 million for letters of credit. We have the ability to increase the line of credit to \$125.0 million subject to the Credit Agreement's accordion feature. Amounts borrowed bear interest at either (1) a LIBOR rate plus an applicable margin ranging from 0.75% to 1.00% based on our A.M. Best insurance group rating, or (2) a rate per annum equal to the greater of (a) the administrative agent's prime rate, (b) 0.50% in excess of the federal funds effective rate, or (c) 1.00% in excess of the one-month LIBOR rate. Based on our A.M. Best insurance

group rating of “A” at September 30, 2015, we would pay interest at a LIBOR rate plus 0.875%. At September 30, 2015, we had \$12.0 million outstanding under the Credit Agreement, with the interest rate on this debt equal to the six-month LIBOR (0.405% at September 30, 2015) plus 0.875%, with interest payments due quarterly.

The Credit Agreement requires us to maintain specified financial covenants measured on a quarterly basis, including minimum consolidated net worth and a maximum debt to capital ratio. In addition, the Credit Agreement contains certain affirmative and negative covenants customary for facilities of this type, including negative covenants that limit or restrict our ability to, among other things, pay dividends, incur additional indebtedness, effect mergers or consolidations, make investments, enter into asset sales, create liens, enter into transactions with affiliates and other restrictions customarily contained in such agreements. As of September 30, 2015, we were in compliance with all covenants.

Table of Contents

We believe that funds generated from operations, including dividends from insurance subsidiaries, parent company cash and funds available under our Credit Agreement, will provide sufficient resources to meet our liquidity requirements for at least the next 12 months. However, if these funds are insufficient to meet fixed charges in any period, we would be required to generate cash through additional borrowings, sale of assets, sale of portfolio securities or similar transactions. If we were required to sell portfolio securities early for liquidity purposes rather than holding them to maturity, we would recognize gains or losses on those securities earlier than anticipated. If we find it necessary to borrow additional funds under our Credit Agreement in order to meet liquidity needs, we would incur additional interest expense, which could have a negative impact on our earnings. Since our ability to meet our obligations in the long-term (beyond a 12-month period) is dependent upon factors such as market changes, insurance regulatory changes and economic conditions, no assurance can be given that the available net cash flow will be sufficient to meet our long-term operating needs. We are not aware of any trends or uncertainties affecting our liquidity, including any significant future reliance on short-term financing arrangements.

Critical Accounting Policies

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and impact amounts reported in the future. Management believes that the establishment of losses and LAE reserves and the determination of “other-than-temporary” impairment on investments are the two areas whereby the degree of judgment required in determining amounts recorded in the financial statements make the accounting policies critical. For a more detailed discussion of these policies, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies” in our Annual Report on Form 10-K for the year ended December 31, 2014.

Losses and LAE Reserves

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of that loss to us and our final payment of that loss and its related LAE. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities. At September 30, 2015 and December 31, 2014, we had \$976.2 million and \$883.1 million, respectively, of gross loss and LAE reserves, representing management’s best estimate of the ultimate loss. Management records, on a monthly and quarterly basis, its best estimate of loss reserves.

For purposes of computing the recorded loss and LAE reserves, we analyze historic data and estimate the impact of various loss development factors, such as our historic loss experience and that of the industry, trends in claims frequency and severity, our mix of business, our claims processing procedures, legislative enactments, judicial decisions, legal developments in imposition of damages and changes and trends in general economic conditions, including the effects of inflation. Additionally, management utilizes analysis that is derived from a review of quarterly results performed by actuaries employed by Great American. In addition, on an annual basis, actuaries from Great American review the recorded reserves for NIIC, VIC, NIIC-HI and TCC and provide a Statement of Actuarial Opinion, required annually in accordance with state insurance regulations, on the statutory reserves recorded by these U.S. insurance subsidiaries. The actuarial analysis of NIIC’s, VIC’s, NIIC-HI’s and TCC’s net reserves as of September 30, 2015 and December 31, 2014 reflected point estimates that were within 1% of management’s recorded net reserves as of such dates. Using this actuarial data along with its other data inputs, management concluded that the recorded reserves appropriately reflect management’s best estimates of the liability as of September 30, 2015 and December 31, 2014.

The quarterly reviews of unpaid loss and LAE reserves by Great American actuaries are prepared using standard actuarial techniques. These may include (but may not be limited to):

- the Case Incurred Development Method;
- the Paid Development Method;
- the Bornhuetter-Ferguson Method; and
- the Projected Claim Count times Projected Claim Severity Methods.

The period of time from the occurrence of a loss through the settlement of the liability is referred to as the “tail.” Generally, the same actuarial methods are considered for both short-tail and long-tail lines of business because most of them work properly for both. The methods are designed to incorporate the effects of the differing length of time to settle particular claims. For short-tail lines, more weight tends to be given to the Case Incurred and Paid Development methods, although the various methods tend to produce similar results. For long-tail lines, more judgment is involved and more weight may be given to the Bornhuetter-Ferguson method. Liability claims for long-tail lines are more susceptible to litigation and can be significantly affected by changing contract interpretation and the legal environment. Therefore, the estimation of loss reserves for these classes is more complex and subject to a higher degree of variability.

Table of Contents

Supplementary statistical information is reviewed by the actuaries to determine which methods are most appropriate and whether adjustments are needed to particular methods. This information includes:

- open and closed claim counts;
- average case reserves and average incurred on open claims;
- closure rates and statistics related to closed and open claim percentages;
- average closed claim severity;
- ultimate claim severity;
- reported loss ratios;
- projected ultimate loss ratios; and
- loss payment patterns.

Other-Than-Temporary Impairment

Our investments are exposed to at least one of three primary sources of investment risk: credit, interest rate and market valuation risks. The financial statement risks are those associated with the recognition of impairments and income, as well as the determination of fair values. We evaluate whether impairments have occurred on a case-by-case basis. Management considers a wide range of factors about the security issuer and uses its best judgment in evaluating the cause and amount of decline in the estimated fair value of the security and in assessing the prospects for near-term recovery. Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Considerations that we use in the impairment evaluation process include, but are not limited to:

- the length of time and the extent to which the market value has been below amortized cost;
- whether the issuer is experiencing significant financial difficulties;
- economic stability of an entire industry sector or subsection;
- whether the issuer, series of issuers or industry has a catastrophic type of loss;
- the extent to which the unrealized loss is credit-driven or a result of changes in market interest rates;
- historical operating, balance sheet and cash flow data;
- internally and externally generated financial models and forecasts;
- our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value; and
- other subjective factors, including concentrations and information obtained from regulators and rating agencies.

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 have 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. Both components are required to be shown in the Consolidated Statements of Income. 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 is required to reduce the amortized cost of that security to fair value. Additional disclosures required by this guidance are contained in Note 4 - "Investments."

We closely monitor each investment that has a fair value that is below its amortized cost and make a determination each quarter for other-than-temporary impairment for each of those investments. During the three and nine months ended September 30, 2015, we recorded other-than-temporary impairment charges of \$3.1 million and \$4.5 million, respectively, in earnings on both equity and fixed maturity securities, primarily within the energy and financial services sectors. The impairment charges on equity securities of \$2.0 million and \$3.0 million for the three and nine months ended September 30, 2015, respectively, were due to the uncertainty surrounding the timing and extent of

ultimate recovery. The impairment charges on fixed maturity securities of \$1.1 million and \$1.5 million for the three and nine months ended September 30, 2015, respectively, occurred as management is uncertain of full principle repayment on these securities. During the three and nine months ended September 30, 2014, we recorded other-than-

Table of Contents

temporary impairment charges of \$0.3 million and \$0.7 million, respectively, in earnings. The impairment charges for the three months ended September 30, 2014 were primarily related to equity securities where management is uncertain of timing and extent of ultimate recovery. The impairment charges for the nine months ended September 30, 2014 were related to equity securities and mortgage-backed securities, for which previous impairment charges had been recorded. While it is not possible to accurately predict if or when a specific security will become impaired, given the inherent uncertainty in the market, charges for other-than-temporary impairment could be material to net income in subsequent quarters. Management believes it is not likely that future impairment charges will have a significant effect on our liquidity. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations - Financial Condition - Investments.”

Contractual Obligations/Off-Balance Sheet Arrangements

During the first nine months of 2015, our contractual obligations did not change materially from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2014.

We do not have any relationships with unconsolidated entities of financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

As of September 30, 2015, there were no material changes to the information provided in our Annual Report on Form 10-K for the year ended December 31, 2014 under Item 7A “Quantitative and Qualitative Disclosures About Market Risk.”

ITEM 4. Controls and Procedures

Our management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. Our management, with participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e)) as of September 30, 2015. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2015, to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There have been no changes in our internal controls over financial reporting or in other factors that have occurred during the quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II – OTHER INFORMATION

ITEM 1. Legal Proceedings

There are no material changes from the legal proceedings previously reported in our Annual Report on Form 10-K for the year ended December 31, 2014. For more information regarding such legal matters please refer to Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2014, Note 15 – “Commitments and Contingencies” to the Consolidated Financial Statements included therein and Note 10 – “Commitments and Contingencies” to the Consolidated Financial Statements contained in this quarterly report.

ITEM 1A. Risk Factors

There are no material changes to the risk factors previously reported in our Annual Report on Form 10-K for the year ended December 31, 2014. For more information regarding such risk factors, please refer to Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2014.

ITEM 6. Exhibits

- 3.1 Amended and Restated Articles of Incorporation ⁽¹⁾
- 3.2 Amended and Restated Code of Regulations ⁽¹⁾
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101 The following financial information from National Interstate Corporation’s Form 10-Q for the quarter ended September 30, 2015 formatted in XBRL (Extensible Business Reporting Language):
 - (i) Consolidated Balance Sheet
 - (ii) Consolidated Statement of Income
 - (iii) Consolidated Statement of Comprehensive Income
 - (iv) Consolidated Statement of Shareholders’ Equity
 - (v) Consolidated Statement of Cash Flows
 - (vi) Notes to Consolidated Financial Statements

⁽¹⁾ These exhibits are incorporated by reference to our Registration Statement on Form S-1 (Registration No. 333-119270).

Table of Contents

SIGNATURES

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

NATIONAL INTERSTATE CORPORATION

Date: November 4, 2015

/s/ David W. Michelson
David W. Michelson
President and Chief Executive Officer
(Duly Authorized Officer and Principal
Executive Officer)

Date: November 4, 2015

/s/ Julie A. McGraw
Julie A. McGraw
Vice President and Chief Financial Officer
(Duly Authorized Officer and Principal
Financial Officer)