FedNat Holding Co
Form 10-Q
November 07, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED September 30, 2018
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
FedNat Holding Company
(Exact name of registrant as specified in its charter)

Florida	65-0248866
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)
14050 N.W. 14th Street, Suite 180, Sunrise, FL	33323
(Address of principal executive offices)	(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 þ 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 þ 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, or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ¨	Accelerated filer þ	Non accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨ Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No þ

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 1, 2018, the registrant had 12,774,444 shares of common stock outstanding.

FEDNAT HOLDING COMPANY
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PART I: FINANCIAL INFORMATION
Item 1. Financial Statements
FEDNAT HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)
(Unaudited)

	September 30, 2018	December 31, 2017
ASSETS		
Investments:		
Debt securities, available-for-sale, at fair value (amortized cost of $432,051 and $422,300, respectively)	$424,148	$423,238
Debt securities, held-to-maturity, at amortized cost	5,255	5,349
Equity securities, at fair value	19,535	15,434
Total investments (including $0 and $26,284 related to the VIE, respectively)	448,938	444,021
Cash and cash equivalents (including $0 and $14,211 related to the VIE, respectively)	69,457	86,228
Prepaid reinsurance premiums	134,285	135,492
Premiums receivable, net of allowance of $81 and $70, respectively (including $0 and $1,184 related to the VIE, respectively)	34,286	46,393
Reinsurance recoverable, net	134,736	124,601
Deferred acquisition costs, net	47,395	40,893
Income taxes, net	3,006	9,817
Property and equipment, net	4,120	4,025
Other assets (including $0 and $2,322 related to the VIE, respectively)	14,388	13,403
Total assets	$890,611	$904,873
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Liabilities		
Loss and loss adjustment expense reserves	$221,114	$230,515
Unearned premiums	296,329	294,423
Reinsurance payable	77,004	71,944
Long-term debt, net of deferred financing costs of $623 and $749, respectively	44,377	49,251
Deferred revenue	4,913	6,222
Other liabilities	23,938	25,059
Total liabilities	667,675	677,414
Commitments and contingencies (see Note 9)		
Shareholders' Equity		
Preferred stock, $0.01 par value: 1,000,000 shares authorized	—	—
Common stock, $0.01 par value: 25,000,000 shares authorized; 12,774,444 and 12,988,247 shares issued and outstanding, respectively	128	130
Additional paid-in capital	140,608	139,728
Accumulated other comprehensive income (loss)	(5,901)	1,770
Retained earnings	88,101	70,009
Total shareholders’ equity attributable to FedNat Holding Company shareholders	222,936	211,637
Non-controlling interest	—	15,822

Total shareholders’ equity	222,936	227,459
Total liabilities and shareholders' equity	$890,611	$904,873

The accompanying notes are an integral part of the unaudited consolidated financial statements.

FEDNAT HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share data)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Revenues:				
Net premiums earned	$98,493	$80,764	$264,159	$245,978
Net investment income	3,137	2,603	9,058	7,481
Net realized and unrealized investment gains (losses)	1,760	6,101	916	8,644
Direct written policy fees	3,796	4,098	10,685	13,617
Other income	3,646	5,131	14,833	14,190
Total revenues	110,832	98,697	299,651	289,910
Costs and expenses:				
Losses and loss adjustment expenses	62,457	75,367	156,098	188,683
Commissions and other underwriting expenses	31,373	28,386	91,467	86,883
General and administrative expenses	5,000	5,042	16,345	14,737
Interest expense	1,032	81	3,139	247
Total costs and expenses	99,862	108,876	267,049	290,550
Income (loss) before income taxes	10,970	(10,179)	32,602	(640)
Income tax expense (benefit)	3,020	(3,781)	8,587	(358)
Net income (loss)	7,950	(6,398)	24,015	(282)
Net income (loss) attributable to non-controlling interest	—	(1,674)	(218)	(1,975)
Net income (loss) attributable to FedNat Holding Company shareholders	$7,950	$(4,724)	$24,233	$1,693
Net Income (Loss) Per Common Share				
Basic	$0.62	$(0.36)	$1.90	$0.13
Diluted	$0.62	$(0.36)	$1.88	$0.13
Weighted Average Number of Shares of Common Stock Outstanding				
Basic	12,749	13,135	12,775	13,211
Diluted	12,870	13,135	12,866	13,302
Dividends Declared Per Common Share	$—	$0.08	$0.16	$0.24

The accompanying notes are an integral part of the unaudited consolidated financial statements.

FEDNAT HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income (loss)	$7,950	$(6,398)	$24,015	$(282)
Change in net unrealized gains (losses) on investments, available-for-sale, net of tax	(551)	(2,445)	(6,601)	514
Comprehensive income (loss)	7,399	(8,843)	17,414	232
Less: comprehensive income (loss) attributable to non-controlling interest, net of tax	—	(1,674)	(447)	(2,233)
Comprehensive income (loss) attributable to FedNat Holding Company shareholders	$7,399	$(7,169)	$17,861	$2,465

The accompanying notes are an integral part of the unaudited consolidated financial statements.

FEDNAT HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
(In thousands, except share data)
(Unaudited)

	Preferred Stock	Common Stock Issued Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity Attributable to FedNat Holding Company Shareholders	Non-Controlling Interest	Total Shareholders' Equity
Balance as of June 30, 2018	$ —	12,731,777	$ 127	$ 140,102	$ (5,350)	$ 80,149	$ 215,028	$ —	$ 215,028
Net income (loss)	—	—	—	—	—	7,950	7,950	—	7,950
Other comprehensive income (loss)	—	—	—	—	(551)	—	(551)	—	(551)
Dividends declared	—	—	—	—	—	2	2	—	2
Shares issued under share-based compensation plans	—	42,667	1	22	—	—	23	—	23
Repurchases of common stock	—	—	—	—	—	—	—	—	—
Share-based compensation	—	—	—	484	—	—	484	—	484
Balance as of September 30, 2018	$ —	12,774,444	$ 128	$ 140,608	$ (5,901)	$ 88,101	$ 222,936	$ —	$ 222,936

	Preferred Stock	Common Stock Issued Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity Attributable to FedNat Holding Company Shareholders	Non-Controlling Interest	Total Shareholders' Equity
Balance as of June 30, 2017	$ —	13,060,207	$ 130	$ 138,191	$ 5,157	$ 73,126	$ 216,604	$ 18,169	$ 234,773
Net income (loss)	—	—	—	—	—	(4,724)	(4,724)	(1,674)	(6,398)
Other comprehensive income (loss)	—	—	—	—	(2,444)	—	(2,444)	(1)	(2,445)
Dividends declared	—	—	—	—	—	(1,097)	(1,097)	—	(1,097)
Shares issued under share-based	—	77,519	—	102	—	—	102	—	102

compensation plans									
Repurchases of common stock	—	(84,445)	—	1	—	(1,317)	(1,316)	—	(1,316)
Share-based compensation	—	—	—	867	—	—	867	—	867
Balance as of September 30, 2017	$ —	13,053,281	$ 130	$ 139,161	$ 2,713	$ 65,988	$ 207,992	$ 16,494	$ 224,486

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FEDNAT HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS’ EQUITY (CONTINUED)
(In thousands, except share data)
(Unaudited)

	Preferred Stock	Common Stock Issued Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity Attributable to FedNat Holding Company Shareholders	Non-Controlling Interest	Total Shareholders' Equity
Balance as of January 1, 2018	$ —	12,988,247	$ 130	$ 139,728	$ 1,770	$ 70,009	$ 211,637	$ 15,822	$ 227,459
Cumulative effect of new accounting standards	—	—	—	—	(994)	994	—	—	—
Net income (loss)	—	—	—	—	—	24,233	24,233	(218)	24,015
Other comprehensive income (loss)	—	—	—	—	(6,372)	—	(6,372)	(229)	(6,601)
Dividends declared	—	—	—	—	—	(2,077)	(2,077)	—	(2,077)
Acquisition of non-controlling interest	—	—	—	(1,005)	(305)	—	(1,310)	(15,375)	(16,685)
Shares issued under share-based compensation plans	—	112,905	1	38	—	—	39	—	39
Repurchases of common stock	—	(326,708)	(3)	—	—	(5,058)	(5,061)	—	(5,061)
Share-based compensation	—	—	—	1,847	—	—	1,847	—	1,847
Balance as of September 30, 2018	$ —	12,774,444	$ 128	$ 140,608	$ (5,901)	$ 88,101	$ 222,936	$ —	$ 222,936

	Preferred Stock	Common Stock Issued Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity Attributable to FedNat Holding Company Shareholders	Non-Controlling Interest	Total Shareholders' Equity

Balance as of January 1, 2017	$ —	13,473,120	$ 134	$ 136,779	$ 1,941	$ 76,884	$ 215,738	$ 18,727	$ 234,465
Net income (loss)	—	—	—	—	—	1,693	1,693	(1,975)	(282)
Other comprehensive income (loss)	—	—	—	—	772	—	772	(258)	514
Dividends declared	—	—	—	—	—	(3,189)	(3,189)	—	(3,189)
Shares issued under share-based compensation plans	—	159,014	—	103	—	—	103	—	103
Repurchases of common stock	—	(578,853)	(4)	—	—	(9,400)	(9,404)	—	(9,404)
Share-based compensation	—	—	—	2,279	—	—	2,279	—	2,279
Balance as of September 30, 2017	$ —	13,053,281	$ 130	$ 139,161	$ 2,713	$ 65,988	$ 207,992	$ 16,494	$ 224,486

The accompanying notes are an integral part of the unaudited consolidated financial statements.

FEDNAT HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2018	2017
Cash flow from operating activities:		
Net income (loss)	$24,015	$(282)
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Net realized and unrealized investment (gains) losses	(916)	(8,644)
Amortization of investment premium or discount, net	1,333	3,065
Depreciation and amortization	1,033	312
Share-based compensation	1,847	2,279
Tax impact related to share-based compensation	(32)	(150)
Changes in operating assets and liabilities:		
Prepaid reinsurance premiums	1,207	(33,025)
Premiums receivable, net	12,107	(291)
Reinsurance recoverable, net	(10,135)	(286,630)
Deferred acquisition costs	(6,502)	(2,363)
Income taxes, net	9,083	(5,110)
Deferred revenue	(1,309)	(73)
Loss and loss adjustment expense reserves	(9,401)	303,115
Unearned premiums	1,906	18,205
Reinsurance payable	5,060	47,325
Other	(1,038)	4,517
Net cash provided by (used in) operating activities	28,258	42,250
Cash flow from investing activities:		
Proceeds from sales of equity securities	7,407	57,016
Proceeds from sales of debt securities	153,970	195,090
Purchases of equity securities	(8,377)	(34,339)
Purchases of debt securities	(254,110)	(268,999)
Maturities and redemptions of debt securities	86,935	28,718
Purchases of property and equipment	(1,002)	(304)
Net cash provided by (used in) investing activities	(15,177)	(22,818)
Cash flow from financing activities:		
Payment of long-term debt	(5,000)	—
Purchase of non-controlling interest	(16,685)	—
Purchases of FedNat Holding Company common stock	(5,061)	(9,404)
Issuance of common stock for share-based awards	39	103
Dividends paid	(3,145)	(3,189)
Net cash provided by (used in) financing activities	(29,852)	(12,490)
Net increase (decrease) in cash and cash equivalents	(16,771)	6,942
Cash and cash equivalents at beginning-of-period	86,228	74,593
Cash and cash equivalents at end-of-period	$69,457	$81,535

The accompanying notes are an integral part of the unaudited consolidated financial statements.

FEDNAT HOLDING COMPANY AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)
(Continued)

	Nine Months Ended September 30,	
	2018	2017
Supplemental disclosure of cash flow information:		
Cash paid (received) during the period for income taxes	$(466)	$(414)

The accompanying notes are an integral part of the unaudited consolidated financial statements.

FedNat Holding Company and Subsidiaries
Notes to Consolidated Financial Statements
September 30, 2018

1. ORGANIZATION, CONSOLIDATION AND BASIS OF PREPARATION

Organization

FedNat Holding Company (“FNHC,” the “Company,” “we,” “us,” or "our") is an insurance holding company that controls substantially all aspects of the insurance underwriting, distribution and claims processes through our subsidiaries and contractual relationships with independent agents and general agents. The Company, through its wholly owned subsidiaries, is authorized to underwrite and/or place homeowners multi-peril ("homeowners"), federal flood and other lines of insurance in Florida and other states. The Company markets, distributes and services its own and third-party insurers’ products and other services through a network of independent and general agents.

FedNat Insurance Company (“FNIC”), our largest wholly owned insurance subsidiary, is licensed as an admitted carrier, to write specific lines of insurance by the state’s insurance departments, in Florida, Louisiana, Texas, Georgia, South Carolina and Alabama. Monarch National Insurance Company (“MNIC”), our other insurance subsidiary, is licensed as an admitted carrier in Florida. Admitted carriers are bound by rate and form regulations, and are strictly regulated to protect policyholders from a variety of illegal and unethical practices. Admitted carriers are also required to financially contribute to the state guarantee fund used to pay for losses if an insurance carrier becomes insolvent or unable to pay loss amounts due to their policyholders.

Monarch National Insurance Company

We completed our acquisition of MNIC in February 2018 by acquiring the membership interests in MNIC’s indirect parent, Monarch Delaware Holdings LLC (“Monarch Delaware”), held by our joint venture partners. Our joint venture partners were Crosswinds Investor Monarch LP (“Crosswinds Investor”), a wholly owned subsidiary of Crosswinds Holdings Inc. (“Crosswinds Holdings”), a private equity firm and asset manager, and Transatlantic Reinsurance Company (“TransRe”), an international property and casualty reinsurance company. We purchased the 42.4% Class A membership interest in Monarch Delaware held by Crosswinds Investor for $12.3 million and the 15.2% non-voting membership interest in Monarch Delaware held by TransRe for $4.4 million. We also repaid the outstanding principal balance and interest due on the $5.0 million promissory note to TransRe. MNIC was organized in March 2015 and writes homeowners property and casualty insurance in Florida.

Crosswinds AUM LLC, a subsidiary of Crosswinds Holdings, serves as an investment consultant to FNHC through December 31, 2018 for a quarterly fee of $75,000. In addition, subsidiaries of Crosswinds Holdings and TransRe each have a right of first refusal through December 31, 2018 to participate in our catastrophe excess of loss reinsurance program, at market rates and terms, up to a placement of $10.0 million in reinsurance limit in the aggregate from Crosswinds Holdings and up to a placement of $10.0 million in reinsurance limit in excess of its placement on our current catastrophe excess of loss reinsurance program from TransRe. TransRe does currently participate in the reinsurance program.

Please refer to Basis of Presentation and Principles of Consolidation and Note 12 below.

Material Distribution Relationships

Ivantage Select Agency, Inc.

The Company is a party to an insurance agency master agreement with Ivantage Select Agency, Inc. (“ISA”), an affiliate of Allstate Insurance Company (“Allstate”), pursuant to which the Company has been authorized by ISA to appoint Allstate agents to offer the Company’s homeowners insurance products to consumers in Florida. As a percentage of the total homeowners premiums we underwrote, 24.5% and 24.6% were from Allstate’s network of Florida agents, for the three months ended September 30, 2018 and 2017, respectively. For the nine months ended September 30, 2018 and 2017, 23.9% and 24.0%, respectively, of the homeowners premiums we underwrote were from Allstate's network of Florida agents.

SageSure Insurance Managers, LLC

The Company is a party to a managing general underwriting agreement with SageSure Insurance Managers, LLC ("SageSure") to facilitate growth in our FNIC homeowners business outside of Florida. As a percentage of the total homeowners premiums, 16.2% and 10.7%, respectively, of the Company's premiums were underwritten by SageSure, for the three months ended September 30, 2018 and 2017, respectively. For the nine months ended September 30, 2018 and 2017, 14.2% and 9.7%, respectively, of the Company's homeowners premiums were underwritten by SageSure.

Basis of Presentation and Principles of Consolidation

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States ("GAAP"). The consolidated financial statements include the accounts of FNHC and its wholly-owned subsidiaries and all entities in which the Company has a controlling financial interest and any variable interest entity ("VIE") of which the Company is the primary beneficiary. The Company's management believes the consolidated financial statements reflect all material adjustments, including normal recurring adjustments, necessary to fairly state the financial position, results of operations and cash flows of the Company for the periods presented. All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company identifies a VIE as an entity that does not have sufficient equity to finance its own activities without additional financial support or where the equity investors lack certain characteristics of a controlling financial interest. The Company assesses its contractual, ownership or other interests in a VIE to determine if the Company's interest participates in the variability the VIE was designed to absorb and pass onto variable interest holders. The Company performs an ongoing qualitative assessment of its variable interests in a VIE to determine whether the Company has a controlling financial interest and would therefore be considered the primary beneficiary of the VIE. If the Company determines it is the primary beneficiary of a VIE, the Company consolidates the assets and liabilities of the VIE in its consolidated financial statements.

As of December 31, 2017, in connection with the investment in Monarch Delaware, the Company had determined that the Company possessed the power to direct the activities of the VIE that most significantly impact its economic performance and the Company was the primary beneficiary of the VIE. As such, the Company consolidated Monarch Delaware in its consolidated financial statements. Refer to Monarch National Insurance Company above, related to our 100% ownership of Monarch Delaware that became effective on February 21, 2018. In accordance with the accounting standard on consolidation, a primary beneficiary that acquires additional ownership of the previously controlled and consolidated subsidiaries is accounted for as an equity transaction and re-measurement of assets and liabilities of previously controlled and consolidated subsidiaries is not permitted. As a result, we accounted for this transaction by eliminating the carrying value of the non-controlling interest to reflect our 100% ownership interest in MNIC as of February 21, 2018. The difference between the consideration paid and the amount by which the non-controlling interest was eliminated has been recognized in additional paid-in capital. Following the closing, Monarch Delaware and Monarch Holdings were merged into MNIC.

Revisions of Previously Issued Financial Statements

Revisions to the three and nine months ended September 30, 2017, were described in Note 1 and Note 16 to our Consolidated Financial Statements set forth in Part II, Item 8, "Financial Statements and Supplementary Data" included in our most recent Form 10-K for the year ended December 31, 2017 (the "2017 Form 10-K").

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND PRACTICES

Our significant accounting policies were described in Note 2 of our 2017 Form 10-K. Other than the changes noted in "Recently Issued Accounting Pronouncements, Adopted" below, there have been no significant changes in our significant accounting policies for the nine months ended September 30, 2018.

Accounting Estimates and Assumptions

The Company prepares the accompanying consolidated financial statements in accordance with GAAP, which 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 may materially differ from those estimates.

Similar to other property and casualty insurers, the Company’s liability for loss and loss adjustment expenses ("LAE") reserves, although supported by actuarial projections and other data, is ultimately based on management’s reasoned expectations of future events. Although

FedNat Holding Company and Subsidiaries
Notes to Consolidated Financial Statements (Continued)
September 30, 2018

considerable variability is inherent in these estimates, the Company believes that the liability and LAE reserve is adequate. The Company reviews and evaluates its estimates and assumptions regularly and makes adjustments, reflected in current operations, as necessary, on an ongoing basis.

Recently Issued Accounting Pronouncements, Adopted

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“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. The update replaces all general and most industry specific revenue recognition guidance (excluding insurance) currently prescribed by GAAP. The core principle is that an entity recognizes revenue to reflect the transfer of a promised good or service to customers in an amount that reflects that consideration to which the entity expects to be entitled in exchange for that good or service. The Company adopted this update and the other related revenue standard clarifications and technical guidance effective January 1, 2018, using the modified retrospective approach. The Company completed the analysis of its non-insurance revenues and has concluded that the implementation did not have any impact on the Company’s consolidated financial condition or results of operations.

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”), which addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. In February 2018, the FASB issued ASU 2018-03, Technical Corrections and Improvements to Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. Most notably, the combined new guidance required 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. The Company adopted the guidance effective January 1, 2018, by reflecting a cumulative adjustment, which increased retained earnings and decreased accumulated other comprehensive income by $1.0 million. This adjustment represented the level of net unrealized gains and losses associated with our equity investments with readily determinable market values as of January 1, 2018. The adoption also resulted in the recognition of $2.6 million in our consolidated statements of operations and statements of comprehensive income (loss), which represented the change in net unrealized gains and losses on our equity securities for the first nine months of 2018. This new guidance increases our earnings volatility compared to the prior accounting rules.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force) to improve the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The update provides guidance on specific cash flow classification issues including the following: (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. Previous GAAP did not include specific guidance on these eight cash flow classification issues. The Company adopted the guidance effective January 1, 2018, and the provisions of this update did not have an impact on our consolidated statements of cash flows or results of operations.

In February 2018, the FASB issued ASU 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The update allowed a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Job Act of 2017 ("Tax Act"). Guidance had previously required the effect of a change in tax laws or rates on deferred tax balances to be reported in income from continuing operations in the accounting period that includes the period of enactment, even if the related income tax effects were originally charged or credited directly to accumulated other comprehensive income. The Company adopted the guidance effective January 1, 2018, by reflecting a cumulative effect adjustment to retained earnings with an off-setting adjustment to accumulated other comprehensive income for less than $0.1 million.

In June 2018, the FASB issued ASU 2018-07, Compensation-Stock Compensation (Topic 718): Improvements to Non-employee Share-Based Payment Accounting. The update expands the scope of Topic 718 to include share-based payment transactions for acquiring goods and services from non-employees. The guidance requires non-employee share-based payments awards to be measured consistently with the accounting for employee share-based payment awards, which is the grant date fair value of the equity security, with measurement at the grant date. Previously, non-employee share-based payment awards were measured at either the fair value of consideration received or the fair value of the equity, at the earlier of the date the non-employee committed to perform or the date of performance completion.

FedNat Holding Company and Subsidiaries
Notes to Consolidated Financial Statements (Continued)
September 30, 2018

The Company adopted the guidance effective June 30, 2018, and the provisions of this update did not have an impact on our consolidated financial position or results of operations.

In February 2018, the FASB issued ASU 2018-03, Technical Corrections and Improvements to Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The update provides corrections and improvements and clarifies certain aspects of the guidance issued in ASU 2016-01. The Company adopted the guidance effective July 1, 2018, and the provisions of this update did not have an impact on our consolidated financial position or results of operations.

Recently Issued Accounting Pronouncements, Not Yet Adopted

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The update will supersede the current lease guidance in Topic 840, Leases and 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. The update 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. All of the Company’s leases are classified as operating leases under current lease accounting guidance. The Company intends to elect the optional transition method and the package of practical expedient, which will allow us to recognize our leases as of January 1, 2019 through a cumulative-effect adjustment to retained earnings, with no adjustment to comparative prior periods presented. We established a comprehensive approach to implement this standard, and have gathered and assessed the necessary data to determine the scope of impact and now completing our evaluation of processes to meet the accounting and disclosure requirements. The Company expects to recognize a right-of-sue asset and lease liability on our consolidated balance sheets, however the amount will depend on our leases in existence on January 1, 2019. However, we do not expect there to be a significant difference in our pattern of lease expense recognition on our consolidated statements of operations, under this ASU.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, 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. The update requires 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 ("OTTI") model. The update also 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. The update is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is in the early stage of evaluating the impact that the update will have on the Company’s consolidated financial position or results of operations.

In August 2018, the FASB issued ASU 2018-15, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract. ASU 2018-15 requires a customer in a cloud computing arrangement that is a service contract to follow the internal-use software guidance in Accounting Standards Codification 350-40 to determine which implementation costs to defer and recognize as an asset. The update is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is in the early stage of evaluating the impact that the update will have on the Company's consolidated financial position or results of operations.

3. FAIR VALUE

Fair Value Disclosures of Financial Instruments

The Company accounts for financial instruments at fair value or the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. 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 recorded at fair value are classified and disclosed in one of the following three categories:

- Level 1 - Quoted market prices (unadjusted) for identical assets or liabilities in active markets 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, or observable inputs.

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- Level 2 - Quoted market prices for similar assets or liabilities and valuations, using models or other valuation techniques using observable market data. Significant other observable that can be corroborated by observable market data; and,
- 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.

The classification of assets and liabilities in the fair value hierarchy is based upon the lowest level input that is significant to the fair value.

The Company's financial instruments measured at fair value on a recurring basis and the level of the fair value hierarchy of inputs used consisted of the following:

	September 30, 2018			
	Level 1	Level 2	Level 3	Total
	(In thousands)			
Debt securities - available-for-sale, at fair value:				
United States government obligations and authorities	$59,689	$54,548	$ —	$114,237
Obligations of states and political subdivisions	—	9,679	—	9,679
Corporate securities	—	283,213	—	283,213
International securities	—	17,019	—	17,019
Debt securities, at fair value	59,689	364,459	—	424,148
Equity securities, at fair value	19,535	—	—	19,535
Total investments, at fair value	$79,224	$364,459	$ —	$443,683

	December 31, 2017			
	Level 1	Level 2	Level 3	Total
	(In thousands)			
Debt securities - available-for-sale, at fair value:				
United States government obligations and authorities	$51,219	$46,918	$ —	$98,137
Obligations of states and political subdivisions	—	66,266	—	66,266
Corporate securities	—	240,919	—	240,919
International securities	—	17,916	—	17,916
Debt securities, at fair value	51,219	372,019	—	423,238
Equity securities, at fair value	15,434	—	—	15,434
Total investments, at fair value	$66,653	$372,019	$ —	$438,672

Held-to-maturity debt securities reported on the consolidated balance sheets at amortized cost and disclosed at fair value below (and in Note 4) and the level of fair value hierarchy of inputs used consisted of the following:

	Level 1	Level 2	Level 3	Total

	(In thousands)			
September 30, 2018	$3,846	$1,232	$ —	$5,078
December 31, 2017	3,936	1,338	—	5,274

The Company has engaged a nationally recognized third party pricing service to provide the fair values of securities in Level 2. The Company reviews the third party pricing methodologies on a quarterly basis and tests for significant differences between the market price used to value the securities and the recent sales activities.

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A summary of the significant valuation techniques and market inputs for each financial instrument carried at fair value includes the following:

- United States Government Obligations and Authorities - In determining the fair value for United States government securities in Level 1, the Company uses quoted prices (unadjusted) in active markets for identical or similar assets. In determining the fair value for United States government securities in Level 2, the Company uses the market approach utilizing primary valuation inputs including reported trades, dealer quotes for identical or similar assets in markets that are not active, benchmark yields, credit spreads, reference data and industry and economic events.
- Obligations of States and Political Subdivisions - In determining the fair value for state and municipal securities, the Company uses the market approach utilizing primary valuation inputs including reported trades, dealer quotes for identical or similar assets in markets that are not active, benchmark yields, credit spreads, reference data and industry and economic events.
- Corporate and International Securities - In determining the fair value for corporate securities the Company uses the market approach utilizing primary valuation inputs including reported trades, dealer quotes for identical or similar assets in markets that are not active, benchmark yields, credit spreads (for investment grade securities), observations of equity and credit default swap curves (for high-yield corporates), reference data and industry and economic events.
- Equity Securities: In determining the fair value for equity securities in Level 1, the Company uses quoted prices (unadjusted) in active markets for identical or similar assets.

There were no changes to the Company’s valuation methodology and the Company is not aware of any events or circumstances that would have a significant adverse effect on the carrying value of its assets and liabilities measured at fair value as of September 30, 2018 and December 31, 2017. There were no transfers between the fair value hierarchy levels during the nine months ended September 30, 2018 and 2017.

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4. INVESTMENTS

Unrealized Gains and Losses

The difference between amortized cost or cost and estimated fair value and gross unrealized gains and losses, by major investment category, consisted of the following:

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
September 30, 2018				
Debt securities - available-for-sale:				
United States government obligations and authorities	$116,969	$ 20	$ 2,752	$114,237
Obligations of states and political subdivisions	9,891	9	221	9,679
Corporate	287,901	246	4,934	283,213
International	17,290	20	291	17,019
	432,051	295	8,198	424,148
Debt securities - held-to-maturity:				
United States government obligations and authorities	4,140	1	174	3,967
Corporate	1,035	3	6	1,032
International	80	—	1	79
	5,255	4	181	5,078
Total investments (1)	$437,306	$ 299	$ 8,379	$429,226

(1) As a result of the adoption of ASU 2016-01 on January 1, 2018 (see additional details in Note 2 above) for our equity securities we now recognize changes in unrealized gains or losses within our statements of operations; therefore they are not included as of September 30, 2018.

	Amortized Cost or Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
December 31, 2017				
Debt securities - available-for-sale:				
United States government obligations and authorities	$98,739	$ 244	$ 846	$98,137
Obligations of states and political subdivisions	66,319	325	378	66,266
Corporate	239,435	2,233	749	240,919
International	17,807	136	27	17,916
	422,300	2,938	2,000	423,238
Debt securities - held-to-maturity:				
United States government obligations and authorities	4,160	9	106	4,063

Corporate	1,123	21	—	1,144
International	66	1	—	67
	5,349	31	106	5,274
Equity securities	14,085	1,628	279	15,434
Total investments	$441,734	$ 4,597	$ 2,385	$443,946

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Net Realized and Unrealized 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.

Net realized and unrealized gains (losses), by major investment category, consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(In thousands)			
Gross realized and unrealized gains:				
Debt securities	$91	$618	$355	$1,471
Equity securities	1,922	6,527	4,163	9,776
Total gross realized and unrealized gains	2,013	7,145	4,518	11,247
Gross realized and unrealized losses:				
Debt securities	(253)	(103)	(2,571)	(1,293)
Equity securities	—	(941)	(1,031)	(1,310)
Total gross realized and unrealized losses	(253)	(1,044)	(3,602)	(2,603)
Net realized and unrealized gains (losses) on investments	$1,760	$6,101	$916	$8,644

Proceeds from sale of investment securities were $161.4 million and $252.1 million for the nine months ended September 30, 2018 and 2017, respectively.

The above line item, net realized and unrealized gains (losses) on investments, includes $1.6 million and $2.6 million of recognized net unrealized gains on equity securities for the three and nine months ended September 30, 2018, respectively.

Contractual Maturity

Actual maturities may differ from contractual maturities because issuers may have the right to call or pre-pay obligations.

Amortized cost and estimated fair value of debt securities, by contractual maturity, consisted of the following:

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	September 30, 2018	
	Amortized Cost	Fair Value
Securities with Maturity Dates	(In thousands)	
Debt securities, available-for-sale:		
One year or less	$36,645	$36,575
Over one through five years	212,426	209,585
Over five through ten years	181,102	176,126
Over ten years	1,878	1,862
	432,051	424,148
Debt securities, held-to-maturity:		
One year or less	750	751
Over one through five years	4,033	3,869
Over five through ten years	472	458
	5,255	5,078
Total	$437,306	$429,226

Net Investment Income

Net investment income consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(In thousands)			
Interest income	$3,089	$2,492	$8,904	$7,073
Dividends income	48	111	154	408
Net investment income	$3,137	$2,603	$9,058	$7,481

Aging of Gross Unrealized Losses

Gross unrealized losses and related fair values for debt securities (and equity securities as of December 31, 2017), grouped by duration of time in a continuous unrealized loss position, consisted of the following:

	Less than 12 months		12 months or longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
			(In thousands)			
September 30, 2018						
Debt securities - available-for-sale:						
United States government obligations and authorities	$83,061	$ 1,450	$27,124	$ 1,302	$110,185	$ 2,752
Obligations of states and political subdivisions	5,879	94	3,265	127	9,144	221

Corporate	202,142	3,701	34,306	1,233	236,448	4,934
International	13,439	285	161	6	13,600	291
	$304,521	$ 5,530	$64,856	$ 2,668	$369,377	$ 8,198

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	Less than 12 months		12 months or longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
			(In thousands)			
December 31, 2017						
Debt securities - available-for-sale:						
United States government obligations and authorities	$52,368	$ 517	$19,287	$ 329	$71,655	$ 846
Obligations of states and political subdivisions	32,030	221	5,676	157	37,706	378
Corporate	109,780	625	6,452	124	116,232	749
International	8,935	27	25	—	8,960	27
	203,113	1,390	31,440	610	234,553	2,000
Equity securities	4,312	279	—	—	4,312	279
Total investments	$207,425	$ 1,669	$31,440	$ 610	$238,865	$ 2,279

As of September 30, 2018, the Company held a total of 1,364 debt securities that were in an unrealized loss position, of which 195 securities were in an unrealized loss position continuously for 12 months or more. As of December 31, 2017, the Company held a total of 866 debt and equity securities that were in an unrealized loss position, of which 73 securities were in an unrealized loss position continuously for 12 months or more. The unrealized losses associated with these securities consisted primarily of losses related to corporate securities.

The Company holds 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 OTTI loss in the Company's 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 did not have any OTTI losses on its available-for-sale debt securities for the first nine months of 2018 and 2017.

As discussed in Note 2 above, beginning January 1, 2018, the Company's equity investments are measured at fair value through net income. See Note 4 of our 2017 Form 10-K for information on how the Company assessed and determined whether unrealized losses on our equity securities were other-than-temporary, which was primarily based on the duration of the decline in the fair value of such securities relative to their cost as of the balance sheet date. The Company did not have any OTTI losses on its equity securities for the first nine months of 2017.

Collateral Deposits

Cash and cash equivalents and investments, the majority of which were debt securities, with fair values of $10.2 million and $12.9 million, were deposited with governmental authorities and into custodial bank accounts as required by law or contractual obligations as of September 30, 2018 and December 31, 2017, respectively.

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5. REINSURANCE

Overview

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 the Company's loss exposure. To the extent that reinsuring companies are unable to meet their obligations assumed under these reinsurance agreements, the Company remains primarily liable to its policyholders.

The Company is selective in choosing reinsurers and considers numerous factors, the most important of which is 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 the Company's exposure to the insolvency of a reinsurer, the Company evaluates the acceptability and review the financial condition of the reinsurer at least annually with the assistance of the Company's reinsurance broker.

Significant Reinsurance Contracts

2017-2018 Excess of Loss Reinsurance Programs

FNIC's 2017-2018 reinsurance programs, which cost $174.4 million, including $124.0 million for the private reinsurance for FNIC's Florida exposure, with prepaid automatic premium reinstatement protection on all layers, along with approximately $50.4 million payable to the Florida Hurricane Catastrophe Fund ("FHCF"). The combination of private and FHCF reinsurance treaties will afford FNIC with $2.2 billion of aggregate coverage with a maximum single event coverage totaling approximately $1.5 billion, exclusive of retentions. FNIC maintained its FHCF participation at 75% for the 2017 hurricane season. FNIC's single event pre-tax retention for a catastrophic event in Florida is $18.0 million.

FNIC's private market excess of loss treaties, covering both Florida and non-Florida exposures, became effective June 1, 2017 and July 1, 2017. All private layers have prepaid automatic reinstatement protection, except the FHCF supplemental layer reinsurance contract, which affords FNIC additional coverage for subsequent events. The reinsurance program includes multiple year protection with $89.0 million of new multiple year protection this year and $156.0 million of renewing multiple year protection from last year. These private market excess of loss treaties structure coverage into layers, with a cascading feature such that substantially all layers attach after $25.1 million in losses for FNIC's exposure. FNIC purchased an underlying limit of protection for $7.1 million excess of $18.0 million with prepaid automatic reinstatement protection. These treaties are with reinsurers that currently have an A.M. Best Company ("A.M. Best") or Standard & Poor's rating of "A-" or better, or have fully collateralized their maximum potential obligations in dedicated trusts.

FNIC's non-Florida excess of loss reinsurance treaties afford us up to an additional $21.0 million of aggregate coverage with first event coverage totaling $5.0 million and second event coverage up to $16.0 million. The Non-Florida retention is lowered to $13.0 million for the first event and $2.0 million for the second event (for hurricane losses only) on a gross basis though it is reduced to $6.5 million and $1.0 million on a net basis after taking into account the profit share agreement that FNIC has with our non-affiliated managing general underwriter that writes our Non-Florida property business. FNIC's Non-Florida reinsurance program cost includes $1.7 million for this private reinsurance, including prepaid automatic premium reinstatement protection.

MNIC's 2017-2018 reinsurance program, which cost $5.0 million, including $3.2 million for the private reinsurance for MNIC's Florida exposure including prepaid automatic premium reinstatement protection on all layers, along with $1.8 million payable to FHCF. The combination of private and FHCF reinsurance treaties affords MNIC with $109.0 million of aggregate coverage with a maximum single event coverage totaling approximately $68.1 million, exclusive of retentions. MNIC maintained its FHCF participation at 75% for the 2017 hurricane season.

MNIC's private market excess of loss treaties are effective July 1, 2017, and all private layers have prepaid automatic reinstatement protection, which affords MNIC additional coverage for subsequent events, and have a cascading feature such that substantially all layers attach at $3.4 million for MNIC's Florida exposure. These treaties are with reinsurers that currently have an A.M. Best or Standard & Poor's rating of "A-" or better, or have fully collateralized their maximum potential obligations in dedicated trusts.

2018-2019 Excess of Loss Reinsurance Programs

With the February 21, 2018 acquisition of the minority interests of MNIC, the Company has combined both FNIC and MNIC under a single program allowing the Company to capitalize on efficiencies and scale. FNIC and MNIC's combined 2018-2019 reinsurance programs is estimated to cost $147.7 million. This amount includes approximately $102.5 million for the private reinsurance for the

Company's exposure, including prepaid automatic premium reinstatement protection, along with approximately $45.2 million payable to the FHCF. The combination of private and FHCF reinsurance treaties affords FNIC and MNIC approximately $1.8 billion of aggregate coverage with a maximum single event coverage totaling approximately $1.3 billion, exclusive of retentions. Both FNIC and MNIC maintained their FHCF participation at 75% for the 2018 hurricane season. FNIC's single event pre-tax retention for a catastrophic event in Florida is $20.0 million, up slightly from the 2017-2018 reinsurance program and MNIC's single event pre-tax retention for a catastrophic event is $3.0 million, down slightly from the 2017-2018 reinsurance program.

The combined FNIC and MNIC private market excess of loss treaties, covering both Florida and non-Florida exposures, became effective July 1, 2018 and all private layers have prepaid automatic reinstatement protection, which affords the Company additional coverage for subsequent events. These private market excess of loss treaties structure coverage into layers, with a cascading feature such that substantially all layers attach after $20.0 million in losses for FNIC and after $3.0 million in losses for MNIC. 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. Given current market conditions, FNIC has elected not to purchase any multiple year protection and terminated the second year of the $89.0 million of multiple year protection that FNIC purchased last year on a two-year basis. FNIC also had $156.0 million of multiple year protection that expired on June 30, 2018. The overall reinsurance programs are with reinsurers that currently have an A.M. Best or Standard & Poor's rating of "A-" or better, or have fully collateralized their maximum potential obligations in dedicated trusts.

FNIC's non-Florida excess of loss reinsurance treaties afford us an additional $23.0 million of aggregate coverage with first event coverage totaling $5.0 million and second event coverage totaling $18.0 million, with the incremental $13.0 million of second event coverage applying to hurricane losses only. The end result is a non-Florida retention of $15.0 million for the first event and $2.0 million for the second event though these retentions are reduced to $7.5 million and $1.0 million after taking into account the profit sharing agreement that FNIC has with the nonaffiliated managing general underwriter that writes our non-Florida property business. FNIC's non-Florida reinsurance program cost will approximate $2.0 million for this private reinsurance, including prepaid automatic premium reinstatement protection.

The Company's cost and amounts of reinsurance are based on management's current analysis of exposure to catastrophic risk. The data will be subjected to exposure level analysis at various dates during the period ending December 31, 2018. This analysis of the Company's exposure level in relation to the total exposures to the FHCF and excess of loss treaties may produce changes in retentions, limits and reinsurance premiums as a result of increases or decreases in the Company's exposure level.

Quota-Share Reinsurance Programs

Our reinsurance programs also include quota-share treaties. One such treaty for 30% became effective July 1, 2014, and another for 10% became effective on July 1, 2015 with each running for two years. The combined treaties provided up to a 40% quota-share reinsurance on covered losses for the homeowners' property and liability 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% quota-share treaty expired on a cut-off basis, which means as of that date the Company retained an incremental 30% of its unearned premiums and losses. On July 1, 2017, the 10% quota-share treaty expired on a cut-off basis, which means as of that date we retained an incremental 10% of the underlying unearned premiums and losses. The reinsurers remain liable for 30% and 10% of the paid losses occurring during the terms of the treaties, until each treaty is commuted.

On July 1, 2017, FNIC bound a 10% quota-share on its Florida homeowners book of business, which excluded named storms. This treaty is not subject to accounting as a retrospectively rated contract.

The existing 10% quota-share expired on July 1, 2018 on a cut-off basis, meaning that the reinsurer will not be liable (under this agreement) for losses as a result of occurrences taking place after the date of termination, and the unearned premium previously ceded will be returned to FNIC.

FNIC’s quota-share reinsurance program for 2018-2019, is a new 2% quota-share on FNIC’s Florida homeowners book of business, which became effective on July 1, 2018 on an in-force, new and renewal basis, excluding named storms. In addition, this quota-share allows FNIC the flexibility to prospectively increase or decrease the cession percentage up to three times during the term of the agreement.

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The Company's private passenger automobile quota-share treaties are typically programs which become effective at different points in the year and cover auto policies across several states. The automobile quota-share treaties cede approximately 75% of all written premiums entered into by the Company, subject to certain limitations including, but not limited to premium and other caps.

Associated Trust Agreements
Certain reinsurance agreements require FNIC and MNIC to secure the credit, regulatory and business risk. Fully funded trust agreements securing these risks for FNIC totaled less than $0.1 million and $2.6 million as of September 30, 2018 and December 31, 2017, respectively.

Reinsurance Recoverable

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 recoverable. Reinsurance recoverable, net consisted of the following:

	September 30, 2018	December 31, 2017
	(In thousands)	
Reinsurance recoverable on paid losses	$42,664	$26,256
Reinsurance recoverable on unpaid losses	92,072	98,345
Reinsurance recoverable, net	$134,736	$124,601

As of September 30, 2018 and December 31, 2017, the Company had reinsurance recoverable of $105.1 million and $88.0 million, respectively as a result of Hurricane Irma. Hurricane Irma made landfall in the United States as a Category 4 hurricane on September 10, 2017. Additionally, all reinsurers in our excess-of-loss reinsurance programs have an A.M. Best or Standard & Poor's rating of "A-" or better, or have fully collateralized their maximum potential obligations in dedicated trusts.

Net Premiums Written and Net Premiums Earned

Net premiums written and net premiums earned consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(In thousands)			
Net Premiums Written				
Direct	$139,022	$154,782	$440,151	$469,525
Ceded	(81,023)	(146,522)	(177,604)	(249,248)
	$57,999	$8,260	$262,547	$220,277
Net Premiums Earned				
Direct	$144,907	$152,779	$438,239	$451,320
Ceded	(46,414)	(72,015)	(174,080)	(205,342)

$98,493	$80,764	$264,159	$245,978

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6. LOSS AND LOSS ADJUSTMENT 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 reported ("IBNR").

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

	Nine Months Ended September 30,	
	2018	2017
	(In thousands)	
Gross reserves, beginning-of-period	$230,515	$158,110
Less: reinsurance recoverable (1)	(98,345)	(40,412)
Net reserves, beginning-of-period	132,170	117,698
Incurred loss, net of reinsurance, related to:		
Current year	159,998	191,747
Prior year loss development (2)	330	8,309
Ceded losses subject to offsetting experience account adjustments (3)	(4,230)	(11,373)
Prior years	(3,900)	(3,064)
Total incurred loss and LAE, net of reinsurance	156,098	188,683
Paid loss, net of reinsurance, related to:		
Current year	87,960	109,988
Prior years	71,266	57,322
Total paid loss and LAE, net of reinsurance	159,226	167,310
Net reserves, end-of-period	129,042	139,071
Plus: reinsurance recoverable (1)	92,072	322,520
Gross reserves, end-of-period	$221,114	$461,591

(1) Reinsurance recoverable in this table includes only ceded loss and LAE reserves.
(2) Reflects loss development from prior accident years impacting pre-tax net income. Excludes losses ceded under retrospective reinsurance treaties to the extent there is an offsetting experience account adjustment.
(3) Reflects losses ceded under retrospective reinsurance treaties to the extent there is an offsetting experience account adjustment, such that there is no impact on pre-tax net income.

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.

During the nine months ended September 30, 2018, the Company experienced $0.3 million of unfavorable loss and LAE reserve development which relates to personal automobile and commercial general liability lines of business, offset by redundancy in the homeowners line of business as a result of lower LAE expenses associated with Hurricane Irma.

During the nine months ended September 30, 2017, the Company experienced $8.3 million of unfavorable loss and LAE reserve development on prior accident years primarily in our personal automobile and homeowners line of business. The automobile’s unfavorable development primarily related to the 2016 accident year from our auto program in the state of Georgia. The homeowners unfavorable development primarily related to the continued impact from assignment of benefits and related ligation costs in the state of Florida.

As previously disclosed, the Company entered into 30% and 10% retrospectively-rated Florida-only property quota-share treaties, which ended on July 1, 2016 and 2017, respectively. These agreements included a profit share (experience account) provision, under which the Company will receive ceded premium adjustments at the end of the treaty to the extent there is a positive balance in the experience account. This experience account is based on paid losses rather than incurred losses. Due to the retrospectively-rated nature of this treaty, when the experience account is positive we cede losses under these treaties as the claims are paid with an equal and offsetting adjustment to ceded premiums (in recognition of the related change to the experience account receivable), with no impact on net income. Conversely, when the experience account is negative, the Company cedes losses on an incurred basis with no offsetting adjustment to ceded premiums, which impacts net income. Loss development can be either favorable or unfavorable regardless of whether the experience account is in a positive or negative position.

7. LONG-TERM DEBT

See Note 7 of our 2017 Form 10-K for information regarding our long-term debt.

As discussed in Note 1 above, the outstanding principal balance and interest due on the $5.0 million promissory note to TransRe was paid in full in February 2018. The associated deferred financing costs for this debt of less than $0.1 million was recognized as interest expense in our consolidated statements of operations for the three months ended March 31, 2018.

8. INCOME TAXES

The Tax Act made broad and complex changes to the U.S. tax code, including, but not limited to reducing the U.S. federal corporate tax rate from 35% to 21%. The Securities and Exchange Commission and FASB previously issued guidance that allow a one-year measurement period after the enactment of the Tax Act to finalize calculations and record the related income tax effects. Subsequent to the Tax Act, we have continued to review and analyze the actual and potential impact. While we do not anticipate any significant changes to amounts currently recorded, any additional adjustments as a result of the Tax Act will be made during 2018.

Our effective income tax rate is the ratio of income tax expense (benefit) over our income (loss) before income taxes. The effective income tax rate was 27.5% and 37.1% for the three months ended September 30, 2018 and 2017, respectively. The effective income tax rate was 26.3% and 55.9% for the nine months ended September 30, 2018 and 2017, respectively. Differences in the effective tax and the statutory Federal income tax rate of 21% and 35% in 2018 and 2017, is driven by state income taxes and anticipated annual permanent differences, including estimates for tax-exempt interest, dividends received deduction, executive compensation and other items.

The Company had an uncertain tax position of $0.6 million as of September 30, 2018 and December 31, 2017. The Company does not have a valuation allowance as of September 30, 2018 and December 31, 2017.

We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense (benefit) in the consolidated statements of operations and statements of comprehensive income (loss). For the nine months ended September 30, 2018 and 2017, the Company did not recognize any expenses related to an uncertain tax position and our associated accrued interest and penalties was less than $0.1 million.

9. COMMITMENTS AND CONTINGENCIES

Litigation and 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. The Company's management believes 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 the Company's consolidated financial statements. The Company is also occasionally involved in other legal and regulatory proceedings, some of which may assert claims for substantial amounts, making the Company party to individual actions in which extra contractual damages, punitive damages or penalties, such as claims alleging bad faith in the handling of insurance claims, are sought.

The Company reviews the outstanding matters, if any, on a quarterly basis. The Company accrues for estimated losses and contingent obligations in the consolidated financial statements if and when the obligation or potential loss from any litigation, legal proceeding or claim is considered probable and the amount of the potential exposure is reasonably estimable. The Company records such probable and estimable losses, through the establishment of legal expense reserves. As events evolve, facts concerning litigation and contingencies become known and as additional information becomes available, the Company's management reassesses its potential liabilities related to pending claims and litigation and may revise its previous estimates and make appropriate adjustment to the financial statements. Estimates that require judgment are subject to change and are based on management's assessment, including the advice of legal counsel, the expected outcome of litigation and legal proceedings or other dispute resolution proceedings or the expected resolution of contingencies. The Company's management believes that the Company's accruals for probable and estimable losses are reasonable and that the amounts accrued do not have a material effect on the Company's consolidated financial statements.

Please see the Company's Form 10-Q for the quarter ended June 30, 2018, filed with the SEC on August 7, 2018, for information regarding the matter involving Federated Mutual Insurance Company.

Please see the Company's Form 10-Q for the quarter ended June 30, 2018, filed with the SEC on August 7, 2018, for information regarding the settlement on May 8, 2018 of the Company's action against its former chief financial officer.

Assessment Related Activity

The Company operates 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.

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. There were no material assessments by the JUA Plan as of December 31, 2017. Future assessments by the JUA and the JUA Plan are indeterminable at this time.

Leases

The Company is committed under an operating lease agreement for office space. FNHC and its subsidiaries lease facilities under a long-term lease agreement. Additional information about leases can be found in Note 9 of our 2017

Form 10-K.

10. SHAREHOLDERS' EQUITY

Common Stock Repurchases

The Company may repurchase shares in open market transactions in accordance with Rule 10b-18 or under Rule 10b5-1 of the Exchange Act from time to time in its discretion, based on ongoing assessments of the Company’s capital needs, the market price of its common stock and general market conditions. The amount and timing of all repurchase transactions are contingent upon market conditions, applicable legal requirements and other factors.

In March 2017, the Company’s Board of Directors authorized a program to repurchase shares of common stock of FNHC, at such times and at prices as management determined advisable, up to an aggregate of $10.0 million of common stock through March 31, 2018. This authorization was fully expended as of March 31, 2018.

FedNat Holding Company and Subsidiaries
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In December 2017, the Company's Board of Directors authorized an additional share repurchase program under which the Company may repurchase up to $10.0 million (plus $0.8 million remaining from previous authorization which was fully expended as of March 31, 2018) of its outstanding shares of common stock through December 31, 2018. During the nine months ended September 30, 2018, the Company repurchased 326,708 shares of its common stock at a total cost of $5.1 million, which is an average price per share of $15.49. As of September 30, 2018, the remaining availability for future repurchases of our common stock under this program was $5.7 million.

Securities Offerings

In June 2018, the Company filed with the Securities and Exchange Commission ("SEC") on Form S-3, a shelf registration statement enabling the Company to offer and sell, from time to time, up to an aggregate of $150.0 million of securities.

Stock Compensation Plan

In April 2012, the Company's Board of Directors adopted, and in September 2012 the Company's shareholders approved, the Company's 2012 Stock Incentive Plan (the "2012 Plan"). The 2012 Plan permits the issuance of up to 1,000,000 shares of the Company's common stock, subject to adjustment as provided for in the 2012 Plan, in connection with the grant of a variety of equity incentive awards, such as stock options and restricted stocks. Officers, directors, executive management and all other employees of the Company and its subsidiaries are eligible to participate in the 2012 Plan. Awards may be granted singly, in combination, or in tandem. The 2012 Plan will expire on April 5, 2022.

In June 2018, the Company filed with the SEC on Form S-8, a registration statement registering 800,000 shares of common stock reserved for issuance under the Company's 2018 Omnibus Incentive Compensation Plan (the "2018 Plan"). The 2018 Plan, which was approved by the Company's shareholders at the 2018 annual meeting, is an equity compensation plan that may be used for our employees, non-employee directors, consultants and advisors.

FedNat Holding Company and Subsidiaries
Notes to Consolidated Financial Statements (Continued)
September 30, 2018

Share-Based Compensation Expense

Share-based compensation arrangements include the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(In thousands)			
Restricted stock	$484	$866	$1,847	$2,279
Stock options	—	—	—	—
Total share-based compensation expense	$484	$866	$1,847	$2,279
Intrinsic value of options exercised	$151	$357	$229	$364
Fair value of restricted stock vested	$622	$686	$2,098	$2,191

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.

Stock Option Awards

A summary of the Company’s stock option activity includes the following:

	Number of Shares	Weighted Average Option Exercise Price
Outstanding at January 1, 2018	50,351	$ 3.72
Granted	—	—
Exercised	(10,834)	3.47
Cancelled	(500)	2.45
Outstanding at September 30, 2018	39,017	$ 3.80

Restricted Stock Awards

The Company recognizes share-based compensation expense for all restricted stock awards (“RSAs”) held by the Company’s directors, executives and other key employees. For all RSA awards, excluding relative total shareholder return ("TSR"), 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 for service awards and over successive one-year requisite service periods for performance based awards.
Our expense for our performance awards depends on achievement of specified results; therefore the ultimate expense can range from 0% to 250% of target. Our TSR cliff vesting awards contain performance criteria which are tied to the

achievement of certain market conditions. The TSR grant date fair value was determined using a Monte Carlo simulation and, unlike the performance condition awards, the expense is not reversed if the performance condition is not met. This value is recognized as expense over the requisite service period using the straight line recognition method.

During the nine months ended September 30, 2018 and 2017, the Board of Directors granted 133,060 and 106,454 RSAs, respectively, vesting over three or five years, to the Company’s directors, executives and other key employees.

FedNat Holding Company and Subsidiaries
Notes to Consolidated Financial Statements (Continued)
September 30, 2018

RSA activity includes the following:

	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at January 1, 2018	297,543	$ 20.57
Granted	133,060	16.31
Vested	(102,071)	20.56
Cancelled	(52,188)	17.93
Outstanding at September 30, 2018	276,344	$ 19.02

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 (Loss)

Accumulated other comprehensive income (loss) associated with debt securities - available-for-sale consisted of the following:

	Three Months Ended September 30,					
	2018			2017		
	Before Tax	Income Tax	Net	Before Tax	Income Tax	Net
	(In thousands)					
Accumulated other comprehensive income (loss), beginning-of-period	$(7,166)	$1,816	$(5,350)	$8,248	$(3,166)	$5,082
Other comprehensive income (loss) before reclassification	(575)	145	(430)	2,013	(710)	1,303
Reclassification adjustment for realized losses (gains) included in net income	(162)	41	(121)	(6,101)	2,353	(3,748)
	(737)	186	(551)	(4,088)	1,643	(2,445)
Accumulated other comprehensive income (loss), end-of-period	$(7,903)	$2,002	$(5,901)	$4,160	$(1,523)	$2,637

	Nine Months Ended September 30,					
	2018			2017		
	Before Tax	Income Tax	Net	Before Tax	Income Tax	Net
	(In thousands)					
Accumulated other comprehensive income (loss), beginning-of-period	$2,287	$(593)	$1,694	$3,324	$(1,201)	$2,123
Cumulative effect of new accounting standards	(1,349)	355	(994)	—	—	—
Other comprehensive income (loss) before reclassification	(10,573)	2,679	(7,894)	9,480	(3,656)	5,824
	1,732	(439)	1,293	(8,644)	3,334	(5,310)

Reclassification adjustment for realized losses (gains) included in net income	(8,841)	2,240	(6,601)	836	(322)	514
Accumulated other comprehensive income (loss), end-of-period	$(7,903)	$2,002	$(5,901)	$4,160	$(1,523)	$2,637

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FedNat Holding Company and Subsidiaries
Notes to Consolidated Financial Statements (Continued)
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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 vested restricted stock awards during the period. 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 and unvested restricted stock awards. 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.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
	(In thousands, except per share data)			
Net income (loss) attributable to FedNat Holding Company shareholders	$7,950	$(4,724)	$24,233	$1,693
Weighted average number of common shares outstanding - basic	12,749	13,135	12,775	13,211
Net income (loss) per common share - basic	$0.62	$(0.36)	$1.90	$0.13
Weighted average number of common shares outstanding - basic	12,749	13,135	12,775	13,211
Dilutive effect of stock compensation plans	121	—	91	91
Weighted average number of common shares outstanding - diluted	12,870	13,135	12,866	