

Edgar Filing: National Interstate CORP - Form 10-K

National Interstate CORP
Form 10-K
March 10, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

Annual Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2015

National Interstate Corporation

(Exact name of registrant as specified in its charter)

Ohio

(State or other jurisdiction of
incorporation or organization)

Commission File No. 000-51130

34-1607394

(I.R.S. Employer
Identification No.)

3250 Interstate Drive

Richfield, Ohio 44286-9000

(330) 659-8900

(Address and telephone number of principal executive offices)

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class

Common Shares, \$0.01 par value

Securities registered pursuant to Section 12(g) of the Act: None

Name of exchange on which registered

Nasdaq Global Select Market

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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. (Check One):

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

Edgar Filing: National Interstate CORP - Form 10-K

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$202.0 million (based upon non-affiliate holdings of 7,395,196 shares and a market price of \$27.32 at June 30, 2015).

As of March 4, 2016 there were 19,924,535 shares of the Registrant's Common Shares (\$0.01 par value) outstanding.

Documents Incorporated by Reference:

Proxy Statement for 2016 Annual Meeting of Shareholders (portions of which are incorporated by reference into Part III hereof).

National Interstate Corporation
 Index to Annual Report on Form 10-K

	Page
	<u>Part I</u>
Item 1 —	<u>Business:</u> 4
	<u>Introduction</u> 4
	<u>Property and Casualty Insurance Operations</u> 4
	<u>Investments</u> 10
	<u>Competition</u> 13
	<u>Ratings</u> 13
	<u>Regulation</u> 14
	<u>Employees</u> 16
Item 1A —	<u>Risk Factors</u> 16
Item 1B —	<u>Unresolved Staff Comments</u> 23
Item 2 —	<u>Properties</u> 23
Item 3 —	<u>Legal Proceedings</u> 23
Item 4 —	<u>Mine Safety Disclosures</u> 23
	<u>Part II</u>
Item 5 —	<u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> 24
Item 6 —	<u>Selected Financial Data</u> 26
Item 7 —	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u> 28
Item 7A —	<u>Quantitative and Qualitative Disclosures About Market Risk</u> 50
Item 8 —	<u>Financial Statements and Supplementary Data</u> 51
Item 9 —	<u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u> 82
Item 9A —	<u>Controls and Procedures</u> 82
Item 9B —	<u>Other Information</u> 82
	<u>Part III</u>
Item 10 —	<u>Directors, Executive Officers and Corporate Governance</u> 83
Item 11 —	<u>Executive Compensation</u> 83
Item 12 —	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> 83
Item 13 —	<u>Certain Relationships and Related Transactions, and Director Independence</u> 83
Item 14 —	<u>Principal Accountant Fees and Services</u> 83
	<u>Part IV</u>
Item 15 —	<u>Exhibits and Financial Statement Schedules</u> 84
<u>Signatures</u>	92

Table of Contents

FORWARD-LOOKING STATEMENTS

The disclosures in this Form 10-K, including information incorporated by reference, contain “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-K 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 make 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.

Table of Contents

PART I

ITEM 1 Business

Introduction

National Interstate Corporation (the “Company”, “we”, “our”, “us”) and its subsidiaries operate as an insurance holding company group that underwrites and sells traditional and alternative property and casualty insurance products primarily to the passenger transportation, trucking and moving and storage industries, general commercial insurance to small businesses in Hawaii and Alaska and personal insurance to owners of recreational vehicles throughout the United States. Our principal executive offices are located at 3250 Interstate Drive, Richfield, Ohio, 44286 and our telephone number is (330) 659-8900. Securities and Exchange Commission (the “SEC”) filings, news releases, our Code of Ethics and Conduct and other information may be accessed free of charge through our website at <http://invest.natl.com>. Information on the website is not part of this Form 10-K. We make all documents that we file with, or furnish to, the SEC, including our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to these reports, available on our website as soon as reasonably practicable. These reports are also available on the SEC's website at <http://www.sec.gov>.

Great American Insurance Company (“Great American”), a wholly-owned subsidiary of American Financial Group, Inc. (“AFG”), is our majority shareholder. At December 31, 2015, Great American owned 51.1% of our outstanding shares. Our common shares trade on the Nasdaq Global Select Market under the symbol “NATL.”

Property and Casualty Insurance Operations

We are a specialty property and casualty insurance company with a niche orientation and a focus on the transportation industry. Founded in 1989, we have had an uninterrupted record of profitability in every year since 1990, our first full year of operation. We have also reported an underwriting profit in 22 of the 27 years we have been in business. For the year ended December 31, 2015, we had gross premiums written (direct and assumed) of \$727.1 million and net income of \$20.8 million.

Our Products

We offer approximately 40 product lines in the specialty property and casualty insurance market, which we group into four general business components (alternative risk transfer (“ART”), transportation, specialty personal lines and Hawaii and Alaska) based on the class of business, insureds’ risk participation or geographic location.

The following table sets forth an analysis of gross premiums written by business component during the years indicated:

	Year Ended December 31,		2014		2013			
	2015		Amount	Percent	Amount	Percent		
	Amount	Percent						
	(Dollars in thousands)							
Alternative Risk Transfer	\$412,443	56.7	% \$374,152	54.3	% \$326,305	51.7	%	
Transportation	237,271	32.6	% 245,261	35.6	% 228,139	36.1	%	
Specialty Personal Lines	35,295	4.9	% 35,597	5.2	% 47,715	7.5	%	
Hawaii and Alaska	22,284	3.1	% 21,276	3.1	% 20,096	3.2	%	
Other	19,826	2.7	% 12,717	1.8	% 9,738	1.5	%	
Gross premiums written	\$727,119	100.0	% \$689,003	100.0	% \$631,993	100.0	%	

The range of in-force premium and annual premium averages at December 31, 2015 for the products we offer for each business component were as follows:

	Premium Range	Annual Averages
	(Dollars in thousands)	
Alternative Risk Transfer	\$1,000 - \$38,100	\$9,600

Edgar Filing: National Interstate CORP - Form 10-K

Transportation	\$2,900 - \$46,400	\$18,200
Specialty Personal Lines	\$3,200 - \$29,600	\$12,100
Hawaii and Alaska	\$10,500 - \$11,300	\$10,900

4

Table of Contents

Alternative Risk Transfer. We underwrite, market and distribute primarily truck transportation, passenger transportation and moving and storage ART insurance products, also known as captives. ART products function by utilizing insurance or reinsurance companies that are owned or “rented” (as described below) by the participants in the program. Participants may include homogeneous groups of passenger transportation, trucking or moving and storage companies, transportation insurance agencies and individual, larger insureds as single participants in our national account ART products. Program participants share in the underwriting profits or losses and the investment results associated with the risks of being insured through the program. Participants in these programs typically are interested in improved risk control, increased participation in the claims settlement process and asset investment features associated with an ART insurance program.

We support two forms of ART programs – member-owned and rental. In a member-owned ART program, the participants form, capitalize and manage their own reinsurance company. In a rental ART program, the reinsurance company is formed, capitalized and managed by someone other than the participants. The participants in a rental ART program pay a fee to use the reinsurance facility in their ART program; in other words, the participants “rent” it. For both member-owned and rental ART programs, we typically underwrite and price the risk, issue the policies and adjust the claims. A portion of the risk and premium is ceded to the ART insurance program. The ART insurance program serves the same purpose for the participants regardless of whether they own the reinsurance company or rent it. Hudson Indemnity, Ltd. (“HIL”), our consolidated subsidiary, is “rented” to program participants to facilitate the transfer of risk to the participants and the respective program’s results are recorded solely in HIL’s financial statements. Captive reinsurance facilities owned and managed directly by the member-owned program participants are not consolidated in our financial results since they are not variable interest entities.

The revenue we earn, our profit margins and the risks we assume are substantially consistent in member-owned and rental ART programs. The primary differences to us are the expenses associated with these programs and who ultimately bears those expenses. In a member-owned ART program, the participants own and manage their own reinsurance company, which includes general management responsibilities, financial statement preparation, actuarial analysis, investment management, corporate governance, regulatory management and legal affairs. If the actual expenses associated with managing a member-owned ART program exceed the funded projections, the participants pay for these added expenses outside the insurance transaction. In our rental ART programs, we include an expense charge in the program premium that we charge participants to fund expenses related to the managing of HIL.

Investment management expenses also are included in the program premium and we cap the participant’s expense contribution regardless of whether or not we collect adequate funds to operate the off-shore reinsurance company.

All other loss, expense and profit margin components are substantially the same for our member-owned or rental ART programs. The advantage of a member-owned ART program to the participants is the ability to change policy issuing companies and service providers without changing the makeup of their group. Rental ART program participants are not obligated to capitalize their own reinsurer. They generally enjoy a slightly lower expense structure and their ART program expenses are fixed for the policy year regardless of the amount of expenses actually incurred to operate the reinsurer and facilitate participant meetings.

The premiums generated by each of the ART insurance programs offered by us are developed in a similar manner.

The most important component of the premium charged is the development of the participants’ loss fund. The loss fund represents the amount of premium needed to cover the participants’ expected losses in the layer of risk being ceded to the captive reinsurer. Participants may assume 100% of the losses in the first loss layer or participate in a quota share arrangement, where the losses are shared between the participants and us. The loss layers typically range from \$50,000 to \$700,000 per occurrence and our members’ participation percentages in quota share arrangements generally range from 30% to 50%. Each participant’s loss fund layer is analyzed quarterly on a policy year basis to determine if the loss fund is sufficient to cover all losses within the layer. If the results in the loss fund layer are unfavorable to expectations an assessment of premium is charged and if results are favorable to expectations a return of premium is credited at the participant or group level. Typically, the premium and losses incurred through the funding of our captive participant’s loss layer are comparable period-over-period. However, increased member participation or assessment premium charged on the loss fund layer through HIL has the potential to unfavorably impact our loss and

LAE ratio, and conversely, have a favorable impact on our underwriting expense ratio, when comparing results to a prior period.

Once the participants' loss fund is established, all other expenses related to the coverages and services being provided are derived by a formula which is agreed to in advance by the ART program participants and the service providers.

We provide services, including policy issuance, claims adjusting and insurance coverage in excess of the ART program retention, for our participants utilizing either our rental captive or a member owned captive. Additionally, for rental captive participants we provide loss control services and management of their captive program, whereas for member owned captive participants we coordinate these services with the member owned captive manager. These items, which are included in premiums charged to the insured, range from approximately 30% to 70% of a \$1 million policy premium depending on the program structure and the loss layer ceded to the ART program.

Since our first member-owned ART program in the passenger transportation insurance market was established in 1995, we have established additional ART products for passenger and commercial transportation, including but not limited to, rental cars,

Table of Contents

paratransit operations, taxi cabs, liquefied petroleum gas distributors, waste haulers, buses, crane and rigging operators, trucks and moving and storage companies. As of December 31, 2015, we insured approximately 450 transportation companies in ART programs. For the year ended December 31, 2015, we collectively had two customers that made up 19.0% of the total ART component revenues with one customer that independently accounted for 10.1% of the total ART revenues. Due to this concentration of revenue among a group of customers, if an event were to adversely affect one of these customers, it could have a material impact on our revenues from ART products. Transportation. We believe that we are one of the largest writers of insurance for the passenger transportation and moving and storage industries in the United States. In our transportation component, we underwrite commercial auto liability, general liability, physical damage, workers' compensation and motor truck cargo and related coverages for truck and passenger operators. Passenger transportation operators include charter and tour bus companies, municipal transit systems, school transportation contractors, limousine companies, inter-city bus services and community service and paratransit operations. We also provide tailored coverages to the moving and storage industry including, but not limited to, commercial auto liability, physical damage, workers' compensation, employers' liability, cargo, commercial umbrella, commercial property, general liability, crime, equipment breakdown, inland marine and movers and warehousemen's liability. No one customer in our transportation component accounted for 10% or more of the revenues of this component during 2015 or 2014.

Specialty Personal Lines. We believe our specialty recreational vehicle, or RV insurance program, differs from those offered by traditional personal auto insurers because we offer coverages written specifically for RV owners, including those who live in their RV full-time. We offer coverage for campsite liability, vehicle replacement coverage and coverage for trailers, golf carts and campsite storage facilities. In addition to our RV product, we also offer companion personal auto coverage to RV policyholders covering automobiles owned by our insured RV policyholders. One feature of our companion auto product that we believe is not generally available from other insurers is the application of a single deductible when an insured RV and the insured companion auto being towed are both damaged in an accident. We also assume all of the net risk related to policies for RV risks underwritten by us and issued by Great American. No one customer in our specialty personal lines component accounted for 10% or more of the revenues of this component during 2015 or 2014.

Hawaii and Alaska. Our Hawaii office provides general commercial and transportation insurance for business owners in both Hawaii and Alaska and has become a leading writer of public and truck transportation in both states. No one customer in our Hawaii and Alaska component accounted for 10% or more of the revenues of this component during 2015 or 2014.

Geographic Concentration

The following table sets forth the geographic distribution of our direct premiums written for the years indicated:

	Year Ended December 31,				
	2015	Percent of Total	2014	Percent of Total	
	Volume		Volume		
	(Dollars in thousands)				
California	\$107,667	15.2	% \$102,328	15.1	%
Texas	40,926	5.8	% 33,784	5.0	%
New York	40,174	5.7	% 39,093	5.8	%
Florida	33,756	4.8	% 32,491	4.8	%
Missouri	33,689	4.8	% 27,960	4.1	%
New Jersey	31,700	4.5	% 30,668	4.5	%
North Carolina	29,083	4.1	% 34,183	5.1	%
Pennsylvania	28,371	4.0	% 29,846	4.4	%
Illinois	24,644	3.5	% 21,479	3.2	%

Edgar Filing: National Interstate CORP - Form 10-K

All other states	338,480	47.6	%	324,989	48.0	%
Direct premiums written	\$708,490	100.0	%	\$676,821	100.0	%

6

Table of Contents

Concentration by Statutory Line of Business

The following table sets forth our direct premiums written by statutory line of business for the years indicated:

	Year Ended December 31,		2014		
	2015	Percent of Total	Volume	Percent of Total	
	(Dollars in thousands)				
Auto and other liability	\$331,451	46.8	% \$359,569	53.1	%
Workers' compensation	278,290	39.3	% 217,455	32.1	%
Auto physical damage	81,947	11.6	% 82,375	12.2	%
All other lines	16,802	2.3	% 17,422	2.6	%
Direct premiums written	\$708,490	100.0	% \$676,821	100.0	%

Product Management Organization

We believe we have a competitive advantage in our major lines of business, in part, as a result of our product management focus. Each of our product lines is headed by a manager who assists in determining and is solely responsible for achieving that product line's planned results. We believe that the use of a product management organization provides the focus required to successfully offer and manage a diverse set of product lines. We offer our large transportation customers flexibility based on their needs by, for example, designing custom insurance programs, such as unique billing plans and deductibles. Our claims, accounting, information technology and other support functions are organized to align their resources with specific product line initiatives and needs. Our product managers are responsible for the underwriting, pricing and marketing and they are held accountable for underwriting profitability of a specific insurance product. Other required services and support are provided across product lines by functional managers.

Underwriting

We employ a pricing segmentation approach in our underwriting that makes extensive use of proprietary data and pricing methodologies. Our pricing strategy enables our product managers to manage rate structures by evaluating detailed policyholder information, such as loss experience based on driver characteristics, financial responsibility scores (where legally permissible) and the make/model of vehicles. This pricing segmentation approach requires extensive involvement of the product managers, who are responsible for the underwriting profitability of a specific product line with direct oversight of product design and rate level structure by our most senior managers. Individual product managers work closely with our pricing and database managers to generate rate level indications and other relevant data. We use this data coupled with information from the National Council on Compensation Insurance and the actuarial loss costs obtained from the Insurance Services Office, an insurance industry advisory service organization, as a benchmark in pricing our products. We believe the quality of our proprietary data, combined with our rigorous approach, has permitted us to generally respond more quickly than our competitors to adverse trends and to obtain appropriate pricing and risk selection for each individual account.

Risk selection and pricing decisions are discussed regularly by product line underwriters and product managers. We believe this group's input and deliberation on pricing and risk selection reaffirms our philosophy and underwriting culture and aids in avoiding unknown exposures. Underwriting files at both our regional and corporate offices are audited by senior management on a regular basis for compliance with our price and risk selection criteria. Product managers are responsible for the underwriting profitability resulting from these risk selection and pricing decisions and the incentive-based portion of their compensation is based, in part, on that profitability.

Marketing and Distribution

We offer our products through multiple distribution channels including independent agents and brokers, program administrators, affiliated agencies and agent internet initiatives. During the year ended December 31, 2015, approximately 90% of our gross premiums written were generated by unaffiliated producers (i.e., independent agents, brokers and program administrators) and approximately 10% were generated by our affiliated agencies. Together, our

top two unaffiliated producers accounted for an aggregate of 13.5% of our gross premiums written during 2015.

7

Table of Contents

Reinsurance

We reinsure a portion of our business to other insurance companies, which permits diversification of our risks and limits our maximum loss arising from large or unusually hazardous risks or catastrophic events. We are subject to credit risk with respect to our reinsurers, because the ceding of risk to a reinsurer generally does not relieve us of liability to our insureds until claims are fully settled. To mitigate this credit risk, we cede business only to reinsurers if they meet our credit ratings criteria of an A.M. Best rating of “A-” or better. If a reinsurer is not rated by A.M. Best or their rating falls below “A-”, our contract with them generally requires that they secure outstanding obligations with cash, a trust or a letter of credit that we deem acceptable.

Claims Management and Administration

We believe that effective claims management is critical and has contributed to our success, and that our process is cost efficient, delivers the appropriate level of claims service and produces superior claims results. We are focused on controlling claims from their inception with thorough investigation, accelerated communication to insureds and claimants and compressing the cycle time of claim resolution to control both loss cost and claim handling cost. Claims arising under our insurance policies are reviewed, supervised and handled by our internal claims department. As of December 31, 2015, our claims organization employed 223 people (31% of our employee group) and operated out of three regional offices. All of our claims employees have been trained to handle claims according to our customer-focused claims management processes and procedures and are subject to periodic audit. We systematically conduct continuing education for our claims staff in the areas of best practices, fraud awareness, legislative changes and litigation management. All large claim reserves are reviewed on a quarterly basis by executive claims management, and adjusters frequently participate in audits and large loss reviews with participating reinsurers. We also employ a formal large loss review methodology that involves senior company management, executive claims management and adjusting staff in a quarterly review of all large loss exposures.

We provide 24-hour, 7 days per week, toll-free service for our policyholders to report claims. When we receive the first notice of loss, our claims personnel open a file and establish appropriate reserving to maximum probable exposure (based on our historical claim settlement experience) as soon as practicable and continually revise case reserves as new information develops. We maintain and implement a fraud awareness program designed to educate our claims employees and others throughout the organization of fraud indicators. Potentially fraudulent claims are referred for special investigation and fraudulent claims are contested.

Our claims department is organized by product and program specific divisions to allow the best understanding of our insured's organizations and particular risks. This structure enables our claims staff to become dedicated experts in particular product areas which enhances communication with our customers and increases cost effectiveness with claims resolution.

Our physical damage claims processes involve the utilization and coordination of internal staff, vendor resources and property specialists. We pay close attention to the vehicle repair process, which we believe reduces the amount we pay for repairs, storage costs and auto rental costs.

We employ highly qualified and experienced liability adjusters who are responsible for overseeing all injury-related losses including those in litigation. We identify and retain specialized outside defense counsel to litigate such matters. We negotiate fee arrangements with retained defense counsel and attempt to limit our litigation costs. The liability focused adjusters manage these claims by placing a priority on detailed file documentation and emphasizing investigation, evaluation and negotiation of liability claims.

Reserves for Unpaid Losses and Loss Adjustment Expenses (“LAE”)

We record our best estimate of liabilities for the costs of losses and LAE for both reported and unreported claims based on historical trends adjusted for changes in loss costs, underwriting standards, policy provisions, product mix and other factors. Estimating the liability for unpaid losses and LAE is inherently judgmental and is influenced by factors that are subject to significant variation. We monitor factors such as the effect of inflation on medical, hospitalization, material repair and replacement costs, general economic trends and the legal environment. While the ultimate liability may be greater than recorded loss reserves, the reserve tail for transportation coverage is generally shorter than that associated with many other casualty coverages and, therefore, generally can be established with less

uncertainty than coverages having longer reserve tails.

We review loss reserve adequacy and claims adjustment effectiveness quarterly. We focus significant management attention on claims reserved above \$100,000. Further, our reserves are reviewed quarterly and opined upon annually by accredited actuaries from Great American. Reserves are routinely adjusted as additional information becomes known. Such routine adjustments are reflected in quarterly results in the period of adjustment.

The following tables present the development of our loss reserves, net of reinsurance, on a U.S. generally accepted accounting principles (“GAAP”) basis for the calendar years 2005 through 2015. The top line of each table shows the estimated liability for

8

Table of Contents

unpaid losses and LAE recorded at the balance sheet date for the indicated year. The next line, "As re-estimated at December 31, 2015," shows the re-estimated liability as of December 31, 2015. The remainder of the table presents intervening development from the initially estimated liability. This development results from additional information and experience in subsequent years. The middle line shows a net cumulative redundancy (deficiency) which represents the aggregate percentage change in the liability initially estimated. The lower portion of the table indicates the cumulative amounts paid as of successive periods.

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Net Liability for Unpaid Losses And LAE:	(Dollars in thousands)								
As originally estimated	\$ 151,444	\$ 181,851	\$ 210,302	\$ 262,440	\$ 276,419	\$ 596,136	\$ 594,448	\$ 607,604	\$ 647,3
As re-estimated at December 31, 2015	135,599	164,932	199,011	253,812	266,998	549,520	605,462	652,198	700,41
Liability re-estimated as of:									
One year later	143,991	176,179	209,448	261,154	269,747	583,663	578,705	609,889	677,93
Two years later	142,929	173,860	207,281	250,185	267,995	553,526	579,048	633,458	700,41
Three years later	139,994	169,879	199,142	248,851	266,085	538,746	592,175	652,198	
Four years later	138,108	166,043	198,852	248,675	263,346	543,274	605,462		
Five years later	135,635	163,855	197,482	248,903	266,482	549,520			
Six years later	134,328	163,279	196,405	251,645	266,998				
Seven years later	134,686	163,055	197,774	253,812					
Eight years later	134,553	164,230	199,011						
Nine years later	135,293	164,932							
Ten years later	135,599								
Net cumulative redundancy (deficiency)	15,845	16,919	11,291	8,628	9,421	46,616	(11,014)	(44,594)	(53,07
[1] Net cumulative redundancy (deficiency) — %	10.5	% 9.3	% 5.4	% 3.3	% 3.4	% 7.8	% (1.9)	% (7.3)	% (8.2
Cumulative paid as of:									

Edgar Filing: National Interstate CORP - Form 10-K

One year later	51,901	63,314	67,673	91,615	90,410	182,652	201,717	240,981	276,652
Two years later	85,193	95,752	111,841	145,279	146,378	302,821	357,834	412,687	445,963
Three years later	101,340	119,984	141,484	182,163	189,177	399,997	466,486	514,939	
Four years later	112,474	133,976	159,410	209,272	213,198	460,765	524,730		
Five years later	117,073	140,160	170,085	220,421	227,573	485,348			
Six years later	119,461	144,133	174,896	227,565	234,863				
Seven years later	121,566	145,996	177,646	232,050					
Eight years later	122,205	147,134	180,025						
Nine years later	122,768	148,351							
Ten years later	123,833								

[1] — Unfavorable development of \$7.0M associated with Vanliner's guaranteed reserves was recorded in 2015. No development associated with Vanliner's guaranteed reserves was recorded in 2014. Favorable development associated with Vanliner's guaranteed reserves recorded in 2013, 2012, and 2011 were \$20.8 million, \$19.0 million, and \$9.8 million, respectively. Vanliner guaranteed reserve development related to accident years 2010 and prior is required to be reflected in calendar year 2010, which was the year of acquisition. See Note 2 to our consolidated financial statements - "Significant Accounting Policies" for a discussion of the contingent consideration related to the Vanliner guaranty. Excluding the Vanliner guaranty, we recorded unfavorable development of \$14.4 million, \$30.6 million and \$23.1 million, for the years ending December 31, 2015, 2014 and 2013, respectively, in our Consolidated Statements of Income. See Note 12 to our consolidated financial statements - "Unpaid Losses and LAE," for a discussion of the impact on our unpaid losses and LAE.

Table of Contents

The following is a reconciliation of our net liability to the gross liability for unpaid losses and LAE:

	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(Dollars in thousands)								
As originally estimated:									
Net liability shown above	\$ 151,444	\$ 181,851	\$ 210,302	\$ 262,440	\$ 276,419	\$ 596,136	\$ 594,448	\$ 607,604	\$ 647,300
Add reinsurance recoverables	71,763	84,115	91,786	137,561	140,841	202,509	182,128	167,701	156,443
Gross liability	\$ 223,207	\$ 265,966	\$ 302,088	\$ 400,001	\$ 417,260	\$ 798,645	\$ 776,576	\$ 775,305	\$ 803,743
As re-estimated at December 31, 2015									
Net liability shown above	\$ 135,599	\$ 164,932	\$ 199,011	\$ 253,812	\$ 266,998	\$ 549,520	\$ 605,462	\$ 652,198	\$ 700,400
Add reinsurance recoverables re-estimated	61,510	59,962	55,530	105,369	83,996	138,692	165,629	179,328	187,450
Gross liability	\$ 197,109	\$ 224,894	\$ 254,541	\$ 359,181	\$ 350,994	\$ 688,212	\$ 771,091	\$ 831,526	\$ 887,850
Gross cumulative (deficiency) redundancy	\$ 26,098	\$ 41,072	\$ 47,547	\$ 40,820	\$ 66,266	\$ 110,433	\$ 5,485	\$ (56,221)	\$ (84,080)
Gross cumulative (deficiency) redundancy —	11.7	% 15.4	% 15.7	% 10.2	% 15.9	% 13.8	% 0.7	% (7.3	)% (10.5
%									

These tables do not present accident or policy year development data. Furthermore, in evaluating the re-estimated liability and cumulative (deficiency) redundancy, we note that each amount includes the effects of changes in amounts for prior periods. Conditions and trends that affected development of the liability in the past may not necessarily exist in the future. Accordingly, extrapolating redundancies and or deficiencies based on this table is inherently uncertain.

The preceding tables show our calendar year development for each of the last ten years resulting from reevaluating the original estimate of the loss and LAE liability on both a net and gross basis. Gross reserves are liabilities for direct and assumed losses and LAE before a reduction for amounts ceded. At December 31, 2015, our liability on a gross basis was \$1.0 billion and our asset for ceded reserves was \$217.8 million. The difference between gross development and net development is ceded loss and LAE reserve development. The range of dollar limits ceded by us is much greater and therefore more volatile than the range of dollar limits we retain, which could cause more volatility in estimates for ceded losses. Therefore, ceded reserves are more susceptible to development than net reserves. Net calendar year reserve development affects our income for the year while ceded reserve development or savings affects the income of reinsurers.

Investments

General

We approach investment and capital management with the intention of supporting insurance operations by providing a stable source of income to supplement underwriting income. We strive to protect capital while optimizing investment income, capital appreciation and maintaining appropriate liquidity. Our Board of Directors has approved investment guidelines established by management and reviews the portfolio performance at least quarterly for compliance with the established guidelines.

During 2015, we reinvested cash flows from sold and matured investments into primarily asset backed securities, which are categorized as other debt obligations, as these securities generally offered the best combination of yield, duration, and credit risk when considering other market opportunities and our existing holdings.

Table of Contents

The following table presents the percentage distribution of our investment portfolio for the dates given based upon fair value:

	At December 31,		
	2015	2014	
Fixed maturities:			
State and local government obligations	26.8	% 30.9	%
Other debt obligations	17.4	% 9.6	%
Corporate obligations	17.1	% 18.0	%
Residential mortgage-backed securities	13.3	% 17.4	%
U.S. Government and government agency obligations	12.8	% 10.3	%
Commercial mortgage-backed securities	1.2	% 1.5	%
Redeemable preferred stock	0.4	% 0.4	%
Total fixed maturities	89.0	% 88.1	%
Equity securities:			
Common stocks	4.8	% 5.7	%
Nonredeemable preferred stocks	2.1	% 2.0	%
Total equity securities	6.9	% 7.7	%
Other invested assets	4.1	% 4.2	%
Total	100.0	% 100.0	%

The following table presents the yields of our investment portfolio exclusive of changes in unrealized gains and losses:

	Year Ended December 31,		
	2015	2014	2013
Yield on fixed maturities:			
Excluding realized gains and losses	3.6	% 3.5	% 3.5
Including realized gains and losses	3.4	% 3.6	% 3.8
Yield on equity securities:			
Excluding realized gains and losses	5.2	% 4.2	% 4.1
Including realized gains and losses	5.4	% 7.2	% 8.5
Yield on other invested assets:			
Excluding realized gains and losses	0.0	% 0.0	% 0.0
Including realized gains and losses	(3.5)	)% 7.6	% 3.9
Yield on all investments:			
Excluding realized gains and losses	3.6	% 3.4	% 3.4
Including realized gains and losses	3.3	% 4.1	% 4.0

Table of Contents

The table below compares total returns on our fixed maturities and equity securities to comparable public indices. We benchmark our fixed maturity portfolio, excluding redeemable preferred stock, to the Barclays Intermediate Aggregate Index because we believe it best matches our investment strategy and the resulting composition of our portfolio. For similar reasons we benchmark our equity securities, including other invested assets, against the Standard & Poor's ("S&P") 500 Index. Both our performance and the indices include investment income, realized gains and losses and changes in unrealized gains and losses.

	Year Ended December 31,			
	2015	2014	2013	
Fixed maturities:				
National Interstate Total Return on Fixed Maturities	2.4	% 5.3	% 1.6	%
Barclays Intermediate Aggregate Index	1.2	% 4.1	% (1.0))%
Equity securities:				
National Interstate Total Return on Equity Securities	(4.3	)% 6.9	% 15.1	%
S&P 500 Index	1.4	% 13.7	% 32.4	%

Fixed Maturity Investments

Our fixed maturity portfolio is primarily invested in investment grade securities. The following table shows our fixed maturity securities by S&P or comparable rating as of December 31, 2015:

S&P or Comparable Rating	Amortized Cost	Fair Value	% of Total	
	(Dollars in thousands)			
AAA, AA, A	\$812,263	\$825,128	78.5	%
BBB	134,334	133,744	12.7	%
Total Investment Grade	946,597	958,872	91.2	%
BB	23,733	21,969	2.1	%
B	9,802	8,347	0.8	%
CCC	19,026	20,529	2.0	%
CC, C, D	39,072	41,271	3.9	%
Total Non-Investment Grade	91,633	92,116	8.8	%
Total	\$1,038,230	\$1,050,988	100.0	%

At December 31, 2015, approximately 67% of our mortgage-backed securities ("MBS"), having a fair value of \$114.6 million, were rated investment grade (BBB or better) by major rating firms. The National Association of Insurance Commissioners ("NAIC") retained a third-party investment management firm 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 statutory carrying value. At December 31, 2015, 98.9% (based on statutory carrying value of \$166.9 million) of our MBS had an NAIC designation of 1 or 2 (the highest of the six designations).

Table of Contents

The table below sets forth the scheduled maturities of available for sale fixed maturity securities at December 31, 2015, based on their fair values. Other debt obligations, which are primarily comprised of asset-backed securities other than those related to mortgages and other securities with sinking funds, 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.

	December 31, 2015		
	Fair Value	% of Total	
	(Dollars in thousands)		
One year or less	\$36,226	3.5	%
More than one year to five years	375,561	35.7	%
More than five years to ten years	387,039	36.8	%
More than ten years	80,391	7.7	%
	879,217	83.7	%
Mortgage-backed securities	171,771	16.3	%
Total fixed maturities	\$1,050,988	100.0	%

Fixed maturity investments are generally invested in securities with intermediate-term maturities with an objective of optimizing total return, including investment income, while allowing flexibility to react to changes in market conditions and maintaining sufficient liquidity to meet policyholder obligations. At December 31, 2015, the weighted average effective duration (adjusted for call provisions) was approximately 4 years and the weighted average maturity was 5.9 years. The concept of weighted average effective duration takes into consideration the probability of the exercise of the various call features associated with many of the fixed maturity securities we hold. Fixed maturity securities are frequently issued with call provisions that provide the issuer the option of accelerating the maturity of the security.

Competition

The commercial transportation insurance industry is highly competitive and, except for regulatory considerations, there are relatively few barriers to entry. We compete with numerous insurance companies and reinsurers, including large national underwriters and smaller niche insurance companies. We believe that our primary competitors in the commercial specialty insurance market include, among others, Lancer Insurance Company, RLI Corporation, Great West Casualty Company (a subsidiary of Old Republic International Corporation), Northland Insurance Company (a subsidiary of the Travelers Companies, Inc.), Sentry Insurance, Liberty Mutual Insurance Company, Baldwin & Lyons, Inc., ProSight Specialty Insurance Group, Inc., AmTrust Financial Services, Inc. and American International Group, Inc. In the specialty personal lines market, our primary competitors are Progressive Corporation, Nationwide Insurance Company and National General Insurance, and in our Hawaii and Alaska markets, our primary competitors are Island Insurance Company, Liberty Mutual Insurance Company, First Insurance, Dongbu Insurance Company, DTRIC Insurance Company, Alaska National Insurance Company, Berkshire Hathaway, Umialik Insurance Company and Zurich Insurance Company. In the moving and storage market we compete against, among others, American International Group, Inc., Travelers Company, Inc., AmTrust Financial Services, Inc., ProSight Specialty Insurance Group, Inc. and Transguard Insurance Company of America.

We compete in the property and casualty insurance marketplace with other insurers on the basis of price, coverages offered, product and program design, claims handling, customer service quality, agent commissions where applicable, geographic coverage, reputation and financial strength ratings by independent rating agencies. We compete by developing product lines to satisfy specific market needs and by maintaining relationships with our independent agents and customers who rely on our expertise. This expertise, along with our experience in offering specialty underwriting products, is our principal means of distinguishing ourselves from our competitors.

We believe we have a competitive advantage in our major lines of business as a result of the extensive experience of our management, our superior service and products, our willingness to design custom insurance programs for our large transportation customers and the extensive use of current technology with respect to our insureds and independent agent force. However, we are not “top-line” oriented and are willing to sacrifice premium volume during periods that we believe exhibit unrealistic rate competition. Accordingly, should competitors determine to “buy” market share with unprofitable rates, our insurance subsidiaries could experience limited growth or a decline in business until market pricing returns to what we view as profitable levels.

Ratings

A.M. Best assigned a current group rating of “A” (Excellent) to our domestic insurance companies. According to A.M. Best, “A” ratings are assigned to insurers that have, on balance, excellent balance sheet strength, operating performance and business profile

Table of Contents

when compared to the standards established by A.M. Best and, in A.M. Best's opinion, have a strong ability to meet their ongoing obligations to policyholders. The objective of A.M. Best's rating system is to provide potential policyholders and other interested parties an opinion of an insurer's financial strength and ability to meet ongoing obligations, including paying claims. This rating reflects A.M. Best's analysis of our balance sheet, financial position, capitalization and management. This rating is subject to periodic review and may be revised downward, upward or revoked at the sole discretion of A.M. Best. Any changes in our rating category could affect our competitive position.

Regulation

State Regulation

General

Our insurance subsidiaries are subject to regulation in all 50 states, Washington D.C. and the Cayman Islands. The extent of regulation varies by jurisdiction and generally derives from statutes that delegate regulatory, supervisory and administrative authority to a department of insurance in each jurisdiction in which the companies transact insurance business. These statutes and regulations generally require each of our insurance subsidiaries to register with the insurance department where the Company is domiciled and to furnish annually financial and other information about the operations of the Company. Certain transactions and other activities by our insurance companies must be approved by Ohio, Missouri or Cayman Islands regulatory authorities, where our active insurance company subsidiaries are domiciled, before the transaction takes place.

The regulation, supervision and administration also relate to statutory capital and reserve requirements and standards of solvency that must be met and maintained, the payment of dividends, changes of control of insurance companies, the licensing of insurers and their agents, the types of insurance that may be written, the regulation of market conduct, including underwriting and claims practices, provisions for unearned premiums, losses, LAE and other obligations, the ability to enter and exit certain insurance markets, the nature of and limitations on investments, premium rates or restrictions on the size of risks that may be insured under a single policy, privacy practices, deposits of securities for the benefit of policyholders, payment of sales compensation to third parties and the approval of policy forms and guaranty funds.

State insurance departments also conduct periodic examinations of the business affairs of our insurance companies and require us to file annual financial and other reports, prepared under statutory accounting principles, relating to the financial condition of companies and other matters. These insurance departments conduct periodic examinations of the books and records, financial reporting, policy filings and market conduct of our insurance companies doing business in their states, generally once every three to five years, although target financial, market conduct and other examinations may take place at any time. These examinations are generally carried out in cooperation with the insurance departments of other states in which our insurance companies transact insurance business under guidelines promulgated by the NAIC. Any adverse findings by insurance departments could result in significant fines and penalties, negatively affecting our profitability.

Generally, state regulators require that all material transactions among affiliated companies in our holding company system to which any of our insurance subsidiaries is a party, including sales, loans, reinsurance agreements, management agreements and service agreements, must be fair and reasonable. In addition, if the transaction is material or of a specified category, prior notice and approval (or absence of disapproval within a specified time limit) by the insurance department where the subsidiary is domiciled is required.

Statutory Accounting Principles ("SAP")

SAP is a basis of accounting developed to assist insurance regulators in monitoring and regulating the solvency of insurance companies. One of the primary goals is to measure an insurer's statutory surplus. Accordingly, statutory accounting focuses on valuing assets and liabilities of our insurance subsidiaries at financial reporting dates in accordance with appropriate insurance laws and regulatory provisions applicable in each insurer's domiciliary jurisdiction. Insurance departments utilize SAP to help determine whether our insurance companies will have sufficient funds to timely pay all the claims of our policyholders and creditors. GAAP gives more consideration to matching of revenue and expenses than SAP. As a result, assets and liabilities will differ in financial statements

prepared in accordance with GAAP as compared to SAP. Major differences for SAP include, but are not limited to, charging policy acquisition costs to expense as incurred rather than spreading the costs over the periods covered by the policies; reporting investment grade bonds and redeemable preferred stocks at amortized cost rather than fair value; netting of reinsurance recoverables and prepaid reinsurance premiums against the corresponding liabilities rather than reporting such items separately; and charging to surplus certain GAAP assets, such as furniture and fixtures and agents' balances over 90 days old.

SAP, as established by the NAIC and adopted, for the most part, by the various state insurance regulators to determine, among other things, the amount of statutory surplus and net income of our insurance subsidiaries and thus determine, in part, the amount of funds they have available to pay as dividends to us.

Table of Contents

Restrictions on Paying Dividends

State insurance laws restrict the ability of our insurance subsidiaries to declare shareholder dividends and require our insurance companies to maintain specified levels of statutory capital and surplus. The amount of an insurer's surplus following payment of any dividends must be reasonable in relation to the insurer's outstanding liabilities and adequate to meet its financial needs. Limitations on dividends are generally based on net income or statutory capital and surplus. In 2016, the maximum amount of dividends that our insurance companies can pay to us without seeking regulatory approval is \$29.6 million. National Interstate Insurance Company ("NIIC") did not pay dividends in 2015 and paid \$10.0 million in both 2014 and 2013 without the need for regulatory approval.

Assessments and Fees Payable

Virtually all states require insurers licensed to do business in their state to bear a portion of the loss suffered by insureds as a result of the insolvency of other insurers or other miscellaneous state assessments. Significant assessments could limit the ability of our insurance subsidiaries to recover such assessments through tax credits or other means. We paid assessments of \$4.4 million, \$6.9 million and \$4.2 million in the years ended December 31, 2015, 2014 and 2013, respectively. Our estimated liability for anticipated assessments was \$5.0 million and \$4.6 million at December 31, 2015 and 2014, respectively.

NAIC Risk-Based Capital ("RBC") Requirements

In order to enhance the regulation of insurer solvency, the NAIC established RBC requirements for insurance companies that are designed to assess capital adequacy and to raise the level of protection that statutory surplus provides for policy holders. These requirements measure three major areas of risk facing property and casualty insurers: (i) underwriting risks, which encompass the risk of adverse loss developments and inadequate pricing; (ii) declines in asset values arising from credit risk; and (iii) other business risks from investments. Insurers having less statutory surplus than required will be subject to varying degrees of regulatory action, depending on the level of capital inadequacy. At December 31, 2015, the capital and surplus of all of our insurance companies, which have been prepared in accordance with NAIC statutory accounting principles, substantially exceeded the RBC requirements.

Insurance Regulatory Information System ("IRIS") Ratios

The NAIC IRIS was developed by a committee of state insurance regulators and is intended primarily to assist state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies operating in their respective states. IRIS identifies 13 industry ratios and specifies "usual values" for each ratio. Departure from the usual values of the IRIS ratios can lead to inquiries from individual state insurance commissioners as to certain aspects of an insurer's business. Our insurance subsidiaries have consistently met the IRIS ratios.

Restrictions on Cancellation, Non-Renewal or Withdrawal

Many states in which we conduct business have laws and regulations that limit the ability of our insurance companies licensed in that state to exit a market, cancel policies or not renew policies. Some states prohibit us from withdrawing one or more lines of business from the state, except pursuant to a plan approved by the state insurance regulator, which may disapprove a plan that may lead to market disruption.

Federal Regulation

General

The federal government generally does not directly regulate the insurance business. However, federal legislation and administrative policies in several areas, including age and sex discrimination, consumer privacy, terrorism, federal taxation and motor-carrier safety, do affect our insurance business. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), among other things, established a Federal Insurance Office ("FIO") within the U.S. Treasury. Regulations will need to be created for the FIO to carry out its mandate to focus on systemic risk oversight. The FIO has limited regulatory authority and is empowered to gather information regarding the insurance industry and insurers. In December 2013, the FIO submitted a report to Congress recommending ways to modernize and improve the system of insurance regulation in the United States. The report concluded that a hybrid

approach to regulation, involving a combination of state and federal government action, could improve the U.S. insurance system by attaining uniformity, efficiency and consistency, particularly with respect to solvency and market conduct regulation. It is not clear to what extent, if any, the report will lead to changes to the current state-based system of insurance industry regulation or how such changes would ultimately impact our operations.

Table of Contents

The Terrorism Risk Insurance Act (“the Act”)

The Terrorism Risk Insurance Program Reauthorization Act of 2015 extended the Federal program that provides for a transparent system of shared public and private compensation for insured losses resulting from certified acts of terrorism through December 31, 2020. The Act requires commercial insurers to make terrorism coverage available for commercial property/casualty losses, including workers' compensation. Commercial auto, burglary/theft, surety, professional liability and farmowners multiple-peril are not included in the program. The "event trigger" under the Act provides that in the case of a certified act of terrorism, no federal compensation shall be paid by the Secretary of the Treasury unless aggregate industry losses exceed \$100 million. This will increase to \$120 million in 2016 and increase annually thereafter by \$20 million per year until the level of insured losses required to trigger coverage reaches \$200 million in 2020. The federal government will pay 85% of covered terrorism losses that exceed the insurer deductibles, in excess of the event trigger. Beginning on January 1, 2016, the federal government's reimbursement obligation will be reduced to 84% and will decrease annually thereafter by 1% per year until the level of reimbursement is reduced to 80%.

We are continuing to take the steps necessary to comply with the Act, as well as the state regulations implementing its provisions, by providing required notices to commercial policyholders describing coverage provided for certified acts of terrorism (as defined by the Act). We do not anticipate terrorism losses to have a material impact on our results of operations. It is possible that future legislation could modify or eliminate the program, which could adversely affect our property and casualty business through increased exposure to a catastrophic level of terrorism losses.

To our knowledge and based on our internal review and control process for compliance, we believe we have been in compliance in all material respects with the laws, rules and regulations described above.

Employees

At December 31, 2015, we employed 715 people, of which 704 are full-time employees. None of our employees are covered by collective bargaining arrangements.

ITEM 1A Risk Factors

All material risks and uncertainties currently known regarding our business operations are included in this section. If any of the following risks, or other risks and uncertainties that we have not yet identified or that we currently consider not to be material, actually occur, our business, prospects, financial condition, results of operations and cash flows could be materially and adversely affected.

Your interests as a holder of our common shares may be different than the interests of our majority shareholder, Great American, and its parent company, American Financial Group, Inc.

The interests of Great American and AFG may differ from the interests of our other shareholders. Current and former senior executives of AFG and Great American hold five out of eleven seats on our Board. As a result, AFG has the ability to exert significant influence over our policies and affairs including the power to affect the election of our Directors, appointment of our management and the approval of any action requiring a shareholder vote, such as amendments to our Amended and Restated Articles of Incorporation or Code of Regulations, transactions with affiliates, mergers or asset sales.

Subject to the terms of our right of first refusal to purchase its shares in certain circumstances, AFG may be able to influence or control matters requiring approval by our shareholders, including the election of directors and the approval of mergers, acquisitions or other extraordinary transactions. AFG may also have interests that differ from those of our other shareholders and may vote in a way with which our other shareholders disagree and which may be adverse to their interests. AFG's majority ownership may have the effect of delaying, preventing or deterring a change of control of the Company, could deprive our shareholders of an opportunity to receive a premium for their common stock as part of a sale of the Company and might ultimately affect the market price of our common stock.

Provisions in our organizational documents, Ohio corporate law and the insurance laws of Ohio and Missouri, among other states, could impede an attempt to replace or remove our management or Directors or prevent or delay a merger or sale, which could diminish the value of our common shares.

Our Amended and Restated Articles of Incorporation and Code of Regulations, the corporate laws of Ohio and the insurance laws of various states contain provisions that could impede an attempt to replace or remove our management or Directors or prevent the sale of our Company that shareholders might consider to be in their best interests. These provisions include, among others:

- a classified Board of Directors consisting of eleven Directors divided into two classes;

Table of Contents

- the inability of our shareholders to remove a Director from the Board without “cause;”
- requiring a vote of holders of 50% of the common shares to call a special meeting of the shareholders;
- requiring a two-thirds vote to amend the shareholder protection provisions of our Code of Regulations and to amend the Amended and Restated Articles of Incorporation;
- requiring the affirmative vote of a majority of the voting power of our shares represented at a special meeting of shareholders;
- excluding the voting power of interested shares to approve a “control share acquisition” under Ohio law; and
- prohibiting a merger, consolidation, combination or majority share acquisition between us and an interested shareholder or an affiliate of an interested shareholder for a period of three years from the date on which the shareholder first became an interested shareholder, unless previously approved by our Board.

These provisions may prevent shareholders from receiving the benefit of any premium over the market price of our common shares offered by a bidder in a potential takeover. In addition, the existence of these provisions may adversely affect the prevailing market price of our common shares if they are viewed as discouraging takeover attempts.

The insurance laws of most states require prior notice or regulatory approval of changes in control of an insurance company or its holding company. The insurance laws of the States of Ohio and Missouri, where our U.S. insurance companies are domiciled, provide that no corporation or other person may acquire control of a domestic insurance or reinsurance company unless it has given notice to such insurance or reinsurance company and obtained prior written approval of the relevant insurance regulatory authorities. Any purchaser of 10% or more of our aggregate outstanding voting power could become subject to these regulations and could be required to file notices and reports with the applicable regulatory authorities prior to such acquisition. In addition, the existence of these provisions may adversely affect the prevailing market price of our common shares if they are viewed as discouraging takeover attempts. For further discussion of insurance laws, see the subsection of “Business” entitled “Regulation.”

We may have conflicts of interest with our majority shareholder, Great American, and its parent company, American Financial Group, Inc., which we would be unable to resolve in our favor.

As of December 31, 2015, AFG, through its wholly-owned subsidiary Great American, owns 51.1% of our outstanding common shares. From time to time, Great American and its affiliated companies engage in underwriting activities and enter into transactions or agreements with us or in competition with us, which may give rise to conflicts of interest. We do not have any agreement or understanding with any of these parties regarding the resolution of potential conflicts of interest. In addition, we may not be in a position to influence any party’s decision not to engage in activities that would give rise to a conflict of interest. These parties may take actions that are not in the best interests of our other shareholders.

We rely on services provided by Great American, and if Great American no longer controlled a majority of our shares, our operating expenses could increase significantly.

We rely on Great American to provide certain services to us without charge including actuarial and consultative services for legal, accounting and internal audit and other support services. If Great American no longer controlled a majority of our shares, it is possible that many of these services would cease or, alternatively, be provided at an increased cost to us. This could impact our personnel resources, require us to hire additional professional staff and generally increase our operating expenses.

Because we are primarily a transportation insurer, conditions in that industry could adversely affect our business. Approximately 90% of our gross premiums written for the years ended December 31, 2015 and 2014 were generated from transportation insurance policies, including ART programs for transportation companies. Adverse developments in the market for transportation insurance, including those which could result from potential declines in commercial and economic activity, could cause our results of operations to suffer. The transportation insurance industry is cyclical. Historically, the industry has been characterized by periods of price competition and excess capacity followed by periods of high premium rates and shortages of underwriting capacity. These downward fluctuations in the business cycle have and could continue to negatively impact our revenues.

Additionally, our results may be affected by risks that impact the transportation industry related to severe weather conditions, as well as explosions, terrorist attacks and riots. Our transportation insurance business also may be affected by cost trends that negatively impact profitability, such as an economic downturn, inflation in vehicle repair costs, vehicle replacement parts costs, used vehicle prices, fuel costs and medical care costs. Increased costs related to the handling and litigation of claims may also negatively impact our profitability.

Table of Contents

If our claims payments and related expenses exceed our reserves, our financial condition and results of operations could be adversely affected.

Our success depends upon our ability to accurately assess and price the risks covered by the insurance policies that we write. We establish reserves to cover our estimated liability for the payment of all losses and LAE incurred with respect to premiums earned on the insurance policies that we write. Reserves do not represent an exact calculation of liability. Rather, reserves are estimates of our expectations regarding the ultimate cost of resolution and administration of claims under the insurance policies that we write. These estimates are based upon multiple factors including, but not limited to, actuarial and statistical projections, assessments of currently available data, historical claims information, as well as estimates and assumptions regarding future trends in claims severity and frequency, judicial theories of liability and other factors. We continually refine our reserve estimates in an ongoing process as experience develops and claims are reported and settled. Each year, our reserves are certified by an accredited actuary from Great American.

Establishing an appropriate level of reserves is an inherently uncertain process. The following factors may have a substantial impact on our future actual losses and LAE experience:

- the amount of claims payments;
- the expenses that we incur in resolving claims;
- legislative and judicial developments; and
- changes in economic conditions, including the effect of inflation.

Unfavorable development in any of these factors could cause our level of reserves to be inadequate. To the extent that actual losses and LAE exceed expectations and the reserves reflected on our financial statements, we will be required to immediately reflect those changes by increasing reserves. When we increase reserves, the pre-tax income for the period in which we do so will decrease by a corresponding amount. In addition to having a negative effect on pre-tax income, increasing or “strengthening” reserves causes a reduction in our insurance companies’ surplus and could cause a downgrading of the rating of our insurance company subsidiaries. Such a downgrade could, in turn, adversely affect our ability to sell insurance policies.

If we expand our operations too rapidly and do not manage that expansion effectively, our financial performance and stock price could be adversely affected.

We intend to grow by developing new products, expanding into new product lines and expanding our insurance distribution network. Continued growth could impose significant demands on our management, including the need to identify, recruit, maintain and integrate additional employees. Our historical growth rates may not accurately reflect our future growth rates or our growth potential. We may experience higher than anticipated indemnity losses arising from new and expanded insurance products. In addition, our systems, procedures and internal controls may not be adequate to support our operations as they expand.

In addition to these organic growth strategies, we regularly explore opportunities to acquire other companies or selected books of business. Upon the announcement of an acquisition, our stock price may fall depending on the size of the acquisition, the purchase price and the potential dilution to existing shareholders depending upon the financial structure of the acquisition. It is also possible that an acquisition could dilute earnings per share.

If we grow through acquisitions, we could have difficulty in integrating an acquired company, which may cause us not to realize expected revenue increases, cost savings, increases in geographic or product presence, and other projected benefits from the acquisition. The integration could result in the loss of key employees, disruption of our business or the business of the acquired company, or otherwise harm our ability to retain customers and employees or achieve the anticipated benefits of the acquisition. Time and resources spent on integration may also impair our ability to grow our existing businesses. Also, the negative effect of any financial commitments required by regulatory authorities or rating agencies in acquisitions or business combinations may be greater than expected.

Any failure by us to manage our growth effectively could have a material adverse effect on our business, financial condition or results of operations.

Table of Contents

If we are not able to attract and retain independent agents and brokers, our revenues could be negatively affected. We compete with other insurance carriers to attract and retain business from independent agents and brokers. Some of our competitors offer independent agents and brokers a larger variety of products, lower prices for insurance coverage or higher commissions than we offer. Our top ten independent agents/brokers accounted for an aggregate of 30.1% of our gross premiums written, and our top two independent agents/brokers accounted for an aggregate of 13.5% of our gross premiums written during the year ended December 31, 2015. If we are unable to attract and retain independent agents/brokers to sell our products, our ability to compete and attract new customers and our revenues would suffer. Our growth strategy includes expanding into product lines in which we have limited experience. We are continually evaluating new products to add to our business mix. In some instances, we have limited experience with marketing and managing these new products and insuring the types of risks involved. Our failure to effectively analyze new underwriting risks, set adequate premium rates and establish reserves for these new products or efficiently adjust claims arising from these new products could have a material adverse effect on our business, financial condition or results of operations. During the start up period for new products, we generally set more conservative loss reserves in recognition of the inherent risk. This could adversely affect our statutory capital, net income and ability to pay dividends.

We are currently rated “A” (Excellent) by A.M. Best, which is its third highest rating out of 16 rating categories. A decline in our rating below “A-” could adversely affect our position in the insurance market, make it more difficult to market our insurance products and cause our premiums and earnings to decrease.

Financial ratings are an important factor influencing the competitive position of insurance companies. A.M. Best ratings, which are commonly used in the insurance industry, currently range from “A++” (Superior) to “F” (In Liquidation). The objective of A.M. Best’s rating system is to provide potential policyholders and other interested parties an opinion of an insurer’s financial strength and ability to meet ongoing obligations, including paying claims. This rating reflects A.M. Best’s analysis of our balance sheet, financial position, capitalization and management. It is not an evaluation of an investment in our common shares, nor is it directed to investors in our common shares and is not a recommendation to buy, sell or hold our common shares. This rating is subject to periodic review and may be revised downward, upward or revoked at the sole discretion of A.M. Best.

If our rating is reduced by A.M. Best below an “A-”, we believe that our competitive position in the insurance industry could suffer, and it could be more difficult for us to market our insurance products. A downgrade could result in a significant reduction in the number of insurance contracts we write and in a substantial loss of business to other competitors with higher ratings, causing premiums and earnings to decrease.

We may experience difficulties with technology or network security, which could have an adverse effect on our financial condition or reputation.

We rely on computer systems to process, transmit, store, retrieve and evaluate company and customer data and information. Systems failures, outages or breaches could compromise our ability to perform business functions in a timely manner, which could harm our ability to conduct business and hurt our relationships with business partners and customers. In the event of a natural disaster, a computer virus, a terrorist attack, war or other disruption inside or outside the United States, our systems may be inaccessible to employees, customers or business partners for an extended period of time. Even if our employees are able to work, they may be unable to perform their duties if our data or systems are disabled or destroyed.

Despite our security measures, our information technology and infrastructure are vulnerable to security breaches such as cyber-attacks, viruses, malware, hackers and other external hazards, equipment and system failures, employee misconduct, as well as inadvertent errors. Our administrative and technical controls, as well as other preventative actions to reduce the risk of such incidents and protect our information, may be insufficient to detect or prevent unauthorized access, other physical and electronic break-ins, cyber-attacks or other security breaches to our computer systems or those of third parties with whom we do business.

The increased risk identified above could expose us to data loss, disruption of service, monetary and reputational damage and significant increases in compliance costs and costs to improve the security and resiliency of our computer systems. The compromise of personal, confidential or proprietary information could also subject us to legal liability or

regulatory action under evolving cyber-security, data protection and privacy laws and regulations enacted by the U.S. federal and state governments or other jurisdictions or by various regulatory organizations or exchanges. As a result, our ability to conduct our business and our results of operations might be materially and adversely affected.

Table of Contents

Market fluctuations, changes in interest rates or a need to generate liquidity can have significant and negative effects on our investment portfolio.

Our results of operations depend in part on the performance of our invested assets. As of December 31, 2015, 89.0% of our investment portfolio (excluding cash and cash equivalents) was invested in fixed maturities, 6.9% was invested in equity securities and 4.1% was invested in other invested assets. As of December 31, 2015, approximately 30.1% of our fixed maturity portfolio was invested in state and local government obligations and approximately 91.2% of our fixed maturities were rated "investment grade" (credit rating of AAA to BBB-) by S&P or another nationally recognized rating agency.

Investment returns are an important part of our overall profitability. We cannot predict which industry sectors in which we maintain investments may suffer losses as a result of potential declines in commercial and economic activity, or how any such decline might impact the ability of companies within the affected industry sectors to pay interest or principal on their securities and we cannot predict how or to what extent the value of any underlying collateral might be affected. During 2015, higher interest rates and wider credit spreads in the financial markets caused a decrease in the fair value of our holdings. Adverse fluctuations in the fixed income or equity markets could adversely impact our profitability, financial condition or cash flows.

Historically, we have not had the need to sell our investments to generate liquidity. If we were forced to sell portfolio securities that have unrealized losses for liquidity purposes rather than holding them to maturity or recovery, we would recognize investment losses on those securities when that determination was made.

Future sales of our common shares may affect the trading price of our common shares.

We cannot predict what effect, if any, future sales of our common shares or the availability of common shares for future sale will have on the trading price of our common shares. Sales of substantial amounts of our common shares in the public market by Great American or our other shareholders, or the possibility or perception that such sales could occur, could adversely affect prevailing market prices for our common shares. If such sales reduce the market price of our common shares, our ability to raise additional capital in the equity markets may be adversely affected.

In 2005, we filed a registration statement on Form S-8 under the Securities Act to register 1,338,800 common shares issued or reserved for issuance for awards granted under our Long Term Incentive Plan ("LTIP"). In 2013, we registered an additional 500,000 common shares issued or reserved for issuance for awards granted under our LTIP on registration statement Form S-8. Shares registered under the registration statement on Form S-8 also could be sold into the public markets, subject to applicable vesting provisions and any volume limitations and other restrictions applicable to our officers and Directors selling shares under Rule 144. The sale of the shares under these registration statements in the public market, or the possibility or perception that such sales could occur, could adversely affect prevailing market prices for our common shares.

We may not be successful in reducing our risk and increasing our underwriting capacity through reinsurance arrangements, which could adversely affect our business, financial condition and results of operations.

In order to reduce our underwriting risk, primarily for our excess coverage and catastrophic exposures, we transfer portions of our insurance risk to other insurers through reinsurance contracts. Ceded premiums written amounted to 16.5% of our gross premiums written for both the years ended December 31, 2015 and 2014. The availability, cost and structure of reinsurance protection are subject to prevailing market conditions that are outside of our control and may affect our level of business and profitability. We continually assess our own risk retention, and may increase or decrease our reinsurance participation based on availability and cost. In order for these contracts to qualify for reinsurance accounting and to provide the additional underwriting capacity that we desire, the reinsurer must assume appropriate risk and have a reasonable possibility of experiencing a significant loss. Our reinsurance facilities are subject to ongoing review and most have annual renewal terms. At times, we may be unable to maintain our current reinsurance facilities or obtain reinsurance facilities in adequate amounts and at competitive rates. If we are unable to renew our expiring facilities or obtain new reinsurance facilities, either our net exposure to risk would increase or, if we are unwilling to bear an increase in net risk exposures, we would have to reduce the amount of risk we underwrite which could adversely impact our results of operations.

Table of Contents

As a holding company, we are dependent on the results of operations of our insurance company subsidiaries to meet our obligations and pay future dividends.

We are a holding company and a legal entity separate and distinct from our insurance company subsidiaries. As a holding company without significant operations of our own, one of our sources of funds are dividends and other distributions from our insurance company subsidiaries. As discussed under the subsection of “Business” entitled “Regulation,” statutory and regulatory restrictions limit the aggregate amount of dividends or other distributions that our insurance subsidiaries may declare or pay within any twelve-month period without advance regulatory approval and require insurance companies to maintain specified levels of statutory capital and surplus. Insurance regulators have broad powers to prevent reduction of statutory capital and surplus to inadequate levels and could refuse to permit the payment of dividends calculated under any applicable formula. As a result, we may not be able to receive dividends from our insurance subsidiaries at times and in amounts necessary to meet our operating needs, to pay dividends to our shareholders or to pay corporate expenses.

We are subject to credit risk with respect to the obligations of our reinsurers and certain of our insureds. The inability of our risk sharing partners to meet their obligations could adversely affect our profitability.

Although the reinsurer is liable to us to the extent of risk ceded by us, we remain ultimately liable to the policyholder on all risks, even those reinsured. As a result, ceded reinsurance arrangements do not limit our ultimate obligations to policyholders to pay claims. We are subject to credit risks with respect to the financial strength of our reinsurers. We are also subject to the risk that our reinsurers may dispute their obligations to pay our claims. As a result, we may not recover sufficient amounts for claims that we submit to our reinsurers in a timely manner, if at all. As of December 31, 2015, we had a total of \$152.7 million of unsecured reinsurance recoverables. In addition, our reinsurance agreements are subject to specified limits and we would not have reinsurance coverage to the extent that we exceed those limits.

With respect to our insurance programs, we are subject to credit risk with regards to the payment of claims and on the portion of risk exposure either ceded to the ART participants or retained by our clients. The credit worthiness of prospective risk sharing partners is a factor we consider when entering into or renewing these ART programs. We typically collateralize balances due through funds withheld, letters of credit or trust agreements. To date, we have not, in the aggregate, experienced material difficulties in collecting balances from our risk sharing partners. These entities may be unable to meet their obligations in the future. The inability of our risk sharing partners to meet their obligations could adversely affect our profitability.

We may not have access to capital in the future due to an economic downturn.

We may need new or additional financing in the future to conduct our operations, expand our business or refinance existing indebtedness. Any sustained weakness in the general economic conditions and/or financial markets in the United States or globally could adversely affect our ability to raise capital on favorable terms or at all. We may rely in the future, on access to financial markets as a source of liquidity for operations, acquisitions and general corporate purposes. Our continued access to funds under our \$100 million unsecured Credit Agreement (“Credit Agreement”) is dependent in part on the ability of the financial institutions that are parties to the facility to meet their funding commitments. Those financial institutions may not be able to meet their funding commitments if they experience shortages of capital and liquidity or if they experience excessive volumes of borrowing requests within a short period of time.

New claim and coverage issues are continually emerging in the insurance industry and these new issues could negatively impact our revenues, our business operations or our reputation.

As insurance industry practices and regulatory, judicial and industry conditions change, unexpected and unintended issues related to pricing, claims, coverage and business practices may emerge. Plaintiffs often target property and casualty insurers in purported class action litigation relating to claims handling and insurance sales practices. The resolution and implications of new underwriting, claims and coverage issues could have a negative effect on our insurance business by extending coverage beyond our underwriting intent, increasing the size of claims or otherwise requiring us to change our business practices. The effects of unforeseen emerging claim and coverage issues could negatively impact our revenues, results of operations and our reputation.

The effects of litigation on our business are uncertain.

The outcome of any litigation is inherently uncertain. We may become subject to material litigation in the future, or any litigation may damage our reputation, which could have a negative impact on our business.

Table of Contents

Our inability to retain our senior executives and other key personnel could adversely affect our business. Our success depends, in part, upon the ability of our executive management and other key personnel to implement our business strategy and on our ability to attract and retain qualified employees. On December 21, 2015 we announced that our Board of Directors appointed Anthony (Tony) J. Mercurio, currently our President and Chief Operating Officer, as President and Chief Executive Officer, effective May 5, 2016 (the “Transition Date”). Mr. Mercurio will succeed David W. Michelson, who has served as our Chief Executive Officer since January 1, 2008. Effective as of the Transition Date, Mr. Michelson will retire from his position as Chief Executive Officer and will become a Senior Advisor to the Company to ensure an orderly transition of the Company’s management team. Our inability to effectuate a successful transition, the loss of other senior executives or our failure to attract and develop talented new executives and managers could adversely affect our business and the market price for our common shares.

We are subject to comprehensive regulation and our ability to earn profits may be restricted by these regulations. We are subject to comprehensive regulation by government agencies in the states and foreign jurisdictions where our active insurance company subsidiaries are domiciled and, to a lesser degree, where these subsidiaries issue policies and handle claims. Failure by one of our insurance company subsidiaries to meet regulatory requirements could subject us to regulatory action. The regulations and associated examinations may have the effect of limiting our liquidity and may adversely affect results of operations.

In addition, state insurance department examiners perform periodic financial, market conduct and other examinations of insurance companies. Compliance with applicable laws and regulations is time consuming and personnel-intensive. In addition to financial examinations, we are subject to market conduct examinations of our claims and underwriting practices. Any adverse findings by insurance departments could result in significant fines and penalties, negatively affecting our profitability.

The federal government generally does not directly regulate the insurance business. However, federal legislation and administrative policies in several areas, including age and sex discrimination, consumer privacy, terrorism, federal taxation and motor-carrier safety, do affect our insurance business. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), among other things, established a Federal Insurance Office (“FIO”) within the U.S. Treasury. Regulations will need to be created for the FIO to carry out its mandate to focus on systemic risk oversight. The FIO has limited regulatory authority and is empowered to gather information regarding the insurance industry and insurers. In December 2013, the FIO submitted a report to Congress recommending ways to modernize and improve the system of insurance regulation in the United States. The report concluded that a hybrid approach to regulation, involving a combination of state and federal government action, could improve the U.S. insurance system by attaining uniformity, efficiency and consistency, particularly with respect to solvency and market conduct regulation. It is not clear to what extent, if any, the report will lead to changes to the current state-based system of insurance industry regulation or how such changes would ultimately impact our operations.

Existing insurance-related laws and regulations may become more restrictive in the future or new or more restrictive regulation, including changes in current tax or other regulatory interpretations affecting the ART insurance model, could make it more expensive for us to conduct our business, restrict the premiums we are able to charge or otherwise change the way we do business. For a further discussion of the regulatory framework in which we operate, see the subsection of “Business” entitled “Regulation.”

We face competition from companies with greater financial resources, broader product lines, higher ratings and stronger financial performance than us, which may impair our ability to retain existing customers, attract new customers and maintain our profitability and financial strength.

The commercial transportation insurance business is highly competitive and, except for regulatory considerations, there are relatively few barriers to entry. Many of our competitors are substantially larger and may enjoy better name recognition, substantially greater financial resources, higher ratings by rating agencies, broader and more diversified product lines and more widespread agency relationships than we do. We compete with large national underwriters and smaller niche insurance companies. In particular, in the commercial specialty insurance market we compete against, among others, Lancer Insurance Company, RLI Corporation, Great West Casualty Company (a subsidiary of Old Republic International Corporation), Northland Insurance Company (a subsidiary of the Travelers Companies, Inc.),

Sentry Insurance, Liberty Mutual Insurance Company and American International Group, Inc. In our specialty personal lines our primary competitors are Progressive Corporation, Nationwide Insurance Company, and National General Insurance, and in our Hawaii and Alaska markets, our primary competitors are Island Insurance Company, Liberty Mutual Insurance Company, First Insurance, Dongbu Insurance Company, DTRIC Insurance Company, Alaska National Insurance Company, Berkshire Hathaway, Umialik Insurance Company and Zurich Insurance Company. In the moving and storage market we compete against, among others, American International Group, Inc., Travelers Company, Inc., AmTrust Financial Services, Inc. and Transguard Insurance Company of America. Our underwriting profits could be adversely impacted if new entrants or existing competitors try to compete with our products, services and programs or offer similar or better products at or below our prices.

Table of Contents

We have continued to develop ART programs, attracting new customers as well as transitioning existing traditional customers into these programs. Our ART component constituted approximately 56.7% of our gross premiums written for the year ended December 31, 2015 and 54.3% of our gross written premiums for the same period in 2014. We are subject to ongoing competition for both the individual customers and entire programs. The departure of an entire program due to competition could adversely affect our results.

Changing climate conditions, including legal, regulatory and social responses thereto, may have a negative effect on our business.

Various scientists, environmentalists, international organizations, regulators and other commentators believe that global climate change has added, and will continue to add, to the unpredictability, frequency and severity of natural disasters (including, but not limited to, hurricanes, tornadoes, freezes, large or significant storms and fires) in certain parts of the world. In response, a number of legal and regulatory measures and social initiatives have been introduced in an effort to reduce greenhouse gas and other carbon emissions that may be chief contributors to global climate change.

We cannot predict the impact that changing climate conditions, if any, will have on us or our customers. However, it is possible that the legal, regulatory and social responses to climate change could have a negative effect on our results of operations or our financial condition.

ITEM 1B Unresolved Staff Comments

None.

ITEM 2 Properties

We own two adjacent buildings that house our corporate headquarters and the surrounding real estate located in Richfield, Ohio. The buildings consist of approximately 164,000 square feet of rentable office space on 17.5 acres. We occupy approximately 143,000 square feet and lease the remainder to unaffiliated tenants.

We lease office space in Fenton, Missouri and Kapolei, Hawaii. The leases account for approximately 47,000 square feet of office space. These leases expire within thirty-one months. The monthly rents, exclusive of operating expenses, to lease these facilities currently total approximately \$84,000. We believe that these leases could be renewed or replaced at commercially reasonable rates without material disruption to our business.

ITEM 3 Legal Proceedings

We 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 our loss and LAE reserves. In addition, regulatory bodies, such as state insurance departments, the SEC, the Department of Labor and other regulatory bodies may make inquiries and conduct examinations or investigations concerning our compliance with insurance laws, securities laws, labor laws and the Employee Retirement Income Security Act of 1974, as amended.

Our insurance companies also have lawsuits pending in which the plaintiff seeks extra-contractual damages from us 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 we are vigorously defending these lawsuits, the outcomes of these cases cannot be determined at this time. We have established loss and LAE reserves for lawsuits as to which we have determined that a loss is both probable and estimable. In addition to these case reserves, we also establish reserves for claims incurred but not reported to cover unknown exposures and adverse development on known exposures. Based on currently available information, we believe that our reserves for these lawsuits are reasonable and that the amounts reserved did not have a material effect on our financial condition or results of operations. However, if any one or more of these cases results in a judgment against or settlement by us for an amount that is significantly greater than the amount so reserved, the resulting liability could have a material effect on our financial condition, cash flows and results of operations.

ITEM 4 Mine Safety Disclosures

None.

23

Table of Contents

PART II

ITEM 5 Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common shares are listed and traded on the Nasdaq Global Select Market under the symbol “NATL.” The information presented in the table below represents the high and low sales prices per share reported on the NASDAQ for the periods indicated.

	2015		2014	
	High	Low	High	Low
First Quarter	\$30.49	\$24.60	\$32.66	\$21.18
Second Quarter	29.25	25.20	29.25	26.52
Third Quarter	28.60	24.78	28.85	25.60
Fourth Quarter	30.40	25.99	30.54	26.49

There were approximately 65 shareholders of record of our common shares on March 4, 2016.

Dividend Policy

The Board has instituted a policy authorizing us to pay quarterly dividends on our common shares in an amount to be determined at each quarterly Board of Directors meeting. The Board recently announced its intention to increase the quarterly dividend to \$0.14 per share for 2016. The Board intends to continue to review our dividend policy annually during each regularly scheduled first quarter meeting, with the anticipation of considering annual dividend increases. We declared and paid quarterly dividends of \$0.13 and \$0.12 per common share in 2015 and 2014, respectively. The declaration and payment of dividends remains subject to the discretion of the Board, and will depend on, among other things, our financial condition, results of operations, capital and cash requirements, future prospects, regulatory and contractual restrictions on the payment of dividends by insurance company subsidiaries and other factors deemed relevant by the Board. In addition, our ability to pay dividends would be restricted in the event of a default on our unsecured Credit Agreement, our failure to make payment obligations with respect to such agreement or our election to defer interest payments on the agreement.

We are a holding company without significant operations of our own. Our principal sources of funds are dividends and other distributions from our subsidiaries including our insurance company subsidiaries. Our ability to receive dividends from our insurance company subsidiaries is also subject to limits under applicable state insurance laws.

Table of Contents

Performance Graph

The following graph shows the percentage change in cumulative total shareholder return on our common shares measured by dividing (i) the sum of (A) the cumulative amount of dividends, assuming dividend reinvestment during the periods presented and (B) the difference between our share price at the end and the beginning of the periods presented by (ii) the share price at the beginning of the periods presented. The graph demonstrates our cumulative five-year total returns compared to those of the Center for Research in Security Prices (“CRSP”) Total Return Index for Nasdaq and the CRSP Total Return Index for Nasdaq Insurance Stocks assuming a \$100 investment at the close of trading on the last trading day preceding the first day of the fifth preceding fiscal year, or December 31, 2010 (\$21.41) through December 31, 2015 (\$26.70).

Cumulative 5-Year Total Return as of December 31, 2015
(Assumes a \$100 investment at the close of trading on December 31, 2010)

Company/Index	2010	2011	2012	2013	2014	2015
NATL Common Stock	\$100	\$117	\$150	\$122	\$160	\$146
Nasdaq Insurance Stocks	100	91	108	153	174	173
Nasdaq Index	100	100	117	156	175	176

Table of Contents

ITEM 6 Selected Financial Data

The following table sets forth selected consolidated financial information for the periods ended and as of the dates indicated. These historical results are not necessarily indicative of the results to be expected from any future period. You should read this selected consolidated financial data together with our consolidated financial statements and the related notes and the section of this Form 10-K entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations."

	At and for the Year Ended December 31,					
	2015	2014	2013	2012	2011	
	(Dollars in thousands, except per share data)					
Operating Data:						
Gross premiums written(1)	\$727,119	\$689,003	\$631,993	\$573,470	\$526,313	
Net premiums written(2)	\$607,426	\$575,574	\$537,604	\$492,215	\$442,200	
Premiums earned	\$585,787	\$557,267	\$525,710	\$458,049	\$429,946	
Net investment income	39,739	35,517	33,377	34,927	30,554	
Net realized (losses) gains on investments	(3,278)	6,758	6,536	6,219	4,477	
Other	3,477	3,399	3,303	3,278	3,541	
Total revenues	625,725	602,941	568,926	502,473	468,518	
Losses and loss adjustment expenses	471,940	466,998	429,556	341,008	308,357	
Commissions and other underwriting expenses	94,075	94,430	92,193	89,917	87,860	
Other operating and general expenses	25,569	20,955	19,722	19,151	17,432	
Transaction expenses	—	2,163	—	—	—	
Expense on amounts withheld(3)	6,458	6,410	5,057	3,953	3,910	
Interest expense	199	220	706	615	298	
Total expenses	598,241	591,176	547,234	454,644	417,857	
Income before income taxes	27,484	11,765	21,692	47,829	50,661	
Provision for income taxes	6,637	739	4,119	13,535	15,113	
Net income	\$20,847	\$11,026	\$17,573	\$34,294	\$35,548	
Selected GAAP Ratios:						
Losses and loss adjustment expense ratio(4)	80.6	% 83.8	% 81.7	% 74.4	% 71.7	%
Underwriting expense ratio(5)	19.8	% 20.1	% 20.7	% 23.1	% 23.7	%
Combined ratio(6)	100.4	% 103.9	% 102.4	% 97.5	% 95.4	%
Return on equity(7)	5.8	% 3.1	% 5.0	% 9.8	% 10.8	%
Per Share Data:						
Earnings per common share, basic	\$1.05	\$0.56	\$0.89	\$1.76	\$1.84	
Earnings per common share, assuming dilution	1.05	0.56	0.89	1.75	1.82	
Book value per common share, basic (at year end)(8)	\$18.03	\$18.29	\$17.92	\$18.07	\$17.99	
Weighted average number of common shares outstanding, basic	19,862	19,755	19,645	19,446	19,371	
Weighted average number of common shares outstanding, diluted	19,910	19,833	19,768	19,579	19,491	
Common shares outstanding (at year end)	19,909	19,793	19,661	19,591	19,398	

Edgar Filing: National Interstate CORP - Form 10-K

Cash dividends per common share	\$0.52	\$0.48	\$0.44	\$2.40	\$0.36
---------------------------------	--------	--------	--------	--------	--------

26

Table of Contents

	At December 31,					
	2015	2014	2013	2012	2011	
Balance Sheet Data:						
Cash and investments	\$1,252,452	\$1,160,343	\$1,075,428	\$1,054,792	\$1,021,104	
Reinsurance recoverables	230,346	180,332	169,210	174,345	199,081	
Total assets	1,935,882	1,754,733	1,623,827	1,570,224	1,523,378	
Unpaid losses and loss adjustment expenses	1,014,195	883,078	803,782	775,305	776,576	
Long-term debt	12,000	12,000	12,000	12,000	22,000	
Total shareholders' equity	358,897	362,089	352,284	353,948	348,899	
	At and for the Year Ended December 31,					
	2015	2014	2013	2012	2011	
Selected Statutory Data(9):						
Policyholder surplus(10)	\$295,596	\$284,680	\$283,419	\$269,696	\$293,614	
Combined ratio(11)	102.6	% 104.9	% 99.4	% 92.6	% 94.7	%

- (1) The sum of premiums written on insurance policies issued by us and premiums assumed by us on policies written by other insurance companies.
- (2) Gross premiums written less premiums ceded to reinsurance companies.
- We invest funds in the participant loss layer for several of the ART programs. We receive 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 our "Net investment income" and "Net realized (losses) gains on investments" lines, respectively, on our Consolidated Statements of Income.
- (3) 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 our "Net investment income" and "Net realized (losses) gains on investments" lines, respectively, on our Consolidated Statements of Income.
- (4) The ratio of losses and LAE to premiums earned.
- (5) The ratio of the net of the sum of commissions and other underwriting expenses, other operating and general expenses less other income to premiums earned.
- (6) The sum of the loss and LAE ratio and the underwriting expense ratio.
- (7) The ratio of net income to the average of the shareholders' equity at the beginning and end of the year.
- (8) Book value per common share is computed using only unrestricted outstanding common shares. As of December 31, 2015 and 2014 total unrestricted common shares were 19,909,000 and 19,793,000, respectively. While financial data is reported in accordance with U.S. generally accepted accounting principles ("GAAP") for shareholder and other investment purposes, it is reported on a statutory basis for insurance regulatory purposes. Certain statutory expenses differ from amounts reported under GAAP. Specifically, under GAAP, premium taxes and other variable costs incurred in connection with writing new and renewal business are capitalized and amortized on a pro rata basis over the period in which the related premiums are earned. On a statutory basis, these items are expensed as incurred. In addition, certain other expenses, such as those related to the expensing or amortization of computer software, are accounted for differently for statutory purposes than the treatment accorded under GAAP.
- The statutory policyholder surplus of National Interstate Insurance Company ("NIIC"), which includes the
- (10) statutory policyholder surplus of its subsidiaries, Vanliner Insurance Company, National Interstate Insurance Company of Hawaii, Inc. and Triumpher Casualty Company.
- Statutory combined ratio of NIIC represents the sum of the following ratios: (1) losses and LAE incurred as a
- (11) percentage of net earned premium and (2) underwriting expenses incurred as a percentage of net written premiums.

Table of Contents

ITEM 7 Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our historical consolidated financial statements should be read in conjunction with our audited consolidated financial statements and the related notes included in this Form 10-K.

Overview

We are a holding company with operations being conducted by our subsidiaries.

Our specialty property and casualty insurance companies are licensed in all 50 states, the District of Columbia and the Cayman Islands. Our goal is to generate underwriting profits by providing what we view as specialty insurance products, services and programs not generally available in the marketplace. While many companies write property and casualty insurance for transportation companies, we believe that few write passenger transportation coverage nationwide and very few write coverage for several of the classes of passenger transportation insurance written by our subsidiaries. We focus on niche insurance markets where we offer insurance products designed to meet the unique needs of targeted insurance buyers that we believe are underserved by the insurance industry. These niche markets typically possess what we view as barriers to entry, such as being too small, too remote or too difficult to attract or sustain most competitors. Examples of products that we write for these markets include captive programs for transportation companies that we refer to as our alternative risk transfer ("ART") programs (56.7% of 2015 gross premiums written), property and casualty insurance for transportation companies (32.6%), specialty personal lines, primarily recreational vehicle (4.9%) and transportation and general commercial insurance in Hawaii and Alaska (3.1%). We strive to become a market leader in the specialty markets that we choose and serve by offering what we believe are specialized products, excellent customer service and superior claims response.

We write commercial insurance for various sizes of transportation fleets. Because of the number of smaller fleets nationwide, we have more opportunities to write smaller risks than larger ones. When general economic conditions improve, entrepreneurs are encouraged to start new transportation companies, which typically commence operations as a smaller risk and a potential traditional insurance customer for us. During periods of economic downturn, smaller risks are more prone to failure due to a decrease in leisure travel and consolidation in the industry. An increase in the number of larger risks results in more prospective ART insurance customers. We generally do not believe that smaller fleets that generate annual premiums of less than \$75 thousand are large enough to retain the risks associated with participation in one of the ART programs we currently offer.

By offering insurance products to all sizes of risks, we believe we have hedged against the possibility that there will be a reduction in demand for the products we offer. We believe that we will continue to have opportunities to grow and profit with both traditional and ART customers based on our assumptions regarding future economic and competitive conditions. We generally incur low start-up costs when we enter new product niches, typically less than \$0.5 million incurred over several quarters. We believe our flexible processes and scalable systems, along with controlled increase of businesses, allow us to manage costs and match them with the revenue flow.

The factors that impact our growth rate are consistent across all products. However, the trends impacting each of these factors may vary for individual products. Those factors are as follows:

Submissions

The increase or decrease in the number of new applications we receive. This is influenced by the effectiveness of our marketing activities compared to the marketing activities of our competitors in each market.

The change in the number of current policyholders that are available for a renewal quote. The number of policyholders available for renewal changes based upon the economic conditions impacting our customer groups and the extent of consolidation that may be taking place within the industries we support.

Quotes

The change in the percentage of the new applications received that do not receive a quote from us. We do not quote risks that do not meet our risk selection criteria or for which we have not been provided complete application data. We refer to this ratio as the "declination ratio" and an increasing declination ratio usually results in reduced opportunities to write new business.

Sales

The change in percentage of the quotes we issue that are actually sold. We refer to this ratio as the “hit ratio.” Hit ratios are affected by the number of competitors, the prices quoted by these competitors and the degree of difference between the competitors’ pricing, terms and conditions and ours.

28

Table of Contents

Rates

The change in our rate structure from period to period. The rates we file and quote are impacted by several factors including: the cost and extent of the reinsurance we purchase; our operating efficiencies; our average loss costs, which reflect the effectiveness of our underwriting; our underwriting profit expectations; and our claims adjusting processes. The difference between our rates and the rates of our competitors is a primary factor impacting the revenue growth of our established product lines.

Product Offerings and Distribution

We operate in multiple markets with multiple distribution approaches to attempt to reduce the probability that an adverse competitive response in any single market will have a significant impact on our overall business. We also attempt to maintain several new products, product line extensions or product distribution approaches in active development status so we are able to take advantage of market opportunities. We select from potential new product ideas based on our stated new business criteria and the anticipated competitive response.

Industry and Trends

The property/casualty (“P/C”) insurance industry is cyclical, with periods of rising premium rates and shortages of underwriting capacity (“hard market”) followed by periods of substantial price competition and excess capacity (“soft market”). Despite several years of sustained improvement in premiums written, the P/C insurance industry experienced a slower pace of premium growth in 2015 as market competition continues to place downward pressure on rates, specifically for high quality large commercial accounts. According to A.M. Best, the P/C insurance industry is expected to report its third consecutive year of underwriting profit in 2015 as lower catastrophic events have contributed positively to this segment's sustained profitability. These results are despite deterioration in the overall industry combined ratio as rate increases continue to moderate and the level of favorable development of prior years' loss reserves decline. While remaining profitable, overall operating results for the P/C insurance industry are also expected to reflect lower investment yields. However, the industry's invested asset base continues to grow and slightly offsets the impact of lower reinvestment yields. The industry is also experiencing lower realized capital gains, especially in the fourth quarter, in light of poor performance in the equity markets late in 2015.

The industry's commercial auto liability line of business continued to have unfavorable results compared to the P/C insurance industry as a whole. Contributing to these results are increased levels of loss frequency and severity, as well as adverse prior year reserve development. Loss cost trends have also increased due in part to accelerating medical inflation, fraudulent activity, litigation costs and a shortage of qualified drivers coupled with an aging workforce. However, in contrast to most other commercial lines, commercial auto rates increased during 2015 as a result of recent negative loss trends. The outlook for the industry's commercial auto liability line of business continues to face several unfavorable trends in the coming years such as, but not limited to, continued competitive market conditions, a moderation in price increases on renewal business, loss ratios that are expected to remain elevated due to increased frequency and severity, potential unfavorable development on prior year loss and LAE reserves and the effect of industry consolidation on this line of business.

The workers' compensation line of business has also lagged the P/C insurance industry as a whole despite improved performance in 2014 and 2015. The industry expects deterioration in this line of business as competition has put pressure on rate levels, which have decelerated in recent periods and have mostly offset exposure growth, and loss cost trends have continued to increase and outpace inflation. Additionally, according to A.M. Best, the workers' compensation line of business is estimated to have the largest reserve deficiency amongst all lines in the P/C industry in 2015. The outlook for the workers' compensation line of business is that of continuing negative trends including, but not limited to, downward pressure on pricing due to competition, increasing claims costs and unfavorable development on prior years' loss and LAE reserves.

Since our inception in 1989, we have placed a consistent emphasis on underwriting profit. In 2014 and 2015 our results did not meet our expectations and were impacted by commercial auto liability industry trends. Our five-year average GAAP combined ratio of 99.9% has been consistently better than or in line with industry results, and we believe the following factors contribute to our performance:

Our pricing model, which is continually monitored and adjusted based on specific market conditions, and bottom line orientation, have resulted in disciplined and consistent risk assessment and pricing adequacy of new and renewal business.

Our ability to attract and retain some of the best transportation companies in the industries we serve - both from a financial stability and risk perspective - and to insure them directly or through our ART programs.

Table of Contents

Our stable operating expenses (which include both “Commissions and other underwriting expenses” and “Other operating and general expenses” on our Consolidated Statements of Income) have historically been at or below the revenue growth rate.

The P/C insurance industry had its third consecutive year of relatively low catastrophe losses in 2015. For weather-related events such as hurricanes, tornados, and hailstorms, we conduct an analysis at least annually pursuant to which we input our in-force exposures (vehicle values in all states and property limits in Hawaii) into an independent catastrophe model that predicts our probable maximum loss at various statistical confidence levels. Our estimated probable maximum loss is impacted by changes in our in-force exposures as well as changes in the assumptions inherent in the catastrophe model. Hurricane and other weather-related events have not had a material adverse impact on our past or current results.

Our transportation insurance business, in particular, is also affected by loss cost trends that negatively impact profitability such as inflation in vehicle repair costs, vehicle replacement parts costs, used vehicle prices, fuel costs and medical care costs. We routinely obtain independent data for vehicle repair inflation, vehicle replacement parts costs, used vehicle prices, fuel costs and medical care costs and adjust our pricing routines to project more accurately the future costs associated with insurance claims. We would expect a negative impact on our future results if we fail to account adequately for and project for these inflationary trends. Increased litigation of claims may also negatively impact our profitability.

As described below, the average revenue dollar per personal lines policy is significantly lower than typical commercial policies. Profitability in the specialty personal lines component is dependent on proper pricing and the efficiency of underwriting and policy administration. We have continued to monitor rate levels and have adjusted them during 2015, as warranted. We continuously strive to improve our underwriting and policy issuance functions to keep this cost element as low as possible by utilizing current technological advances.

To succeed as a transportation and personal lines underwriter, we must understand and be able to quantify the different characteristics of the risks we consider quoting. Certain coverages are more stable and predictable than others, and we must recognize the various components of the risks we assume when we write any specific class of insurance business. Examples of trends that can change and, therefore, impact our profitability are loss frequency, loss severity, geographic loss cost differentials, societal and legal factors impacting loss costs (such as tort reform, punitive damage inflation and increasing jury awards) and changes in regulation impacting the insurance relationship. Any changes in these factors that are not recognized and priced for accordingly will affect our future profitability.

Revenues

We derive our revenues primarily from premiums from our insurance policies and income from our investment portfolio. Our underwriting approach is to price our products to achieve an underwriting profit even if it requires us to forgo volume. As with all P/C insurance companies, the impact of price changes is reflected in our financial results over time. Price changes on our in-force policies occur as they are renewed, which generally takes twelve months for our entire book of business and up to an additional twelve months to earn a full year of premium at the average renewal rate. Insurance rates charged on renewing policies reflected an approximate average increase of 5% in 2015 and 7% in 2014.

There are distinct differences in the timing of premiums written in traditional transportation insurance compared to the majority of our ART insurance component. We write traditional transportation insurance policies throughout all twelve months of the year and commence new annual policies at the expiration of the old policy. Under most ART programs, all members of the group share a common renewal date. These common renewal dates are scheduled throughout the calendar year. Any new ART program participant that joins after the common date will be written for other than a full annual term so its next renewal date coincides with the common expiration date of the program it has joined. Several of our larger group programs have common renewal dates during the first six months of the year, but as we have added new ART programs in recent years, we now experience renewal dates that occur throughout the calendar year. The ART component of our business accounted for 56.7% of total gross premiums written during 2015 as compared to 54.3% in 2014.

The projected profitability from traditional transportation accounts and transportation ART programs are substantially comparable. Increased investment income opportunities generally are available with traditional insurance, but the lower acquisition expenses and persistence of the ART programs generally provide for lower operating expenses from these programs. The lower expenses associated with our ART programs generally offset the projected reductions in investment income potential. From a projected profitability perspective, we are ambivalent as to whether a transportation operator elects to purchase traditional insurance or one of our ART program options.

All of our transportation products, traditional or ART, are priced to achieve targeted underwriting margins. Because traditional insurance tends to have a higher operating expense structure, the portion of the premiums available to pay losses tends to be lower

Table of Contents

for a traditional insurance quote versus an ART insurance quote. We use a cost plus pricing approach that projects future losses based upon the insured's historic losses and other factors. Operating expenses, premium taxes and a profit margin are then added to the projected loss component to achieve the total premium to be quoted. The lower the projected losses, expenses and taxes, the lower the total quoted premiums regardless of whether it is a traditional or ART program quotation. Quoted premiums are computed in accordance with our approved insurance department filings in each state.

Our specialty personal lines products are also priced to achieve targeted underwriting margins. The average premium per policy for this business component is significantly less than transportation lines.

We approach investment and capital management with the intention of supporting insurance operations by providing a stable source of income to supplement underwriting income and mitigate underwriting losses. The goals of our investment policy are to protect capital, optimize investment income and capital appreciation and to maintain appropriate liquidity. We follow a formal investment policy and the Board reviews the portfolio performance at least quarterly for compliance with the established guidelines. In 2015, market interest rates increased and credit spreads widened, which contributed to an overall decrease in the fair value of our holdings. We recorded a \$3.3 million pre-tax net realized loss on investments in 2015 as compared to a pre-tax net realized gain of \$6.8 million in 2014. Included in these pre-tax net realized losses and gains are other-than-temporary impairment charges of \$7.8 million and \$2.0 million, respectively.

Expenses

Losses and loss adjustment expenses ("LAE") are a function of the amount and type of insurance contracts we write and of the loss experience of the underlying risks. We record losses and LAE based on management's best estimate of losses we expect to be reported on policies written. We seek to establish case reserves at the maximum probable exposure based on our historical claims experience. Our ability to estimate losses and LAE accurately 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 the value of the reserves for unpaid losses and LAE between the beginning and the end of the period.

Commissions and other underwriting expenses consist principally of brokerage and agent commissions and to a lesser extent premium taxes and assessments. The brokerage and agent commissions are reduced by ceding commissions received from assuming reinsurers that represent a percentage of the premiums on insurance policies and reinsurance contracts written and vary depending upon the amount and types of contracts written.

Other operating and general expenses consist primarily of personnel expenses (including salaries, benefits and certain costs associated with awards under our equity compensation plans, such as stock compensation expense) and other general operating expenses. Our personnel expenses are primarily fixed in nature and do not vary with the amount of premiums written. Interest expenses associated with outstanding debt and "Expense on amounts withheld" are disclosed separately from operating and general expenses. We invest funds in the participant loss layer for several of our ART programs. We receive investment income and generate gains or losses and incur an equal expense on the amounts owed to ART participants. "Expense on amounts withheld" represents investment income and net realized gains that we remit back to ART participants. The related investment income and net realized gains are included in the "Net investment income" and "Net realized (losses) gains on investments" lines on our Consolidated Statements of Income. 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.

Table of Contents

Results of Operations

Overview

Our net income, determined in accordance with U.S. generally accepted accounting principles ("GAAP"), includes items that may not be indicative of our ongoing operations. The following table identifies such items and reconciles 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.

	Year Ended December 31,		2014		2013	
	2015	Per Share	Amount	Per Share	Amount	Per Share
	(Dollars in thousands, except per share data)					
Net income from operations	\$22,978	\$1.16	\$8,039	\$0.41	\$13,325	\$0.67
After-tax net realized (losses) gains from investments	(2,131)	(0.11)	4,393	0.22	4,248	0.22
After-tax impact from transaction expense	—	—	(1,406)	(0.07)	—	—
Net income	\$20,847	\$1.05	\$11,026	\$0.56	\$17,573	\$0.89

Our net income for 2015 was \$20.8 million (\$1.05 per share diluted) compared to \$11.0 million (\$0.56 per share diluted) in 2014. The increase in net income during the current year reflects an improvement in the loss and LAE ratio to 80.6% compared to 83.8% last year. The 2015 loss and LAE ratio, while improved compared to the prior year, was elevated due to the impact of prior year development, including reserve strengthening, on the commercial auto liability line of business related to the 2012 and 2013 accident years. The 2014 loss and LAE ratio was also primarily attributable to unfavorable development from prior years' loss reserves including \$20.0 million of reserve strengthening recorded in the second quarter of 2014, 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 over the prior year was increased net investment income due primarily to higher average investment balances in the current year compared to last year. Additionally, 2014 net income was adversely impacted by after-tax transaction expenses related to the Great American tender offer. Partially offsetting these increases to net income was after-tax net realized losses of \$2.1 million (\$0.11 per share diluted) in 2015 compared to after-tax net realized gains of \$4.4 million (\$0.22 per share diluted) in 2014. Such losses in 2015 were attributable to other-than-temporary impairment charges primarily from securities related to the energy and financial services sectors. The declines in these sectors and equity markets in general also impacted our other invested assets which produced net realized losses during 2015 compared to net realized gains in the prior year.

Our net income from operations for 2015 was \$23.0 million (\$1.16 per share diluted) compared to \$8.0 million (\$0.41 per share diluted) 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 table sets 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:

	Year Ended December 31,		2014		2013	
	2015	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)					
Alternative Risk Transfer	\$412,443	56.7 %	\$374,152	54.3 %	\$326,305	51.7 %

Edgar Filing: National Interstate CORP - Form 10-K

Transportation	237,271	32.6	%	245,261	35.6	%	228,139	36.1	%
Specialty Personal Lines	35,295	4.9	%	35,597	5.2	%	47,715	7.5	%
Hawaii and Alaska	22,284	3.1	%	21,276	3.1	%	20,096	3.2	%
Other	19,826	2.7	%	12,717	1.8	%	9,738	1.5	%
Gross premiums written	\$727,119	100.0	%	\$689,003	100.0	%	\$631,993	100.0	%

32

Table of Contents

Gross premiums written includes both direct premium and assumed premium. During 2015, our gross premiums written increased \$38.1 million, or 5.5%, compared to 2014, primarily attributable to growth in our ART component. Gross premiums written in our ART component increased \$38.3 million, or 10.2%, during 2015 compared to 2014 and was primarily due to growth within our national account ART product's workers' compensation line of business. Additionally, our ART business achieved average rate increases on renewed business of approximately 5% and benefited from increased exposures and high renewal retention amongst our group ART programs. Partially offsetting such growth was the loss of several insureds resulting from rate actions taken within our group captive and national account ART products, as well as the loss of one national account insured to aggressive competition. Gross premiums written in our transportation component decreased \$8.0 million, or 3.3%, due primarily 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 of approximately 6% on renewed business, as well as new business written on our expanded limits coverage offered to trucking customers and our traditional crane and heavy haul insurance products. 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 \$7.1 million, or 55.9%, compared to 2014.

Our 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 years ended 2015 and 2014, we recorded net premium assessments of \$7.7 million and \$12.1 million, respectively.

Premiums Earned

2015 compared to 2014. We operate our business as one segment, property and casualty insurance. We manage this segment through a product management structure. The following table shows premiums earned for the years ended December 31, 2015 and 2014 summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

	Year Ended December 31,		Change		
	2015	2014	Amount	Percent	
	(Dollars in thousands)				
Premiums earned:					
Alternative Risk Transfer	\$321,262	\$300,922	\$20,340	6.8	%
Transportation	195,960	191,482	4,478	2.3	%
Specialty Personal Lines	30,718	35,086	(4,368)	(12.4))%
Hawaii and Alaska	19,602	18,009	1,593	8.8	%
Other	18,245	11,768	6,477	55.0	%
Total premiums earned	\$585,787	\$557,267	\$28,520	5.1	%

During 2015, our premiums earned increased \$28.5 million, or 5.1%, to \$585.8 million compared to \$557.3 million for the year ended December 31, 2014. The increase is primarily attributable to our ART component, which grew \$20.3 million, or 6.8%. Our ART component growth was due to the addition of one large insured to our national account ART product, as well as rate and exposure increases on renewed business in our group ART programs. Growth in our transportation component of \$4.5 million, or 2.3%, was primarily due to rate increases on renewed

business, as well as new business premium from several of our recently introduced traditional program offerings including our home delivery, ambulance and crane and heavy haul 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 was primarily due to the continued impact of our decision to stop selling our commercial vehicle product during the third quarter of 2013. The slight increase in our Hawaii and Alaska component was due primarily to rate increases on renewed business, high renewal retention and new business premium. The growth in the other component is due to an increase in premiums from assigned risk policies that we receive from

Table of Contents

involuntary state insurance plans from the states in which our insurance company subsidiaries operate and over which we have no control.

2014 compared to 2013. The following table shows premiums earned for the years ended December 31, 2014 and 2013 summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

	Year Ended December 31,		Change Amount	Percent	
	2014	2013			
	(Dollars in thousands)				
Premiums earned:					
Alternative Risk Transfer	\$300,922	\$283,725	\$17,197	6.1	%
Transportation	191,482	172,367	19,115	11.1	%
Specialty Personal Lines	35,086	45,311	(10,225)	(22.6))%
Hawaii and Alaska	18,009	15,357	2,652	17.3	%
Other	11,768	8,950	2,818	31.5	%
Total premiums earned	\$557,267	\$525,710	\$31,557	6.0	%

Our premiums earned increased \$31.6 million, or 6.0%, to \$557.3 million during the year ended December 31, 2014 compared to \$525.7 million for the year ended December 31, 2013. The increase was primarily attributable to our ART and transportation components, which grew \$17.2 million, or 6.1%, and \$19.1 million, or 11.1%, respectively, and was partially offset by a \$10.2 million, or 22.6%, decrease in our specialty personal lines component. The ART component growth in premiums earned was primarily associated with our existing group ART programs, due to rate increases and increased exposures on renewal business as well as the addition of new customers. This growth was partially offset by the impact of ending business relationships with two agents within the program portion of our ART component, which occurred in late 2012 and 2013, as well as taking rate actions and non-renewing unprofitable business during 2013 and 2014. The increase in the transportation component reflected our continued growth from new business written as well as rate and exposure increases on renewed business experienced throughout 2013 and 2014. The decrease in our specialty personal lines component was primarily due to our decision to stop selling our commercial vehicle product during the third quarter of 2013.

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.

The premiums generated by each of the ART insurance programs includes the premium charged related to the development of the participants' loss fund. The loss fund represents the amount of premium needed to cover the participants' expected losses in the layer of risk being ceded to the captive reinsurer. Typically, the premium and losses incurred through the funding of our captive participant's loss layer are comparable period-over-period. However, increased member participation or assessment premium charged on the loss fund layer through Hudson Indemnity, Ltd. ("HIL") has the potential to unfavorably impact our loss and LAE ratio, and conversely, have a favorable impact on our underwriting expense ratio, when comparing results to a prior period.

Our underwriting approach is to price our products to achieve an underwriting profit even if we forgo volume as a result. We continue to see overall rate level increases on renewal business, which averaged approximately 5% in 2015 and 7% in 2014. In both 2015 and 2014, several of our products achieved double-digit rate level increases and we continue to apply the same pricing

Table of Contents

disciplines 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 consider industry loss cost trends. The table below presents our premiums earned and combined ratios for the periods indicated:

	Year Ended December 31,			
	2015	2014	2013	
	(Dollars in thousands)			
Gross premiums written	\$727,119	\$689,003	\$631,993	
Ceded reinsurance	(119,693)	(113,429)	(94,389)	
Net premiums written	607,426	575,574	537,604	
Change in unearned premiums, net of ceded	(21,639)	(18,307)	(11,894)	
Total premiums earned	\$585,787	\$557,267	\$525,710	
Combined Ratios:				
Loss and LAE ratio excluding prior year development (accident year)	78.1	% 78.3	% 77.3	%
Prior year loss and LAE development	2.5	% 5.5	% 4.4	%
Loss and LAE ratio (calendar year)(1)	80.6	% 83.8	% 81.7	%
Underwriting expense ratio(2)	19.8	% 20.1	% 20.7	%
Combined ratio	100.4	% 103.9	% 102.4	%

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

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

The table below presents our accident year loss and LAE ratio for 2015, 2014 and 2013 as of December 31, 2015:

	Year Ended December 31,			
	2015	2014	2013	
Accident year loss and LAE ratio reported at original year-end	78.1	% 78.3	% 77.3	%
Loss and LAE development since original year-end	—	% (0.2)	)% 2.1	%
Accident year loss and LAE ratio as of December 31, 2015	78.1	% 78.1	% 79.4	%

2015 compared to 2014. Our loss and LAE ratio for the year ended December 31, 2015 improved 3.2 combined ratio points to 80.6% compared to 83.8% for the year ended December 31, 2014. This improvement reflects less adverse development recorded in 2015 than in the prior year. For the year ended December 31, 2015, we had unfavorable development from prior years' loss reserves of \$14.4 million, or 2.5 combined ratio points, compared to \$30.6 million, or 5.5 combined ratio points, for the same period last year. The unfavorable development that occurred in the current year included reserve strengthening of \$9.7 million primarily related to the commercial auto liability line of business for the 2012 and 2013 accident years and is indicative of emerging claims severity on these accident years. The remaining portion of the unfavorable development in the current year is concentrated in our commercial auto liability line of business and 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 largely 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 2015 accident year loss and LAE ratio of 78.1% is equal to the loss and LAE ratio for the 2014 accident year as developed through December 31, 2015. While these results do include severity on the commercial auto liability line of business which do not meet our expectations, both periods show improvement from recent accident years and reflect the cumulative impact of rate increases on renewed business since 2013, as well as improved pricing discipline applied to new business. We continue to be diligent in monitoring and maintaining our disciplined underwriting criteria and risk selection among all lines of business and will continue

to 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

Specific to our commercial auto liability results in recent years, industry trends indicated that commercial auto policies written during the prolonged soft market conditions were at rates below those required to keep pace with changing economic and societal influences related to claims settlements. These influences, such as increased litigation costs, lower spending on safety measures and increased fraud have resulted in adverse industry trends of prior year reserves in the commercial auto liability line. Similar to the industry, we had experienced unfavorable prior year claim development for seven consecutive quarters through June 30, 2014. Though such development appeared to be subsiding in the first quarter of 2014, as compared to the previous three quarters, during the 2014 second quarter actual incurred claims developed higher than expected by approximately \$8.1 million, primarily related to accident years 2010, 2011 and 2012 for the commercial auto coverages. In consideration of the continued adverse prior year claims development, we engaged a leading independent global actuarial firm to conduct a review of our loss and LAE reserves. We used this additional actuarial data as well as various data inputs and other factors including, but not limited to, claims processing procedures, our historic loss experience and that of the industry, and loss development factors as well as actuarial analysis as routinely provided by Great American when establishing our best estimate for loss reserves for the second quarter of 2014. As a result of our review and analysis of the various data points discussed above we increased our loss and LAE reserves related to prior periods by \$20.0 million in the second quarter of 2014. During the fourth quarter of 2015 emerging prior year claim severity in our commercial auto liability line of business resulted in an additional \$9.7 million of reserve strengthening primarily on accident years 2012 and 2013.

The underwriting expense ratio for the years ended December 31, 2015 and 2014 of 19.8% and 20.1%, respectively, is indicative of our effective management of operating costs over an increased earned premiums base.

2014 compared to 2013. Our loss and LAE ratio for the year ended December 31, 2014 increased 2.1 combined ratio points to 83.8% compared to 81.7% during the same period in 2013. This increase over the prior period was primarily attributable to adverse development on prior years' loss reserves, inclusive of \$20.0 million in reserve strengthening recorded during the second quarter of 2014, as well as an elevated current accident year loss and LAE ratio compared to the undeveloped prior year loss and LAE ratio. For the year ended December 31, 2014, we had unfavorable development from prior years' loss reserves of \$30.6 million, or 5.5 combined ratio points, compared to unfavorable development of \$23.1 million, or 4.4 combined ratio points, for the prior period. Unfavorable development is primarily related to settlements above the established case reserves and revisions to our estimated future settlements on an individual case by case basis.

In 2013, we exited several unprofitable businesses including the commercial vehicle product, and we priced away or chose not to renew over \$65 million of business. Applying the same disciplines, in 2014 we shed approximately \$40 million in business through non-renewals or rate actions.

The underwriting expense ratio for the year ended December 31, 2014 decreased 0.6 percentage points to 20.1% compared to 20.7% for the same period in 2013, which was primarily attributable to a lower cost structure in our mix of business written and leveraging our operating costs over increased premiums earned.

Net Investment Income

2015 compared to 2014. Net investment income increased \$4.2 million, or 11.9%, to \$39.7 million in 2015 compared to 2014. The increase in net investment income is primarily due to higher average invested assets.

2014 compared to 2013. Net investment income increased \$2.1 million, or 6.4%, to \$35.5 million in 2014 compared to 2013. The increase in net investment income is primarily due to higher average invested assets and our ability to invest in new securities with average yields that are comparable to maturing securities.

Net Realized Gains on Investments

2015 compared to 2014. In 2015, we had pre-tax net realized losses of \$3.3 million compared to pre-tax net realized gains of \$6.8 million for 2014. The pre-tax net realized losses for the year ended December 31, 2015 were primarily generated from other-than-temporary impairment charges of \$7.8 million on both equity and fixed maturity securities, which were primarily common stock securities concentrated within the energy and financial services sectors. In addition, other invested assets produced net losses of \$1.7 million as these investments were impacted by turmoil in the energy sector during 2015. Partially offsetting these losses were gains generated from the sales or redemptions of securities of \$6.2 million. The pre-tax net realized gains for the year ended December 31, 2014 were primarily

generated from the sales or redemptions of securities of \$5.4 million, as well as net gains associated with other invested assets of \$3.3 million. Offsetting these gains were other-than-temporary impairment charges of \$2.0 million primarily concentrated within the energy and financial services sectors.

Table of Contents

2014 compared to 2013. In 2014, we had pre-tax net realized gains of \$6.8 million compared to \$6.5 million for 2013. The pre-tax net realized gains for the year ended December 31, 2014 were primarily generated from the sales or redemptions of securities of \$5.4 million, as well as net gains associated with other invested assets of \$3.3 million. Offsetting these gains were other-than-temporary impairment charges of \$2.0 million primarily concentrated within the energy and financial services sectors. The pre-tax net realized gains for the year ended December 31, 2013 were primarily generated from net realized gains from the sales or redemptions of securities of \$5.2 million, as well as net gains associated with other invested assets of \$1.5 million. Offsetting these gains were other-than-temporary impairment charges of \$0.2 million.

Commissions and Other Underwriting Expenses

2015 compared to 2014. Commissions and other underwriting expenses for the year ended December 31, 2015 were relatively flat, decreasing \$0.4 million, or 0.4%, to \$94.1 million from \$94.4 million in the comparable period in 2014. As a percentage of premiums earned, commissions and other underwriting expenses decreased to 16.1% for the year ended December 31, 2015 as compared to 16.9% for the same period in 2014. Such decrease is attributable to changes in the business mix written and an increase in earned premiums over relatively flat other underwriting expenses during 2015 as compared to 2014.

2014 compared to 2013. Commissions and other underwriting expenses for the year ended December 31, 2014 increased \$2.2 million, or 2.4%, to \$94.4 million from \$92.2 million in the comparable period in 2013, primarily due to the premium growth experienced in 2014. As a percentage of premiums earned, commissions and other underwriting expenses decreased to 16.9% for the year ended December 31, 2014 as compared to 17.5% for the same period in 2013. Such decrease is attributable to changes in the business mix written, resulting in a lower net commissions expense structure, over an increase in earned premiums during 2014 as compared to 2013.

Other Operating and General Expenses

2015 compared to 2014. Other operating and general expenses increased \$4.6 million, or 22.0%, to \$25.6 million during the year ended December 31, 2015 compared to \$21.0 million for the same period in 2014. Such growth is due primarily to growth in our employee headcount and related personnel expenses, as well as an increased investment in information technology to support business decisions and sustain continued growth. As a percentage of premiums earned, such expenses were 4.4% and 3.8% for both years ended December 31, 2015 and 2014, respectively.

2014 compared to 2013. Other operating and general expenses increased \$1.2 million, or 6.3%, to \$21.0 million during the year ended December 31, 2014 compared to \$19.7 million for the same period in 2013, attributable primarily to growth in our employee headcount and related personnel expenses. As a percentage of premiums earned, such expenses were flat at 3.8% for both years ended December 31, 2014 and 2013.

Transaction Expenses

During 2014, we incurred \$2.2 million in transaction expenses related to the Great American tender offer. Transaction expenses primarily consist of financial advisory and legal services incurred in connection with the tender offer and related litigation. Included in 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. We incurred no such expense in 2015 or 2013.

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 our "Net investment income" and "Net realized (losses) gains on investments" lines, respectively, on our Consolidated Statements of Income. For the year ended December 31, 2015, the expense on amounts withheld was flat, increasing \$48 thousand, or 0.7%, compared to the same period in 2014.

2014 compared to 2013. For the year ended December 31, 2014, the expense on amounts withheld increased \$1.4 million, or 26.8%, compared to the same period in 2013, primarily due to growth experienced in our ART programs participant loss layer.

Interest Expense

2015 compared to 2014. Interest expense for the year ended December 31, 2015 was relatively flat, decreasing \$21 thousand, or 9.5%, to \$199 thousand from \$220 thousand in the comparable period in 2014.

2014 compared to 2013. For the year ended December 31, 2014, interest expense decreased \$0.5 million compared to the same period in 2013, primarily due to a decrease in the interest accrued related to contractual amounts payable to UniGroup, Vanliner's former owner, under the balance sheet guaranty.

Table of Contents

Income Taxes

2015 compared to 2014. The 2015 effective tax rate (ETR) was 24.2%, increasing 17.9 percentage points from a rate of 6.3% in 2014. Such increase is attributed to the \$15.7 million increase in income before taxes compared to the prior year, resulting in tax-exempt income having a less favorable impact on the current year ETR.

2014 compared to 2013. The 2014 effective tax rate was 6.3%, decreasing 12.7 percentage points from a rate of 19.0% in 2013. The decrease in our ETR can be attributed to the \$9.9 million decrease in income before taxes while tax-exempt income remained stable.

Financial Condition

Investments

At December 31, 2015, our investment portfolio contained \$1.1 billion in fixed maturity securities and \$81.6 million in equity securities, all carried at fair value, with unrealized gains and losses reported as a separate component of shareholders' equity and \$47.9 million in other invested assets, which are limited partnership investments accounted for in accordance with the equity method. At December 31, 2015, we had pre-tax net unrealized gains of \$12.8 million on fixed maturities and pre-tax net unrealized losses of \$0.3 million on equity securities. Consistent with the guidelines in our investment policy, our investment portfolio allocation is based on diversification among primarily high quality fixed maturity investments.

Fixed maturity investments are generally invested in securities with intermediate-term maturities. At December 31, 2015, the weighted average maturity of our fixed maturity investments was approximately 5.9 years. At December 31, 2015, 91.2% 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 December 31, 2015 were \$316.4 million of state and local government obligations, which represented approximately 30.1% of our fixed maturity portfolio, with approximately \$275.5 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 98.9% of such securities were rated investment grade at December 31, 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 December 31, 2015.

Also included in fixed maturities at December 31, 2015 were \$171.8 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. Summary information for our MBS at December 31, 2015 is shown in the following table. 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	Fair Value	Fair Value as % of Cost	Unrealized Gain
	(Dollars in thousands)			
Residential:				
Agency-backed	\$88,719	\$88,988	100.3	% \$269
Non-agency prime	12,390	13,319	107.5	% 929
Alt-A	18,195	19,404	106.6	% 1,209
Subprime	33,887	35,692	105.3	% 1,805
Commercial	13,703	14,368	104.9	% 665

\$166,894 \$171,771 102.9 % \$4,877

The National Association of Insurance Commissioners ("NAIC") assigns creditworthiness designations on a scale of 1 to 6 with 1 being the highest quality and 6 being the lowest quality. The NAIC retained a third-party investment management firm 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 statutory carrying value. At December 31, 2015, 98.9% (based on statutory carrying value of \$166.9 million) of our MBS had an NAIC designation of 1 or 2.

Table of Contents

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 December 31, 2015, less than 5% of our investments consisted of European debt and we owned no sovereign debt issued by the peripheral countries. At December 31, 2015, \$53.0 million, or 5.0%, of our fixed maturity portfolio and \$5.0 million, or 6.1%, of our equity portfolio consisted of investments issued by energy and commodity related entities, with unrealized loss exposure to these entities totaling \$4.9 million and \$0.5 million, respectively. Investment-grade rated fixed maturities represented 80.2% of that total.

Table of Contents

Summary information for securities with unrealized gains or losses at December 31, 2015 is shown in the following table. Approximately \$8.8 million of fixed maturities and \$4.7 million of equity securities had no unrealized gains or losses at December 31, 2015.

	Securities with Unrealized Gains (Dollars in thousands)	Securities with Unrealized Losses		
Fixed Maturities:				
Fair value of securities	\$699,570	\$342,607		
Amortized cost of securities	675,792	353,627		
Gross unrealized gain or (loss)	\$23,778	\$(11,020))	
Fair value as a % of amortized cost	103.5	% 96.9	%	
Number of security positions held	616	349		
Number individually exceeding \$50,000 gain or (loss)	125	41		
Concentration of gains or losses by type or industry:				
U.S. Government and government agencies	\$2,197	\$(296))	
State, municipalities and political subdivisions	10,927	(180))	
Residential mortgage-backed securities	5,407	(1,195))	
Commercial mortgage-backed securities	675	(10))	
Other debt obligations	384	(2,057))	
Financial institutions, insurance and real estate	1,770	(1,129))	
Industrial and other	\$2,418	\$(6,153))	
Percent rated investment grade (a)	92.5	% 88.8	%	
Equity Securities:				
Fair value of securities	\$41,764	\$35,175		
Cost of securities	36,804	40,425		
Gross unrealized gain or (loss)	\$4,960	\$(5,250))	
Fair value as a % of cost	113.5	% 87.0	%	
Number individually exceeding \$50,000 gain or (loss)	36	24		

(a) Investment grade of AAA to BBB- by nationally recognized rating agencies.

The table below sets forth the scheduled maturities of available for sale fixed maturity securities at December 31, 2015, based on their fair values. Other debt obligations, which are primarily comprised of asset-backed securities other than those related to mortgages and other securities with sinking funds, 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	4.4	% 1.5	%	
After one year through five years	35.0	% 37.4	%	
After five years through ten years	34.0	% 41.9	%	
After ten years	9.6	% 3.8	%	
	83.0	% 84.6	%	
Mortgage-backed securities	17.0	% 15.4	%	
	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 December 31, 2015		Fair Value as % of Cost Basis	
	Aggregate Fair Value	Aggregate Unrealized Gain (Loss)		
	(Dollars in thousands)			
Fixed Maturities:				
Securities with unrealized gains:				
Exceeding \$50,000 and for:				
Less than one year (22 issues)	\$34,501	\$1,554	104.7	%
One year or longer (103 issues)	219,680	14,789	107.2	%
Less than \$50,000 (491 issues)	445,389	7,435	101.7	%
	\$699,570	\$23,778		
Securities with unrealized losses:				
Exceeding \$50,000 and for:				
Less than one year (37 issues)	\$39,343	\$(5,755)	87.2	%
One year or longer (4 issues)	2,470	(1,226)	66.8	%
Less than \$50,000 (308 issues)	300,794	(4,039)	98.7	%
	\$342,607	\$(11,020)		
Equity Securities:				
Securities with unrealized gains:				
Exceeding \$50,000 and for:				
Less than one year (24 issues)	\$14,384	\$1,754	113.9	%
One year or longer (12 issues)	8,977	2,324	134.9	%
Less than \$50,000 (45 issues)	18,403	882	105.0	%
	\$41,764	\$4,960		
Securities with unrealized losses:				
Exceeding \$50,000 and for:				
Less than one year (24 issues)	\$21,549	\$(4,608)	82.4	%
Less than \$50,000 (32 issues)	13,626	(642)	95.5	%
	\$35,175	\$(5,250)		

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."

Net realized gains on securities sold, including net (losses) gains on other invested assets, and charges for other-than-temporary impairment on securities held were as follows:

Net Realized Gains on Sales	Net (Losses) Gains on Other Invested Assets	Charges for Impairment	Net Realized (Losses) Gains on Investments
(Dollars in thousands)			

Year ended:

Edgar Filing: National Interstate CORP - Form 10-K

2015	\$6,154	\$(1,670	) \$(7,762	) \$(3,278)
2014	5,411	3,310	(1,963	) 6,758	
2013	5,177	1,514	(155	) 6,536	

41

Table of Contents

Fair Value Measurements

We must determine the appropriate level in the fair value hierarchy for each applicable measurement. The fair value hierarchy prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. We are responsible for the valuation process and use 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 our 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, our 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 we believe that significant discrepancies exist, we 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 primarily 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 December 31, 2015, Level 2 included \$219.8 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. We believe these estimates reflect fair value, but we are unable to verify inputs to the valuation methodology. We obtained at least one quote or price per instrument from brokers and pricing services for all Level 3 securities and did not adjust any quotes or prices that we obtained. Our internal and affiliated investment professionals review these broker quotes using any recent trades, if such information is available, or market prices of similar investments. We primarily use the market approach valuation technique for all investments.

Liquidity and Capital Resources

Capital Ratios. The National Association of Insurance Commissioners' model law for risk-based capital ("RBC") provides formulas to determine the amount of capital and surplus that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired. At December 31, 2015 and 2014, the capital and surplus of all our insurance companies substantially exceeded the RBC requirements.

Sources of Funds. 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, 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

Table of Contents

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 \$18.4 million from \$53.6 million at December 31, 2014 to \$71.9 million at December 31, 2015. For 2015, 2014 and 2013, net cash provided by operating activities was \$134.0 million, \$86.4 million and \$50.4 million, respectively. The \$47.6 million and \$36.0 million increases in cash flows from operations in 2015 from 2014 and 2014 from 2013, respectively, are primarily attributable to increases in premiums collected and relatively flat payments made to settle claims.

Net cash used in investing activities was \$107.2 million, \$61.5 million and \$49.2 million for the years ended December 31, 2015, 2014 and 2013, respectively. The \$45.7 million increase in cash used in investing activities during 2015, as compared to 2014, was primarily driven by securities purchases exceeding sales, maturities and redemptions. Purchases of and proceeds from the redemption of fixed maturity securities were \$276.2 million and \$168.2 million, respectively, for the year ended December 31, 2015, compared to \$199.4 million and \$143.1 million, respectively, for 2014. The increase in purchases of fixed maturity securities was concentrated in other debt obligations and was primarily driven by reinvesting funds in excess of cash requirements. The \$12.3 million increase in cash used in investing activities during 2014, as compared to 2013, was primarily driven by investing net operating cash to purchase fixed maturity and equity securities which outpaced the proceeds from sales and redemptions of such securities. Proceeds from sales and redemptions of fixed maturity securities decreased amid the low interest rate environment, which led to a shift in asset allocation from callable U.S. government agency bonds into longer duration state and local government bonds, residential mortgage-backed securities and corporate obligations.

Net cash used in financing activities was \$8.5 million, \$7.0 million and \$7.5 million for the years ended December 31, 2015, 2014 and 2013, respectively. The increase in net cash used in financing activities in 2015, as compared to 2014, was primarily due to an increase in dividends paid to shareholders, as well as a decrease in proceeds received from the issuance of common shares from treasury upon exercise of stock options. The decrease in net cash used in financing activities in 2014, as compared to 2013, was primarily due to an increase in proceeds received from the issuance of common shares upon the exercise of options which was partially offset by an increase in dividends paid to shareholders.

Under tax allocation and cost sharing agreements among the Company and its subsidiaries, taxes and expenses are allocated among the entities. The federal income tax provision of our individual subsidiaries is computed as if the subsidiary filed a separate tax return. The resulting provision (or credit) is currently payable to (or receivable from) us. On November 19, 2012, we replaced our \$50.0 million credit agreement with 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. At December 31, 2015, we had \$12.0 million outstanding under the Credit Agreement. Based on our A.M. Best insurance group rating of "A" at December 31, 2015, the interest rate on this debt is equal to the six-month LIBOR (0.524% at December 31, 2015) rate plus 87.5 basis points, 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 December 31, 2015, we were in compliance with all covenants.

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-

Table of Contents

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.

Off-Balance Sheet Items. We do not have any material off-balance sheet arrangements as such term is defined in applicable SEC rules.

We do not currently 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.

Contractual Obligations. The following table summarizes our long-term contractual obligations as of December 31, 2015:

	Payment Due by Period				
	Total	Within 1 Year	2-3 Years	4-5 Years	More than 5 Years
	(Dollars in thousands)				
Gross unpaid losses and LAE(a)	\$1,014,195	\$366,286	\$388,879	\$120,821	\$138,209
Limited partnership commitments(b)	14,792	1,000	7,154	6,638	—
Debt obligations	12,000	—	12,000	—	—
Operating lease obligations	887	597	290	—	—
Total	\$1,041,874	\$367,883	\$408,323	\$127,459	\$138,209

Dollar amounts and time periods are estimates based on historical net payment patterns applied to the gross reserves and do not represent actual contractual obligations. Actual payments and their timing could differ significantly from these estimates, and the estimates provided do not reflect potential recoveries under reinsurance treaties.

Limited partnership agreements have expiration dates up to five years whereby the entire amounts or a portion thereof could be required to be funded at any time prior to the expiration dates. The commitment amounts are presented using the expiration dates of the agreements.

Table of Contents

Critical Accounting Policies

The preparation of financial statements in conformity with 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 loss and LAE reserves and the determination of “other-than-temporary” impairment on investments are two areas whereby the degree of judgment required in determining amounts recorded in the financial statements make the accounting policies critical. We discuss these two policies below. Our other significant accounting policies are described in Note 2 to our consolidated financial statements - “Significant Accounting Policies.”

Loss and Loss Adjustment Expenses 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 December 31, 2015 and 2014, we had \$1.0 billion 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, management utilizes various data inputs as noted below, including analysis that is derived from our internal actuary, as well as a review of quarterly results performed by actuaries employed by Great American. In addition, on an annual basis, actuaries from Great American provide a Statement of Actuarial Opinion, required annually in accordance with state insurance regulations, on the statutory reserves recorded by National Interstate Insurance Company (“NIIC”), Vanliner Insurance Company (“VIC”), National Interstate Insurance Company of Hawaii, Inc. (“NIIC-HI”) and Triumpher Casualty Company (“TCC”). The actuarial analysis of NIIC’s, VIC’s, NIIC-HI’s and TCC’s net reserves as of December 31, 2015 and 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 each year end.

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; and
- the Bornhuetter-Ferguson Method.

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.

Supplementary statistical information is also 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.

When a claim is reported, claims personnel establish a “case reserve” for the estimated amount of ultimate payment. The amount of the reserve is based upon an evaluation of the type of claim involved, the circumstances surrounding each claim and the policy provisions relating to the loss. The estimate reflects informed judgment of our claims personnel based on general insurance reserving

45

Table of Contents

practices and on the experience and knowledge of the claims personnel. Management seeks to establish reserves at the maximum probable exposure based on our historic claims experience. During the loss adjustment period, these estimates are revised as deemed necessary by our claims department based on developments and periodic reviews of the cases. Individual case reserves are reviewed for adequacy at least quarterly by senior claims management. Claims that management views as potentially significant are subject to a rigorous review process involving the adjuster, claims management and executive management.

Incurred but not yet reported (“IBNR”) reserves are determined separate from the case reserving process and include estimates for potential adverse development of the recorded case reserves. IBNR reserves are adjusted monthly based on historic patterns and current trends and exposures. Management monitors IBNR reserves monthly with actuaries from Great American.

When establishing and reviewing reserves, we analyze historic data and estimate the impact of various sources of 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. As of December 31, 2015, management has not made any key assumptions that are inconsistent with historical loss reserve development patterns. A change in any of these aforementioned factors from the assumptions implicit in our estimate can cause our actual loss experience to be better or worse than our reserves and the difference can be material. There is no precise method, however, for evaluating the impact of any specific factor on the adequacy of reserves. Currently established reserves may not prove adequate in light of subsequent actual occurrences. To the extent that reserves are inadequate and are increased or “strengthened,” the amount of such increase is treated as a charge to income in the period that the deficiency is recognized. To the extent that reserves are redundant and are released, the amount of the release is a benefit to income in the period that redundancy is recognized.

The changes we have recorded in our reserves in the past three years illustrate the potential for revisions inherent in estimating reserves. In 2015, we experienced unfavorable development of \$14.4 million (1.8% of total net reserves) from claims incurred prior to 2015. In 2014, we experienced unfavorable development of \$30.6 million (4.3% of total net reserves) from claims incurred prior to 2014. In 2013, we experienced unfavorable development of \$23.1 million (3.6% of total net reserves) from claims incurred prior to 2013. The development reflected settlements that differed from the established case reserves, changes in the case reserves based on new information for that specific claim or the differences in the timing of actual settlements compared to the payout patterns assumed in our accident year IBNR reductions. The types of coverages we offer and risk levels we retain have a direct influence on the development of claims. Specifically, short duration claims and lower risk retention levels generally are more predictable and normally have less development. Future favorable or unfavorable development of reserves from past development experience should not be assumed or estimated. The reserves reported in the financial statements are our best estimate.

The following table shows the breakdown of our gross loss reserves between case reserves (estimated amounts required to settle claims that have already been reported), IBNR reserves (estimated amounts that will be needed to settle claims that have already occurred, but have not yet been reported to us, as well as reserves for possible development on known claims) and LAE reserves (estimated amounts required to adjust, record and settle claims, other than the claim payments themselves) by our statutory lines of business:

Statutory Lines of Business:	At December 31, 2015			Total
	Case	IBNR	LAE	
	(Dollars in thousands)			
Commercial auto liability	\$234,374	\$205,361	\$72,630	\$512,365
Workers’ compensation	122,984	200,990	47,825	371,799

Edgar Filing: National Interstate CORP - Form 10-K

General liability	48,315	36,000	9,716	94,031
Auto physical damage	6,189	4,207	4,330	14,726
Private passenger	3,020	3,900	1,325	8,245
Inland marine	729	5,432	786	6,947
Commercial multiple peril	800	2,600	1,007	4,407
Other lines	106	1,461	108	1,675
	\$416,517	\$459,951	\$137,727	\$1,014,195

Following is a discussion of certain critical variables affecting the estimation of loss reserves of the more significant lines of business. Many other variables may also impact ultimate claim costs.

Table of Contents

An important assumption underlying reserve estimates is that the cost trends implicitly built into development patterns will continue into the future. However, future results could vary due to an unexpected change in underlying cost trends. This unexpected change could arise from a variety of sources including a general increase in economic inflation, inflation from social programs, new medical technologies or other factors such as those listed below in connection with our largest lines of business. It is not possible to isolate and measure the potential impact of just one of these variables, and future cost trends could be partially impacted by several such variables. However, it is reasonable to address the sensitivity of the reserves to a potential impact from changes in these variables by measuring the effect of a possible overall 1% change in future cost trends that may be caused by one or more variables. Utilizing the effect of a 1% change in overall cost trends enables changes greater than 1% to be estimated by extrapolation.

The estimated cumulative unfavorable impact that this 1% change would have on net income is shown below:

Line of Business	Cumulative Impact
Commercial Auto Liability	\$6.4 million
Workers' Compensation	\$6.8 million

The judgments and uncertainties surrounding management's reserve estimation process and the potential for reasonably possible variability in management's most recent reserve estimates may also be viewed by looking at how recent historical estimates of reserves for all lines of business have developed. If our December 31, 2015 reserves (net of reinsurance) developed at the same rate as the average development of the most recent five years, the effect on net earnings would be a decrease of \$11.1 million.

5-yr. Average Development (*)	Net Reserves December 31, 2015	Effect on Net Earnings
1.4%	\$796.4 million	\$(11.1) million

(*) Net of tax effect.

The following discussion describes key assumptions and important variables that affect the estimate of the reserve for loss and LAE of our two most significant lines of business, which represent 87.2% of our total reserves and explains what caused them to change from assumptions used in the preceding period. Management has not made any changes in key assumptions used in calculating current year reserves based on historical loss development patterns.

Within each line, Great American actuaries review the results of individual tests, supplementary statistical information and input from management to select their point estimate of the ultimate liability. This estimate may be one test, a weighted average of several tests or a judgmental selection as the actuaries determine is appropriate. The actuarial review is performed each quarter as a test of the reasonableness of management's point estimate and to provide management with an actuarial estimate to consider in setting reserve assumptions. The Great American actuaries do not develop ranges of losses.

The level of detail at which data is analyzed varies among the different lines of business. Generally, data is analyzed by major product or coverage, using countrywide data. The appropriate segmentation of the data is determined based on data volume, data credibility, mix of business and other actuarial considerations. Point estimates are selected by the actuaries based on test indications and judgment.

Commercial Auto Liability. In this line of business, we provide coverage protecting buses, limousines, other public transportation vehicles and trucks for accidents causing property damage or personal injury to others. Property damage liability and medical payments exposures are typically short-tail lines of business with relatively quick reporting and settlement of claims. Bodily injury exposure is long-tail because although the claim reporting of this line

of business is relatively quick, the final settlement can take longer to achieve.

Some of the important variables affecting our estimation of loss reserves for commercial auto liability include:

- litigious climate and trends;
- unpredictability of judicial decisions regarding coverage issues;
- magnitude of jury awards;
- outside counsel costs; and
- change in frequency of severe accidents.

Table of Contents

We recorded unfavorable prior year development of \$22.3 million, \$29.0 million, and \$32.5 million in 2015, 2014 and 2013, respectively, for this line of business. We have experienced significantly higher than expected claim severity and case development from accident years 2011 through 2014. We continue to pay particular attention to the commercial auto liability line of business and are taking the necessary steps to restore our historically profitable underwriting results, including responding with rate increases, non-renewals or other corrective actions, as necessary. We continually monitor development trends in each line of business as a component of estimating future ultimate loss and related LAE liabilities.

Workers' Compensation. In this long-tail line of business, we provide coverage for employees who may be injured in the course of employment. Some of the important variables affecting our estimation of loss reserves for workers' compensation include:

- legislative actions and regulatory and legal interpretations;
- future medical cost inflation;
- economic conditions; and
- timing of claims reporting.

We recorded favorable prior year loss development of \$4.8 million in 2015 and unfavorable prior year loss development of \$2.8 million and \$1.2 million in 2014 and 2013, respectively. Due to the long-tail nature of this business it is difficult to predict ultimate liabilities until a higher percentage of claims have been paid and the ultimate impact of these decisions can be estimated with more precision. Management continues to review the frequency, severity, and loss and LAE ratios implied by the indications from the standard tests while considering the uncertainties of future costs in determining the appropriate reserve level.

Reinsurance Recoverables. We are also subject to credit risks with respect to our third party reinsurers. Although reinsurers are liable to us to the extent we cede risks to them, we are ultimately liable to our policyholders on all these risks. As a result, reinsurance does not limit our ultimate obligation to pay claims to policyholders and we may not be able to recover claims made to our reinsurers. We manage this credit risk by selecting what we believe to be quality reinsurers, closely monitoring their financial condition, timely billing and collecting amounts due and obtaining sufficient collateral when necessary.

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's 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."

Table of Contents

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 years ended December 31, 2015, 2014 and 2013, we recorded other-than-temporary impairment charges of \$7.8 million, \$2.0 million and \$0.2 million, respectively, in earnings. The impairment charges during 2015 were elevated due to market turmoil and consist of \$5.8 million on equity securities and \$2.0 million on fixed maturity securities and were primarily within the energy and financial services sectors. The impairment charges on equity securities were due to the uncertainty surrounding the timing and extent of ultimate recovery, while the impairment charges on fixed maturity securities occurred as management is uncertain of full principle repayment. The impairment charges during 2014 and 2013 were primarily related to equity securities and were not concentrated in any one sector. 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.”

Table of Contents

ITEM 7A Quantitative and Qualitative Disclosures About Market Risk

Market risk represents the potential economic loss arising from adverse changes in the fair value of financial instruments. Our exposures to market risk relate primarily to our investment portfolio, which is also exposed to interest rate risk and credit risk. We have not entered and do not plan to enter, into any derivative financial instruments for trading or speculative purposes.

The fair value of our fixed maturities portfolio is directly impacted by changes in interest rates, in addition to credit risk. Our fixed maturities portfolio is comprised of primarily investment grade fixed rate investments with primarily intermediate-term maturities. We believe this practice allows us to be flexible in reacting to fluctuations of interest rates. We manage the portfolios of our insurance companies to attempt to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet policyholder obligations. We invest in a diverse allocation of fixed maturity securities to capture what we believe are adequate risk-adjusted returns in an evolving investment environment.

During 2015, interest rates increased and credit spreads widened, thereby decreasing the fair value of many of our fixed maturity investments. As a result of these effects, we had a pre-tax unrealized gain of \$12.8 million in our fixed maturities portfolio at December 31, 2015 compared to a pre-tax unrealized gain of \$28.8 million at December 31, 2014. At December 31, 2015 our equity securities had a pre-tax unrealized loss of \$0.3 million compared to the prior years' pre-tax unrealized gain of \$8.9 million and declined primarily due to the sales of equity securities during 2015, which had unrealized gains at December 31, 2014, as well as greater volatility within the U.S. equity markets.

The following table demonstrates the sensitivity of the fair value of our fixed maturity portfolio to reasonably likely changes in interest rates by illustrating the estimated effect that an immediate increase of 100 basis points in the interest rate yield curve would have based on the duration of the portfolio. Effects of increases or decreases from the 100 basis points illustrated would be approximately proportional.

	At December 31,	
	2015	2014
	(Dollars in thousands)	
Fair value of fixed maturity portfolio	\$ 1,050,988	\$ 974,746
Pretax impact on fair value of 100bps increase in interest rates	(42,040)	(38,990)
Pretax impact as % of total fixed maturity portfolio	(4.0)%	(4.0)%

Included in fixed maturities at December 31, 2015 were \$316.4 million of state and local government obligations, which represented 30.1% of our fixed maturity portfolio, with approximately \$275.5 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 98.9% of such securities were rated investment grade at December 31, 2015. We had no state and local government obligations for any state, municipality or political subdivision that comprised 10% or more of the fair value of such obligations at December 31, 2015.

At December 31, 2015, \$53.0 million, or 5.0%, of our fixed maturity portfolio consisted of securities issued by energy and commodity related entities. Investment-grade rated fixed maturities represented 80.2% of that total, with an unrealized loss exposure to these entities totaling \$4.9 million.

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 December 31, 2015, less than 5% of our investments consisted of European debt and we owned no sovereign debt issued by the peripheral countries.

Equity Risk. Equity risk represents the potential economic losses due to adverse changes in equity security prices. As of December 31, 2015, approximately 6.9% of the carrying value of our investment portfolio (excluding cash and cash equivalents) was invested in equity securities. We manage equity price risk primarily through asset allocation and industry and issuer diversification. At December 31, 2015, \$5.0 million, or 6.1%, of our equity securities consisted of investments issued by energy and commodity related entities, with an unrealized loss exposure to these entities totaling \$0.5 million. We manage equity price risk primarily through asset allocation and industry and issuer diversification.

Table of Contents

ITEM 8 Financial Statements and Supplementary Data

	Page
Index to Financial Statements	
<u>Management's Report on Internal Control Over Financial Reporting</u>	<u>52</u>
<u>Reports of Independent Registered Public Accounting Firm</u>	<u>53</u>
<u>Consolidated Balance Sheets:</u>	<u>55</u>
December 31, 2015 and 2014	
<u>Consolidated Statements of Income:</u>	<u>56</u>
Years ended December 31, 2015, 2014 and 2013	
<u>Consolidated Statements of Comprehensive Income:</u>	<u>57</u>
Years ended December 31, 2015, 2014 and 2013	
<u>Consolidated Statements of Shareholders' Equity:</u>	<u>58</u>
Years ended December 31, 2015, 2014 and 2013	
<u>Consolidated Statements of Cash Flows:</u>	<u>59</u>
Years ended December 31, 2015, 2014 and 2013	
<u>Notes to Consolidated Financial Statements</u>	<u>60</u>
Selected "Quarterly Operating Results" have been included in Note 17 to the consolidated financial statements.	

Table of Contents

MANAGEMENT’S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

We, as management of National Interstate Corporation and its subsidiaries (the “Company”), are responsible for establishing and maintaining adequate internal control over financial reporting. Pursuant to the rules and regulations of the Securities and Exchange Commission, internal control over financial reporting is a process designed by, or under the supervision of, the Company’s principal executive and principal financial officers or persons performing similar functions and effected by the Company’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company’s assets that could have a material effect on the financial statements.

Management has evaluated the effectiveness of the Company’s internal control over financial reporting as of December 31, 2015, based on the control criteria established in a report entitled Internal Control — Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework). Based on such evaluation, we have concluded that the Company’s internal control over financial reporting is effective as of December 31, 2015.

The independent registered public accounting firm of Ernst & Young LLP, as auditors of the Company’s consolidated financial statements, has issued an attestation report on the effectiveness of the Company’s internal control over financial reporting.

/s/ David W. Michelson
David W. Michelson
Chief Executive Officer

/s/ Julie A. McGraw
Julie A. McGraw
Vice President and Chief Financial Officer

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of
National Interstate Corporation and subsidiaries

We have audited National Interstate Corporation and subsidiaries' internal control over financial reporting as of December 31, 2015, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). National Interstate Corporation and subsidiaries' management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, National Interstate Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of National Interstate Corporation and subsidiaries as of December 31, 2015 and 2014 and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2015 of National Interstate Corporation and subsidiaries and our report dated March 9, 2016 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Cleveland, Ohio

March 9, 2016

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of
National Interstate Corporation and subsidiaries

We have audited the accompanying consolidated balance sheets of National Interstate Corporation and subsidiaries as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2015. Our audits also included the financial statement schedules listed in the Index at Item 15(a). These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of National Interstate Corporation and subsidiaries at December 31, 2015 and 2014, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2015, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), National Interstate Corporation and subsidiaries' internal control over financial reporting as of December 31, 2015, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated March 9, 2016 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP
Cleveland, Ohio
March 9, 2016

Table of ContentsNATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2015	2014
	(In thousands, except per share data)	
ASSETS		
Investments:		
Fixed maturities available-for-sale, at fair value (amortized cost - \$1,038,230 and \$945,956, respectively)	\$ 1,050,988	\$ 974,746
Equity securities available-for-sale, at fair value (amortized cost - \$81,919 and \$76,352, respectively)	81,629	85,228
Other invested assets	47,891	46,786
Total investments	1,180,508	1,106,760
Cash and cash equivalents	71,944	53,583
Accrued investment income	9,227	8,724
Premiums receivable, net of allowance for doubtful accounts of \$2,127 and \$2,627, respectively	294,812	271,336
Reinsurance recoverable on paid and unpaid losses	230,346	180,332
Prepaid reinsurance premiums	51,176	47,013
Deferred policy acquisition costs	22,265	22,654
Deferred federal income taxes	33,835	23,150
Property and equipment, net	22,562	24,538
Funds held by reinsurer	7,850	4,335
Intangible assets, net	7,650	7,791
Prepaid expenses and other assets	3,707	4,517
Total assets	\$ 1,935,882	\$ 1,754,733
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Unpaid losses and loss adjustment expenses	\$ 1,014,195	\$ 883,078
Unearned premiums and service fees	336,934	311,255
Long-term debt	12,000	12,000
Amounts withheld or retained for accounts of others	115,174	101,799
Reinsurance balances payable	37,097	31,069
Accounts payable and other liabilities	41,277	33,402
Commissions payable	15,307	15,392
Assessments and fees payable	5,001	4,649
Total liabilities	1,576,985	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 3,441 and 3,557 shares, respectively, in treasury	234	234
Additional paid-in capital	61,926	59,386
Retained earnings	293,516	283,031

Edgar Filing: National Interstate CORP - Form 10-K

Accumulated other comprehensive income	8,105		24,483	
Treasury shares	(4,884	)	(5,045)
Total shareholders' equity	358,897		362,089	
Total liabilities and shareholders' equity	\$ 1,935,882		\$ 1,754,733	

See notes to consolidated financial statements.

55

Table of ContentsNATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,			
	2015	2014	2013	
	(In thousands, except per share data)			
Revenues:				
Premiums earned	\$585,787	\$557,267	\$525,710	
Net investment income	39,739	35,517	33,377	
Net realized (losses) gains on investments (*)	(3,278	) 6,758	6,536
Other	3,477	3,399	3,303	
Total revenues	625,725	602,941	568,926	
Expenses:				
Losses and loss adjustment expenses	471,940	466,998	429,556	
Commissions and other underwriting expenses	94,075	94,430	92,193	
Other operating and general expenses	25,569	20,955	19,722	
Transaction expense	—	2,163	—	
Expense on amounts withheld	6,458	6,410	5,057	
Interest expense	199	220	706	
Total expenses	598,241	591,176	547,234	
Income before income taxes	27,484	11,765	21,692	
Provision for income taxes	6,637	739	4,119	
Net income	\$20,847	\$11,026	\$17,573	
Net income per share – basic	\$1.05	\$0.56	\$0.89	
Net income per share – diluted	\$1.05	\$0.56	\$0.89	
Weighted average of common shares outstanding - basic	19,862	19,755	19,645	
Weighted average of common shares outstanding - diluted	19,910	19,833	19,768	
Cash dividends per common share	\$0.52	\$0.48	\$0.44	
(*) Consists of the following:				
Net realized gains before impairment losses	\$4,484	\$8,721	\$6,691	
Total losses on securities with impairment charges	(7,750) (1,733) (155)
Non-credit portion recognized in other comprehensive income	(12) (230) —)
Net impairment charges recognized in earnings	(7,762) (1,963) (155)
Net realized (losses) gains on investments	\$(3,278	) \$6,758	\$6,536

Table of Contents

See notes to consolidated financial statements.

NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Net income	\$20,847	\$11,026	\$17,573
Other comprehensive (loss) income, before tax:			
Net unrealized holding (losses) gains on available-for-sale securities:			
Net unrealized holding (losses) gains on securities arising during the period	(26,806	) 12,593	(14,745
Reclassification adjustment for net realized losses (gains) included in net income	1,608	(4,590	) (4,260
Total other comprehensive (loss) income, before tax	(25,198	) 8,003	(19,005
Deferred income tax (benefit) expense on other comprehensive (loss) income	(8,820	) 2,801	(6,652
Other comprehensive (loss) income, net of tax	(16,378	) 5,202	(12,353
Total comprehensive income	\$4,469	\$16,228	\$5,220

See notes to consolidated financial statements.

Table of ContentsNATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common Shares	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Shares	Total
	(Dollars in thousands)					
Balance at January 1, 2013	\$234	\$54,788	\$272,618	\$ 31,634	\$(5,326)	\$353,948
Net income			17,573			17,573
Other comprehensive loss, net of tax				(12,353)		(12,353)
Dividends on common shares			(8,673)			(8,673)
Issuance of 69,662 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		1,031			96	1,127
Net tax effect from exercise/vesting of share-based compensation		25				25
Share-based compensation expense		637				637
Balance at December 31, 2013	234	56,481	281,518	19,281	(5,230)	352,284
Net income			11,026			11,026
Other comprehensive income, net of tax				5,202		5,202
Dividends on common shares			(9,513)			(9,513)
Issuance of 132,712 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		2,229			185	2,414
Net tax effect from exercise/vesting of share-based compensation		51				51
Share-based compensation expense		625				625
Balance at December 31, 2014	234	59,386	283,031	24,483	(5,045)	362,089
Net income			20,847			20,847
Other comprehensive loss, net of tax				(16,378)		(16,378)
Dividends on common shares			(10,362)			(10,362)
Issuance of 116,013 treasury shares upon exercise of options and restricted stock issued, net of forfeitures		1,779			161	1,940
Net tax effect from exercise/ vesting of share-based compensation		(48)				(48)
Share-based compensation expense		809				809
Balance at December 31, 2015	\$234	\$61,926	\$293,516	\$ 8,105	\$(4,884)	\$358,897

See notes to consolidated financial statements.

Table of ContentsNATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Operating activities			
Net income	\$20,847	\$11,026	\$17,573
Adjustments to reconcile net income to net cash provided by operating activities:			
Net amortization of bond premiums and discounts	3,054	4,180	6,084
Provision for depreciation and amortization	5,133	5,512	3,878
Net realized losses (gains) on investment securities	3,278	(6,758)	(6,536)
Deferred federal income taxes	(1,865)	(125)	708
Share-based compensation expense	809	625	637
Change in:			
Deferred policy acquisition costs, net	389	371	2,221
Reserves for losses and loss adjustment expenses	131,117	79,296	28,477
Premiums receivable	(23,476)	(26,402)	(29,244)
Unearned premiums and service fees	25,679	27,673	17,456
Interest receivable and other assets	(3,208)	(2,865)	93
Prepaid reinsurance premiums	(4,163)	(9,146)	(5,297)
Accounts payable, commissions and other liabilities and assessments and fees payable	6,388	(11,420)	(11,507)
Amounts withheld or retained for accounts of others	13,375	20,800	13,997
Reinsurance recoverable	(50,014)	(11,122)	5,135
Reinsurance balances payable	6,028	4,752	6,844
Other operating activities, net	621	40	(116)
Net cash provided by operating activities	133,992	86,437	50,403
Investing activities			
Purchases of fixed maturities	(276,222)	(199,414)	(245,969)
Purchases of equity securities	(28,423)	(31,717)	(35,986)
Proceeds from sale of fixed maturities	15,240	22,146	55,538
Proceeds from sale of equity securities	20,497	12,670	8,748
Proceeds from maturities and redemptions of investments	168,160	143,111	174,304
Change in other investments, net	(2,775)	(3,231)	(2,120)
Capital expenditures	(3,638)	(5,055)	(3,694)
Net cash used in investing activities	(107,161)	(61,490)	(49,179)
Financing activities			
Net tax effect from exercise/vesting of share-based compensation	(48)	51	25
Proceeds from the issuance of common shares from treasury	1,940	2,414	1,127
Cash dividends paid on common shares	(10,362)	(9,513)	(8,673)
Net cash used in financing activities	(8,470)	(7,048)	(7,521)
Net increase (decrease) in cash and cash equivalents	18,361	17,899	(6,297)
Cash and cash equivalents at beginning of year	53,583	35,684	41,981
Cash and cash equivalents at end of year	\$71,944	\$53,583	\$35,684

See notes to consolidated financial statements.

59

Table of Contents

NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO NOTES

<u>1. Background, Basis of Presentation and Principles of Consolidation</u>	<u>11. Reinsurance</u>
<u>2. Significant Accounting Policies</u>	<u>12. Unpaid Losses and LAE</u>
<u>3. Fair Value Measurements</u>	<u>13. Expense on Amounts Withheld</u>
<u>4. Investments</u>	<u>14. Statutory Accounting Principles</u>
<u>5. Long-term Debt</u>	<u>15. Commitments and Contingencies</u>
<u>6. Income Taxes</u>	<u>16. Segment Information</u>
<u>7. Share-Based Compensation</u>	<u>17. Quarterly Operating Results (Unaudited)</u>
<u>8. Employee Benefit Plan</u>	<u>18. Accumulated Other Comprehensive Income</u>
<u>9. Earnings Per Common Share</u>	<u>19. Subsequent Event</u>
<u>10. Transactions with Related Parties</u>	

1. Background, Basis of Presentation and Principles of Consolidation

National Interstate Corporation (the “Company”) and its subsidiaries operate as an insurance holding company group that underwrites and sells traditional and alternative risk transfer property and casualty insurance products primarily to the passenger transportation, trucking and moving and storage industries, general commercial insurance to small businesses in Hawaii and Alaska and personal insurance to owners of recreational vehicles throughout the United States.

The Company is a 51.1% owned subsidiary of Great American Insurance Company (“Great American”), a wholly-owned subsidiary of American Financial Group, Inc. (“AFG”).

The Company has five property and casualty insurance subsidiaries: National Interstate Insurance Company (“NIIC”), Vanliner Insurance Company (“VIC”), National Interstate Insurance Company of Hawaii, Inc. (“NIIC-HI”), Triumpher Casualty Company (“TCC”), and Hudson Indemnity, Ltd. (“HIL”) and six active agency and service subsidiaries. The Company writes its 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 43 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 Company’s alternative risk transfer (“ART”) component. Insurance products are marketed through multiple distribution channels including independent agents and brokers, program administrators, affiliated agencies and agent internet initiatives. The Company uses its six active agency and service subsidiaries to sell and service the Company’s insurance business. Approximately 15.2% of the Company’s premiums are written in the state of California, and an additional 37.2%, collectively, in the states of Texas, New York, Florida, Missouri, New Jersey, North Carolina, Pennsylvania, and Illinois.

A summary of the significant accounting policies applied in the preparation of the consolidated financial statements follows.

Basis of Presentation

The accompanying consolidated financial statements of the Company and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) which differ in some respects from statutory accounting principles (“SAP”) permitted by state regulatory agencies (see Note 14 – “Statutory Accounting Principles”).

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries (NIIC, VIC, NIIC-HI, HIL, TCC, Hudson Management Group, Ltd., National Interstate Insurance Agency, Inc. ("NIIA"), American Highways Insurance Agency,

60

Table of Contents

Inc., TransProtection Service Company, Explorer RV Insurance Agency, Inc. and Safety, Claims and Litigation Services, LLC) since their formation or acquisition. Significant intercompany transactions have been eliminated. For each program in the Company's ART business, a portion of the risk and premium is ceded to a captive reinsurer that is either "rented" or owned by the program participants (the insureds). HIL, the Company's consolidated subsidiary, is "rented" to program participants to facilitate the transfer of risk to the participants and the respective program's results are recorded solely in HIL's financial statements. Captive reinsurance facilities owned and managed directly by the member-owned program participants are not consolidated since they are not variable interest entities.

Use of Estimates

The preparation of financial statements in accordance with GAAP 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. Significant Accounting Policies

Contingent Consideration

The Company accounted for the contingent consideration associated with the contractual obligations of the 2010 acquisition of Vanliner in accordance with ASC 805, Business Combinations. As part of the Purchase Agreement (the "Agreement"), UniGroup, Inc. ("UniGroup") agreed to provide NIIC with comprehensive financial guarantees, including a four and a half year balance sheet guaranty effective through December 31, 2014, whereby both favorable and unfavorable developments related to specified line items on the closing balance sheet, as defined in sections 2.06 and 2.07 of the Agreement, inured to UniGroup. The Company and UniGroup reached a final settlement related to the balance sheet guarantee in the third quarter of 2015, as discussed further below.

The total sum of the difference between acquired amounts and actual or expected settlement amounts for the balance sheet line items which were contractually guaranteed by UniGroup is the calculated contingent consideration. The Company determined the fair value of the contingent consideration that existed at December 31, 2014 based on the present value of expected cash flows associated with the balance sheet line items contractually guaranteed by UniGroup. The estimate of fair value of the contingent consideration required subjective assumptions to be made regarding future business results, discount rates and probabilities assigned to various potential business result scenarios. This amount was discounted based on the appropriate treasury yield curve rate to obtain the discounted fair value at the balance sheet date. At December 31, 2014, the Company had a short-term receivable recorded at fair value for contingent consideration of \$1.2 million. In 2015, the Company reached final settlement and received payment from UniGroup in the amount of \$5.7 million. As a result, no contingent consideration interests are included on the Company's Consolidated Balance Sheet at December 31, 2015.

Cash Equivalents

The Company considers all highly liquid investments with a maturity date of three months or less at the date of acquisition to be cash equivalents.

Premium, Commissions and Service Fee Recognition

Insurance premiums, commissions and service fees generally are recognized over the terms of the policies on a daily pro rata basis. Unearned premiums, commissions and service fees are related to the unexpired terms of the policies in-force.

Investments

The Company classifies its fixed maturity and equity securities as available-for-sale, which are recorded at fair value, with unrealized gains and losses (net of tax) on such securities reported as accumulated other comprehensive income, a separate component of shareholders' equity. The Company accounts for its other invested assets, which are limited partnership investments, under the equity method with changes in value reported as a component of net realized gains or losses on investments. Earnings from limited partnerships are generally reported on a one month to one quarter lag and are invested in debt and equity securities that are listed and traded on exchanges, as well as private equity investments. Cash contributions made to and distributions received from limited partnerships are recorded in the period in which the transaction occurs.

Net investment income is adjusted for amortization of premiums to the earliest of the call date or maturity date and accretion of discounts to maturity. Realized gains and losses credited or charged to income are determined by the specific identification method. Estimated fair values for investments are determined based on published market quotations or where not available, based on other observable market data, broker quotations or other independent sources. When a decline in fair value is deemed to be other-than-

Table of Contents

temporary, a provision for impairment is charged to earnings (included in realized (losses) gains) and the cost basis of that investment is reduced. Interest income is recognized when earned and dividend income is recognized when declared.

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

Additional disclosures required by this guidance are contained in Note 4 – "Investments."

Deferred Policy Acquisition Costs ("DPAC")

Policy acquisition costs, principally commissions, premium taxes and assessments, directly related to the production of new business, are deferred and amortized over the period in which the related premiums are earned. Policy acquisition costs are limited based upon recoverability without any consideration for anticipated investment income and are charged to operations ratably over the terms of the related policies. The Company accelerates the amortization of these costs for premium deficiencies. The amount of deferred policy acquisition costs amortized during both years ended December 31, 2015 and 2014 was \$85.0 million, and for December 31, 2013 was \$82.2 million. There were no premium deficiencies for the years ended December 31, 2015, 2014 or 2013.

Property and Equipment

Property and equipment are reported at cost, less accumulated depreciation and amortization, and include capitalized software developed or acquired for internal use. Property and equipment are depreciated or amortized over the estimated useful lives on a straight-line basis. The useful lives range from three to five years for computer equipment; 20 to 40 years for buildings and improvements; three years for capitalized software; and five to seven years for all other property and equipment. Upon sale or retirement, the cost of the asset and related accumulated depreciation are eliminated from their respective accounts and the resulting gain or loss is included in operations. Repairs and maintenance are charged to operations when incurred. The Company recorded depreciation expense of \$5.0 million, \$5.2 million and \$5.1 million for the years ended December 31, 2015, 2014 and 2013, respectively.

Intangible Assets

The Company recognized certain intangible assets as part of the Vanliner acquisition in 2010 based on their fair value as required by ASC 805. These intangible assets consist of acquired state insurance licenses, with an indefinite life, and an acquired relationship asset relating to renewal rights, trade names, customer relationships and distribution networks. Intangible assets with definite lives are amortized over their estimated useful life, which is five years for the acquired relationship asset. The Company recorded amortization expense of \$0.1 million for the year ended December 31, 2015 and \$0.3 million for both the years ended December 31, 2014 and 2013 relating to this intangible asset, which became fully amortized in 2015. All identifiable intangible assets are tested for recoverability whenever events or changes in circumstances indicate that a carrying amount may not be recoverable. Indefinite-lived intangible assets are subject to annual impairment testing, which was performed during the fourth quarter of 2015. Based upon this review, no impairment losses were recognized in 2015.

Unpaid Losses and Loss Adjustment Expenses ("LAE")

The liabilities for unpaid losses and LAE represent management's best estimate and are based on estimates of policy claims reported and estimates of unreported claims established using historical and industry data. The estimates of policy claim amounts are continuously reviewed and any resulting adjustments are reflected in current operations. Although considerable variability is inherent in such estimates, management believes that the liabilities for unpaid losses and LAE are adequate. These liabilities are reported net of amounts recoverable from salvage and subrogation.

Assessments

The Company recognizes liabilities for estimated assessments for reported insolvencies of other insurers and other charges from regulatory organizations. Management accrues for these liabilities as assessments are imposed or when it is probable an assessment has occurred and the amount of the assessment can be reasonably estimated.

Table of Contents

Premiums Receivable

Premiums receivable are carried at cost, which approximate fair value. Management provides an allowance for doubtful accounts in the period that collectability is deemed impaired.

Reinsurance

Reinsurance premiums, commissions, expense reimbursements and reserves related to reinsured business are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. A significant portion of the reinsurance is related to excess of loss reinsurance contracts. Premiums ceded are reported as a reduction of premiums earned.

Federal Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the periods in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided if it is more likely than not that some or all of the deferred tax assets will not be realized. Management evaluates the realizability of the deferred tax assets and assesses the need for a valuation allowance quarterly. The Company recognizes the tax benefits of uncertain tax positions only when the position is more likely than not to be sustained under examination by the appropriate taxing authority. Management considers the accumulated earnings of the Company's foreign subsidiary to be indefinitely reinvested pursuant to a specific plan for reinvestment. As a result, management has not recorded a deferred tax liability of approximately \$2.7 million on approximately \$8.7 million of undistributed earnings of the Company's foreign subsidiary. Should the Company decide to repatriate the foreign earnings, in the form of dividends or otherwise, it would be subject to both U.S. income taxes and withholding taxes payable to the foreign jurisdiction.

Comprehensive Income

Comprehensive income is defined as all changes in shareholders' equity except those arising from transactions with shareholders. It includes the Company's net income and other comprehensive income, which consists entirely of changes in net unrealized gains or losses (net of income taxes) on the Company's available-for-sale securities. The details of comprehensive income are reported in the Consolidated Statements of Comprehensive Income.

Earnings Per Common Share

Basic earnings per common share is computed based on the weighted average number of common shares outstanding during the period. Diluted earnings per share are based on the weighted average number of common shares and dilutive potential common shares outstanding during the period using the treasury stock method.

Share-Based Compensation

The Company grants options and other share awards to officers under its Long Term Incentive Plan ("LTIP"). The LTIP and share-based compensation are more fully described in Note 7 – "Share-Based Compensation." Compensation expense is recognized for options and restricted share awards issued on a straight-line basis over their vesting periods based on the fair value of these awards at the date of grant. The Company uses the Black-Scholes pricing model to measure the fair value of employee options, while the market price of the Company's common stock on December 31 is used for restricted share awards.

Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers ("ASU 2014-09") to clarify the principles for recognizing revenue. This standard is intended to help reduce diversity in practice and enhance comparability between entities related to revenue recognition. While insurance contracts are not within the scope of this updated guidance, the Company's fee income related to claim and loss prevention services will be subject to this updated guidance. In July 2015, the FASB deferred the effective date of the updated guidance by one year. The updated guidance is effective for the quarter ending March 31, 2018. The Company is in the process of assessing the impact the adoption of this guidance will have on its consolidated financial statements and related disclosures.

In February 2015, the FASB issued 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 ASU 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

Table of Contents

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. 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. The Company will incorporate the required disclosures upon adoption with its annual financial statements as of December 31, 2016 and interim statements beginning with the first quarter of 2017. The new guidance does not affect the existing recognition or measurement guidance and therefore will have no impact on the Company's financial condition or results of operations.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments - Overall (Topic 825), which, among other things, will require all equity securities currently classified as "available-for-sale" to be reported at fair value, with holding gains and losses recognized in net income instead of accumulated other comprehensive income ("AOCI"). The Company will be required to adopt this guidance effective January 1, 2018.

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, 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 primarily 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 December 31, 2015, Level 2 included \$219.8 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

Table of Contents

methodology. The Company obtained at least one quote or price per instrument from its brokers and pricing services for all Level 3 securities and did not adjust any quotes or prices that it obtained. The Company's internal and affiliated investment professionals review these broker quotes using any recent trades, if such information is available, or market prices of similar investments. The Company primarily uses the market approach valuation technique for all investments.

The following table presents the Company's investment portfolio, categorized by the level within the fair value hierarchy in which the fair value measurements fell as of December 31, 2015:

	Level 1 (Dollars in thousands)	Level 2	Level 3	Total
Fixed maturities:				
U.S. Government and government agency obligations	\$4,179	\$147,124	\$—	\$151,303
State and local government obligations	—	311,351	5,021	316,372
Residential mortgage-backed securities	—	157,403	—	157,403
Commercial mortgage-backed securities	—	14,368	—	14,368
Corporate obligations	—	194,045	7,476	201,521
Other debt obligations	—	190,515	14,846	205,361
Redeemable preferred stocks	4,162	—	498	4,660
Total fixed maturities	8,341	1,014,806	27,841	1,050,988
Equity securities:				
Common stocks	53,584	806	2,302	56,692
Nonredeemable preferred stocks	20,868	4,069	—	24,937
Total equity securities	74,452	4,875	2,302	81,629
Total fixed maturities and equity securities	82,793	1,019,681	30,143	1,132,617
Cash and cash equivalents	71,944	—	—	71,944
Total fixed maturities, equity securities and cash and cash equivalents at fair value	\$154,737	\$1,019,681	\$30,143	\$1,204,561

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 (Dollars in thousands)	Level 2	Level 3	Total
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

Edgar Filing: National Interstate CORP - Form 10-K

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

The tables above exclude other invested assets of \$47.9 million and \$46.8 million at December 31, 2015 and 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.

Table of Contents

The Company uses the end of the reporting period as its policy for determining transfers into and out of each level. During the year ended December 31, 2015, the Company transferred four nonredeemable preferred stocks, one common stock and one redeemable preferred stock, with total fair values of \$1.2 million, \$0.9 million, and \$0.2 million, respectively, from Level 1 to Level 2 due to decreases in trading activity. Conversely, during the same period, the Company transferred four nonredeemable preferred stocks, one common stock and one redeemable preferred stock, with total fair values of \$1.5 million, \$19 thousand, and \$0.2 million, respectively, from Level 2 to Level 1 due to increases in trading activity.

During the year ended December 31, 2014, the Company transferred seven nonredeemable preferred stocks with a total fair value of \$5.9 million, from Level 1 to Level 2, due to decreases in trading activity. Conversely, during the same period, the Company transferred seven nonredeemable preferred stocks, with a total fair value of \$6.1 million, from Level 2 to Level 1 due to increases in trading activity. During the year ended December 31, 2013, the Company transferred eight nonredeemable preferred stocks, two common stocks, and one redeemable preferred stock, with total fair values of \$3.8 million, \$1.7 million, and \$1.0 million, respectively, from Level 2 to Level 1, due to increases in trading activity.

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 years ending December 31, 2015, 2014 and 2013. 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.

	Year Ended December 31, 2015				
	State and Local Government Obligations (Dollars in thousands)	Corporate Obligations	Other Debt Obligations	Redeemable Preferred Stocks	Common Stock
Beginning balance at January 1, 2015	\$2,887	\$7,100	\$3,995	\$495	\$3,988
Total gains (losses):					
Included in earnings	—	8	—	—	(278)
Included in other comprehensive income	96	70	(301)	3	(600)
Purchases and issuances	—	500	11,819	—	158
Sales, settlements and redemptions	—	(202)	(2,668)	—	—
Transfers in and/or (out) of Level 3	2,038	—	2,001	—	(966)
Ending balance at December 31, 2015	\$5,021	\$7,476	\$14,846	\$498	\$2,302
The amount of total gains (losses) for the year included in earnings and attributable to the change in unrealized gains (losses) relating to assets still held at the reporting date	\$—	\$—	\$—	\$—	\$(278)

	Year Ended December 31, 2014				
	State and Local Government Obligations	Corporate Obligations	Other Debt Obligations	Redeemable Preferred Stocks	Common Stock	Nonredeemable Preferred Stocks

Edgar Filing: National Interstate CORP - Form 10-K

(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	318	(29	) 8	(26) —	
Purchases and issuances	2,000	1,000	1,500	—	2,514	—	
Sales, settlements and redemptions	—	(202) (811) —	—	(583)
Transfers in and/or (out) of Level 3	—	1,015	—	—	—	—	
Ending balance at December 31, 2014	\$ 2,887	\$ 7,100	\$ 3,995	\$ 495	\$ 3,988	\$ —	
The amount of total gains (losses) for the year included in earnings and attributable to the change in unrealized gains (losses) relating to assets still held at the reporting date	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	

Table of Contents

	Year Ended December 31, 2013					
	State and Local Government Obligations	Corporate Obligations	Other Debt Obligations	Redeemable Preferred Stocks	Common Stock	Nonredeemable Preferred Stocks
	(Dollars in thousands)					
Beginning balance at January 1, 2013	\$ 837	\$ 7,658	\$ —	\$ 483	\$ —	\$ —
Total gains (losses):						
Included in earnings	—	248	—	—	—	13
Included in other comprehensive income	22	(137)	—	4	—	18
Purchases and issuances	—	1,000	—	—	1,500	969
Sales, settlements and redemptions	—	(3,800)	—	—	—	(417)
Transfers in and/or (out) of Level 3	—	—	3,311	—	—	—
Ending balance at December 31, 2013	\$ 859	\$ 4,969	\$ 3,311	\$ 487	\$ 1,500	\$ 583

The amount of total gains (losses) for the year included in earnings and attributable to the change in unrealized gains (losses) relating to assets still held at the reporting date

At December 31, 2015 the Company had 29 securities with a fair value of \$30.1 million that are included in Level 3, which represents approximately 3.0% 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 reasonably obtainable or 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 8.0% of the Company's shareholders' equity at December 31, 2015, reasonable 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
December 31, 2015:				
Fixed maturities:				
U.S. Government and government agency obligations	\$ 149,402	\$ 2,197	\$(296)	) \$ 151,303
State and local government obligations	305,625	10,927	(180)	) 316,372
Residential mortgage-backed securities	153,191	5,407	(1,195)	) 157,403
Commercial mortgage-backed securities	13,703	675	(10)	) 14,368
Corporate obligations	204,761	4,039	(7,279)	) 201,521
Other debt obligations	207,034	384	(2,057)	) 205,361
Redeemable preferred stocks	4,514	149	(3)	) 4,660
Total fixed maturities	1,038,230	23,778	(11,020)	) 1,050,988
Equity securities:				
Common stocks	57,785	3,839	(4,932)	) 56,692
Nonredeemable preferred stocks	24,134	1,121	(318)	) 24,937
Total equity securities	81,919	4,960	(5,250)	) 81,629
Total fixed maturities and equity securities	\$ 1,120,149	\$ 28,738	\$(16,270)	) \$ 1,132,617
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 \$47.9 million and \$46.8 million at December 31, 2015 and 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 30.1% of the Company's fixed maturity portfolio at December 31, 2015, with approximately \$275.5 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 98.9% of such securities rated investment grade (as determined by nationally recognized agencies) at December 31, 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 December 31, 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 December 31, 2015 and 2014.

The amortized cost and fair value of fixed maturities at December 31, 2015, by contractual maturity, are shown below.

Other debt obligations, which are primarily comprised of asset-backed securities other than mortgage-backed securities, and other securities

Table of Contents

with sinking funds are categorized based on their average maturity. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The average life of mortgage-backed securities is 3.8 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	\$35,903	\$36,226
Due after one year through five years	373,783	375,561
Due after five years through ten years	384,313	387,039
Due after ten years	77,337	80,391
	871,336	879,217
Mortgage-backed securities	166,894	171,771
Total	\$1,038,230	\$1,050,988

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

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Fixed maturity gains	\$854	\$1,352	\$3,495
Fixed maturity losses	(2,661	) (262	) (602
Equity security gains	6,430	4,404	2,375
Equity security losses	(6,231	) (2,046	) (246
Other invested assets, net (losses) gains	(1,670	) 3,310	1,514
Net realized (losses) gains on investments	\$(3,278	) \$6,758	\$6,536

Pre-tax net realized losses on investments were \$3.3 million for the year ended December 31, 2015, as compared to net realized gains of \$6.8 million and \$6.5 million for the years ended December 31, 2014 and 2013, respectively. The net realized losses in 2015 were driven by \$7.8 million in other-than-temporary impairment charges on both equity and fixed maturity securities, which were concentrated within the energy and financial services sectors, as compared to \$2.0 million and \$0.2 million for the years ended December 31, 2014 and 2013, respectively. The other-than-temporary impairment charges for the years ended December 31, 2015, 2014 and 2013, occurred on securities where management is uncertain of the timing and the extent of ultimate recovery. In addition, other invested assets produced net losses of \$1.7 million as these investments were impacted by turmoil in the energy sector during 2015, as compared to net gains of \$3.3 million and \$1.5 million for the years ended December 31, 2014 and 2013, respectively.

Partially offsetting these losses for 2015, and contributing to the gains on investments in 2014 and 2013, were net realized gains associated with the sales or redemptions of securities of \$6.2 million, \$5.4 million and \$5.2 million for the years ended December 31, 2015, 2014 and 2013, respectively.

Table of Contents

Realized gains (losses) and changes in unrealized appreciation (depreciation) 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)				
Year Ended December 31, 2015:					
Realized before impairments	\$ 189	\$ 5,965	\$(1,670)	) \$(1,569	) \$ 2,915
Realized - impairments	(1,996	) (5,766	) —	2,717	(5,045)
Change in unrealized	(16,032	) (9,166	) —	8,820	(16,378)
Year Ended December 31, 2014:					
Realized before impairments	1,352	4,059	3,310	(3,052	) 5,669
Realized - impairments	(262	) (1,701	) —	687	(1,276)
Change in unrealized	9,360	(1,357	) —	(2,801	) 5,202
Year Ended December 31, 2013:					
Realized before impairments	2,900	2,277	1,514	(2,342	) 4,349
Realized - impairments	(7	) (148	) —	54	(101)
Change in unrealized	(25,271	) 6,266	—	6,652	(12,353)

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)								
December 31, 2015:								
Fixed maturities:								
U.S. Government and government agency obligations	\$45,631	\$(296)	99.4 %	22	\$—	\$—	0.0 %	—
State and local government obligations	15,498	(137)	99.1 %	15	1,627	(43)	97.4 %	3
Residential mortgage-backed securities	23,502	(318)	98.7 %	28	28,426	(877)	97.0 %	31
Commercial mortgage-backed securities	440	(1)	99.8 %	1	495	(9)	98.2 %	1
Corporate obligations	75,756	(5,660)	93.0 %	99	3,658	(1,619)	69.3 %	5
Other debt obligations	138,531	(1,860)	98.7 %	131	8,201	(197)	97.7 %	11
Redeemable preferred stocks	344	(1)	99.7 %	1	498	(2)	99.6 %	1
Total fixed maturities	299,702	(8,273)	97.3 %	297	42,905	(2,747)	94.0 %	52
Equity securities:								
Common stocks	26,993	(4,932)	84.6 %	42	—	—	0.0 %	—
Nonredeemable preferred stocks	5,387	(113)	97.9 %	11	2,795	(205)	93.2 %	3
Total equity securities	32,380	(5,045)	86.5 %	53	2,795	(205)	93.2 %	3
Total fixed maturities and equity securities	\$332,082	\$(13,318)	96.1 %	350	\$45,700	\$(2,952)	93.9 %	55
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

Edgar Filing: National Interstate CORP - Form 10-K

Other debt obligations	50,733	(273)	99.5 %	54	13,291	(267)	98.0 %	13
Redeemable preferred stocks	—	—	0.0 %	—	495	(5)	99.0 %	1
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

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 \$16.3 million at December 31, 2015. The increase in gross unrealized losses was driven primarily by an increase in interest rates and credit spreads, as well as the continued downturn in the energy and energy related sectors, leading to lower valuations. The \$11.0 million in gross unrealized losses at December 31, 2015 on fixed maturity securities was primarily on holdings in corporate obligations and to a lesser extent, other debt obligations and residential mortgage-backed securities. Investment grade securities represented 88.8% of all fixed maturity securities with unrealized losses. The gross unrealized losses on equity securities at December 31, 2015 consist of \$4.9 million of common stocks that have been in an unrealized loss position for less than twelve months as well as \$0.3 million of primarily investment grade nonredeemable preferred stocks, all of which are considered to be temporary.

At December 31, 2015, corporate obligations, with gross unrealized losses of \$7.3 million, had 99 securities that were in an unrealized loss position of \$5.7 million for less than 12 months and 5 securities with gross unrealized losses of \$1.6 million for 12 months or more. Investment grade securities represented 75.2% of all corporate obligations with unrealized losses. At December 31, 2015, other debt obligations, with gross unrealized losses of \$2.1 million, had 131 securities that were in an unrealized loss position of \$1.9 million for less than 12 months and 11 securities with unrealized losses of \$0.2 million for 12 months or more. Investment grade securities represented 99.4% of all other debt obligations with unrealized losses.

At December 31, 2015, residential mortgage-backed securities, with gross unrealized losses of \$1.2 million, had 28 securities that were in an unrealized loss position of \$0.3 million for less than 12 months and 31 securities with gross unrealized losses of \$0.9 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 at December 31, 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:

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Beginning balance at January 1	\$2,368	\$2,183	\$2,282
Additional credit impairments on:			
Previously impaired securities	15	230	—
Securities without prior impairment	37	—	—
Reductions - disposals	(29	) (45	) (99
Ending balance at December 31	\$2,391	\$2,368	\$2,183

Table of Contents

The following table summarizes investment income earned and investment expenses incurred:

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Investment income:			
Fixed maturities	\$36,498	\$33,516	\$32,753
Equity securities	4,480	3,179	2,003
Short-term investments and cash equivalents	8	4	5
Total investment income	40,986	36,699	34,761
Investment expense	(1,247	) (1,182	) (1,384
Net investment income	\$39,739	\$35,517	\$33,377

At December 31, 2015 and 2014, the carrying value of all deposits with state insurance departments was \$119.4 million and \$104.8 million, respectively. These deposits consisted of fixed maturity investments, certificates of deposit and money market funds.

5. Long-Term Debt

Long-term debt outstanding was \$12.0 million at December 31, 2015 and December 31, 2014.

On November 19, 2012, the Company replaced its \$50.0 million credit agreement with 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. The Company has 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 0.750% to 1.000% based on the Company's 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) 0.5% in excess of the federal funds effective rate, or (c) 1.0% in excess of the one-month LIBOR rate. Based on the Company's A.M. Best insurance group rating of "A" at December 31, 2015, the interest rate on this debt is equal to the six-month LIBOR (0.524% at December 31, 2015) rate plus 87.5 basis points, with interest payments due quarterly. Commitment fees on the average daily unused portion of the Credit Agreement also vary with the Company's A.M. Best insurance group rating and range from 0.075% to 0.125%, or 0.100% at December 31, 2015.

The Credit Agreement requires the Company 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 the Company's 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 December 31, 2015, the Company was in compliance with all covenants.

Interest paid on long-term debt during the years ended December 31, 2015, 2014 and 2013 was \$0.2 million, \$0.1 million and \$0.2 million, respectively.

6. Income Taxes

Income tax (benefit) expense was as follows:

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Current federal income tax provision	\$8,142	\$1,014	\$3,350
Current state income tax provision	360	265	232
Deferred federal income tax (benefit) expense	(1,865	) (540	) 537
	\$6,637	\$739	\$4,119

Table of Contents

A reconciliation of the provision for income taxes for financial reporting purposes and the provision for income taxes calculated at the statutory rate of 35% is as follows:

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Federal income tax expense at statutory rate	\$9,619	\$4,118	\$7,592
Effect of:			
Tax-exempt investment income	(3,305	) (3,569	) (3,829
Other items, net	323	190	356
	\$6,637	\$739	\$4,119

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:

	December 31,	
	2015	2014
	(Dollars in thousands)	
Deferred tax assets:		
Unearned premiums	\$19,959	\$18,442
Unpaid losses and loss adjustment expenses	18,687	19,609
Assessments and fees payable	1,576	1,491
Realized losses on investments, primarily impairments	5,147	4,138
Accrued compensation	1,959	1,897
Limited partnership investments	61	—
Other, net	2,185	2,548
Total deferred tax assets	49,574	48,125
Deferred tax liabilities:		
Deferred policy acquisition costs	(7,793	) (7,929
Unrealized gains on investments	(4,363	) (13,183
Intangible assets	(2,678	) (2,727
Limited partnership investments	—	(236
Prepaid expense	(279) —
Other, net	(626	) (900
Total deferred tax liabilities	(15,739	) (24,975
Net deferred tax assets	\$33,835	\$23,150

Federal income taxes paid, net of refunds, for 2015, 2014 and 2013 were \$6.2 million, \$2.5 million and \$16.2 million, respectively. At December 31, 2015 and December 31, 2014, income tax recoverables were \$1.4 million and \$0.9 million, respectively, and are included in the "Prepaid expense and other assets" line-item on the Company's Consolidated Balance Sheets.

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

The Company had no liability recorded for unrecognized tax benefits at December 31, 2015 and 2014. In addition, the Company has not accrued for interest and penalties related to unrecognized tax benefits. However, if interest and penalties would need to be accrued related to unrecognized tax benefits, such amounts would be recognized as a component of the provision for federal income taxes.

The Company files income tax returns in the U.S. federal jurisdiction and various state and U.S. territory jurisdictions. With limited exceptions, the Company is no longer subject to U.S. federal or state income tax examination for years before 2012.

Table of Contents

7. Share-Based Compensation

The Company grants options and other share awards to officers and key employees of the Company under the LTIP. At December 31, 2015, there were 745,389 of the Company's common shares reserved for issuance under the LTIP, of which 180,000 common shares are for outstanding options. 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. Restricted share awards generally cliff vest three years from 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. Treasury shares are used to fulfill the options exercised and other awards granted.

The Company recognized share-based compensation expense, inclusive of options forfeited, of \$0.8 million for the year ended December 31, 2015 and \$0.6 million for both years ended December 31, 2014 and 2013. Related income tax benefits were approximately \$0.2 million for each of the years ended December 31, 2015, 2014 and 2013. At December 31, 2015, there was \$0.3 million and \$0.8 million of unrecognized compensation expense related to nonvested options and restricted share awards, respectively. These amounts are both expected to be recognized over a weighted average of 1.5 years. The Company has included share-based compensation expense within the "Other operating and general expenses" line-item in the Consolidated Statements of Income.

A summary of option activity in the LTIP is as follows:

	Year Ended December 31, 2015			
	Total Options Outstanding		Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
	Shares	Weighted Average Exercise Price		
Options outstanding, beginning of year	286,853	\$22.15		
Expired	(3,000	) 13.50		
Exercised	(103,853	) 18.82		
Options outstanding, end of year	180,000	\$24.22	5.5 years	\$447
Options exercisable, end of year	116,000	\$23.96	5.1 years	\$318

The intrinsic value of options exercised was \$0.9 million, \$1.1 million and \$0.6 million for the years ended December 31, 2015, 2014 and 2013, respectively. The total fair value of options vested during the years ended December 31, 2015, 2014, and 2013 was \$0.2 million, \$0.3 million, and \$0.4 million, respectively. The Company has not granted options since 2012.

A summary of restricted stock activity in the LTIP is as follows:

	Year Ended December 31, 2015	
	Total Nonvested Shares	
	Shares	Weighted Average Grant Date Fair Value
Nonvested shares, beginning of year	64,320	\$ 29.63
Granted	15,555	29.80
Vested	(12,000	) 32.11
Forfeited	(4,321	) 27.79
Nonvested shares, end of year	63,554	\$ 29.32

The Company granted 18,885 restricted shares (fair value of \$23.00 per share) in 2014. There were 12,543 restricted shares (fair value \$32.33 per share) granted in 2013. The fair value of shares vested was \$0.4 million for the year ended December 31, 2015 and \$0.3 million for each of the years ended December 31, 2014 and 2013.

8. Employee Benefit Plan

The Company maintains a retirement savings plan under Section 401(k) of the Internal Revenue Code of 1986, as amended, covering substantially all full-time employees (the "Plan"). Contributions to the profit sharing portion of the Plan are made at the discretion of the Company and are based on a percentage of employees' earnings after their eligibility date. Profit sharing expense for the year ended December 31, 2015 was \$0.1 million and was \$1.0 million for both of the years ended December 31, 2014 and 2013. Effective August 2015, the Plan provides for employer matching of participant contributions for 100% on the first 3% and

Table of Contents

50% on the next 3% of the employee's qualifying salary. For the year ended December 31, 2015, matching contributions made by the Company for the Plan were \$0.6 million. There were no matching contributions made by the Company to the Plan for the years ended December 31, 2014 and 2013. Profit sharing distributions and employee and employer matching contributions are invested at the direction of the employee in a number of investment options available under the Plan, offered by an unaffiliated investment manager. Participants in the Plan may choose to invest in the Company's common shares as an investment option. The Company does not provide other postretirement and postemployment benefits.

9. Earnings Per Common Share

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

	Year Ended December 31,		
	2015	2014	2013
	(In thousands, except per share data)		
Net income	\$20,847	\$11,026	\$17,573
Weighted average shares outstanding during period	19,862	19,755	19,645
Additional shares issuable under employee common stock option plans using treasury stock method	48	78	123
Weighted average shares outstanding assuming exercise of stock options	19,910	19,833	19,768
Net income per share:			
Basic	\$1.05	\$0.56	\$0.89
Diluted	\$1.05	\$0.56	\$0.89

For both years ended December 31, 2015 and 2014 there were 97,870 outstanding options and restricted shares excluded from dilutive earnings because they were anti-dilutive. For the year ended December 31, 2013 there were 100,000 outstanding options and restricted shares excluded from dilutive earnings because they were anti-dilutive.

10. Transactions with Related Parties

The Company's principal insurance subsidiary, NIIC, is involved in the assumption of reinsurance. NIIC is a party to a reinsurance agreement, and NIIA, a wholly-owned subsidiary of the Company, is a party to an underwriting management agreement with Great American. As of December 31, 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. The Company was also previously involved in the cession of 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 was not material.

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

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Assumed premiums written	\$280	\$566	\$1,725
Assumed premiums earned	415	1,024	2,134
Assumed losses and loss adjustment expense incurred	36	796	2,426
Ceded premiums written	4	68	51

Edgar Filing: National Interstate CORP - Form 10-K

Ceded premiums earned	29	66	54
Ceded losses and loss adjustment expense recoveries	467	862	1,959
	December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Payable to Great American as of year end	\$3	\$56	\$103

76

Table of Contents

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.

During 2015, Virginia, Washington, and Connecticut 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 AFG, whereby AMMC manages approximately 58.0% 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 \$1.0 million for the year ended December 31, 2015 and \$0.9 million for both years ended December 31, 2014 and 2013.

Great American or its parent, AFG, perform, and have for many years performed, certain services for the Company without charge including, without limitation, actuarial services and on a consultative basis, as needed, 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.

On April 18, 2014, the Company entered into an agreement with Alan R. Spachman, whereby the Company agreed to reimburse Mr. Spachman for a portion of the legal fees and expenses that he incurred personally in connection with the tender offer by Great American to purchase all the publicly traded shares of the Company that Great American did not already own. The agreement provided that the Company pay \$0.6 million to Mr. Spachman. Such amount is included in the "Transaction expenses" line item on our Consolidated Statements of Income. The Company recognized the expense in the first quarter and remitted the payment of \$0.6 million on April 25, 2014.

11. Reinsurance

Premiums and reinsurance activity consisted of the following:

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Direct premiums written	\$708,490	\$676,821	\$621,532
Reinsurance assumed	18,629	12,182	10,461
Reinsurance ceded	(119,693)	(113,429)	(94,389)
Net premiums written	\$607,426	\$575,574	\$537,604
Direct premiums earned	\$683,967	\$649,764	\$604,673
Reinsurance assumed	17,349	11,786	10,129
Reinsurance ceded	(115,529)	(104,283)	(89,092)
Total premiums earned	\$585,787	\$557,267	\$525,710
	December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Reinsurance recoverable	\$230,346	\$180,332	\$169,210

The Company cedes premiums through reinsurance agreements with reinsurers to reduce exposure in certain of its property-casualty insurance programs. Ceded losses and loss adjustment expense recoveries recorded for the years

ended December 31, 2015, 2014 and 2013 were \$55.0 million, \$60.8 million and \$66.6 million, 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

Table of Contents

to meet their obligations for losses assumed. To minimize its exposure to significant losses from reinsurer insolvencies, the Company seeks to do business with only reinsurers rated "Excellent" 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.

12. Unpaid Losses and LAE

The following table provides a reconciliation of the beginning and ending reserve balances for unpaid losses and LAE, on a net of reinsurance basis, for the dates indicated, to the gross amounts reported in the Company's Consolidated Balance Sheets:

	December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Reserve for losses and LAE, net of related reinsurance recoverables, at beginning of year	\$713,635	\$647,339	\$607,604
Add:			
Provision for unpaid losses and LAE for claims net of reinsurance, occurring during:			
Current year	457,516	436,400	406,483
Prior years	14,424	30,598	23,073
	471,940	466,998	429,556
Deduct:			
Losses and LAE payments for claims, net of reinsurance, occurring during:			
Current year	123,480	124,049	128,052
Prior years	272,712	276,653	240,981
	396,192	400,702	369,033
Effect on loss and LAE expenses relating to changes in guaranteed reserves	7,001	—	(20,788)
Reserve for losses and LAE, net of related reinsurance recoverables, at end of year	796,384	713,635	647,339
Reinsurance recoverable on unpaid losses and LAE, at end of year	217,811	169,443	156,443
Reserve for unpaid losses and LAE, gross of reinsurance recoverables	\$1,014,195	\$883,078	\$803,782

The foregoing reconciliation shows unfavorable prior year development of \$14.4 million, \$30.6 million, and \$23.1 million for the years ended December 31, 2015, 2014, and 2013, respectively. The unfavorable development and reserve strengthening reported in each of these three years was predominately in the commercial auto liability line of business. In both 2014 and 2015, the unfavorable development, while related to several accident years, was more prominent in accident years 2011 through 2013. Included in the \$14.4 million of unfavorable development in 2015 is \$9.7 million related to reserve strengthening primarily for accident years 2012 and 2013, recorded during the fourth quarter of 2015. Included in the \$30.6 million of unfavorable development in 2014 is \$20.0 million related to reserve strengthening for accident years 2011 through 2013 recorded during the second quarter of 2014. The \$23.1 million of unfavorable development in 2013 was predominately related to accident years 2010 and 2011, of which a portion is related to commercial auto business that is no longer in force, and includes \$6.0 million related to reserve strengthening in accident year 2011 recorded during the second quarter of 2013.

In 2015, the Company recorded unfavorable development on the Vanliner reserves acquired in 2010, compared to no development in 2014 and favorable reserve development in 2013. The development recorded in 2013 and 2015 was

subject to a contractual balance sheet guaranty that expired on December 31, 2014 with the final settlement of such contractual amounts occurring during 2015. Accordingly, offsetting charges to loss and LAE expense were recorded in the Consolidated Statements of Income to record the \$7.0 million relating to the development in 2015 as a receivable from the guarantor and the \$20.8 million relating to the unfavorable development in 2013 as a payable to the guarantor. Management of the Company evaluates case and IBNR reserves based on data from a variety of sources including the Company's historical experience, knowledge of various factors and industry data extrapolated from other insurers writing similar lines of business.

13. Expense on Amounts Withheld

The Company invests funds in the participant loss layer for several of the ART programs. The Company has investment income and realized gains or losses, and incurs an equal expense on the amounts owed to ART participants. "Expense on amounts withheld" represents both investment income and realized gains or losses that the Company remits back to ART participants. The related investment income and realized gains or losses are included in the Company's "Net investment income" and "Net realized (losses)gains on investments" lines, respectively, on its Consolidated Statements of Income.

Table of Contents

The following table summarizes the activity and balances related to ART programs:

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Expense on amounts withheld related to ART programs	\$6,458	\$6,410	\$5,057
	December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Investment balance related to ART programs	\$278,903	\$231,140	\$196,821

14. Statutory Accounting Principles ("SAP")

The Company's insurance subsidiaries report to various insurance departments using SAP prescribed or permitted by the applicable regulatory agency of the domiciliary commissioner. The statutory capital and surplus and statutory net income of NIIC, VIC, TCC and NIIC-HI were as follows:

	December 31,		
	(unaudited)		
	2015	2014	2013
	(Dollars in thousands)		
NIIC statutory capital and surplus	\$295,596	\$284,680	\$283,419
VIC statutory capital and surplus	130,796	127,260	121,918
TCC statutory capital and surplus	19,099	18,450	17,633
NIIC-HI statutory capital and surplus	12,706	12,166	11,292

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
NIIC statutory net income	\$12,548	\$5,355	\$21,925
VIC statutory net income	4,975	4,940	9,466
TCC statutory net income	851	823	1,170
NIIC-HI statutory net income	348	181	673

The statutory capital and surplus of VIC, TCC and NIIC-HI is included in the statutory capital and surplus of NIIC for reporting purposes.

NIIC, VIC, TCC and NIIC-HI are subject to insurance regulations that limit the payment of dividends without the prior approval of their respective insurance regulators. Without prior regulatory approval, the maximum amount of dividend that may be paid in 2016 by NIIC to the Company based on the greater of 10% of prior year surplus or net income is \$29.6 million. VIC's maximum distribution to NIIC based on the greater of 10% of prior year surplus or net income, excluding realized gains, is \$13.1 million. TCC's and NIIC-HI's maximum distribution to NIIC based on the greater of 10% of prior year surplus or net income is \$1.9 million and \$1.3 million, respectively.

NIIC paid no dividends to the Company in 2015 and paid \$10.0 million to the Company in both 2014 and 2013. Also, in accordance with statutory restrictions each of the insurance companies' subsidiaries must meet minimum Risk-Based Capital ("RBC") levels. At December 31, 2015, NIIC, VIC, TCC and NIIC-HI exceeded the minimum RBC levels and are well in excess of minimum capital requirements set forth by the companies' respective states of domicile.

15. 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 LAE reserves. In addition, regulatory bodies, such as state insurance departments, the SEC, the Department of Labor

Table of Contents

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 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 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 December 31, 2015 and 2014, the liability for such assessments was \$5.0 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 \$14.8 million. These limited partnership contractual agreements have expiration dates up to five years whereby the entire amounts or a portion thereof could be required to be funded at any time prior to the expiration dates.

16. 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:

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Revenue:			
Premiums earned:			
Alternative Risk Transfer	\$321,262	\$300,922	\$283,725
Transportation	195,960	191,482	172,367
Specialty Personal Lines	30,718	35,086	45,311
Hawaii and Alaska	19,602	18,009	15,357
Other	18,245	11,768	8,950
Total premiums earned	585,787	557,267	525,710
Net investment income	39,739	35,517	33,377
Net realized (losses) gains on investments	(3,278	) 6,758	6,536

Edgar Filing: National Interstate CORP - Form 10-K

Other	3,477	3,399	3,303
Total revenues	\$625,725	\$602,941	\$568,926

Table of Contents

17. Quarterly Operating Results (Unaudited)

The following are quarterly results of operations for the years ended December 31, 2015 and 2014:

	1 st Quarter (Dollars in thousands)	2 nd Quarter (b)	3 rd Quarter	4 th Quarter	Year Ended
2015					
Revenues	\$ 149,378	\$ 155,037	\$ 158,620	\$ 162,690	\$ 625,725
Net income	7,109	6,642	5,145	1,951	20,847
Net income per share – basic (a)	0.36	0.33	0.26	0.10	1.05
Net income per share – diluted (a)	0.36	0.33	0.26	0.10	1.05
2014					
Revenues	\$ 145,570	\$ 149,775	\$ 152,702	\$ 154,894	\$ 602,941
Net income (loss)	8,055	(10,743)	8,793	4,921	11,026
Net income (loss) per share – basic (a)	0.41	(0.54)	0.44	0.25	0.56
Net income (loss) per share – diluted (a)	0.41	(0.54)	0.44	0.25	0.56

Earnings per share are computed independently for each quarter and the full year based upon respective average (a) shares outstanding. Therefore, the sum of the quarterly earnings per share amounts may not equal the annual amounts reported.

(b) During the second quarter of 2014, the Company experienced an increase in adverse prior year development.

18. Accumulated Other Comprehensive Income, Net of Tax

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

	Year ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Beginning balance	\$ 24,483	\$ 19,281	\$ 31,634
Net unrealized (losses) gains on available-for-sale securities:			
Net unrealized holding (losses) gains on securities arising during the period, net of tax	(17,423)	8,186	(9,584)
Reclassification adjustment for net realized losses (gains) included in net income, net of tax	1,045	(2,984)	(2,769)
Other comprehensive (loss) income, net of tax	(16,378)	5,202	(12,353)
Ending balance	\$ 8,105	\$ 24,483	\$ 19,281

The following table presents amounts related to unrealized gains and losses on available-for-sale securities which were reclassified out of AOCI during the years ended December 31, 2015, 2014, and 2013 categorized by the respective affected line items in the Consolidated Statements of Income:

	Year Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
(Decrease) Increase to net realized (losses) gains on investments	\$(1,608)	\$ 4,590	\$ 4,260
(Decrease) Increase to income before income taxes	(1,608)	4,590	4,260
(Decrease) Increase to (benefit) provision for income taxes	(563)	1,606	1,491
(Decrease) Increase to net income	\$(1,045)	\$ 2,984	\$ 2,769

19. Subsequent Event

On March 7, 2016, AFG announced that it had submitted a proposal to the Company to acquire all of the outstanding shares of Common Stock of the Company (“Common Stock”) not already owned by AFG’s wholly-owned subsidiary, Great American, at

81

Table of Contents

a purchase price of \$30.00 per share in cash. As of March 7, 2016, Great American beneficially owned 10,200,000, or approximately 51.0%, of the outstanding shares of Common Stock.

ITEM 9 Changes in and Disagreements With Accountants on Accounting and Financial Disclosure
None.

ITEM 9A 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 December 31, 2015. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of December 31, 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 SEC'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 control over financial reporting during the year ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Management's Report on Internal Control over Financial Reporting and the Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting, on pages 51 and 52, respectively, are incorporated herein by reference.

ITEM 9B Other Information
None.

Table of Contents

PART III

The information required by the following Items, except as to the information provided below under Item 10 and Item 12, will be included in our definitive Proxy Statement for the 2016 Annual Meeting of Shareholders, which will be filed with the SEC within 120 days after the end of our fiscal year, and is incorporated herein by reference.

ITEM 10 Directors, Executive Officers and Corporate Governance

Our Code of Ethics applicable to our Chief Executive Officer and Chief Financial Officer (“Code of Ethics and Conduct”) is available free of charge in the Corporate Governance Section of our investor relations website (<http://invest.natl.com>). We also intend to disclose any future amendments to, and any waivers from (though none are anticipated), the Code of Ethics and Conduct by posting such information to the Corporate Governance Section of our website.

The information required by this Item 10 is incorporated herein by reference to the information set forth under the captions “Matters to be Considered — Proposal No. 1 Election of Class II Directors,” “Management,” and “Corporate Governance, Committee Descriptions and Reports” and “Nominations and Shareholder Proposals” in our Proxy Statement.

ITEM 11 Executive Compensation

The information required by this Item 11 is incorporated herein by reference to the information set forth under the captions “Compensation Discussion and Analysis,” “Summary Compensation Table,” “Grants of Plan-Based Awards,” “Narrative Disclosure to Summary Compensation Table and Grants of Plan-Based Awards Table,” “Outstanding Equity Awards at Fiscal Year-End,” “Option Exercises and Stock Vested,” “Potential Payments Upon Termination or Change in Control,” “Corporate Governance, Committee Descriptions and Reports” and “2016 Director Compensation” in our Proxy Statement.

ITEM 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item 12 is incorporated herein by reference to the information set forth under the captions “Principal Shareholders” and “Management” in our Proxy Statement.

Equity Compensation Plan Information

The table below shows information regarding awards outstanding and common shares available for issuance (as of December 31, 2015) under the National Interstate Corporation Long Term Incentive Plan, as amended.

Equity Compensation Plans	Number of Securities to be Issued upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (Excluding Securities Reflected in Column (a))
	(a)	(b)	(c)
Approved by shareholders	180,000	\$24.22	565,389
Not approved by shareholders	none	N/A	none

ITEM 13 Certain Relationships and Related Transactions, and Director Independence

The information required by this Item 13 is incorporated herein by reference to the information set forth under the captions “Certain Relationships and Related Transactions,” “Matters to be Considered – Proposal No. 1 Election of Class

II Directors” and “Corporate Governance, Committee Descriptions and Reports” in our Proxy Statement.

ITEM 14 Principal Accountant Fees and Services

The information required by this Item 14 is incorporated herein by reference to the information set forth under the captions “Matters to be Considered — Proposal No. 2 Ratification of the Appointment of Our Independent Registered Public Accounting Firm” and “Corporate Governance, Committee Descriptions and Reports” in our Proxy Statement.

Table of Contents

PART IV

ITEM 15 Exhibits and Financial Statement Schedules

(A)The following documents are filed as part of this report:

1. The Financial Statements as included in Part II, Item 8.
2. The Financial Statement Schedules listed in the following Financial Statement Schedule Index are filed as part of this report.

Index to Financial Statement Schedules

Schedule	Description	Page	Filing Basis
Schedule I	Summary of Investments	—	(2)
Schedule II	Condensed Financial Information of Parent Company	86	—
Schedule III	Supplementary Insurance Information	89	—
Schedule IV	Reinsurance	—	(3)
Schedule V	Valuation and Qualifying Accounts	90	—
Schedule VI	Supplementary Information Concerning Property-Casualty Insurance Operations	—	(4)

Table of Contents

The Exhibits listed below are filed as part of, or incorporated by reference into, this report:

Number	Description	Filing Basis
3.1	Amended and Restated Articles of Incorporation	(1)
3.2	Amended and Restated Code of Regulations	(1)
10.1	Long Term Incentive Plan, as amended and restated through August 1, 2014*	(10)
10.2	Deferred Compensation Plan*	(1)
10.3	Underwriting Management Agreement dated November 1, 1989, as amended, among National Interstate Insurance Agency, Inc., Great American Insurance Company, Agricultural Insurance Company, American Alliance Insurance Company and American National Fire Insurance Company	(1)
10.4	Registration Rights Agreement effective February 2, 2005 among National Interstate Corporation, Alan Spachman and Great American Insurance Company	(1)
10.5	Agreement of Reinsurance No. 0012 dated November 1, 1989 between National Interstate Insurance Company and Great American Insurance Company	(1)
10.6	Amended and Restated Employee Retention Agreement between National Interstate Insurance Agency, Inc. and David W. Michelson, dated December 28, 2007*	(5)
10.7	Employment and Non-Competition Agreement dated March 12, 2007 between National Interstate Corporation and David W. Michelson, as amended as of January 1, 2008*	(5),(8)
10.8	Restricted Shares Agreement dated March 12, 2007 between National Interstate Corporation and David W. Michelson*	(8)
10.9	Stock Bonus Agreement dated March 12, 2007 between National Interstate Corporation and David W. Michelson*	(8)
10.10	National Interstate Corporation Amended and Restated Management Bonus Plan, as amended as of November 6, 2009*	(6),(9)
10.11	Credit Agreement among National Interstate Corporation, Fifth Third Bank and U.S. Bank National Association, dated as of November 19, 2012	(7)
10.12	Purchase Agreement, dated as of April 26, 2010, among UniGroup, Inc., National Interstate Insurance Company and National Interstate Corporation	(11)
10.13	Letter Agreement, dated as of February 18, 2011, among UniGroup, Inc., National Interstate Insurance Company and National Interstate Corporation	(12)
10.14	Investment Management Agreement effective October 1, 2012 between American Money Management Corporation, National Interstate Insurance Company, National Interstate Insurance Company of Hawaii, Inc., Vanliner Insurance Company and Triumphe Casualty Company	(13)
10.15	Form of Award Agreement for Restricted Shares and Performance Shares*	(14)
10.16	Agreement dated July 1, 2014, by and among Alan R. Spachman, National Interstate Insurance Corporation, American Financial Group, Inc. and Great American Insurance Company.	(15)
10.17	Employment and Non-Competition Agreement, dated December 21, 2015, between National Interstate Corporation and Anthony J. Mercurio*	(16)
10.18	Employment and Non-Competition Agreement, dated December 21, 2015, between National Interstate Corporation and David W. Michelson*	(16)
21.1	List of subsidiaries	
23.1	Consent of Independent Registered Public Accounting Firm	
24.1	Power of attorney	
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.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

Table of Contents

*Indicates a management contract or compensatory plan or arrangement.

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

(2) This information is contained in Notes to Consolidated Financial Statements at Note Four "Investments."

(3) This information is contained in Notes to Consolidated Financial Statements at Note Eleven "Reinsurance."

(4) This information is contained in Notes to Consolidated Financial Statements at Note Twelve "Unpaid Losses and LAE" and in Schedule III "Supplementary Insurance Information."

(5) This exhibit is incorporated by reference to our Form 8-K filed January 4, 2008.

(6) This exhibit is incorporated by reference to our Form 8-K filed September 27, 2007.

(7) This exhibit is incorporated by reference to our Form 8-K filed November 20, 2012.

(8) This exhibit is incorporated by reference to our Form 10-K filed March 14, 2007.

(9) This exhibit is incorporated by reference to our Form 8-K filed November 12, 2009.

(10) This exhibit is incorporated by reference to our Form 8-K filed September 22, 2014.

(11) This exhibit is incorporated by reference to our Form 8-K filed April 28, 2010.

(12) This exhibit is incorporated by reference to our Form 8-K filed February 23, 2011.

(13) This exhibit is incorporated by reference to our Form 10-K filed March 8, 2013.

(14) This exhibit is incorporated by reference to our Form 8-K filed February 25, 2013.

(15) This exhibit is incorporated by reference to our Form 8-K filed July 7, 2014.

(16) This exhibit is incorporated by reference to our Form 8-K filed December 21, 2015.

Table of Contents

NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
 SCHEDULE II — CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY
 CONDENSED BALANCE SHEETS

	December 31,	
	2015	2014
	(In thousands, except per share data)	
ASSETS		
Investment in subsidiaries	\$ 351,355	\$ 345,399
Investments:		
Fixed maturities available-for-sale, at fair value (cost of \$1,930 and \$5,934, respectively)	1,904	5,816
Equity securities available-for-sale, at fair value (cost of \$0 and \$21, respectively) —		116
Total investments	1,904	5,932
Receivable from subsidiary	11,950	11,278
Cash and cash equivalents	3,290	7,302
Property and equipment, net	1,797	2,734
Other assets	2,411	3,263
Total assets	\$ 372,707	\$ 375,908
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Long-term debt	\$ 12,000	\$ 12,000
Other liabilities	1,810	1,819
Total liabilities	13,810	13,819
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 3,441 and 3,557 shares, respectively, in treasury	234	234
Additional paid-in capital	61,926	59,386
Retained earnings	293,516	283,031
Accumulated other comprehensive income	8,105	24,483
Treasury shares	(4,884	) (5,045
Total shareholders' equity	358,897	362,089
Total liabilities and shareholders' equity	\$ 372,707	\$ 375,908

Table of Contents

NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES

SCHEDULE II — CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY
CONDENSED STATEMENTS OF INCOME

	Year Ended December 31,		
	2015	2014	2013
	(In thousands)		
Revenues:			
Fees from subsidiaries	\$27,749	\$23,294	\$20,919
Net investment income	105	12	24
Total revenues	27,854	23,306	20,943
Expenses:			
General and administrative expenses	30,014	26,710	22,311
Interest expense	199	185	195
Total expenses	30,213	26,895	22,506
Loss before income taxes and equity in undistributed income of subsidiaries	(2,359	) (3,589	) (1,563
Income tax benefit	(826	) (1,256	) (547
Loss before equity in undistributed income of subsidiaries	(1,533	) (2,333	) (1,016
Equity in undistributed income of subsidiaries, net of tax	22,380	13,359	18,589
Net income	\$20,847	\$11,026	\$17,573

Table of Contents

NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES

SCHEDULE II — CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY
CONDENSED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2015	2014	2013
	(In thousands)		
Operating activities			
Net income	\$20,847	\$11,026	\$17,573
Adjustments to reconcile net income to net cash used in operating activities	(19,721	) (15,097	) (18,607
Net cash provided by (used in) operating activities	1,126	(4,071	) (1,034
Investing activities			
Distributions from subsidiaries	—	10,000	10,000
Purchases of investments	—	(2,934	) (10,767
Proceeds from sale or maturities of investments	4,021	2,001	6,750
Capital expenditures	(689	) (673	) (1,279
Net cash provided by investing activities	3,332	8,394	4,704
Financing activities			
Net tax effect from exercise/vesting of stock-based compensation	(48	) 51	25
Issuance of common shares from treasury	1,940	2,414	1,127
Cash dividends paid on common shares	(10,362	) (9,513	) (8,673
Net cash used in financing activities	(8,470	) (7,048	) (7,521
Net decrease in cash and cash equivalents	(4,012	) (2,725	) (3,851
Cash and cash equivalents at beginning of year	7,302	10,027	13,878
Cash and cash equivalents at end of year	\$3,290	\$7,302	\$10,027

Table of Contents

NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES

SCHEDULE III — SUPPLEMENTARY INSURANCE INFORMATION

	Deferred Policy Acquisition Costs	Liability for Unpaid Losses and LAE	Unearned Premiums	Earned Premiums	Net Investment Income	Losses and LAE	Amortization of Deferred Policy Acquisition Costs	Other Underwriting Expenses	Net Premiums Written
	(In thousands)								
Year ended December 31, 2015	\$22,265	\$1,014,195	\$336,934	\$585,787	\$39,739	\$471,940	\$84,975	\$9,100	\$607,426
Year ended December 31, 2014	22,654	883,078	311,255	557,267	35,517	466,998	84,954	9,476	575,574
Year ended December 31, 2013	23,025	803,782	283,582	525,710	33,377	429,556	82,240	9,953	537,604

Table of Contents

NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES

SCHEDULE V — VALUATION AND QUALIFYING ACCOUNTS

	Balance at Beginning of Period (In thousands)	Additions Charged/(Credited) to Expenses	Charged to Other Accounts	Deductions (a)	Balance at End of Period
Year ended December 31, 2015					
Premiums in course of collection	\$2,627	\$(453)	) \$—	\$ 47	\$2,127
Year ended December 31, 2014					
Premiums in course of collection	3,225	(400)	) —	198	2,627
Year ended December 31, 2013					
Premiums in course of collection	2,809	443	—	27	3,225

(a) Deductions include write-offs of amounts determined to be uncollectible.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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

By: /s/ DAVID W. MICHELSON
Name: David W. Michelson
Title: Chief Executive Officer

Signed: March 9, 2016

Pursuant to the requirements of Section 12 or 15(d) of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacity and on the dates indicated.

Signature	Title	Date
/s/ DAVID W. MICHELSON David W. Michelson	Director and Chief Executive Officer (Principal Executive Officer)	March 9, 2016
/s/ JULIE A. MCGRAW Julie A. McGraw	Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 9, 2016
/s/ JOSEPH E. (JEFF) CONSOLINO* Joseph E. Consolino	Chairman of the Board	March 9, 2016
/s/ RONALD J. BRICHLER* Ronald J. Brichler	Director	March 9, 2016
/s/ I. JOHN CHOLNOKY* I. John Cholnoky	Director	March 9, 2016
/s/ PATRICK J. DENZER* Patrick J. Denzer	Director	March 9, 2016
/s/ GARY J. GRUBER* Gary J. Gruber	Director	March 9, 2016
/s/ KEITH A. JENSEN* Keith A. Jensen	Director	March 9, 2016
/s/ DONALD D. LARSON* Donald D. Larson	Director	March 9, 2016
/s/ NORMAN L. ROSENTHAL* Norman L. Rosenthal	Director	March 9, 2016
/s/ DONALD W. SCHWEGMAN* Donald W. Schwegman	Director	March 9, 2016

/s/ ALAN R. SPACHMAN* Director
Alan R. Spachman

March 9, 2016

*By Arthur J. Gonzales and Julie A. McGraw, attorneys-in-fact

92