

FEDERATED NATIONAL HOLDING CO
Form 10-Q
November 08, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2016

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

Commission File number 000-25001

Federated National Holding Company

(Exact name of registrant as specified in its charter)

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Florida
(State or Other Jurisdiction of Incorporation or Organization)

65-0248866
(IRS Employer Identification Number)

14050 N.W. 14th Street, Suite 180, Sunrise, FL
(Address of principal executive offices)

33323
(Zip Code)

800-293-2532

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer Non accelerated filer Smaller reporting company
(Do not check if a 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of November 4, 2016, the registrant had 13,801,757 shares of common stock outstanding.

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FEDERATED NATIONAL HOLDING COMPANY

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

(Unaudited)

| | September 30, 2016 | December 31, 2015 |
|--|-----------------------|-------------------------|
| ASSETS | | |
| Investments: | | |
| Debt securities, available-for-sale, at fair value (amortized cost of \$370,881 and \$338,021, respectively) | \$ 378,879 | \$ 339,178 |
| Debt securities, held-to-maturity, at amortized cost | 5,880 | 6,619 |
| Equity securities, available-for-sale, at fair value (cost of \$34,905 and \$33,581, respectively) | 41,334 | 38,534 |
| Total investments (including \$28,290 and \$22,670 related to the VIE, respectively) | 426,093 | 384,331 |
| Cash and cash equivalents (including \$14,753 and \$14,616 related to the VIE, respectively) | 106,200 | 53,038 |
| Prepaid reinsurance premiums | 58,763 | 120,771 |
| Premiums receivable, net of allowance of \$57 and \$302, respectively (including \$1,589 and \$355 related to the VIE, respectively) | 63,605 | 38,594 |
| Reinsurance recoverable, net | 25,151 | 12,714 |
| Deferred acquisition costs | 41,247 | 15,547 |
| Income taxes receivable | 16,706 | 2,691 |
| Property and equipment, net | 3,863 | 2,894 |
| Other assets (including \$1,269 and \$1,037 related to the VIE, respectively) | 7,829 | 7,605 |
| TOTAL ASSETS | \$ 749,457 | \$ 638,185 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| LIABILITIES: | | |
| Loss and loss adjustment expense reserves | \$ 127,485 | \$ 97,340 |

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| | | |
|--|-------------------|-------------------|
| Unearned premiums | 309,283 | 253,960 |
| Debt from consolidated variable interest entity | 4,903 | 4,887 |
| Deferred income taxes, net | 12,912 | 5,627 |
| Other liabilities | 31,521 | 25,612 |
| Total liabilities | 486,104 | 387,426 |
| SHAREHOLDERS' EQUITY: | | |
| Preferred stock, \$0.01 par value: 1,000,000 shares authorized | — | — |
| Common stock, \$0.01 par value: 25,000,000 shares authorized; 13,801,607 and 13,798,773 shares issued and outstanding, respectively | 138 | 138 |
| Additional paid-in capital | 136,359 | 131,998 |
| Accumulated other comprehensive income | 8,800 | 3,985 |
| Retained earnings | 99,336 | 96,461 |
| Total Federated National Holding Company shareholders' equity | 244,633 | 232,582 |
| Noncontrolling interest | 18,720 | 18,177 |
| Total shareholders' equity | 263,353 | 250,759 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 749,457 | \$ 638,185 |

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|-----------|------------------------------------|------------|
| | 2016 | 2015 | 2016 | 2015 |
| Revenue: | | | | |
| Net premiums earned | \$ 69,405 | \$ 62,286 | \$ 184,447 | \$ 156,298 |
| Net investment income | 2,164 | 1,907 | 6,398 | 5,154 |
| Net realized investment gains | 1,126 | 1,126 | 2,060 | 3,743 |
| Other income | 11,095 | 7,280 | 34,909 | 21,130 |
| Total revenue | 83,790 | 72,599 | 227,814 | 186,325 |
| Costs and expenses: | | | | |
| Losses and loss adjustment expenses | 43,613 | 28,412 | 120,183 | 75,510 |
| Commissions and other underwriting expenses | 34,512 | 21,610 | 75,408 | 47,934 |
| General and administrative expenses | 4,044 | 4,887 | 13,211 | 11,973 |
| Interest expense | 81 | 65 | 259 | 161 |
| Total costs and expenses | 82,250 | 54,974 | 209,061 | 135,578 |
| Income before income taxes | 1,540 | 17,625 | 18,753 | 50,747 |
| Income taxes | 102 | 7,054 | 6,594 | 19,519 |
| Net income | 1,438 | 10,571 | 12,159 | 31,228 |
| Net income (loss) attributable to noncontrolling interest | 44 | (22) | 239 | (383) |
| Net income attributable to Federated National Holding Company shareholders | \$ 1,394 | \$ 10,593 | \$ 11,920 | \$ 31,611 |
| Net income per share attributable to Federated National Holding Company shareholders: | | | | |
| Basic | \$ 0.10 | \$ 0.77 | \$ 0.86 | \$ 2.31 |
| Diluted | \$ 0.10 | \$ 0.76 | \$ 0.85 | \$ 2.26 |
| Weighted average number of shares of common stock outstanding: | | | | |
| Basic | 13,780 | 13,749 | 13,807 | 13,710 |
| Diluted | 13,943 | 13,977 | 13,999 | 13,978 |

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|--|---------|---------|---------|---------|
| Dividends declared per share of common stock | \$ 0.08 | \$ 0.04 | \$ 0.17 | \$ 0.13 |
|--|---------|---------|---------|---------|

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|--|-----------|------------------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| Net income | \$ 1,438 | \$ 10,571 | \$ 12,159 | \$ 31,228 |
| Change in net unrealized (losses) gains on investments, available-for-sale | (774) | (2,671) | 8,316 | (4,681) |
| Comprehensive income before income taxes | 664 | 7,900 | 20,475 | 26,547 |
| Income tax benefit (expense) related to items of other comprehensive income | 152 | 1,083 | (3,197) | 1,734 |
| Comprehensive income | 816 | 8,983 | 17,278 | 28,281 |
| Less: comprehensive income (loss) attributable to noncontrolling interest | 44 | (17) | 543 | (494) |
| Comprehensive income attributable to Federated National Holding Company shareholders | \$ 772 | \$ 9,000 | \$ 16,735 | \$ 28,775 |

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

(In thousands, except share data)

(Unaudited)

| | Common Stock | | Additional Paid-in Capital | Accumulated | | Total Shareholders' Equity Attributable to Federated National Holding Company Shareholders | Noncontrolling Interest | Total Shareholders' Equity | |
|---|--------------------|------------------|----------------------------------|----------------------------------|----------------------|---|----------------------------|----------------------------------|------------|
| | Preferred Stock | Issued Shares | | Other Comprehensive Income | Retained Earnings | | | | |
| Balance as of December 31, 2015 | \$ — | 13,798,773 | \$ 138 | \$ 131,998 | \$ 3,985 | \$ 96,461 | \$ 232,582 | \$ 18,177 | \$ 250,759 |
| Net income | — | — | — | — | — | 11,920 | 11,920 | 239 | 12,159 |
| Other comprehensive income | — | — | — | — | 4,815 | — | 4,815 | 304 | 5,119 |
| Dividends | — | — | — | — | — | (3,563) | (3,563) | — | (3,563) |
| Shares issued under share- based compensation plans | — | 288,815 | — | 360 | — | — | 360 | — | 360 |
| Tax benefits from share-based awards | — | — | — | 843 | — | — | 843 | — | 843 |
| Repurchases of common stock | — | (285,981) | — | — | — | (5,482) | (5,482) | — | (5,482) |
| Share-based compensation | — | — | — | 3,158 | — | — | 3,158 | — | 3,158 |
| Balance as of September 30, | \$ — | 13,801,607 | \$ 138 | \$ 136,359 | \$ 8,800 | \$ 99,336 | \$ 244,633 | \$ 18,720 | \$ 263,353 |

2016

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2016 | 2015 |
| | (in thousands) | |
| Cash flow from operating activities: | | |
| Net income | \$ 12,159 | \$ 31,228 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Net realized investment gains | (2,060) | (3,743) |
| Amortization of investment premium or discount, net | 3,910 | 3,795 |
| Depreciation and amortization | 620 | 495 |
| Share-based compensation | 4,001 | 3,175 |
| Changes in operating assets and liabilities: | | |
| Prepaid reinsurance premiums | 62,008 | (40,967) |
| Premiums receivable, net | (25,011) | (7,653) |
| Reinsurance recoverable, net | (12,437) | 4,186 |
| Deferred acquisition costs | (25,699) | 88 |
| Income taxes receivable, net | (14,858) | (3,953) |
| Loss and loss adjustment expense reserves | 30,146 | 13,343 |
| Unearned premiums | 55,323 | 57,973 |
| Deferred income taxes, net of other comprehensive income | 5,491 | 5,277 |
| Other, net | 5,676 | 16,970 |
| Net cash provided by operating activities | 99,269 | 80,214 |
| Cash flow from investing activities: | | |
| Sales, maturities and redemptions of investment securities | 151,884 | 134,918 |
| Purchases of investment securities | (188,576) | (195,278) |
| Purchases of property and equipment | (1,573) | (1,500) |
| Net cash used in investing activities | (38,265) | (61,860) |
| Cash flow from financing activities: | | |
| Noncontrolling interest equity investment | — | 18,498 |
| Tax benefit related to share-based compensation | 843 | 869 |
| Purchases of FNHC common stock | (5,482) | — |
| Issuance of common stock for share-based awards | 360 | 130 |
| Dividends paid | (3,563) | (1,847) |
| Net cash (used in) provided by financing activities | (7,842) | 17,650 |
| Net increase in cash and cash equivalents | 53,162 | 36,004 |

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| | | |
|--|------------|-----------|
| Cash and cash equivalents at beginning of period | 53,038 | 40,157 |
| Cash and cash equivalents at end of period | \$ 106,200 | \$ 76,161 |

See accompanying notes to unaudited consolidated financial statements.

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FEDERATED NATIONAL HOLDING COMPANY AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Continued)

| | Nine Months Ended September 30, 2016 2015 (in thousands) | |
|---|--|-----------|
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the period for: | | |
| Income taxes | \$ 14,360 | \$ 15,662 |
| Non-cash investing and finance activities: | | |
| Accrued dividends payable | \$ 1,134 | \$ 712 |

See accompanying notes to unaudited consolidated financial statements.

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1. ORGANIZATION, CONSOLIDATION AND BASIS OF PRESENTATION

Organization

Federated National Holding Company, (“FNHC,” the “Company,” “we,” or “us”), is an insurance holding company that controls substantially all steps in the insurance underwriting, distribution and claims processes through our subsidiaries and our contractual relationships with our independent agents and general agents. We are authorized to underwrite, and/or place through our wholly owned subsidiaries, homeowners’ multi-peril (“homeowners”), personal automobile, commercial general liability, federal flood, and other lines of insurance in Florida and other states. We market, distribute and service our own and third-party insurers’ products and our other services through a network of independent agents.

Our wholly owned insurance subsidiary is Federated National Insurance Company (“FNIC”), which is licensed as an admitted carrier in Florida, Texas, Georgia, Alabama, Louisiana and South Carolina. We also serve as managing general agent for Monarch National Insurance Company (“MNIC”), which was founded in 2015 through the joint venture, described below, and is licensed as an admitted carrier in Florida. An admitted carrier is an insurance company that has received a license from the state department of insurance giving the Company the authority to write specific lines of insurance in that state. These companies are also bound by rate and form regulations, and are strictly regulated to protect policyholders from a variety of illegal and unethical practices, including fraud. Admitted carriers are also required to financially contribute to the state guarantee fund, which is used to pay for losses if an insurance carrier becomes insolvent or unable to pay the losses due to their policyholders.

On March 19, 2015, the Company entered into a joint venture to organize MNIC, which received its certificate of authority to write homeowners’ property and casualty insurance in Florida from the Florida Office of Insurance Regulation (the “Florida OIR”). The Company’s joint venture partners are a majority-owned limited partnership of Crosswinds Holdings Inc., a publicly traded Canadian private equity firm and asset manager (“Crosswinds”); and Transatlantic Reinsurance Company (“TransRe”).

The Company and Crosswinds each invested \$14.0 million in Monarch Delaware Holdings LLC (“Monarch Delaware”), the indirect parent company of MNIC, for a 42.4% interest in Monarch Delaware (each holding 50% of the voting interests in Monarch Delaware). TransRe invested \$5.0 million for a 15.2% non-voting interest in Monarch Delaware and advanced an additional \$5.0 million in debt evidenced by a six-year promissory note bearing 6% annual interest payable by Monarch National Holding Company (“MNHC”), a wholly owned subsidiary of Monarch Delaware and the direct parent company of MNIC.

Significant Customer

We entered into an Insurance Agency Master Agreement with Ivantage Select Agency, Inc., (“ISA”), an affiliate of Allstate Insurance Company (“Allstate”), pursuant to which we are authorized by ISA to appoint Allstate agents to offer our homeowners’ and commercial general liability insurance products to consumers in Florida. As a percentage of the total homeowners’ premiums we underwrote in the three months ended September 30, 2016 and 2015, 24.7% and 25.4%, respectively, were from Allstate’s network of Florida agents. For the nine months ended September 30, 2016 and 2015 23.9% and 23.3%, respectively, of the homeowners’ premiums we underwrote were from Allstate’s network of Florida agents.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of FNHC and all other entities in which we have a controlling financial interest and any variable interest entities (“VIE”) in which we are the primary beneficiary. All material inter-company accounts and transactions have been eliminated in consolidation. A VIE is an entity that does not have sufficient equity to finance its own activities without additional financial support or where investors lack certain characteristics of a controlling financial interest. We assess our contractual, ownership or other interests in a VIE to determine if our interest participates in the variability the VIE was designed to absorb and pass onto variable interest holders. We perform an ongoing qualitative assessment of our variable interests in VIEs to determine whether we have a controlling financial interest and would therefore be considered the primary beneficiary of the VIE. If we determine we are the primary beneficiary of a VIE, we consolidate the assets and liabilities of the VIE in our consolidated financial statements.

In connection with the investment in Monarch Delaware, we have determined that we are the primary beneficiary of this VIE, as we possess the power to direct the activities of the VIE that most significantly impact its economic performance. Accordingly, we consolidate the VIE in our consolidated financial statements. Refer to Note 12 for additional information on the VIE.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and with the rules and regulations of the Securities and Exchange Commission (“SEC”). Accordingly, these financial statements do not include all of the information and notes required by GAAP for

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complete financial statements. Additionally, operating results for interim periods are not necessarily indicative of the results that can be expected for a full year. These unaudited consolidated financial statements reflect, in the opinion of management, all material adjustments (which include only normal recurring adjustments) necessary to fairly state, in all material respects, our financial position and results of operations for the periods presented. Certain GAAP policies, which significantly affect the determination of financial condition, results of operations and cash flows, are summarized below.

This report should be read in conjunction with the Company's 2015 Annual Report on Form 10-K, as amended (the "2015 Form 10-K").

2. SIGNIFICANT ACCOUNTING POLICIES AND PRACTICES

Our significant accounting policies were described in Note 2 to our Consolidated Financial Statements set forth in Part II, Item 8, "Financial Statements and Supplementary Data" of the 2015 Form 10-K. There have been no significant changes in our significant accounting policies for the nine months ended September 30, 2016.

Accounting Estimates and Assumptions

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates.

Similar to other property and casualty insurers, our liability for losses and loss adjustment expense reserves, although supported by actuarial projections and other data, is ultimately based on management's reasoned expectations of future events. Although considerable variability is inherent in these estimates, we believe that this liability is adequate. Estimates are reviewed regularly and adjusted as necessary. Such adjustments are reflected in current operations. Refer to Note 6 accompanying our consolidated financial statements for a discussion of our liability for losses and loss adjustment expense reserves.

Reclassifications

Certain amounts in prior year's consolidated financial statements have been reclassified to conform to the 2016 presentation. These reclassifications had no effect on the reported consolidated statements of operations, balance sheets, and cash flows. In the current period, the Company concluded it was appropriate to reclassify certain revenue accounts that do not have material balances and include them within other income in the consolidated statements of operations. In addition, during the current period, the Company reclassified certain costs and expenses, principally, operating and underwriting expenses, salaries and wages and amortization of deferred policy acquisition costs. These respective account balances are now included in commissions and other underwriting expenses and general and administrative expenses in the consolidated statements of operations. The Company believes these reclassifications provide greater clarity and insight into the consolidated financial statements for the periods presented.

Adjustments

During our third quarter 2015 analysis of actual experience to date under the July 1, 2014 quota share reinsurance contract, we re-evaluated the accounting treatment for quota share reinsurance contracts with retrospective rating provisions. As a result of this re-evaluation, we concluded reinsurance contracts, which have retrospective rating provisions, should be accounted for under Accounting Standards Codification 944, Financial Services — Insurance (“ASC 944”), where amounts due to (from) the assuming companies are accrued based on estimated contract experience to date as though the contracts were terminated. Refer to Note 2 in our Form 10-Q for the period ended September 30, 2015 for additional information.

The adjustments to our accounting for the July 1, 2014 quota share reinsurance treaty, inclusive of other adjustments, are not material in any prior quarter or annual period based on an analysis of quantitative and qualitative factors in accordance with SEC guidance.

As a result, we recorded these adjustments during the year ended December 31, 2015. The prior period adjustments increased net income by \$2.2 million for the three and nine months ended September 30, 2015, respectively.

Adopted Accounting Pronouncements

In February 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standard Update (“ASU”) 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis (“ASU 2015-02”). ASU 2015-02 amended the consolidation guidance by modifying the evaluation criteria for whether limited partnerships and similar legal entities are variable interest entities or voting interest entities, eliminating the presumption that a general partner should consolidate a limited partnership, and affecting the

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consolidation analysis of reporting entities that are involved with variable interest entities. We adopted the provisions of ASU 2015-02 effective January 1, 2016 and re-evaluated all legal entity investments under the revised consolidation model. The adoption of ASU 2015-02 did not have any impact on our consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, Interest-Imputation of Interest. ASU 2015-03 reduces the complexity of disclosing debt issuance costs and debt discount and premium on the balance sheet by requiring that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with debt discounts. The Company adopted this ASU retrospectively as of January 1, 2016. Other assets and debt from consolidated variable interest entity have been reclassified to be consistent with the adoption of this standard, which resulted in a reduction of \$0.1 million each. There were no changes to shareholders' equity as a result of this adoption. There were no other impacts on the Company's consolidated financial statements.

In May 2015, the FASB issued ASU 2015-09, Financial Services – Insurance (Topic 944): Disclosures about Short-Duration-Contracts. The amendments in this ASU apply to all insurance entities that issue short-duration contracts as defined in Topic 944, Financial Services—Insurance. The amendments require insurance entities to disclose for annual reporting periods information on the liability for unpaid claims and claim adjustment expenses. The amendments in this ASU are effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016. This new guidance affects disclosures only and will have no impact on the Company's consolidated financial statements.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”). ASU 2014-09 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in United States Generally Accepted Accounting Principles when it becomes effective. In July 2015, the FASB voted to delay the effective date of ASU 2014-09 by one year, making it effective for fiscal years, and interim periods within those years, beginning after December 15, 2017, with early adoption permitted as of the original effective date. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. In addition, during 2016 the FASB issued ASU 2016-08, ASU 2016-10, and ASU 2016-12, all of which clarify certain implementation guidance within ASU 2014-09. The Company is evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures.

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, which addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most notably, this new guidance requires equity investments (except those accounted for under the

equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. This new guidance is effective for annual reporting periods beginning after December 15, 2017. We are currently evaluating the impact the adoption of this standard would have on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02"). Upon the effective date, ASU 2016-02 will supersede the current lease guidance in Topic 840, Leases. Under the new guidance, lessees will be required to recognize for all leases, with the exception of short-term leases, a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis. Concurrently, lessees will be required to recognize a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The guidance is required to be applied using a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative periods presented in the financial statements. We are currently evaluating the effects the adoption of ASU 2016-02 will have on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"), which is intended to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods therein. Early application is permitted. We are currently evaluating the impact of this guidance on our consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments- Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13") which significantly changes the measurement of credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. ASU 2016-13 will require entities to record allowances for available-for-sale debt securities rather than reduce the carrying amount, as currently performed under the other-than-temporary impairment model. Additionally, the standard will require enhanced disclosures for financial assets measured at amortized cost and available-for-sale debt securities to help the financial statement users better understand significant judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an entity's portfolio. ASU 2016-13 is effective for interim and annual

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reporting periods beginning after December 15, 2019, with early adoption permitted. We are currently evaluating the effects the adoption of ASU 2016-13 will have on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). ASU 2016-15 provides guidance on the following eight specific cash flow classification issues: (1) debt prepayment or debt extinguishment costs; (2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investees; (7) beneficial interests in securitization transactions; and (8) separately identifiable cash flows and application of the predominance principle. Current GAAP does not include specific guidance on these eight cash flow classification issues. The amendments of this ASU are effective for reporting periods beginning after December 15, 2017, with early adoption permitted. The Company is evaluating the effect that ASU 2015-16 will have on its consolidated financial statements and related disclosures.

3. FAIR VALUE

Fair value measurements are generally based upon observable and unobservable inputs. Observable inputs are based on market data from independent sources, while unobservable inputs reflect the Company's view of market assumptions in the absence of observable market information. All assets and liabilities that are carried at fair value are classified and disclosed in one of the following categories:

Level 1 — Quoted prices (unadjusted) in active markets for identical assets or liabilities. An active market is defined as a market where transactions for the financial statement occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 — Quoted market prices for similar assets or liabilities and valuations, using models or other valuation techniques that use observable market data. All significant inputs are observable, or derived from observable information in the marketplace, or are supported by observable levels at which transactions are executed in the market place.

Level 3 — Instruments that use non-binding broker quotes or model driven valuations that do not have observable market data or those that are estimated based on an ownership interest to which a proportionate share of net assets is attributed. Currently, the Company has no level 3 investments.

The Company's financial instruments measured at fair value and the level of the fair value hierarchy of inputs used were as follows:

| | September 30, 2016 | | | Total |
|--|---------------------------|------------|---------|------------|
| | Level 1 (in thousands) | Level 2 | Level 3 | |
| Debt securities: | | | | |
| United States government obligations and authorities | \$ 38,933 | \$ 26,877 | \$ — | \$ 65,810 |
| Obligations of states and political subdivisions | — | 150,873 | — | 150,873 |
| Corporate | — | 149,210 | — | 149,210 |
| International | — | 12,986 | — | 12,986 |
| | 38,933 | 339,946 | — | 378,879 |
| Equity securities | 40,458 | 876 | — | 41,334 |
| Total investments | \$ 79,391 | \$ 340,822 | \$ — | \$ 420,213 |

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| | December 31, 2015 | | | Total |
|--|---------------------------|------------|---------|------------|
| | Level 1 (in thousands) | Level 2 | Level 3 | |
| Debt securities: | | | | |
| United States government obligations and authorities | \$ 34,733 | \$ 26,820 | \$ — | \$ 61,553 |
| Obligations of states and political subdivisions | — | 110,702 | — | 110,702 |
| Corporate | — | 154,620 | — | 154,620 |
| International | — | 12,303 | — | 12,303 |
| | 34,733 | 304,445 | — | 339,178 |
| Equity securities | 38,012 | 522 | — | 38,534 |
| Total investments | \$ 72,745 | \$ 304,967 | \$ — | \$ 377,712 |

4. INVESTMENTS

Unrealized Gains and Losses

The following table details the difference between amortized cost or cost and estimated fair value, by major investment category, at September 30, 2016 and at December 31, 2015:

| | Amortized Cost or Cost (in thousands) | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--|--|------------------------------|-------------------------------|------------|
| September 30, 2016 | | | | |
| Debt securities - available-for-sale: | | | | |
| United States government obligations and authorities | \$ 64,810 | \$ 1,039 | \$ 39 | \$ 65,810 |
| Obligations of states and political subdivisions | 148,366 | 2,556 | 49 | 150,873 |
| Corporate | 144,990 | 4,305 | 85 | 149,210 |
| International | 12,715 | 273 | 2 | 12,986 |

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| | | | | |
|--|------------|-----------|----------|------------|
| | 370,881 | 8,173 | 175 | 378,879 |
| Debt securities - held-to-maturity: | | | | |
| United States government obligations and authorities | 4,173 | 70 | 59 | 4,184 |
| Corporate | 1,636 | 47 | — | 1,683 |
| International | 71 | 2 | — | 73 |
| | 5,880 | 119 | 59 | 5,940 |
| Equity securities | 34,905 | 7,278 | 849 | 41,334 |
| Total investments | \$ 411,666 | \$ 15,570 | \$ 1,083 | \$ 426,153 |

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| | Amortized Cost or Cost (in thousands) | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|--|--|------------------------------|-------------------------------|------------|
| December 31, 2015 | | | | |
| Debt securities - available-for-sale: | | | | |
| United States government obligations and authorities | \$ 61,384 | \$ 489 | \$ 320 | \$ 61,553 |
| Obligations of states and political subdivisions | 109,152 | 1,590 | 40 | 110,702 |
| Corporate | 154,957 | 1,153 | 1,490 | 154,620 |
| International | 12,528 | 18 | 243 | 12,303 |
| | 338,021 | 3,250 | 2,093 | 339,178 |
| Debt securities - held-to-maturity: | | | | |
| United States government obligations and authorities | 4,275 | 30 | 204 | 4,101 |
| Corporate | 2,253 | 14 | 20 | 2,247 |
| International | 91 | — | — | 91 |
| | 6,619 | 44 | 224 | 6,439 |
| Equity securities | 33,581 | 6,809 | 1,856 | 38,534 |
| Total investments | \$ 378,221 | \$ 10,103 | \$ 4,173 | \$ 384,151 |

Net Realized Gains and Losses

The Company calculates the gain or loss realized on the sale of investments by comparing the sales price (fair value) to the cost or amortized cost of the security sold. Net realized gains and losses on investments are determined in accordance with the specific identification method. The following tables detail the Company's net realized gains (losses) by major investment category for the three and nine months ended September 30, 2016 and 2015:

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2016 | |
|----------------------------|--|--------|--|--------|
| | 2015 | 2015 | 2015 | 2015 |
| | (in thousands) | | (in thousands) | |
| Gross realized gains: | | | | |
| Debt securities | \$ 897 | \$ 226 | \$ 2,822 | \$ 973 |
| Equity securities | 597 | 1,847 | 1,752 | 4,188 |
| Total gross realized gains | 1,494 | 2,073 | 4,574 | 5,161 |

Gross realized losses:

| | | | | |
|-----------------------------------|----------|----------|----------|----------|
| Debt securities | (20) | (178) | (614) | (504) |
| Equity securities | (348) | (769) | (1,900) | (914) |
| Total gross realized losses | (368) | (947) | (2,514) | (1,418) |
| Net realized gains on investments | \$ 1,126 | \$ 1,126 | \$ 2,060 | \$ 3,743 |

During the three months ended September 30, 2016 and 2015, the proceeds from sales of available-for-sale investment securities were \$30.1 million and \$42.5 million, respectively. During the nine months ended September 30, 2016 and 2015, the proceeds from sales of available-for-sale investment securities were \$129.5 million and \$134.9 million, respectively.

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Contractual Maturity

The amortized cost and estimated fair value of debt securities as of September 30, 2016 and December 31, 2015 by contractual maturity are shown below. Expected maturities may differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | September 30, 2016 | | December 31, 2015 | |
|--------------------------------------|--------------------|------------|-------------------|------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Securities with maturity dates: | (in thousands) | | | |
| Debt securities, available-for-sale: | | | | |
| One year or less | \$ 41,507 | \$ 41,565 | \$ 24,470 | \$ 24,488 |
| Over one through five years | 182,129 | 185,001 | 170,797 | 171,113 |
| Over five through ten years | 145,639 | 150,694 | 142,728 | 143,545 |
| Over ten years | 1,606 | 1,619 | 26 | 32 |
| | 370,881 | 378,879 | 338,021 | 339,178 |
| Debt securities, held-to-maturity: | | | | |
| One year or less | 413 | 413 | 486 | 487 |
| Over one through five years | 1,887 | 1,949 | 1,899 | 1,915 |
| Over five through ten years | 3,580 | 3,578 | 4,234 | 4,037 |
| | 5,880 | 5,940 | 6,619 | 6,439 |
| Total | \$ 376,761 | \$ 384,819 | \$ 344,640 | \$ 345,617 |

Net Investment Income

The following table summarizes the Company's net investment income for the three and nine months ended September 30, 2016 and 2015:

| Three Months Ended | Nine Months Ended |
|-----------------------|----------------------|
|-----------------------|----------------------|

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| | September 30, | | September 30, | |
|-----------------------|----------------|----------|---------------|----------|
| | 2016 | 2015 | 2016 | 2015 |
| | (in thousands) | | | |
| Interest income | \$ 1,963 | \$ 1,760 | \$ 5,801 | \$ 4,773 |
| Dividends income | 201 | 147 | 597 | 381 |
| Net investment income | \$ 2,164 | \$ 1,907 | \$ 6,398 | \$ 5,154 |

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Aging of Gross Unrealized Losses

As of September 30, 2016 and December 31, 2015, gross unrealized losses and related fair values for available-for-sale debt securities and equity securities, grouped by duration of time in a continuous unrealized loss position, were as follows:

| | Less than 12 months | | 12 months or longer | | Total | | |
|--|---------------------|------------|---------------------|------------|-----------|------------|--|
| | Fair | Gross | Fair | Gross | Fair | Gross | |
| | Value | Unrealized | Value | Unrealized | Value | Unrealized | |
| | | Losses | | Losses | | Losses | |
| | | | (in thousands) | | | | |
| September 30, 2016 | | | | | | | |
| Debt securities - available-for-sale: | | | | | | | |
| United States government obligations and authorities | \$ 8,995 | \$ 38 | \$ 121 | \$ 1 | \$ 9,116 | \$ 39 | |
| Obligations of states and political subdivisions | 28,481 | 47 | 1,015 | 2 | 29,496 | 49 | |
| Corporate | 11,405 | 33 | 3,345 | 52 | 14,750 | 85 | |
| International | 1,170 | 1 | 302 | 1 | 1,472 | 2 | |
| | 50,051 | 119 | 4,783 | 56 | 54,834 | 175 | |
| Equity securities | 5,590 | 679 | 2,179 | 170 | 7,769 | 849 | |
| Total investments | \$ 55,641 | \$ 798 | \$ 6,962 | \$ 226 | \$ 62,603 | \$ 1,024 | |

| | Less than 12 months | | 12 months or longer | | Total | | |
|--|---------------------|------------|---------------------|------------|-----------|------------|--|
| | Fair | Gross | Fair | Gross | Fair | Gross | |
| | Value | Unrealized | Value | Unrealized | Value | Unrealized | |
| | | Losses | | Losses | | Losses | |
| | | | (in thousands) | | | | |
| December 31, 2015 | | | | | | | |
| Debt securities - available-for-sale: | | | | | | | |
| United States government obligations and authorities | \$ 30,464 | \$ 303 | \$ 659 | \$ 17 | \$ 31,123 | \$ 320 | |
| Obligations of states and political subdivisions | 16,652 | 40 | — | — | 16,652 | 40 | |
| Corporate | 87,176 | 1,420 | 3,590 | 70 | 90,766 | 1,490 | |

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| | | | | | | |
|-------------------|------------|----------|----------|--------|------------|----------|
| International | 8,660 | 191 | 281 | 52 | 8,941 | 243 |
| | 142,952 | 1,954 | 4,530 | 139 | 147,482 | 2,093 |
| Equity securities | 11,790 | 1,850 | 84 | 6 | 11,874 | 1,856 |
| Total investments | \$ 154,742 | \$ 3,804 | \$ 4,614 | \$ 145 | \$ 159,356 | \$ 3,949 |

The Company holds its equity securities and some of its debt securities as available-for-sale and as such, these securities are recorded at fair value. The Company continually monitors the difference between cost and the estimated fair value of its investments, which involves uncertainty as to whether declines in value are temporary in nature. If the decline of a particular investment is deemed temporary, the Company records the decline as an unrealized loss in shareholders' equity. If the decline is deemed to be other than temporary, the Company will write the security's cost-basis or amortized cost-basis down to the fair value of the investment and recognizes an other than temporary impairment ("OTTI") loss in our consolidated statement of operations. Additionally, any portion of such decline related to debt securities that is believed to arise from factors other than credit will be recorded as a component of other comprehensive income rather than charged against income.

The Company's assessment of equity securities initially involves an evaluation of all securities that are in an unrealized loss position, regardless of the duration or severity of the loss, as of the applicable balance sheet date. Such initial review consists primarily of assessing whether: (i) there has been a negative credit or news event with respect to the issuer that could indicate the existence of an OTTI; and (ii) the Company has the ability and intent to hold an equity security for a period of time sufficient to allow for an anticipated recovery (generally considered to be one year from the balance sheet date).

To the extent that an equity security in an unrealized loss position is not impaired based on the initial review described above, the Company then evaluates such equity security by considering qualitative and quantitative factors. These factors include but are not limited to facts and circumstances specific to individual securities, asset classes, the financial condition of the issuer, changes in dividend

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payment, the length of time fair value had been less than cost, the severity of the decline in fair value below cost, industry outlook and our ability and intent to hold each position until its forecasted recovery.

If the Company intends to sell, or it is more likely than not that, the Company will sell, a debt security before recovery of its amortized cost basis, the total amount of the unrealized loss position is recognized as an OTTI loss in our consolidated statement of operations. To the extent a debt security in an unrealized loss position is not impaired based on the preceding; the Company will consider that security to be impaired when it believes collection of the amortized cost is not probable.

During the Company's quarterly evaluation of its securities for impairment, there were no identified OTTI losses in our investments in debt and equity securities during the three months ended September 30, 2016 and \$0.3 million OTTI losses in our investments in debt and equity securities during the nine months ended September 30, 2016. We did not have any OTTI losses in our investments in debt and equity securities that were in an unrealized loss position during the three and nine months ended September 30, 2015.

Collateral Deposits

As of September 30, 2016, investments with fair values of approximately \$10.7 million, the majority of which were debt securities, were deposited with governmental authorities and into custodial bank accounts as required by law or contractual obligations.

5. REINSURANCE

Reinsurance is used to mitigate the exposure to losses, manage capacity and protect capital resources. The Company reinsures (cedes) a portion of written premiums on an excess of loss or a quota share basis in order to limit our loss exposure. To the extent that reinsuring companies are unable to meet their obligations assumed under these reinsurance agreements, we remain primarily liable to our policyholders.

We are selective in choosing reinsurers and consider numerous factors, the most important of which are the financial stability of the reinsurer or capital specifically pledged to uphold the contract, its history of responding to claims and its overall reputation. In an effort to minimize our exposure to the insolvency of a reinsurer, we evaluate the acceptability and review the financial condition of the reinsurer at least annually with the assistance of our reinsurance broker.

Significant Reinsurance Contracts

FNIC and MNIC operate primarily by underwriting and accepting risks for their direct account on a gross basis and reinsuring a portion of the exposure on either an individual risk or an aggregate basis to the extent those exceed the desired retention level. We continually evaluate the relative attractiveness of different forms of reinsurance contracts and different markets that may be used to achieve our risk and profitability objectives. All of our reinsurance contracts do not relieve FNIC or MNIC from their direct obligations to the insured.

FNIC's 2015-2016 catastrophe reinsurance program, which ran either from June 1 to May 31 or from July 1 to June 30, consists of the Florida Hurricane Catastrophe Fund ("FHCF"), excess of loss treaties placed with the private market and a 40% property quota-share program. The property quota-share reinsurance is a form of proportional reinsurance that provides coverage for the homeowners' property lines for wind related catastrophes in Florida. The FHCF treaty affords coverage for losses sustained in Florida and represents only a portion of the reinsurance coverage in Florida.

The excess of loss and FHCF treaties, which became effective on July 1, 2015 and June 1, 2015, respectively, insure for approximately \$1.82 billion of aggregate catastrophic losses and loss adjustment expenses ("LAE") with a maximum single event coverage totaling approximately \$1.26 billion, with the Company retaining the first \$12.9 million in Florida and \$5.0 million in Louisiana, Alabama and South Carolina for losses and LAE from each event. Ceded premiums in connection with this program totaled approximately \$149.7 million.

Additionally, the Company's private market excess of loss treaties became effective July 1, 2016 and all private layers have prepaid automatic reinstatement protection, which affords us additional coverage against multiple catastrophic events in the same hurricane season. The Company obtained multiple year protection for a portion of its program; as a result, some of the coverage will expire on June 30, 2017, and a portion of the coverage will remain in-force one additional treaty year until June 30, 2018. These private market excess of loss treaties structure coverage into layers, with a cascading feature such that substantially all private layers attach after \$18.45 million in losses for FNIC's Florida exposure. If the aggregate limit of the preceding layer is exhausted, the next layer drops down (cascades) in its place. Additionally, any unused layer protection drops down for subsequent events until exhausted.

FNIC's 2016-2017 reinsurance programs, costing approximately \$179.5 million, include approximately \$125.7 million for the private reinsurance for Federated National's Florida exposure, including prepaid automatic premium reinstatement protection on all

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layers, along with approximately \$53.8 million payable to the FHCF. The combination of private and FHCF reinsurance treaties will afford Federated National with approximately \$2.22 billion of aggregate coverage with a maximum single event coverage totaling approximately \$1.58 billion, exclusive of retentions. FNIC maintained its FHCF participation at 75% for the 2016 hurricane season. FNIC's single event pre-tax retention for a catastrophic event in Florida is \$18.45 million. In addition, FNIC purchases separate underlying reinsurance layers in Louisiana, Alabama, and South Carolina to cover losses and LAE outside of Florida for each catastrophic event from \$8.0 million to \$18.45 million. Depending on the characteristics of the catastrophic event, and the states involved, FNIC's single event pre-tax retention could be as low as \$8.0 million. The maximum pre-tax retention of \$18.45 million for Florida represents 7.01% of the Company's shareholders' equity as of September 30, 2016.

MNIC's 2016-2017 catastrophe reinsurance program, which runs from either June 1 to May 31 or June 1 to June 30 (13 month period), consists of the FHCF and private market excess of loss treaties. All private layers have prepaid automatic reinstatement protection, which affords MNIC additional coverage, and have a cascading feature such that substantially all layers attach at \$3.4 million for MNIC's Florida exposure.

The Company's property quota share treaties, which are included in the reinsurance program, run for a two-year period from July 1 to July 1 of the following year. The property quota-share treaties consist of two different treaties, one for 30% which became effective July 1, 2014, and the other for 10% which became effective July 1, 2015. The combined treaties provided a 40% quota-share reinsurance on the first \$100 million of covered losses for the homeowners' property insurance program in Florida. The treaties are accounted for as retrospectively rated contracts whereby the estimated ultimate premium or commission is recognized over the period of the contracts.

On July 1, 2016, the 30% property quota-share treaty expired on a cut-off basis, which means as of that date the Company will retain 30% of its unearned premiums and losses. The reinsurers will remain liable for 30% of the paid losses occurring during the term of the treaty, until the treaty is commuted.

The Company's private passenger automobile quota share treaties are typically one-year programs which become effective at different points in the year and cover auto policies across several states. These automobile quota share treaties cede 75% to 90% of all written premiums entered into by the Company.

Certain reinsurance agreements require FNIC to secure the credit, regulatory and business risk. Fully funded trust agreements securing these risks totaled \$2.6 million as of September 30, 2016 and \$3.5 million as of December 31, 2015.

Reinsurance Recoverables

Amounts recoverable from reinsurers are recognized in a manner consistent with the claims liabilities associated with the reinsurance placement and presented on the consolidated balance sheet as reinsurance recoverables. The following table presents reinsurance recoverables as reflected in the consolidated balance sheets as of September 30, 2016 and December 31, 2015:

| | December | |
|--|----------------|-----------|
| | September 30, | |
| | 2016 | 2015 |
| | (in thousands) | |
| Reinsurance recoverable on paid losses | \$ 8,094 | \$ 5,218 |
| Reinsurance recoverable on unpaid losses | 17,057 | 7,496 |
| Reinsurance recoverable, net | \$ 25,151 | \$ 12,714 |

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Premiums Written and Earned

The following table presents premiums written and earned for the three and nine months ended September 30, 2016 and 2015:

| | Three Months Ended | | Nine Months Ended | |
|-----------------------|-----------------------|------------|-----------------------|------------|
| | September 30, 2016 | 2015 | September 30, 2016 | 2015 |
| | (in thousands) | | (in thousands) | |
| Net premiums written: | | | | |
| Direct | \$ 161,137 | \$ 129,840 | \$ 468,379 | \$ 368,560 |
| Ceded | (96,327) | (119,985) | (259,307) | (231,046) |
| | \$ 64,810 | \$ 9,855 | \$ 209,072 | \$ 137,514 |
| Net premiums earned: | | | | |
| Direct | \$ 147,624 | \$ 112,253 | \$ 413,056 | \$ 310,587 |
| Ceded | (78,219) | (49,967) | (228,609) | (154,289) |
| | \$ 69,405 | \$ 62,286 | \$ 184,447 | \$ 156,298 |

6. LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

The liability for loss and LAE reserves is determined on an individual-case basis for all claims reported. The liability also includes amounts for unallocated expenses, anticipated future claim development and incurred but not yet reported ("IBNR").

Activity in the liability for loss and LAE reserves is summarized as follows:

| | Nine Months Ended | Year Ended December 31, 2015 |
|---|-------------------------|--|
| | September 30, 2016 | 2015 |
| | (in thousands) | |
| Gross reserves, beginning of period | \$ 97,340 | \$ 78,330 |
| Less: reinsurance recoverable (1) | (7,496) | (10,394) |
| Net reserves, beginning of period | 89,844 | 67,936 |
| Incurred loss, net of reinsurance, related to: | | |
| Current year | 109,237 | 113,819 |
| Prior years | 10,946 | (9,466) |
| Total incurred loss and LAE, net of reinsurance | 120,183 | 104,353 |
| Paid loss, net of reinsurance, related to: | | |
| Current year | 46,073 | 49,531 |
| Prior years | 53,526 | 32,914 |
| Total paid loss and LAE, net of reinsurance | 99,599 | 82,445 |
| Net reserves, end of period | 110,428 | 89,844 |
| Plus: reinsurance recoverable (1) | 17,057 | 7,496 |
| Gross reserves, end of period | \$ 127,485 | \$ 97,340 |

(1) Reinsurance recoverable in this table includes only ceded loss and LAE reserves.

The establishment of loss reserves is an inherently uncertain process and changes in loss reserve estimates are expected as such estimates are subject to the outcome of future events. The factors influencing changes in claim costs are often difficult to isolate or quantify and developments in paid and incurred losses from historical trends are frequently subject to multiple interpretations. Changes in estimates, or differences between estimates and amounts ultimately paid, are reflected in the operating results of the period during which such adjustments are made.

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During the nine months ended September 30, 2016, the Company experienced unfavorable loss and LAE reserve development on prior year accident years primarily in its all other peril homeowners' coverage in Florida. The deficiency primarily relates to higher severity above the expected development factor anticipated at December 31, 2015 which was driven by the impact from assignment of benefits and other related adjusting expenses.

During the year ended December 31, 2015, the Company experienced a redundancy on prior year accident years primarily a result of continued favorable loss experience (mostly caused by decreased severity in reported claims) in the Company's all other peril homeowners' coverage caused in part by the absence of severe weather in Florida. Specifically, we have experienced better severity than expected on the 2014 and 2013 accident years.

7. LONG-TERM DEBT

On March 17, 2015, MNHC, a wholly owned subsidiary of Monarch Delaware, and MNIC's direct parent, our consolidated VIE, issued a promissory note with a principal amount of \$5.0 million bearing 6% annual interest, due March 17, 2021 with interest payable on an annual basis due March 17 each year. The debt was issued to TransRe, a related party, in connection with its investment in Monarch Delaware, and is being carried at the unpaid principal balance, net of debt issuance costs, and any accrued and unpaid interest is recognized in other liabilities in the consolidated balance sheet. The Company recorded \$0.1 million of debt issuance costs related to the 6% promissory note.

8. INCOME TAXES

The provision for income tax expense for the three and nine months ended September 30, 2016 and 2015 is as follows:

| Three Months Ended | | Nine Months Ended | |
|--------------------|------|-------------------|------|
| September 30, | | September 30, | |
| 2016 | 2015 | 2016 | 2015 |
| (in thousands) | | (in thousands) | |

Federal:

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| | | | | |
|----------------------------|-------------|----------|------------|-----------|
| Current | \$ (10,433) | \$ 5,040 | \$ (2,275) | \$ 11,016 |
| Deferred | 10,709 | 1,194 | 8,222 | 5,982 |
| Federal income tax expense | 276 | 6,234 | 5,947 | 16,998 |
| State: | | | | |
| Current | (1,960) | 665 | (613) | 1,760 |
| Deferred | 1,786 | 155 | 1,260 | 761 |
| State income tax expense | (174) | 820 | 647 | 2,521 |
| Total income tax expense | \$ 102 | \$ 7,054 | \$ 6,594 | \$ 19,519 |

The actual income tax expense differs from the “expected” income tax expense (computed by applying the combined applicable effective federal and state tax rates to income before income tax expense) as follows:

| | Three Months Ended September 30, 2016 2015 (in thousands) | | Nine Months Ended September 30, 2016 2015 (in thousands) | |
|--|---|----------|---|-----------|
| Computed expected tax expense provision, at federal rate | \$ 552 | \$ 6,374 | \$ 6,604 | \$ 17,761 |
| State tax, net of federal tax benefit | (148) | 578 | 396 | 1,685 |
| Other | (302) | 102 | (406) | 73 |
| Total income tax expense | \$ 102 | \$ 7,054 | \$ 6,594 | \$ 19,519 |

The Company files income tax returns in the U.S. federal jurisdiction and various states and local jurisdictions. As a matter of course, various taxing authorities, including the Internal Revenue Service (“IRS”), regularly audit us. As of September 30, 2016, no open tax years are under examination by the IRS or any material state and local jurisdictions.

As of September 30, 2016 and December 31, 2015, we have determined that there are no uncertain tax positions.

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9. COMMITMENTS AND CONTINGENCIES

Legal Proceedings

In the ordinary course of business, the Company is involved in various legal proceedings, specifically claims litigation. The Company's insurance subsidiaries participate in most of these proceedings by either defending third-party claims brought against insureds or litigating first-party coverage claims. The Company accounts for such activity through the establishment of loss and LAE reserves. We believe that the ultimate liability, if any, with respect to such ordinary-course claims litigation, after consideration of provisions made for potential losses and costs of defense, is immaterial to our consolidated financial statements. The Company is also occasionally involved in other legal and regulatory proceedings, some of which may assert claims for substantial amounts. These other legal proceedings may occasionally make us party to individual actions in which extra-contractual damages, punitive damages or penalties are sought, such as claims alleging bad faith in the handling of insurance claims.

On a quarterly basis, the Company reviews these outstanding matters, if any. Consistent with GAAP, the Company establishes reserves for specific legal matters when it determines that the likelihood of an unfavorable outcome is probable and the loss is reasonably estimable. The Company does not establish reserves for identified legal matters when we believe that the likelihood of an unfavorable outcome is not probable. Based on our quarterly review, the Company believes that our accruals for probable and estimable losses are reasonable and that the amounts accrued do not have a material effect on our consolidated financial statements.

The Company is a party to a Co-Existence Agreement effective as of August 30, 2013 (the "Co-Existence Agreement") with Federated Mutual Insurance Company ("Mutual") pursuant to which the Company has agreed to certain restrictions on its use of the word "FEDERATED" without the word "NATIONAL" when referring to FNHC and FNIC. In response to Mutual's allegations that the Company's use of the word "FED" as part of the Company's federally registered "FEDNAT" trademark infringes on Mutual's federal and common law trademark rights, which the Company disputes, on July 21, 2016, the Company filed a declaratory judgment action for non-infringement of trademark in the U.S. District Court for the Southern District of Florida. Specifically, the Company seeks a declaration that its federally registered trademark "FEDNAT" does not infringe any alleged trademark rights of Mutual and that Mutual does not own any trademark rights to the name or mark "FED" in connection with insurance services outside of Owatonna, Minnesota.

On July 26, 2016, Mutual filed a demand for arbitration against the Company before the American Arbitration Association alleging a breach of the Co-Existence Agreement. Both matters are in their preliminary stages and FNHC intends to vigorously defend against all of Mutual's allegations, although there can be no assurances as to the outcome of either matter.

Assessment Related Activity

We operate in a regulatory environment where certain entities and organizations have the authority to require us to participate in assessments. Currently these entities and organizations include: Florida Insurance Guaranty Association (“FIGA”), Citizens Property Insurance Corporation (“Citizens”), FHCF, Florida Joint Underwriters Insurance Association (“JUA”), Georgia Insurers Insolvency Pool (“GIIP”), Special Insurance Fraud Fund (“SIIF”), Fair Access to Insurance Requirements Plan (“FAIRP”), Georgia Automobile Insurance Plan (“GAIP”), Property Insurance Association of Louisiana (“PIAL”), Louisiana Automobile Insurance Plan (“LAIP”), South Carolina Property & Casualty Insurance Guaranty Association (“SCPCIGA”), Texas Property and Casualty Insurance Guaranty Association (“TPCIGA”), Texas Windstorm Insurance Association (“TWIA”), Texas Automobile Insurance Plan Association (“TAIPA”), Alabama Insurance Guaranty Association (“AIGA”), and Alabama Insurance Underwriters Association (“AIUA”). As a direct premium writer in Florida, we are required to participate in certain insurer solvency associations under Florida law, administered by FIGA. Future assessments are likely, although the impact of these assessments on our balance sheet, results of operations or cash flow are undeterminable at this time.

FNIC is also required to participate in an insurance apportionment plan under Florida law, which is referred to as a JUA Plan. The JUA Plan provides for the equitable apportionment of any profits realized, or losses and expenses incurred, among participating automobile insurers. In the event of an underwriting deficit incurred by the JUA Plan which is not recovered through the policyholders in the JUA Plan, such deficit shall be recovered from the companies participating in the JUA Plan in the proportion that the net direct written premiums of each such member during the preceding calendar year bear to the aggregate net direct premiums written in this state by all members of the JUA Plan. FNIC was not assessed by the JUA Plan. Future assessments by this association are undeterminable at this time.

Leases

FNHC and its subsidiaries lease certain facilities, furniture and equipment under long-term lease agreements. Additional information about leases can be found in Note 8 to our Consolidated Financial Statements set forth in Part II, Item 8, “Financial Statements and Supplementary Data,” of the 2015 Form 10-K.

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10. SHAREHOLDERS' EQUITY

Common Stock Repurchases

In March 2016, our Board of Directors authorized a program to repurchase shares of common stock of FNHC, at such times and at prices as management determines advisable, up to an aggregate of \$10.0 million through March 31, 2017. Common stock repurchases are conducted in the open market. The amount and timing of all repurchase transactions are contingent upon market conditions, applicable legal requirements and other factors. This program may be modified, suspended or terminated by us at any time without notice.

Pursuant to our Board of Directors' authorizations, the Company repurchased 285,981 shares of its common stock at a total cost of approximately \$5.5 million, which is an average price per share of \$19.22, during the nine months ended September 30, 2016. As of September 30, 2016, the remaining availability for future repurchases of our common stock was \$4.5 million.

Share-Based Compensation Expense

The following table provides certain information in connection with the Company's share-based compensation arrangements for the three and nine months ended September 30, 2016 and 2015, respectively:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| | (in thousands) | | (in thousands) | |
| Restricted stock | \$ 525 | \$ 936 | \$ 3,158 | \$ 2,277 |
| Stock options | — | 5 | — | 29 |
| Total share-based compensation expense | \$ 525 | \$ 941 | \$ 3,158 | \$ 2,306 |
| Intrinsic value of options exercised | \$ 12,464 | \$ 396 | \$ 13,681 | \$ 8,551 |
| Fair value of restricted stock vested | \$ 10,685 | \$ 24,444 | \$ 39,607 | \$ 36,216 |

The intrinsic value of options exercised represents the difference between the stock option exercise price and the weighted average closing stock price of FNHC common stock on the exercise dates, as reported on The NASDAQ Global Market.

At September 30, 2016, there was approximately \$6.3 million of unrecognized share-based compensation expense, net of estimated forfeitures, related to restricted stock awards, which is currently expected to be recognized over a weighted average period of approximately 1.85 years.

Stock Option Awards

A summary of the Company's stock option activity for the period from January 1, 2016 to September 30, 2016 is as follows:

| | Number of Shares | Weighted Average Option Exercise Price |
|-----------------------------------|------------------|--|
| Outstanding at January 1, 2016 | 174,633 | \$ 3.79 |
| Granted | — | \$ — |
| Exercised | (93,899) | \$ 3.85 |
| Cancelled | — | \$ — |
| Outstanding at September 30, 2016 | 80,734 | \$ 3.71 |

Restricted Stock Awards

The Company recognizes share-based compensation expense for all restricted stock awards ("RSAs") held by employees. The accounting charge is measured at the grant date as the fair value of FNHC common stock and expensed as non-cash compensation over the vesting term using the straight-line basis.

During the first quarter of 2016 and 2015, the Board of Directors granted 128,472 and 116,140 RSAs, respectively, vesting over three or five years, to the Company's directors, executives and other key employees.

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The following table summarizes RSA activity during the nine months ended September 30, 2016:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|-----------------------------------|------------------|---|
| Outstanding at January 1, 2016 | 418,807 | \$ 20.14 |
| Granted | 128,472 | \$ 19.16 |
| Vested | (194,916) | \$ 20.32 |
| Cancelled | (540) | \$ 19.16 |
| Outstanding at September 30, 2016 | 351,823 | \$ 19.68 |

The weighted average grant date fair value is measured using the closing price of FNHC common stock on the grant date, as reported on The NASDAQ Global Market.

Accumulated Other Comprehensive Income

The following table presents a reconciliation of the changes in accumulated other comprehensive income during the three and nine months ended September 30, 2016 and 2015:

| Three Months Ended September 30, | | | | | |
|----------------------------------|---------------|-----|---------------|---------------|-----|
| 2016 | | | 2015 | | |
| Before Tax | Income Tax | Net | Before Tax | Income Tax | Net |

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(in thousands)

| | | | | | | |
|---|-----------|------------|----------|-----------|------------|----------|
| Accumulated other comprehensive income, beginning of period | \$ 15,201 | \$ (5,596) | \$ 9,605 | \$ 10,407 | \$ (4,048) | \$ 6,359 |
| Other comprehensive income before reclassifications | 690 | (186) | 504 | (746) | 284 | (462) |
| Reclassification adjustment for realized gains included in net income | (1,464) | 338 | (1,126) | (1,925) | 799 | (1,126) |
| | (774) | 152 | (622) | (2,671) | 1,083 | (1,588) |
| Accumulated other comprehensive income, end of period | \$ 14,427 | \$ (5,444) | \$ 8,983 | \$ 7,736 | \$ (2,965) | \$ 4,771 |

Nine Months Ended September 30,
2016
Before Income Net
Tax Tax
(in thousands)

| | | | | | | |
|---|-----------|------------|----------|-----------|------------|----------|
| Accumulated other comprehensive income, beginning of period | \$ 6,111 | \$ (2,247) | \$ 3,864 | \$ 12,417 | \$ (4,699) | \$ 7,718 |
| Other comprehensive income before reclassifications | 11,296 | (4,117) | 7,179 | 1,601 | (805) | 796 |
| Reclassification adjustment for realized gains included in net income | (2,980) | 920 | (2,060) | (6,282) | 2,539 | (3,743) |
| | 8,316 | (3,197) | 5,119 | (4,681) | 1,734 | (2,947) |
| Accumulated other comprehensive income, end of period | \$ 14,427 | \$ (5,444) | \$ 8,983 | \$ 7,736 | \$ (2,965) | \$ 4,771 |

11. EARNINGS PER SHARE

Basic earnings per share (“EPS”) is computed by dividing net income by the weighted average number of common shares outstanding for the period, including outstanding unvested restricted stock awards and vested restricted stock awards. Diluted EPS is computed by dividing net income by the weighted average number of shares outstanding, noted above, adjusted for the dilutive effect of stock options. Dilutive securities are common stock equivalents that are freely exercisable into common stock at less than market prices or otherwise dilute earnings if converted. The net effect of common stock equivalents is based on the incremental common stock that would be issued upon the assumed exercise of common stock options and the vesting of RSAs using the treasury stock method. Common stock equivalents are not included in diluted earnings per share when their inclusion is antidilutive.

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The computations of diluted EPS available to our shareholders do not include approximately 0.2 million stock options and RSAs for the three months ended September 30, 2016 and 2015, respectively, and 0.2 million stock options and RSAs for the nine months ended September 30, 2016 and 2015, respectively, as the effect of their inclusion would have been antidilutive to earnings per share.

The following table presents the calculation of basic and diluted EPS:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|--|-----------|--|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| | (in thousands, except per share data) | | (in thousands, except per share data) | |
| Net income attributable to Federated National Holding Company shareholders | \$ 1,394 | \$ 10,593 | \$ 11,920 | \$ 31,611 |
| Weighted average number of common shares outstanding - basic | 13,780 | 13,749 | 13,807 | 13,710 |
| Net income per share - basic | \$ 0.10 | \$ 0.77 | \$ 0.86 | \$ 2.31 |
| Weighted average number of common shares outstanding - basic | 13,780 | 13,749 | 13,807 | 13,710 |
| Dilutive effect of stock compensation plans | 163 | 228 | 192 | 268 |
| Weighted average number of common shares outstanding - diluted | 13,943 | 13,977 | 13,999 | 13,978 |
| Net income per share - diluted | \$ 0.10 | \$ 0.76 | \$ 0.85 | \$ 2.26 |
| Dividends per share | \$ 0.08 | \$ 0.04 | \$ 0.17 | \$ 0.13 |

Dividends Declared

In February 2016, our Board of Directors declared a quarterly dividend payment of \$0.05 per common share, paid in March 2016, amounting to \$0.7 million. In May and June 2016, our Board of Directors declared quarterly dividend payments of \$0.06 per common share, respectively, paid in June and August 2016, respectively, totaling \$1.7 million.

In September 2016, our Board of Directors declared a \$0.08 per common share dividend payable December 1, 2016 to shareholders of record on November 1, 2016.

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12. VARIABLE INTEREST ENTITY

The carrying amounts of the assets of Monarch Delaware, our consolidated VIE, which can only be used to settle obligations of Monarch Delaware, and liabilities of Monarch Delaware for which creditors do not have recourse are as follows:

| | September 30, 2016 | December 2015 |
|--|-----------------------|------------------|
| (in thousands) | | |
| ASSETS | | |
| Investments | | |
| Debt securities, available for sale, at amortized cost | \$ 26,710 | \$ 21,312 |
| Equity securities, available-for-sale, at fair value | 1,580 | 1,358 |
| Total investments | 28,290 | 22,670 |
| Cash and cash equivalents | 14,753 | 14,616 |
| Prepaid reinsurance premiums | — | 34 |
| Premiums receivable, net | 1,589 | 355 |
| Other assets | 1,269 | 1,037 |
| Total assets | \$ 45,902 | \$ 38,712 |
| LIABILITIES | | |
| Loss and loss adjustment expense reserves | \$ 822 | \$ 237 |
| Unearned premiums | 6,426 | 1,448 |
| Debt | 4,903 | 4,887 |
| Income taxes payable | — | 8 |
| Other liabilities | 1,461 | 374 |
| Total liabilities | \$ 13,612 | \$ 6,954 |

13. SUBSEQUENT EVENT

Hurricane Matthew impacted the east coast of Florida as a Category 4 hurricane and South Carolina as a Category 2 hurricane during the first week of October 2016. The Company's initial gross catastrophic loss estimate in the state of Florida is \$75 million and \$2 million in the state of South Carolina. After taking into consideration our reinsurance treaties, including the Company's 10% property quota-share treaty, the Company expects to incur the full retention limit \$18.45 million.

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General information about Federated National Holding Company can be found at www.FedNat.com; however, the information that can be accessed through our web site is not part of our report. We make our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports filed or furnished pursuant to the Securities and Exchange Act of 1934 available free of charge on our web site, as soon as reasonably practicable after they are electronically filed with the SEC.

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

Overview

The following discussion and analysis should be read in conjunction with our unaudited consolidated financial statements and notes thereto included under Part I, Item 1 of this Quarterly Report on Form 10-Q (the “Form 10-Q”). In addition, reference should be made to our audited consolidated financial statements and notes thereto and related “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in our most recent Annual Report on Form 10-K for the year ended December 31, 2015 (the “2015 Form 10-K”).

Unless the context requires otherwise, as used in this Form 10-Q, the terms “FNHC,” “Company,” “we,” “us” and “our” refers Federated National Holding Company and its consolidated subsidiaries.

Forward-Looking Statements

Statements in this Form 10-Q or in documents that are incorporated by reference that are not historical fact are forward-looking statements that are subject to certain risks and uncertainties that could cause actual events and results to differ materially from those discussed herein. Without limiting the generality of the foregoing, words such as “anticipate,” “believe,” “budget,” “contemplate,” “continue,” “could,” “envision,” “estimate,” “expect,” “guidance,” “indicate,” “might,” “plan,” “possibly,” “potential,” “predict,” “probably,” “pro-forma,” “project,” “seek,” “should,” “target,” or “will” or thereof or other variations thereon and similar words or phrases or comparable terminology are intended to identify forward-looking statements.

Forward-looking statements might also include, but are not limited to, one or more of the following:

- Projections of revenues, income, earnings per share, dividends, capital structure or other financial items or measures;
- Descriptions of plans or objectives of management for future operations, insurance products/or services;
- Forecasts of future insurable events, economic performance, liquidity, need for funding and income; and
- Descriptions of assumptions or estimates underlying or relating to any of the foregoing.

The risks and uncertainties include, without limitation, risks and uncertainties related to estimates, assumptions and projections generally; the nature of the Company's business; the adequacy of its reserves for loss and loss adjustment expense ("LAE"); claims experience; weather conditions (including the severity and frequency of storms, hurricanes, tornadoes and hail) and other catastrophic losses; reinsurance costs and the ability of reinsurers to indemnify the Company; raising additional capital and our potential failure to meet minimum capital and surplus requirements; potential assessments that support property and casualty insurance pools and associations; the effectiveness of internal financial controls; the effectiveness of our underwriting, pricing and related loss limitation methods; changes in loss trends, including as a result of insureds' assignment of benefits; court decisions and trends in litigation; our potential failure to pay claims accurately; ability to obtain regulatory approval applications for requested rate increases, or to underwrite in additional jurisdictions, and the timing thereof; the impact that the results of the Monarch joint venture may have on our results of operations; inflation and other changes in economic conditions (including changes in interest rates and financial markets); pricing competition and other initiatives by competitors; legislative and regulatory developments; the outcome of litigation pending against the Company, and any settlement thereof; dependence on investment income and the composition of the Company's investment portfolio; insurance agents; ratings by industry services; the reliability and security of our information technology systems; reliance on key personnel; acts of war and terrorist activities; and other matters described from time to time by the Company in this report and other filings filed with the United States Securities and Exchange Commission, including the Company's Form 10-K.

In addition, investors should be aware that U.S. generally accepted accounting principles ("GAAP") prescribe when a company may reserve for particular risks, including claims and litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a contingency. Reported results may therefore appear to be volatile in certain accounting periods.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date on which they are made. We do not undertake any obligation to update publicly or revise any forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made.

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GENERAL

FNHC is an insurance holding company that controls substantially all steps in the insurance underwriting, distribution and claims processes through our subsidiaries and our contractual relationships with our independent agents and general agents. We are authorized to underwrite, and/or place through our wholly owned subsidiaries, homeowners' multi-peril ("homeowners"), commercial general liability, federal flood, personal automobile and other lines of insurance in Florida and other states. We market, distribute and service our own and third-party insurers' products and our other services through a network of independent agents.

Our wholly owned insurance subsidiary is Federated National Insurance Company ("FNIC"), which is licensed as an admitted carrier in Florida, Texas, Georgia, Alabama, Louisiana and South Carolina. We also serve as managing general agent for Monarch National Insurance Company ("MNIC"), which was founded in 2015 through the joint venture described below, and is licensed as an admitted carrier in Florida. An admitted carrier is an insurance company that has received a license from the state department of insurance giving the Company the authority to write specific lines of insurance in that state. These companies are also bound by rate and form regulations, and are strictly regulated to protect policyholders from a variety of illegal and unethical practices, including fraud. Admitted carriers are also required to financially contribute to the state guarantee fund, which is used to pay for losses if an insurance carrier becomes insolvent or unable to pay the losses due to their policyholders.

Monarch National Insurance Company Joint Venture

On March 19, 2015, the Company entered into a joint venture to organize MNIC, which received its certificate of authority to write homeowners' property and casualty insurance in Florida from the Florida Office of Insurance Regulation (the "Florida OIR"). The Company's joint venture partners are a majority-owned limited partnership of Crosswinds Holdings Inc., a publicly traded Canadian private equity firm and asset manager ("Crosswinds") and Transatlantic Reinsurance Company ("TransRe").

The Company and Crosswinds each invested \$14.0 million in Monarch Delaware Holdings, LLC ("Monarch Delaware"), the indirect parent company of MNIC, for a 42.4% interest in Monarch Delaware (each holding 50% of the voting interests in Monarch Delaware). TransRe invested \$5.0 million in debt evidenced by a six-year promissory note bearing 6% annual interest payable by Monarch National Holding Company ("MNHC"), a wholly owned subsidiary of Monarch Delaware and the direct parent company of MNIC.

In connection with the organization of MNIC, the parties entered into the following agreements dated as of March 17, 2015:

- MNIC entered into a Managing General Agent and Claims Administration Agreement (the “Monarch MGA Agreement”) with FedNat Underwriters, Inc. (“FNU”), a wholly owned subsidiary of the Company, pursuant to which FNU provides underwriting, accounting, reinsurance placement and claims administration services to Monarch. For its services under the Monarch MGA Agreement, FNU receives 4% of Monarch’s total written annual premium, excluding acquisition expenses payable to agents, for FNU’s managing general agent services; 3.6% of Monarch’s total earned annual premium for FNU’s claims administration services; and a per-policy administrative fee of \$25 for each policy underwritten for Monarch. The Company also receives an annual expense reimbursement for accounting and related services.
- MNIC, MNHC and Monarch Delaware (collectively, the “Monarch Entities”) entered into an Investment Management Agreement (the “Monarch Investment Agreement”) with Crosswinds AUM LLC, a wholly owned subsidiary of Crosswinds (“Crosswinds AUM”), pursuant to which Crosswinds AUM manages the investment portfolios of the Monarch Entities. The management fee, on an annual basis, is 0.75% of assets under management up to \$100 million; 0.50% of assets under management of more than \$100 million but less than \$200 million; and 0.30% of assets under management of more than \$200 million.
- MNIC also entered into a Reinsurance Capacity Right of First Refusal Agreement with TransRe, pursuant to which TransRe has a right of first refusal for all quota share and excess of loss reinsurance that Monarch Insurance deems necessary in its sole discretion for so long as TransRe remains a member of Monarch Delaware or the MNHC debt remains outstanding. Pursuant to this agreement, TransRe has the right to provide, at market rates and terms, a maximum of 15% of any reinsurance coverage obtained by Monarch Delaware in any individual reinsurance contract.
- The Company’s Chief Executive Officer and Interim Chief Financial Officer hold their respective positions with Monarch Entities while they remain employed by the Company.

The Monarch Entities are consolidated as a variable interest entity (“VIE”) in the accompanying unaudited consolidated financial statements included in Part I, Item 1 of this Form 10-Q.

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Executive Offices

Our executive offices are located at 14050 N.W. 14th Street, Suite 180, Sunrise, Florida 33323 and our telephone number is (800) 293-2532.

Overview of Insurance Lines of Business

Homeowners' Property and Casualty Insurance

FNIC and MNIC underwrite homeowners' insurance in Florida and FNIC also underwrites insurance in Alabama, Louisiana and South Carolina. Homeowners' insurance generally protects an owner of real and personal property against covered causes of loss to that property. The Florida homeowners' policies in-force totaled 271,461 and 242,702 at September 30, 2016 and at December 31, 2015, respectively.

Our homeowners' insurance products provide maximum dwelling coverage in the amount of approximately \$3.8 million, with the aggregate maximum policy limit being approximately \$6.5 million. We currently offer dwelling coverage "A" up to \$4.0 million with an aggregate total insured value of \$6.5 million. We continually subject these limits to review; during 2015, coverage "A" was increased by \$1.0 million and total insured value increased by \$1.5 million. The typical deductible is either \$2,500 or \$1,000 for non-hurricane-related claims and generally 2% of the coverage amount for the structure for hurricane-related claims.

Premium rates charged to our homeowners' insurance policyholders are continually evaluated to assure that they meet the expectation that they are actuarially sound and produce a reasonable level of profit (neither excessive, inadequate or discriminatory). Premium rates in Florida and other states are regulated and approved by the respective states' insurance regulators. MNIC applied for and was approved by the Florida OIR for a rate decrease of 11.9% for Florida homeowners' multiple-peril insurance policies, which became effective for new and renewals on April 15, 2016. Additionally, FNIC applied for and was approved by the Florida OIR for a rate increase of 5.6% for Florida homeowners' multiple-peril insurance policies, which became effective for new and renewals on August 1, 2016. We continue to monitor and seek appropriate adjustment to our rates in order to remain competitive and profitable.

Other Lines of Business

Personal Automobile: Nonstandard personal automobile insurance is principally provided to insureds that are unable to obtain standard insurance coverage because of their driving record, age, vehicle type or other factors, including market conditions. We market this through licensed general agents in their respective territories.

Commercial General Liability: We underwrite for approximately 380 classes of skilled craft workers (excluding homebuilders and developers) and mercantile trades (such as owners, landlords and tenants). The limits of liability range from \$100,000 per occurrence with a \$200,000 policy aggregate to \$1.0 million per occurrence with a \$2.0 million policy aggregate. We market the commercial general liability insurance products through independent agents and a limited number of general agents unaffiliated with the Company.

Flood: FNIC writes flood insurance through the National Flood Insurance Program (“NFIP”). We write the policy for the NFIP, which assumes 100% of the flood risk while we retain a commission for our service.

See the discussion in Item 1: “Business” in our 2015 Form 10-K for additional information with respect to our business.

RESULTS OF OPERATIONS

Operating Results Overview - Three Months Ended September 30, 2016 Compared with Three Months Ended September 30, 2015

The following overview does not address all of the matters covered in the other sections of Management’s Discussion and Analysis of Financial Condition and Results of Operations or contain all of the information that may be important to our shareholders

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or the investing public. This overview should be read in conjunction with the other sections of Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following table summarizes our unaudited results of operations for the three months ended September 30, 2016 and 2015:

| | Three Months Ended September 30, | | |
|--|-------------------------------------|----------|------------|
| | 2016 | % Change | 2015 |
| | (Dollars in thousands) | | |
| Revenue: | | | |
| Gross premiums written | \$ 161,137 | 24.1% | \$ 129,840 |
| Increase in unearned premiums | (13,513) | (23.2)% | (17,587) |
| Gross premiums earned | 147,624 | 31.5% | 112,253 |
| Ceded premiums | (78,219) | 56.5% | (49,967) |
| Net premiums earned | 69,405 | 11.4% | 62,286 |
| Net investment income | 2,164 | 13.5% | 1,907 |
| Net realized investment gains | 1,126 | —% | 1,126 |
| Other income | 11,095 | 52.4% | 7,280 |
| Total revenue | 83,790 | 15.4% | 72,599 |
| Costs and expenses: | | | |
| Losses and loss adjustment expenses | 43,613 | 53.5% | 28,412 |
| Commissions and other underwriting expenses | 34,512 | 59.7% | 21,610 |
| General and administrative expenses | 4,044 | (17.2)% | 4,887 |
| Interest expense | 81 | 24.6% | 65 |
| Total costs and expenses | 82,250 | 49.6% | 54,974 |
| Income before income taxes | 1,540 | (91.3)% | 17,625 |
| Income taxes | 102 | (98.6)% | 7,054 |
| Net income | 1,438 | (86.4)% | 10,571 |
| Net loss attributable to noncontrolling interest | 44 | (300.0)% | (22) |
| Net income attributable to FNHC | \$ 1,394 | (86.8)% | \$ 10,593 |
| Ratios to net premiums earned: | | | |
| Net loss ratio (1) | 62.8% | | 45.6% |
| Net expense ratio(2) | 55.7% | | 42.6% |
| Net combined ratio(3) | 118.5% | | 88.3% |

- (1) The net loss ratio is calculated as losses and LAE divided by net premiums earned.
- (2) The net expense ratio is calculated as all operating expenses less interest expense divided by net premiums earned.
- (3) The net combined ratio is calculated as the sum of losses and LAE and all operating expenses less interest expense divided by net premiums earned.

Revenue

Total revenue for the three months ended September 30, 2016 of \$83.8 million increased \$11.2 million, or 15.4%, compared to revenue of \$72.6 million in 2015.

Gross Premiums Written

Gross premiums written increased \$31.3 million, or 24.1%, to \$161.1 million for the three months ended September 30, 2016, compared with \$129.8 million for the same three-month period last year. The increase predominantly reflects market share growth in our homeowners' and personal automobile lines of business. Homeowners' gross premiums written increased \$14.6 million, or 12.3%, to \$133.5 million for the three months ended September 30, 2016, compared with \$118.9 million for the same three-month period last year. Gross premiums written for our personal automobile line of business increased by \$16.5 million to \$21.5 million in the third quarter of 2016 compared to \$5.0 million in the prior year period. These increases reflect management's strategy to continue to grow market

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share in Florida as well as expand operations outside of Florida with the growth in our personal automobile line of business. With the expansion into areas outside of Florida, we are able to continue to leverage our personnel and, at the same time, diversify our insurance risk.

Ceded Premiums Earned

Ceded premiums earned increased by \$28.3 million, or 56.5%, to \$78.2 million for the three months ended September 30, 2016, compared with \$50.0 million in the same three-month period last year. This increase is driven by the additional excess-of-loss reinsurance costs purchased for the 2016 – 2017 reinsurance program, which became effective on June 1, 2016 and July 1, 2016 and the additional ceded premiums related to premium growth in our personal automobile line of business from this current period compared to the same-period last year.

Additionally, during the third quarter of 2015, we re-evaluated the accounting treatment for quota-share reinsurance contracts which lead to a decrease in ceded premiums of \$10.9 million in the prior year period. Refer to our 2015 Form 10-K for additional information regarding the ceded premiums adjustment. These items were offset by lower ceded premiums this quarter from the 30% property quota-share treaty which ended on July 1, 2016.

Net Premiums Earned

Net premiums earned increased \$7.1 million, or 11.4%, to \$69.4 million during the three months ended September 30, 2016, compared with \$62.3 million during the three months ended September 30, 2015. This increase was primarily driven by an increase in our Florida homeowners' in-force policy count to 271,461 as of September 30, 2016, compared with 231,828 in the prior year.

Net Investment Income

Total investments increased \$41.8 million, to \$426.1 million as of September 30, 2016, compared with \$384.3 million as of December 31, 2015. As a result, net investment income increased \$0.3 million, or 13.5%, to \$2.2 million during the three months ended September 30, 2016, compared to \$1.9 million during the three months ended September 30, 2015. This increase is mainly due to greater interest income earned, which is attributed to the year-over-year growth of our investment portfolio. Our debt securities investment yield, net, was 2.4% for the three months ended September 30, 2016 and 2015.

Net Realized Investment Gains

Net realized investment gains remained constant at \$1.1 million for the three months ended September 30, 2016 and 2015, respectively. From time to time, our portfolio managers, under our control, move out of positions due to both macro and micro conditions; these movements generate both realized gains and losses.

Other Income

Other income increased \$3.8 million, or 52.4%, to \$11.1 million for the three months ended September 30, 2016, compared with \$7.3 million in the prior year period. The following table represents the other income detail as follows:

| | Three Months Ended September 30, | | |
|----------------------------|-------------------------------------|-------------|----------|
| | 2016 | % Change | 2015 |
| | (Dollars in thousands) | | |
| Other income: | | | |
| Direct written policy fees | \$ 4,318 | 55.2% | \$ 2,783 |
| Commission income | 3,921 | 110.5% | 1,863 |
| Brokerage | 2,279 | 3.2% | 2,209 |
| Finance | 577 | 35.8% | 425 |
| Total other income | \$ 11,095 | 52.4% | \$ 7,280 |

The increase in direct written policy fees is correlated to the increase in gross written premiums in our homeowners and personal automobile lines of business compared to the prior year. These fees are generated when the Company writes a policy and the fee varies from state to state and by line of business. Policy fees generated by the managing general agent are earned by the Company. All other policy fees are collected by us and passed through to the general agent as acquisition costs and recognized in commission and other underwriting expenses.

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The increase in commission income primarily reflects the growth in ceded commissions from personal automobile and the fees we receive for managing that business. These fees are received by FNIC and passed through to FNU for its services as a managing general agent. The commission income from personal automobile is designed to offset the commission and other acquisition costs incurred when the Company writes the policies, which are recognized in the commissions and other underwriting expenses account.

Expenses

Losses and Loss Adjustment Expenses

Losses and loss adjustment expenses (“LAE”) increased \$15.2 million, or 53.5%, to \$43.6 million for the three months ended September 30, 2016, compared with \$28.4 million for the same three-month period last year. The increase in losses and LAE was driven by approximately \$9.0 million in additional losses related to increasing our Florida homeowners’ current year attritional loss ratio, which is currently now at 36.1%, as compared to the same period in prior year. We believe this measure is useful to investors as the Company uses the attritional loss ratio to monitor losses associated with ordinary insurance operations. Additionally, the Company incurred \$4.0 million in catastrophe losses, net of reinsurance, correlated with the impact of Hurricane Hermine, and \$4.5 million of additional losses incurred related to higher premiums this quarter as compared to same period in prior year.

During the third quarter of 2015, we re-evaluated the accounting treatment for quota-share reinsurance contracts which led to an additional \$4.5 million in losses and LAE in the prior year period. Refer to our 2015 Form 10-K for additional information regarding the losses and LAE adjustment.

Commissions and Other Underwriting Expenses

Commissions and other underwriting expenses increased \$12.9 million, or 59.7%, to \$34.5 million for the three months ended September 30, 2016, compared with \$21.6 million for the three months ended September 30, 2015. The increase is driven by \$6.0 million in prior year expense reduction related to the commission credit received as part of the 30% property quota share treaty for the three months ended September 30, 2015, and the remaining \$7.0 million increase is primarily the additional acquisition costs related to the \$35.3 million growth in gross premiums earned during this quarter as compared to the same period in prior year. The gross premiums earned increase is driven from homeowners and personal automobile lines of business. Although personal automobile quota-share treaties cede 75% to 90% of all written premiums, the full expense for commissions and other acquisition costs are recognized in this line item and offset the related commission income within other income.

General and Administrative Expenses

General and administrative expenses decreased \$0.8 million, or 17.2%, to \$4.0 million for the three months ended September 30, 2016, compared with \$4.9 million for the three months ended September 30, 2015. The decrease is primarily driven by lower executive and employee bonus expense which fluctuates based on the Company's performance.

Income Taxes

Income taxes decreased \$7.0 million, or 98.6%, to \$0.1 million for the three months ended September 30, 2016, compared with \$7.1 million for the three months ended September 30, 2015. The change was due to a decrease in taxable income and a decrease in our effective tax rate related to adjustments in our permanent items, including increased federal deductions in our state tax expense and return to provision adjustments.

Operating Results Overview - Nine Months Ended September 30, 2016 Compared with Nine Months Ended September 30, 2015

The following overview does not address all of the matters covered in the other sections of Management's Discussion and Analysis of Financial Condition and Results of Operations or contain all of the information that may be important to our shareholders

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or the investing public. This overview should be read in conjunction with the other sections of Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following table reports our unaudited results of operations for the nine months ended September 30, 2016 and 2015:

| | Nine Months Ended | | |
|---|------------------------|----------|------------|
| | September 30, | | |
| | 2016 | % Change | 2015 |
| | (Dollars in thousands) | | |
| Revenue: | | | |
| Gross premiums written | \$ 468,379 | 27.1% | \$ 368,560 |
| Increase in unearned premiums | (55,323) | (4.6)% | (57,973) |
| Gross premiums earned | 413,056 | 33.0% | 310,587 |
| Ceded premiums | (228,609) | 48.2% | (154,289) |
| Net premiums earned | 184,447 | 18.0% | 156,298 |
| Net investment income | 6,398 | 24.1% | 5,154 |
| Net realized investment gains | 2,060 | (45.0)% | 3,743 |
| Other income | 34,909 | 65.2% | 21,130 |
| Total revenue | 227,814 | 22.3% | 186,325 |
| Expenses: | | | |
| Losses and LAE | 120,183 | 59.2% | 75,510 |
| Commissions and other underwriting expenses | 75,408 | 57.3% | 47,934 |
| General and administrative expenses | 13,211 | 10.3% | 11,973 |
| Interest expense | 259 | 60.9% | 161 |
| Total costs and expenses | 209,061 | 54.2% | 135,578 |
| Income before income taxes | 18,753 | (63.0)% | 50,747 |
| Income taxes | 6,594 | (66.2)% | 19,519 |
| Net income | 12,159 | (61.1)% | 31,228 |
| Net (income) loss attributable to noncontrolling interest | 239 | (162.4)% | (383) |
| Net income attributable to FNHC | \$ 11,920 | (62.3)% | \$ 31,611 |
| Ratios to net premiums earned: | | | |
| Net loss ratio (1) | 65.2% | | 48.3% |
| Net expense ratio(2) | 48.2% | | 38.4% |
| Net combined ratio(3) | 113.4% | | 86.7% |

- (1) The net loss ratio is calculated as losses and LAE divided by net premiums earned.
- (2) The net expense ratio is calculated as all operating expenses less interest expense divided by net premiums earned.
- (3) The net combined ratio is calculated as the sum of losses and LAE and all operating expenses less interest expense divided by net premiums earned.

Revenue

Total revenue for the nine months ended September 30, 2016 of \$227.8 million increased \$41.5 million, or 22.3%, compared to revenue of \$186.3 million in 2015.

Gross Premiums Written

Gross premiums written increased \$99.8 million, or 27.1%, to \$468.4 million for the nine months ended September 30, 2016, compared with \$368.6 million for the same nine-month period last year. The increase predominantly reflects market share growth in our homeowners' and personal automobile lines of business. Homeowners' gross premiums written increased \$53.6 million, or 15.8%, to \$393.8 million for the nine months ended September 30, 2016, compared with \$340.2 million for the same nine-month period in the prior year. Gross premiums written for the personal automobile line of business increased by \$45.4 million to \$56.2 million in the first nine months of 2016, compared to \$10.8 million in the prior year period. These increases reflect management's strategy to continue to grow market share in Florida as well as expand operations outside of Florida with the growth in the Company's personal automobile

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line of business. With the expansion into areas outside of Florida, we are able to continue to leverage our personnel and, at the same time, diversify our insurance risk.

Ceded Premiums Earned

Ceded premiums earned increased by \$74.3 million, or 48.2%, to \$228.6 million for the nine months ended September 30, 2016, compared with \$154.3 million in the same nine-month period last year. This increase is driven by additional excess-of-loss reinsurance costs during the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015 and additional ceded premiums from quota-share agreements in our homeowners' and personal automobile lines of business. These items were offset by lower ceded premiums in the third quarter of 2016 from the 30% property quota-share treaty which ended on July 1, 2016.

Net Premiums Earned

Net premiums earned increased \$28.1 million, or 18.0%, to \$184.4 million during the nine months ended September 30, 2016, compared with \$156.3 million during the nine months ended September 30, 2015. This increase was primarily driven by an increase in our Florida homeowners' in-force policy count to 271,460 as of September 30, 2016, compared with 231,828 in the prior year.

Net Investment Income

Net investment income increased \$1.2 million, or 24.1%, to \$6.4 million during the nine months ended September 30, 2016, compared to \$5.2 million in 2015. This increase is mainly due to greater interest income earned, which is attributed to the year-over-year growth of our investment portfolio. Our debt securities investment yield, net, was 2.4% for the nine months ended September 30, 2016 and 2015.

Net Realized Investment Gains

Net realized investment gains totaled \$2.1 million for the first nine months of 2016, compared with \$3.7 million for the same period in 2015. From time to time, our portfolio managers, under our direction, move out of positions due to both macro and micro conditions; these movements generate both realized gains and losses.

Other Income

Other income increased \$13.8 million, or 65.2%, to \$34.9 million for the nine months ended September 30, 2016, compared with \$21.1 million in the prior year period. The following table represents the other income detail as follows:

| | Nine Months Ended | | |
|----------------------------|------------------------|----------|-----------|
| | September 30, | | |
| | 2016 | % Change | 2015 |
| | (Dollars in thousands) | | |
| Other income: | | | |
| Direct written policy fees | \$ 13,445 | 70.5% | \$ 7,887 |
| Commission income | 14,779 | 244.0% | 4,296 |
| Brokerage revenue | 5,039 | 10.8% | 4,548 |
| Quota-share profit sharing | — | (100.0)% | 3,077 |
| Finance revenue | 1,646 | 24.5% | 1,322 |
| Total other income | \$ 34,909 | 65.2% | \$ 21,130 |

The increase in direct written policy fees is correlated related to the increase in gross written premiums in our homeowners and personal automobile lines of business compared to prior year. The increase in direct written policy fees is directly related to the increase in gross written premiums in our homeowners and personal automobile lines of business compared to the prior year. These fees are generated when the Company writes a policy and varies from state to state, and by line of business. Policy fees generated by the managing general agent are earned by the Company. All other policy fees are collected by us and passed through to the general agent as acquisition costs and recognized in commission and other underwriting expenses.

The increase in commission income primarily reflects the growth in ceded commissions from personal automobile and the fees we receive for managing that business. The commission income from personal automobile is designed to offset the commission and other acquisition costs incurred when the Company writes the policies, which are recognized in the commissions and other underwriting expenses account.

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The decrease in quota-share profit sharing is the result of our re-evaluation, effective September 30, 2015, of the accounting treatment for the quota-share reinsurance contracts with retrospective rating provisions. At that time, we eliminated recording of future estimated quota-share profits in one line, ("Quota-share profit sharing") on the consolidated statement of operations.

Expenses

Losses and LAE

Losses and LAE increased \$44.7 million, or 59.2%, to \$120.2 million for the nine months ended September 30, 2016, compared with \$75.5 million for the same nine-month period in the prior year. The increase in losses and LAE was driven by approximately \$26.0 million in additional losses related to increasing our Florida homeowners' current year accident year attritional loss ratio, which is currently now at 36.1%, and \$10.4 million related to higher premiums this period as compared to same period in prior year, offset by higher ceded losses from the property quota-share treaties. The increase in the attritional loss ratio is a direct result of the continued impact from assignment of benefits and other related adjusting expenses, and the impact from the temporary discontinuation of our underwriting analytics. We believe this measure is useful to investors as the Company uses the attritional loss ratio to monitor losses associated with ordinary insurance operations.

Additionally, the Company incurred \$11.9 million in gross catastrophe losses correlated with severe weather events that impacted the State of Florida (i.e., tornadoes, Tropical Storm Colin, and Hurricane Hermine) and \$11.0 million in prior year development in the all other peril homeowners' coverage in Florida relating to the 2015 accident year.

As of September 30, 2016, the Company recorded \$127.5 million in losses and LAE expense reserves for all lines of business, which includes \$76.7 million in incurred but not yet reported ("IBNR") reserves. As of December 31, 2015, the Company recorded \$97.3 million in losses and LAE expense reserves for all lines of business, which includes \$51.1 million in IBNR reserves.

Commissions and Other Underwriting Expenses

Commissions and other underwriting expenses increased \$27.5 million, or 57.3%, to \$75.4 million for the nine months ended September 30, 2016, compared with \$47.9 million for the nine months ended September 30, 2015. The increase is driven by additional acquisition costs and underwriting expenses related to the growth in gross premiums

earned during this period as compared to the same period in prior year. The increase in gross premiums earned is driven by the homeowners' and personal automobile lines of business. Although personal automobile quota-share treaties cede 75% to 90% of all written premiums, the full expense for commissions and other acquisition costs are recognized in this line item and offset the related commission income with the other income line item.

Additionally, with the 30% quota share treaty ending on July 1, 2016, the Company did not receive the commission credit from the 30% quota share which increased expenses by approximately \$9.0 million during the third quarter of 2016.

General and Administrative Expenses

General and administrative expenses increased \$1.2 million, or 10.3%, to \$13.2 million for the nine months ended September 30, 2016, compared with \$12.0 million for the nine months ended September 30, 2015. The increase primarily reflects expenses incurred of \$1.9 million in connection with the resignation of the Company's former Chief Financial Officer during the second quarter of 2016.

Income Taxes

Income taxes decreased \$12.9 million, or 66.2%, to \$6.6 million for the nine months ended September 30, 2016, compared with \$19.5 million for the nine months ended September 30, 2015. Our effective tax rate was 35.2% for the nine months ended September 30, 2016, compared with 38.5% for the nine months ended September 30, 2015. The change was due to a decrease in taxable income and a decrease in our effective tax rate related to adjustments in our permanent items, including increased federal deductions in our state tax expense and return to provision adjustments.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of funds are net premiums, investment income, commissions and fee income. Our primary uses of funds are the payment of claims and operating expenses. As of September 30, 2016, FNHC held \$426.1 million in investments. Cash and cash equivalents increased \$53.2 million, to \$106.2 million as of September 30, 2016, compared with \$53.0 million as of December 31, 2015.

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Cash Flows Discussion

Operating Activities

Net cash provided by operating activities increased to \$99.3 million in the nine months ended September 30, 2016 from \$80.2 million in the same period in 2015. This increase primarily reflects the increase in prepaid reinsurance premiums, partly offset by decreases in the deferred acquisition costs and premiums receivable. The decrease in deferred acquisition costs reflects the unwinding effect of the 30% quota-share treaty which expired on a cut-off basis on July 1, 2016.

Investing Activities

Net cash used in investing activities of \$38.3 million in the nine months ended September 30, 2016 related to purchases of investment securities of \$188.6 million, partly offset by sales, maturities and redemptions of our investment securities of \$151.9 million. Net cash used in investing activities of \$61.9 million in the nine months ended September 30, 2015 related to purchases of investment securities of \$195.3 million, partly offset by sales, maturities and redemptions of our investment securities of \$134.9 million.

Financing Activities

Net cash used in financing activities for the nine months ended September 30, 2016 of \$7.8 million, primarily reflects repurchases of our common stock of \$5.5 million and dividend payments of \$3.6 million, partially offset by \$0.8 million in tax benefits related to share-based compensation. Net cash provided by financing activities of \$17.7 million for the nine months ended September 30, 2015 reflects \$18.5 million related to the noncontrolling interest equity investment, partially offset by dividend payments of \$1.8 million.

We believe that existing cash and investment balances, when combined with anticipated cash flows as noted above, will be adequate to meet our expected liquidity needs in both the short-term and the reasonably foreseeable future. We currently expect to continue declaring and paying dividends at comparable levels, subject to our future liquidity needs and reserve requirements. The Company also considers various opportunities, including common stock repurchases, to deploy its excess capital. Any future growth strategy may require external financing, and we may from time to time seek to obtain external financing. We cannot assure that additional sources of financing will be available to us on favorable terms, or at all, or that any such financing would not negatively impact our results of operations.

Dividends and Common Stock Repurchases

In February 2016, our Board of Directors declared a quarterly dividend payment of \$0.05 per common share, paid in March 2016, amounting to \$0.7 million. In May and June 2016, our Board of Directors declared quarterly dividend payments of \$0.06 per common share, respectively, paid in June and August 2016, respectively, totaling \$1.7 million.

In September 2016, our Board of Directors declared a \$0.08 per common share dividend payable December 1, 2016 to shareholders of record on November 1, 2016. Based on the number of shares of common stock outstanding as of September 30, 2016, at a dividend of \$0.08 per share, the anticipated cash outflow would be \$1.1 million in the fourth quarter of 2016. We currently expect to declare and pay quarterly dividends of similar amounts.

In March 2016, our Board of Directors authorized a program to repurchase shares of common stock of FNHC, at such times and at prices as management determines advisable, up to an aggregate of \$10.0 million through March 31, 2017. Common stock repurchases are conducted in the open market. The amount and timing of all repurchase transactions are contingent upon market conditions, applicable legal requirements and other factors. This program may be modified, suspended or terminated by us at any time without notice.

During the first nine months of 2016, we repurchased 0.3 million shares of common stock for \$5.5 million, including commissions. The remaining availability for future repurchases of our common stock was \$4.5 million.

Impact from Hurricane Matthew

Based on our preliminary estimate of the losses caused by Hurricane Matthew as described in Note 13 — “Subsequent Event” to our unaudited consolidated financial statements under Item 1 of this Form 10-Q, we do not believe there will be a significant impact on our future liquidity and financial position.

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Impact of Inflation and Changing Prices

The consolidated financial statements and related data presented herein have been prepared in accordance with GAAP, which requires the measurement of financial position and operating results in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation. Our primary assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or with the same magnitude as the inflationary effect on the cost of paying losses and LAE.

Insurance premiums are established before we know the amount of losses and LAE and the extent to which inflation may affect such expenses. Consequently, we attempt to anticipate the future impact of inflation when establishing rate levels. While we attempt to charge adequate premiums, we may be limited in raising premium levels for competitive and regulatory reasons. Inflation may also affect the market value of our investment portfolio and the investment rate of return. Any future economic changes that result in prolonged and increasing levels of inflation could cause increases in the dollar amount of incurred losses and LAE and thereby materially adversely affect future liability requirements.

Critical Accounting Policies

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

We believe our most critical accounting estimates inherent in the preparation of our financial statements are: (i) fair value measurements of our investments, (ii) investments, (iii) premium and unearned premium calculation, (iv) reinsurance contracts, (v) the amount and recoverability of amortization of deferred acquisition costs (“DAC”), (vi) reserve for loss and LAE and (vii) income taxes. The accounting estimates that result require the use of assumptions about certain matters that are highly uncertain at the time of estimation. To the extent actual experience differs from the assumptions used, our financial condition, results of operations, and cash flows would be affected.

There have been no significant changes to our critical accounting estimates during the nine months ended September 30, 2016. Refer to Part II, Item 7: “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Estimates” included in our 2015 Form 10-K for a more complete description

of our critical accounting estimates.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our investment objective is to maximize total rate of return after federal income taxes while maintaining liquidity and minimizing risk. Our current investment policy limits investment in non-investment-grade debt securities (including high-yield bonds), and limits total investments in preferred stock, common stock and mortgage notes receivable. We also comply with applicable laws and regulations that further restrict the type, quality and concentration of our investments. In general, these laws and regulations permit investments, within specified limits and subject to certain qualifications, in federal, state and municipal obligations, corporate bonds, preferred and common equity securities and real estate mortgages.

Our investment policy is established by the Board of Directors Investment Committee and is reviewed on a regular basis. Pursuant to this investment policy, as of September 30, 2016, approximately 92% of investments were in debt securities and cash and cash equivalents, which are considered to be either held until maturity or available-for-sale, based upon our estimates of required liquidity. Approximately 98% of the debt securities are considered available-for-sale and are marked to market. We may in the future consider additional debt securities to be held-to-maturity and carried at amortized cost. We do not use any swaps, options, futures or forward contracts to hedge or enhance our investment portfolio.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act 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 disclosures.

Our management, with the participation of our Chief Executive Officer and Interim Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as of September 30, 2016. Based upon their evaluation, the Chief Executive Officer and Interim Chief Financial Officer concluded that our

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disclosure controls and procedures, as of September 30, 2016, were effective to provide reasonable assurance that information required to be disclosed by us in the reports filed or submitted by it under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and to provide reasonable assurance that information required to be disclosed by us in such reports is accumulated and communicated to our management, including our Chief Executive Officer and Interim Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes during the three months ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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Part II: OTHER INFORMATION

Item 1. Legal Proceedings

The Company is a party to a Co-Existence Agreement effective as of August 30, 2013 (the “Co-Existence Agreement”) with Federated Mutual Insurance Company (“Mutual”) pursuant to which the Company has agreed to certain restrictions on its use of the word “FEDERATED” without the word “NATIONAL” when referring to FNHC and Federated National Insurance Company. In response to Mutual’s allegations that the Company’s use of the word “FED” as part of the Company’s federally registered “FEDNAT” trademark infringes on Mutual’s federal and common law trademark rights, which the Company disputes, on July 21, 2016, the Company filed a declaratory judgment action for non-infringement of trademark in the U.S. District Court for the Southern District of Florida. Specifically, the Company seeks a declaration that its federally registered trademark "FEDNAT" does not infringe any alleged trademark rights of Mutual and that Mutual does not own any trademark rights to the name or mark "FED" in connection with insurance services outside of Owatonna, Minnesota. On July 26, 2016, Mutual filed a demand for arbitration against the Company before the American Arbitration Association alleging a breach of the Co-Existence Agreement. Both matters are in their preliminary stages and FNHC intends to vigorously defend against all of Mutual’s allegations, although there can be no assurances as to the outcome of either matter.

Refer to Note 9 to our consolidated financial statements set forth in Part I, “Financial Statements” for further information about legal proceedings.

Item 1A. Risk Factors

There have been no material changes from the risk factors previously disclosed in Part I, Item 1A, “Risk Factors,” of the Company’s 2015 Form 10-K. Please refer to that section for disclosures regarding what we believe are the most significant risks and uncertainties related to our business.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities. The following table sets forth information with respect to purchases of shares of our common stock made during the quarter ended September 30, 2016 by or on behalf of FNHC. All purchases were made in the open market in accordance with Rule 10b-18 of the Exchange Act.

| | Total Number of Shares Repurchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans | Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans (1) |
|----------------|--|--|---|---|
| July 2016 | — | \$ — | — | \$ — |
| August 2016 | 112,565 | \$ 18.02 | 112,565 | \$ 5,592,911 |
| September 2016 | 61,240 | \$ 17.77 | 61,240 | \$ 4,504,817 |

(1) In March 2016, our Board of Directors authorized a program to repurchase shares of common stock of FNHC, at such times and at prices as management determines advisable, up to an aggregate of \$10.0 million through March 31, 2017.

Item 3. Defaults upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

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Item 6. Exhibits

| Exhibit No. | Description |
|-------------|--|
| 10.1 | FHCF Supplemental Layer Reinsurance Contract, effective June 1, 2016 between Federated National Insurance Company and subscribing reinsurers.* |
| 10.2 | Multi-Year Excess Catastrophe Reinsurance Contract, effective July 1, 2016 between Federated National Insurance Company and subscribing reinsurers.* |
| 10.3 | Non-Florida Property Catastrophe Excess of Loss Reinsurance Contract, effective July 1, 2016 between Federated National Insurance Company and subscribing reinsurers.* |
| 10.4 | Non-Florida Reinstatement Premium Protection Reinsurance Contract, effective July 1, 2016 between Federated National Insurance Company and subscribing reinsurers.* |
| 10.5 | Reinstatement Premium Protection Reinsurance Contract, effective July 1, 2016, between Federated National Insurance Company and subscribing reinsurers.* |
| 10.6 | Excess Catastrophe Reinsurance Contract, effective July 1, 2016 between Federated National Insurance Company and subscribing reinsurers.* |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act** |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act** |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act** |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act** |
| 101.INS | XBRL Instance Document*** |
| 101.SCH | XBRL Taxonomy Extension Schema Document*** |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document*** |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document*** |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document*** |

* This exhibit is subject to a confidential treatment request filed with the SEC.

** Filed herewith

*** In accordance with Rule 406T of Regulation S-T, these interactive data files are deemed not filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

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SIGNATURES

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

FEDERATED NATIONAL HOLDING COMPANY

By: /s/ Michael H. Braun
Michael H. Braun, Chief Executive Officer
(Principal Executive Officer)

/s/ Erick A. Fernandez
Erick A. Fernandez, Interim Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: November 8, 2016