

National Interstate CORP
Form 10-Q
November 04, 2008

Table of Contents

**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, 2008**

OR

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

National Interstate Corporation

(Exact name of registrant as specified in its charter)

Ohio

*(State or other jurisdiction of
incorporation or organization)*

34-1607394

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

**3250 Interstate Drive
Richfield, Ohio 44286-9000
(330) 659-8900**

(Address and telephone number of principal executive offices)

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 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

The number of shares outstanding of the registrant's sole class of common shares as of October 29, 2008 was 19,394,244.

National Interstate Corporation
Table of Contents

| | Page |
|--|------|
| <u>Part I Financial Information</u> | 1 |
| <u>Item 1. Financial Statements</u> | 1 |
| <u>Consolidated Balance Sheets</u> | 1 |
| <u>Consolidated Statements of Income</u> | 2 |
| <u>Consolidated Statements of Shareholders' Equity</u> | 3 |
| <u>Consolidated Statements of Cash Flows</u> | 4 |
| <u>Notes to Consolidated Financial Statements</u> | 5 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 12 |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u> | 23 |
| <u>Item 4. Controls and Procedures</u> | 24 |
| <u>Part II Other Information</u> | 25 |
| <u>Item 1. Legal Proceedings</u> | 25 |
| <u>Item 1A. Risk Factors</u> | 25 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 25 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 25 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 25 |
| <u>Item 5. Other Information</u> | 25 |
| <u>Item 6. Exhibits</u> | 25 |
| <u>EX-31.1</u> | |
| <u>EX-31.2</u> | |
| <u>EX-32.1</u> | |
| <u>EX-32.2</u> | |

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. Financial Statements**

National Interstate Corporation and Subsidiaries
Consolidated Balance Sheets
(In thousands, except per share data)

| | September 30, 2008 (Unaudited) | December 31, 2007 |
|---|---|----------------------------------|
| ASSETS | | |
| Investments: | | |
| Fixed maturities available-for-sale, at fair value (amortized cost \$442,204 and \$376,019, respectively) | \$ 432,937 | \$ 376,300 |
| Equity securities available-for-sale, at fair value (cost \$57,079 and \$57,800, respectively) | 46,376 | 52,640 |
| Short-term investments, at cost which approximates fair value | 85 | 20,907 |
| | | |
| Total investments | 479,398 | 449,847 |
| Cash and cash equivalents | 64,750 | 43,069 |
| Securities lending collateral (cost \$85,758 and \$141,316, respectively) | 78,007 | 139,305 |
| Accrued investment income | 4,954 | 4,783 |
| Premiums receivable, net of allowance for doubtful accounts of \$450 and \$462, respectively | 118,754 | 84,708 |
| Reinsurance recoverables on paid and unpaid losses | 138,516 | 98,091 |
| Prepaid reinsurance premiums | 39,585 | 24,325 |
| Deferred policy acquisition costs | 22,066 | 17,578 |
| Deferred federal income taxes | 19,257 | 11,993 |
| Property and equipment, net | 19,876 | 19,502 |
| Funds held by reinsurer | 2,949 | 3,337 |
| Prepaid expenses and other assets | 2,363 | 2,096 |
| | | |
| Total assets | \$ 990,475 | \$ 898,634 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Liabilities: | | |
| Unpaid losses and loss adjustment expenses | \$ 388,715 | \$ 302,088 |
| Unearned premiums and service fees | 185,577 | 145,296 |
| Long-term debt | 15,000 | 15,464 |
| Amounts withheld or retained for account of others | 48,413 | 38,739 |
| Reinsurance balances payable | 17,441 | 7,596 |
| Securities lending obligation | 86,900 | 141,316 |
| Accounts payable and other liabilities | 27,572 | 24,363 |
| Commissions payable | 10,810 | 7,332 |
| Assessments and fees payable | 5,230 | 3,634 |
| | | |
| Total liabilities | 785,658 | 685,828 |
| Shareholders' equity: | | |
| Preferred shares - no par value | | |

Edgar Filing: National Interstate CORP - Form 10-Q

| | | |
|---|------------|------------|
| Authorized 10,000 shares | | |
| Issued 0 shares | | |
| Common shares \$0.01 par value | | |
| Authorized 50,000 shares | | |
| Issued 23,350 shares, including 4,055 and 4,145 shares, respectively, in treasury | 234 | 234 |
| Additional paid-in capital | 47,680 | 45,566 |
| Retained earnings | 184,406 | 178,190 |
| Accumulated other comprehensive loss | (21,765) | (5,321) |
| Treasury shares | (5,738) | (5,863) |
| Total shareholders equity | 204,817 | 212,806 |
| Total liabilities and shareholders equity | \$ 990,475 | \$ 898,634 |

See notes to consolidated financial statements.

Table of Contents

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

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|------------------|--------------------------|------------------|
| | September 30, | | September 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| Revenues: | | | | |
| Premiums earned | \$ 75,058 | \$ 66,187 | \$ 214,521 | \$ 189,742 |
| Net investment income | 5,417 | 5,690 | 16,849 | 16,421 |
| Net realized gains (losses) on investments | (8,376) | (319) | (10,824) | (47) |
| Other | 605 | 1,564 | 2,199 | 3,384 |
| Total revenues | 72,704 | 73,122 | 222,745 | 209,500 |
| Expenses: | | | | |
| Losses and loss adjustment expenses | 51,995 | 39,844 | 144,097 | 112,564 |
| Commissions and other underwriting expenses | 18,529 | 13,803 | 46,685 | 36,348 |
| Other operating and general expenses | 3,241 | 2,795 | 9,786 | 8,990 |
| Expense on amounts withheld | 1,001 | 997 | 3,261 | 2,641 |
| Interest expense | 133 | 393 | 704 | 1,160 |
| Total expenses | 74,899 | 57,832 | 204,533 | 161,703 |
| Income (loss) before federal income taxes | (2,195) | 15,290 | 18,212 | 47,797 |
| Provision for federal income taxes | 2,033 | 5,145 | 8,499 | 15,327 |
| Net income (loss) | \$ (4,228) | \$ 10,145 | \$ 9,713 | \$ 32,470 |
| | | | | |
| Net income (loss) per common share basic | \$ (0.22) | \$ 0.53 | \$ 0.50 | \$ 1.69 |
| | | | | |
| Net income (loss) per common share diluted | \$ (0.22) | \$ 0.52 | \$ 0.50 | \$ 1.67 |
| | | | | |
| Weighted average of common shares outstanding basic | 19,293 | 19,199 | 19,281 | 19,189 |
| | | | | |
| Weighted average of common shares outstanding diluted | 19,293 | 19,459 | 19,375 | 19,401 |
| | | | | |
| Cash dividends per common share | \$ 0.06 | \$ 0.05 | \$ 0.18 | \$ 0.15 |

See notes to consolidated financial statements.

Table of Contents

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

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Total |
|---|-----------------|----------------------------------|----------------------|---|-------------------|------------|
| Balance at January 1, 2008 | \$ 234 | \$ 45,566 | \$ 178,190 | \$ (5,321) | \$ (5,863) | \$ 212,806 |
| Net income | | | 9,713 | | | 9,713 |
| Unrealized depreciation of investment securities, net of tax benefit of \$4,387 | | | | (16,444) | | (16,444) |
| Comprehensive loss | | | | | | (6,731) |
| Dividends on common stock | | | (3,497) | | | (3,497) |
| Issuance of 89,723 treasury shares upon exercise of options and restricted stock issued, net of forfeitures | | 706 | | | 125 | 831 |
| Tax benefit realized from exercise of stock options | | 396 | | | | 396 |
| Stock compensation expense | | 1,012 | | | | 1,012 |
| Balance at September 30, 2008 | \$ 234 | \$ 47,680 | \$ 184,406 | \$ (21,765) | \$ (5,738) | \$ 204,817 |
| Balance at January 1, 2007 | \$ 234 | \$ 43,921 | \$ 138,450 | \$ (2,915) | \$ (5,927) | \$ 173,763 |
| Net income | | | 32,470 | | | 32,470 |
| Unrealized depreciation of investment securities, net of tax benefit of \$76 | | | | (141) | | (141) |
| Comprehensive income | | | | | | 32,329 |
| Dividends on common stock | | | (2,892) | | | (2,892) |
| Issuance of 45,847 treasury shares upon exercise of options and stock award grants | | 388 | | | 64 | 452 |

Edgar Filing: National Interstate CORP - Form 10-Q

| | | | | | | | |
|---|--------|-----------|------------|------------|------------|------------|-----|
| Tax benefit realized from exercise of stock options | | | 201 | | | | 201 |
| Stock compensation expense | | | 776 | | | | 776 |
| Balance at September 30, 2007 | \$ 234 | \$ 45,286 | \$ 168,028 | \$ (3,056) | \$ (5,863) | \$ 204,629 | |

See notes to consolidated financial statements.

3

Table of Contents

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

| | Nine Months Ended September | |
|--|------------------------------------|-------------|
| | 30, | |
| | 2008 | 2007 |
| Operating activities | | |
| Net income | \$ 9,713 | \$ 32,470 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net amortization of bond premiums and discounts | 1,251 | 253 |
| Provision for depreciation and amortization | 1,017 | 948 |
| Net realized losses on investment securities | 10,824 | 47 |
| Deferred federal income taxes | (2,877) | (268) |
| Stock compensation expense | 1,012 | 776 |
| Increase in deferred policy acquisition costs, net | (4,488) | (4,621) |
| Increase in reserves for losses and loss adjustment expenses | 86,627 | 43,903 |
| Increase in premiums receivable | (34,046) | (26,229) |
| Increase in unearned premiums and service fees | 40,281 | 34,206 |
| Increase in interest receivable and other assets | (80) | (2,089) |
| Increase in prepaid reinsurance premiums | (15,260) | (10,914) |
| Increase in accounts payable, commissions and other liabilities and assessments and fees payable | 8,283 | 9,380 |
| Increase in amounts withheld or retained for account of others | 9,674 | 7,505 |
| Increase in reinsurance recoverable | (40,425) | (18,877) |
| Increase in reinsurance balances payable | 9,845 | 3,386 |
| Other | (3) | |
| Net cash provided by operating activities | 81,348 | 69,876 |
| Investing activities | | |
| Purchases of fixed maturities | (342,290) | (127,238) |
| Purchases of equity securities | (3,443) | (57,143) |
| Proceeds from sale of fixed maturities | 1,148 | |
| Proceeds from sale of equity securities | 10,115 | 14,593 |
| Proceeds from maturity of investments | 278,896 | 111,672 |
| Capital expenditures | (1,359) | (1,578) |
| Net cash used in investing activities | (56,933) | (59,694) |
| Financing activities | | |
| Decrease in securities lending collateral | 54,416 | 11,187 |
| Decrease in securities lending obligation | (54,416) | (11,187) |
| Additional long-term borrowings | 15,000 | |
| Reductions of long-term debt | (15,464) | |
| Tax benefit realized from exercise of stock options | 396 | 201 |
| | 831 | 452 |

Edgar Filing: National Interstate CORP - Form 10-Q

| | | |
|--|-----------|-----------|
| Issuance of common shares from treasury upon exercise of stock options or stock award grants | | |
| Cash dividends paid on common shares | (3,497) | (2,892) |
| Net cash used in financing activities | (2,734) | (2,239) |
| Net increase in cash and cash equivalents | 21,681 | 7,943 |
| Cash and cash equivalents at beginning of period | 43,069 | 22,166 |
| Cash and cash equivalents at end of period | \$ 64,750 | \$ 30,109 |

See notes to consolidated financial statements.

4

Table of Contents

**NATIONAL INTERSTATE CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

1. Basis of Presentation

The accompanying unaudited consolidated financial statements of National Interstate Corporation (the Company) and its subsidiaries have been prepared in accordance with the instructions to Form 10-Q, which differ in some respects from statutory accounting principles permitted by state regulatory agencies.

The consolidated financial statements include the accounts of the Company and its subsidiaries, National Interstate Insurance Company (NIIC), Hudson Indemnity, Ltd. (HIL), National Interstate Insurance Company of Hawaii, Inc. (NIIC-HI), Triumpher Casualty Company (TCC), National Interstate Insurance Agency, Inc. (NIIA), Hudson Management Group, Ltd. (HMG), American Highways Insurance Agency, Inc., Safety, Claims and Litigation Services, Inc., Explorer RV Insurance Agency, Inc. and Safety, Claims and Litigation Services, LLC. Significant intercompany transactions have been eliminated.

These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007. The interim financial statements reflect all adjustments which are, in the opinion of management, necessary for the fair presentation of the results for the periods presented. Such adjustments are of a normal recurring nature.

Operating results for the three and nine month period ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Changes in circumstances could cause actual results to differ materially from those estimates. Certain reclassifications have been made to financial information presented for prior years to conform to the current year's presentation.

2. Recent Accounting Pronouncements

The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, which permits entities to elect to measure many financial instruments and certain other items at fair value. Upon adoption of SFAS No. 159, an entity may elect the fair value option for eligible items that exist at the adoption date. Subsequent to the initial adoption, the election of the fair value option should only be made at the initial recognition of the asset or liability or upon a re-measurement event that gives rise to the new-basis of accounting. All subsequent changes in fair value for that instrument are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be recorded at fair value nor does it eliminate disclosure requirements included in other accounting standards. SFAS No. 159 was effective January 1, 2008 for calendar year companies. The Company did not elect the fair value option for any of its eligible assets or liabilities at the effective date.

3. Fair Value Measurements

On January 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Under SFAS No. 157, the Company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy in SFAS No. 157 prioritizes the inputs, which refer broadly to assumptions market participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

Level 1 inputs are quoted prices (unadjusted) in active markets for identical securities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the security, either directly or indirectly. Level 2 inputs include quoted prices for similar securities in active markets, quoted prices for identical or similar securities that are not active and observable inputs other than

quoted prices, such as interest rate and yield curves. Level 3 inputs are unobservable inputs for the asset or liability.

Table of Contents

Level 1 consists of publicly traded equity securities whose fair value is based on quoted prices that are readily and regularly available in an active market. Level 2 primarily consists of financial instruments whose fair value is based on quoted prices in markets that are not active and include U.S. government and government agency securities, fixed maturity investments, preferred stock and certain publicly traded common stocks that are not actively traded. Included in Level 2 are \$10.3 million of securities, which are valued based upon a non-binding broker quote and validated by management by observable market data. Level 3 consists of financial instruments that are not traded in an active market, whose fair value is estimated by management based on inputs from independent financial institutions, which include non-binding broker quotes, for which the Company believes reflects fair value, but are unable to verify inputs to the valuation methodology. We obtained one quote or price per instrument from our brokers and pricing services and did not adjust any quotes or prices that we obtained.

The following table presents the Company's investment portfolio, categorized by the level within the SFAS No. 157 hierarchy in which the fair value measurements fall at September 30, 2008:

| | | September 30, 2008 | | |
|---|----------------|-------------------------------|----------------|-------------------|
| | Level 1 | Level 2 | Level 3 | Fair Value |
| | | (Dollars in thousands) | | |
| Fixed maturities: | | | | |
| U.S. Government and government agency obligations | \$ | \$ 208,695 | \$ | \$ 208,695 |
| State and local government obligations | | 108,207 | 7,069 | 115,276 |
| Mortgage-backed securities | | 66,189 | | 66,189 |
| Corporate obligations | | 38,459 | 4,318 | 42,777 |
| Total fixed maturities | | 421,550 | 11,387 | 432,937 |
| Equity securities: | | | | |
| Preferred stock | 10,407 | 1,834 | 7,813 | 20,054 |
| Common stock | 15,855 | 10,467 | | 26,322 |
| Total equity securities | 26,262 | 12,301 | 7,813 | 46,376 |
| Short-term investments | | 85 | | 85 |
| Total investments | \$ 26,262 | \$ 433,936 | \$ 19,200 | \$ 479,398 |

The following table presents the underlying securities included in the Company's securities lending collateral asset, categorized by the level within the SFAS No. 157 hierarchy in which the fair value measurements fall at September 30, 2008:

| | | September 30, 2008 | | |
|----------------------------|----------------|-------------------------------|----------------|-------------------|
| | Level 1 | Level 2 | Level 3 | Fair Value |
| | | (Dollars in thousands) | | |
| Fixed maturities: | | | | |
| Cash and cash equivalents | \$ 22,852 | \$ 2,000 | \$ | \$ 24,852 |
| Mortgage-backed securities | | 19,062 | 3,416 | 22,478 |
| Corporate obligations | | 28,102 | 2,575 | 30,677 |
| Total fixed maturities: | \$ 22,852 | \$ 49,164 | \$ 5,991 | \$ 78,007 |

Table of Contents

The following tables presents a reconciliation of the beginning and ending balances for all investments measured at fair value on a recurring basis using Level 3 inputs for the three and nine months ended September 30, 2008:

Three Months Ended September 30, 2008

| | State and local | | | Securities lending collateral |
|---|----------------------------------|-----------------------------------|----------------------------|--|
| | Corporate obligations | government obligations | Preferred stock | |
| | (Dollars in thousands) | | | |
| Beginning balance at June 30, 2008 | \$ 1,403 | \$ 7,279 | \$ 8,348 | \$ 3,489 |
| Total gains or (losses): | | | | |
| Included in realized investment gains and (losses) | | | | (495) |
| Included in other comprehensive income | (10) | (210) | (535) | (35) |
| Purchases, issuances and settlements ⁽¹⁾ | | | | (384) |
| Transfers in and/or (out) of Level 3 ⁽²⁾ | 2,925 | | | 3,416 |
| Ending balance at September 30, 2008 | \$ 4,318 | \$ 7,069 | \$ 7,813 | \$ 5,991 |

The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date

| | | | | |
|--|----|----|----|----------|
| | \$ | \$ | \$ | \$ (495) |
|--|----|----|----|----------|

| | State and local | | | Securities lending collateral |
|---|----------------------------------|-----------------------------------|----------------------------|--|
| | Corporate obligations | government obligations | Preferred stock | |
| | (Dollars in thousands) | | | |
| Beginning balance at January 1, 2008 | \$ 1,388 | \$ | \$ 3,812 | \$ 4,675 |
| Total gains or (losses): | | | | |
| Included in realized investment gains and (losses) | | | | (1,141) |
| Included in other comprehensive income | 5 | (210) | (549) | 321 |
| Purchases, issuances and settlements ⁽¹⁾ | | | | (1,280) |
| Transfers in and/or (out) of Level 3 ⁽²⁾ | 2,925 | 7,279 | 4,550 | 3,416 |
| Ending balance at September 30, 2008 | \$ 4,318 | \$ 7,069 | \$ 7,813 | \$ 5,991 |

The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at the reporting date

| | | | | |
|--|----|----|----|------------|
| | \$ | \$ | \$ | \$ (1,142) |
|--|----|----|----|------------|

- (1) The settlement is attributable to a security which experienced a principal pay down during the three and nine months ended September 30, 2008.
- (2) Transfers in and/or (out) of Level 3 during the three and nine months ended September 30, 2008 are attributable to a change in the availability of market observable information for securities within the respective category.

4. Securities Lending

The Company participates in a securities lending program whereby certain fixed maturity and equity securities from the Company's investment portfolio are loaned to other institutions for short periods of time. The Company requires cash collateral equal to 102% of the market value of the loaned securities plus accrued interest and records the obligation to return the collateral as a liability. The collateral is subsequently invested by the lending agent generating investment income, net of applicable fees. The Company is not permitted to sell or re-pledge the collateral on the securities lending program. The Company accounts for this program as a secured borrowing and records the collateral held on the Company's Consolidated Balance Sheets at fair value. The securities loaned remain a recorded asset of the Company. Prior to 2008, collateral could be invested in investments with maturities beyond the loan term, including asset backed securities and corporate obligations. However, in light of the recent market turmoil, beginning in 2008, new cash collateral is only invested in overnight investments.

Table of Contents

We examine all investments, including securities lending collateral, held by the Company for possible other-than-temporary declines in the value. In the first nine months of 2008, we recorded an other-than-temporary impairment on one fixed maturity investment within our securities lending collateral portfolio.

| | September 30, 2008 | December 31, 2007 |
|---|-----------------------------------|----------------------------------|
| | (Dollars in thousands) | |
| Collateral obligation | \$ 86,900 | \$ 141,316 |
| Pretax unrealized loss on fair value of collateral held | (7,751) | (2,011) |
| Other than temporary impairment charge | (1,142) | |
| Fair value of collateral held | 78,007 | 139,305 |
| Fair value of securities lent plus accrued interest | 85,280 | 138,581 |

5. Shareholders Equity and Stock-Based Compensation

The Company grants options and other stock awards to officers of the Company under the Long Term Incentive Plan (LTIP). At September 30, 2008, there were 824,468 of the Company's common shares reserved for issuance under the LTIP and options for 607,050 shares were outstanding. Treasury shares are used to fulfill the options exercised and other awards granted. Options and restricted shares vest pursuant to the terms of a written grant agreement. Options must be exercised no later than the tenth anniversary of the date of grant. As set forth in the LTIP, the Compensation Committee of the Board of Directors may accelerate vesting and exercisability of options.

For both the three months ended September 30, 2008 and 2007, the Company recognized stock-based compensation expense of \$0.3 million, with related income tax benefits of approximately \$0.1 million. For the nine months ended September 30, 2008 and 2007, the Company recognized stock-based compensation expense of \$1.0 million and \$0.8 million, respectively. Related income tax benefits of \$0.2 million and \$0.1 million were recognized for the nine months ended September 30, 2008 and 2007, respectively.

The Company paid a dividend of \$0.06 and \$0.05 and \$0.18 and \$0.15 per common share for the three and nine months ended September 30, 2008 and 2007, respectively.

6. Transactions with Related Parties

The Company's principal insurance subsidiary, NIIC is a party to a reinsurance agreement involving an assumption of reinsurance with Great American Insurance Company (Great American). NIIA, a wholly owned subsidiary of the Company, is a party to an underwriting management agreement also with Great American. As of September 30, 2008, Great American owned 52.6% of the outstanding shares of the Company. The reinsurance agreement calls for the assumption by NIIC of all of the risk on Great American's net premiums written for public transportation and recreational vehicle risks underwritten pursuant to the reinsurance agreement. NIIA provides administrative services to Great American in connection with Great American's underwriting of these risks. In addition, NIIC and two other subsidiaries, NIIC-HI and HIL, are involved in cessions of reinsurance with Great American to reduce exposure in certain property-casualty insurance programs.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (Dollars in thousands) | | (Dollars in thousands) | |
| Assumed premiums written | \$ 821 | \$ 1,288 | \$ 4,779 | \$ 4,901 |
| Assumed premiums earned | 1,617 | 1,467 | 4,818 | 4,060 |
| Assumed losses and loss adjustment expense incurred | 1,347 | 2,123 | 3,763 | 4,581 |
| Ceded premiums written | 576 | 658 | 3,026 | 3,410 |
| Ceded premiums earned | 880 | 1,013 | 2,707 | 2,966 |

Edgar Filing: National Interstate CORP - Form 10-Q

| | | | | |
|---|-----|-----|-----|-------|
| Ceded losses and loss adjustment expense recoveries | 452 | 146 | 849 | 1,186 |
| Payable to Great American as of period end | 526 | 725 | 526 | 725 |

Great American or its parent, American Financial Group, Inc., performs certain services for the Company without charge including, without limitation, actuarial services and on a consultative basis, as needed, internal audit, legal, accounting and other support services. If Great American no longer controlled a majority of the Company's common shares, it is possible that many of these services would cease or, alternatively, be provided at an increased cost to us. This could impact our personnel resources, require us to hire additional

Table of Contents

professional staff and generally increase our operating expenses. Management believes, based on discussions with Great American, that these services will continue to be provided by the affiliated entity in future periods and the relative impact on operating results is not material.

On January 17, 2008, Great American filed an Undertaking on Appeal as surety with the Superior Court of the State of California for the County of Los Angeles in the amount of \$17.9 million on behalf of NIIC. This surety was purchased from Great American to secure a judgment amount associated with the Company's pending appellate case as noted in Note 8 Commitments and Contingencies.

7. Reinsurance

Premiums and reinsurance activity consisted of the following:

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|-------------|----------------------------------|-----------|-----------|-----------|---------------------------------|------------|------------|------------|
| | 2008 | | 2007 | | 2008 | | 2007 | |
| | Written | Earned | Written | Earned | Written | Earned | Written | Earned |
| | (Dollars in thousands) | | | | (Dollars in thousands) | | | |
| Direct | \$ 75,487 | \$ 93,386 | \$ 67,867 | \$ 79,700 | \$ 304,508 | \$ 264,561 | \$ 265,626 | \$ 231,713 |
| Assumed | 1,964 | 2,748 | 4,190 | 3,878 | 7,739 | 7,934 | 9,244 | 8,952 |
| Ceded | (15,035) | (21,076) | (12,786) | (17,391) | (72,674) | (57,974) | (61,837) | (50,923) |
| Net Premium | \$ 62,416 | \$ 75,058 | \$ 59,271 | \$ 66,187 | \$ 239,573 | \$ 214,521 | \$ 213,033 | \$ 189,742 |

The Company cedes premiums through reinsurance agreements with reinsurers to reduce exposure in certain of its property-casualty insurance programs. Ceded losses and loss adjustment expense recoveries recorded were \$8.9 million for both the three months ended September 30, 2008 and 2007 and were \$22.3 million and \$25.6 million for the nine months ended September 30, 2008 and 2007, respectively. The Company remains primarily liable as the direct insurer on all risks reinsured and a contingent liability exists to the extent that the reinsurance companies are unable to meet their obligations for losses assumed. The Company regularly evaluates the financial condition of its reinsurers and to minimize its exposure to significant losses from reinsurer insolvencies, seeks to do business with only reinsurers rated Excellent or better by A.M. Best Company or obtains collateral to secure the reinsurers obligations.

8. Commitments and Contingencies

The Company and its subsidiaries are subject at times to various claims, lawsuits and legal proceedings arising in the ordinary course of business. All legal actions relating to claims made under insurance policies are considered in the establishment of our loss and loss adjustment expense reserves. In addition, regulatory bodies, such as state insurance departments, the Securities and Exchange Commission, the Department of Labor and other regulatory bodies may make inquiries and conduct examinations or investigations concerning our compliance with insurance laws, securities laws, labor laws and the Employee Retirement Income Security Act of 1974, as amended.

Our insurance companies also have lawsuits pending in which the plaintiff seeks extra-contractual damages from us in addition to damages claimed or in excess of the available limits under an insurance policy. These lawsuits, which are in various stages of development, generally mirror similar lawsuits filed against other carriers in the industry.

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

On August 3, 2007, the Company was informed that the jury in a case pending in the Superior Court of the State of California for the County of Los Angeles (the Court), had issued, on August 2, 2007, a special verdict adverse to the Company's interests in a pending lawsuit against one of the Company's insurance companies. The Court entered a formal judgment on October 25, 2007 and the Company received notice of that formal judgment on November 5, 2007. The current exposure to the Company for this judgment approximates \$9.0 million, net of anticipated reinsurance and, as required by the Court, the Company secured the judgment amount with a surety bond on January 17, 2008. However, the Company believes that it has a strong appellate case and strategy and intends to vigorously pursue

Table of Contents

the appellate process. Upon appeal, the Company believes the matter will be resolved in a manner that will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows. As of September 30, 2008, the Company had not established a case reserve for this claim but has and will continue to closely monitor this case with counsel. The Company has consistently established litigation expense reserves to account for the cost associated with the defense of the Company's position, which it will continue to reserve for throughout the appeal process.

As a direct writer of insurance, the Company receives assessments by state funds to cover losses to policyholders of insolvent or rehabilitated companies and other authorized fees. These mandatory assessments may be partially recovered through a reduction in future premium taxes in some states over several years. At September 30, 2008 and December 31, 2007, the liability for such assessments was \$5.2 million and \$3.6 million, respectively, and will be paid over several years as assessed by the various state funds.

9. Earnings Per Common Share

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (In thousands, except per share) | | (In thousands, except per share) | |
| Net (loss) income | \$ (4,228) | \$ 10,145 | \$ 9,713 | \$ 32,470 |
| Weighted average shares outstanding during period | 19,293 | 19,199 | 19,281 | 19,189 |
| Additional shares issuable under employee common stock option plans using treasury stock method | | 260 | 94 | 212 |
| Weighted average shares outstanding assuming exercise of stock options ¹ | 19,293 | 19,459 | 19,375 | 19,401 |
| Net (loss) income per share: | | | | |
| Basic | \$ (0.22) | \$ 0.53 | \$ 0.50 | \$ 1.69 |
| Diluted | \$ (0.22) | \$ 0.52 | \$ 0.50 | \$ 1.67 |

¹ Since the Company reported a net loss for third quarter 2008, the calculated diluted earnings per share was antidilutive; therefore, basic earnings per share is used.

For the three months ended September 30, 2008 and 2007, there were 607,050 and 51,440, respectively, outstanding options excluded from diluted earnings per share because they were anti-dilutive. For the nine months ended September 30, 2008 and 2007, there were 264,113 and 102,723, respectively, outstanding options excluded from

diluted earnings per share because they were anti-dilutive.

10. Segment Information

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (Dollars in thousands) | | (Dollars in thousands) | |
| Revenue: | | | | |
| Premiums earned: | | | | |
| Alternative Risk Transfer | \$ 35,814 | \$ 27,033 | \$ 99,212 | \$ 77,495 |
| Transportation | 19,162 | 18,596 | 56,882 | 55,436 |
| Specialty Personal Lines and Commercial Vehicle | 14,046 | 13,252 | 40,797 | 38,564 |
| Hawaii and Alaska | 4,467 | 4,562 | 13,393 | 13,075 |
| Other | 1,569 | 2,744 | 4,237 | 5,172 |
| Total premiums earned | 75,058 | 66,187 | 214,521 | 189,742 |
| Net investment income | 5,417 | 5,690 | 16,849 | 16,421 |
| Net realized gains (losses) on investments | (8,376) | (319) | (10,824) | (47) |
| Other | 605 | 1,564 | 2,199 | 3,384 |
| Total revenues | \$ 72,704 | \$ 73,122 | \$ 222,745 | \$ 209,500 |

Table of Contents**11. Income Taxes**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| | (Dollars in thousands) | | | |
| Expected federal income tax expense (benefit) at statutory rate | \$ (768) | \$ 5,351 | \$ 6,374 | \$ 16,729 |
| Tax effect of tax-exempt investment income | (339) | (241) | (1,006) | (665) |
| Change of valuation allowance on capital losses | 3,191 | | 3,191 | |
| Other items, net | (51) | 35 | (60) | (737) |
| | \$ 2,033 | \$ 5,145 | \$ 8,499 | \$ 15,327 |

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

| | September 30, 2008 | December 31, 2007 |
|-----------------------------------|-----------------------------------|------------------------------|
| | (Dollars in thousands) | |
| Deferred Tax Assets: | | |
| Unearned premiums | \$ 10,280 | \$ 8,528 |
| Unpaid losses and LAE expenses | 8,024 | 6,599 |
| Assignments and assessments | 1,516 | 992 |
| Unrealized losses on investments | 9,702 | 2,412 |
| Realized losses on investments | 3,867 | |
| Other, net | 1,949 | 1,220 |
| | 35,338 | 19,751 |
| Valuation allowance | (6,976) | (842) |
| | 28,362 | 18,909 |
| Deferred Tax Liabilities: | | |
| Deferred policy acquisition costs | (7,723) | (6,152) |
| Other, net | (1,382) | (764) |
| Total deferred tax liabilities | (9,105) | (6,916) |
| Net deferred income tax assets | \$ 19,257 | \$ 11,993 |

Management has reviewed the recoverability of the deferred tax asset and believes that with the exception of unrealized losses on investments and capital losses, the amount will be recoverable against future earnings. The gross deferred tax assets have been reduced by a valuation allowance on unrealized losses on equity investments of \$3.7 million and a valuation allowance on realized losses on investments of \$3.2 million based on limitations set forth

in the Internal Revenue Code which restrict the recoverability of taxes.

12. Comprehensive Income

Comprehensive income or loss includes the Company's net income or loss plus the changes in the unrealized gains or losses (net of income taxes) on the Company's available-for-sale securities. There was a total comprehensive loss for the third quarter of 2008 of \$11.6 million and comprehensive income of \$11.2 million for the third quarter of 2007.

The total comprehensive loss for the nine months ended September 30, 2008 was \$6.7 million and total comprehensive income for the nine months ended September 30, 2007 was \$32.3 million.

Table of Contents

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

Forward-Looking Statements

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

- general economic conditions and other factors, including prevailing interest rate levels and stock and credit market performance, which may affect (among other things) our ability to sell our products, our ability to access capital resources and the costs associated with such access to capital and the market value of our investments;

- customer response to new products and marketing initiatives;

- tax law changes;

- increasing competition in the sale of our insurance products and services and the retention of existing customers;

- changes in legal environment;

- regulatory changes or actions, including those relating to regulation of the sale, underwriting and pricing of insurance products and services and capital requirements;

- levels of natural catastrophes, terrorist events, incidents of war and other major losses;

- adequacy of insurance reserves; and

- availability of reinsurance and ability of reinsurers to pay their obligations.

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

General

We underwrite and sell traditional and alternative risk transfer property and casualty insurance products to the passenger transportation industry and the trucking industry, general commercial insurance to small businesses in Hawaii and Alaska and personal insurance to owners of recreational vehicles, commercial vehicles and watercraft throughout the United States.

As of September 30, 2008, Great American Insurance Company (Great American) owned 52.6% of our outstanding common shares. Great American is a wholly-owned subsidiary of American Financial Group, Inc. We have four property and casualty insurance subsidiaries, National Interstate Insurance Company (NIIC), Hudson Indemnity, Ltd. (HIL), National Interstate Insurance Company of Hawaii, Inc. (NIIC-HI) and Triumphe Casualty Company (TCC) and six other agency and service subsidiaries. NIIC is licensed in all 50 states and the District of Columbia. HIL is domiciled in the Cayman Islands and conducts insurance business outside the United States. We write our insurance policies on a direct basis through NIIC, NIIC-HI and TCC. We also assume a portion of premiums written by other affiliated companies whose passenger transportation insurance business we manage. Insurance products are marketed through multiple distribution channels, including independent agents and brokers, affiliated agencies and agent internet initiatives. We use our six other agency and service subsidiaries to sell and service our insurance business.

Results of Operations

Overview

Through the operations of our subsidiaries, we are engaged in property and casualty insurance operations. We generate underwriting profits by providing specialized insurance products, services and programs not generally available in the marketplace. We focus on niche insurance markets where we offer insurance products designed to meet the unique needs of targeted insurance buyers that we believe are underserved by the insurance industry.

Table of Contents

We derive our revenues primarily from premiums generated by our insurance policies and income from our investment portfolio. Our expenses consist primarily of losses and loss adjustment expenses (LAE), commissions and other underwriting expenses, and other operating and general expenses.

For the third quarter of 2008, we had a net loss of \$4.2 million (\$0.22 per share, diluted) compared to net earnings for the third quarter 2007 of \$10.1 million (\$0.52 per share, diluted). For the nine months ended September 30, 2008 and 2007, we reported net income of \$9.7 million (\$0.50 per share, diluted) compared to \$32.5 million (\$1.67 per share, diluted), respectively. Our income in the third quarter and year-to-date were adversely impacted by the turbulent market environment, as evidenced by our net realized losses on investments of \$8.4 million for the third quarter of 2008 and \$10.8 million for year-to-date 2008.

Exclusive of our net realized investment losses, we had pre-tax operating income of \$6.2 million for the three months ended September 30, 2008 compared to \$15.6 million in the comparable period in 2007. For the nine months ended September 30, 2008 and 2007, we had pre-tax operating income of \$29.0 million and \$47.8 million, respectively.

Although, we have experienced strong revenue growth for the third quarter of 2008 and through the first nine months of 2008, our revenue growth has been offset by an increase in large loss severity, primarily due to our charter passenger transportation business. While the losses have occurred with both large and small charter companies, we have focused our attention on the small fleet operators, which represent a relatively small portion of our public transportation premium and have historically performed well. We are in the process of reviewing most of our large fleet charter transportation book and our entire in-force small fleet book of charter transportation business to ensure that our high underwriting standards are in place. Other initiatives centered on risk selection and pricing adequacy have been implemented relative to the entire charter transportation product. In addition to an increase in loss severity, we have also experienced a higher net commission expense compared to prior year due to a change in our business mix.

Gross Premiums Written

We operate our business as one segment, property and casualty insurance. We manage this segment through a product management structure. The following table sets forth an analysis of gross premiums written by business component during the periods indicated:

| | Three Months Ended September 30, | | | |
|---|---|----------------|---------------|----------------|
| | 2008 | | 2007 | |
| | Amount | Percent | Amount | Percent |
| | (Dollars in thousands) | | | |
| Alternative Risk Transfer | \$ 33,808 | 43.7% | \$ 22,435 | 31.1% |
| Transportation | 20,972 | 27.1% | 25,717 | 35.7% |
| Specialty Personal Lines and Commercial Vehicle | 14,120 | 18.2% | 12,773 | 17.7% |
| Hawaii and Alaska | 6,996 | 9.0% | 7,747 | 10.8% |
| Other | 1,555 | 2.0% | 3,385 | 4.7% |
| Gross premiums written | \$ 77,451 | 100.0% | \$ 72,057 | 100.0% |

| | Nine Months Ended September 30, | | | |
|---|--|----------------|---------------|----------------|
| | 2008 | | 2007 | |
| | Amount | Percent | Amount | Percent |
| | (Dollars in thousands) | | | |
| Alternative Risk Transfer | \$ 172,024 | 55.1% | \$ 132,866 | 48.4% |
| Transportation | 71,735 | 23.0% | 72,830 | 26.5% |
| Specialty Personal Lines and Commercial Vehicle | 46,800 | 15.0% | 43,746 | 15.9% |
| Hawaii and Alaska | 17,727 | 5.7% | 19,834 | 7.2% |
| Other | 3,961 | 1.2% | 5,594 | 2.0% |

| | | | | |
|------------------------|------------|--------|------------|--------|
| Gross premiums written | \$ 312,247 | 100.0% | \$ 274,870 | 100.0% |
|------------------------|------------|--------|------------|--------|

Gross premiums written include both direct premium and assumed premium. Gross premiums written increased \$5.4 million for the third quarter of 2008 compared to 2007. During the third quarter of 2008, as a percent of total gross premiums written, the alternative risk transfer component of the business had the largest dollar increase of \$11.4 million, or 50.7%, compared to the same period in 2007. The growth in this business component is primarily due to the addition of a new captive program in the third quarter of 2008 and continued growth in our existing captive programs. Our specialty personal lines and commercial vehicle (CV) component grew \$1.3 million during the third quarter 2008 compared to 2007, due to additional policies in force for both our CV and watercraft products. The increases in the alternative risk transfer and specialty personal lines and CV components were offset by decreases in the transportation, Hawaii and Alaska and Other components of \$4.7 million, \$0.8 million and \$1.8 million, respectively. The transportation and Hawaii

Table of Contents

and Alaska components decreased due to the increased competition in the market and our focus on maintaining our underwriting discipline by achieving an underwriting profit even if we forgo volume as a result. Our Other component is comprised of assigned risk policies over which we have no control.

For the first nine months of 2008, both the alternative risk transfer component and the specialty personal lines component experienced growth in gross premiums written. Our alternative risk transfer component increased \$39.2 million, or 29.5%, over the comparable period in 2007. The growth in this component is primarily due to three new captive programs added during 2008, which contributed to \$16.1 million of the total year-to-date increase. Additional increases in this component are related to expanded lines of coverage in one of our existing captive programs and the addition of new members to existing captive programs.

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

As part of our captive programs, we have analyzed, on a quarterly basis, captive members' loss performance on a policy year basis to determine if there would be a premium assessment to participants, or if there would be a return of premium to members as a result of less than expected losses. We record assessment premium and return of premium as adjustments to written premium (assessments increase written premium; returns of premium reduce written premium). For the third quarter of 2008 and 2007, we recorded a return of premium of \$2.8 million and \$0.3 million, respectively. For the first nine months of 2008 and 2007, we recorded a return of premium of \$5.3 million and \$1.6 million, respectively.

In addition to the alternative risk transfer component, our specialty personal lines and CV component had a \$3.1 million, or 7.0%, increase in gross premiums written for the nine months ended September 30, 2008 over the same period in 2007. The growth in this component is primarily due to additional policies in force in our CV and watercraft products from expanded marketing initiatives and product enhancements. Our Transportation and Hawaii and Alaska components decreased \$1.1 million and \$2.1 million, respectively, over the comparable period in 2007 due to increased competition in a soft market. The Other component, which is comprised of assigned risk policies that we receive from involuntary state insurance plans normally based on our written premium in that state and over which we have no control, decreased \$1.6 million, or 29.2%, compared to the same period in 2007.

Premiums Earned

Three months ended September 30, 2008 compared to September 30, 2007. The following table shows premiums earned summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

| | Three Months Ended | | Change | |
|---------------------------------|---------------------------|-------------|-------------------------------|----------------|
| | 2008 | 2007 | Amount | Percent |
| | | | (Dollars in thousands) | |
| Premiums earned: | | | | |
| Alternative Risk Transfer | \$ 35,814 | \$ 27,033 | \$ 8,781 | 32.5% |
| Transportation | 19,162 | 18,596 | 566 | 3.0% |
| Specialty Personal Lines and CV | 14,046 | 13,252 | 794 | 6.0% |
| Hawaii and Alaska | 4,467 | 4,562 | (95) | (2.1%) |
| Other | 1,569 | 2,744 | (1,175) | (42.8%) |
| Total premiums earned | \$ 75,058 | \$ 66,187 | \$ 8,871 | 13.4% |

Our net premiums earned increased \$8.9 million, or 13.4%, to \$75.1 million during the three months ended September 30, 2008 compared to \$66.2 million for the same period in 2007. This increase is primarily attributable to the \$8.8 million increase in the alternative risk transfer component due to expanded insurance offerings in one of our larger programs, and continued growth in our existing captive programs. The specialty personal lines and CV component increased \$0.8 million, or 6.0%, during the third quarter of 2008 compared to 2007, due to an increase in the number of policies in force in our CV product. Our transportation component grew \$0.6 million, or 3.0%, from growth experienced in our community and medical transportation product and truck products during the fourth quarter of 2007 and first half of 2008. Our Other component decreased \$1.2 million, or 42.8%, due to a decrease in our assigned risk policies over which we have no control.

Table of Contents

Nine months ended September 30, 2008 compared to September 30, 2007. The following table shows premiums earned summarized by the broader business component description, which were determined based primarily on similar economic characteristics, products and services:

| | Nine Months Ended | | Change | |
|---------------------------------|--------------------------|----------------------|-------------------------------|----------------|
| | September 30, | September 30, | Amount | Percent |
| | 2008 | 2007 | (Dollars in thousands) | |
| Premiums earned: | | | | |
| Alternative Risk Transfer | \$ 99,212 | \$ 77,495 | \$ 21,717 | 28.0% |
| Transportation | 56,882 | 55,436 | 1,446 | 2.6% |
| Specialty Personal Lines and CV | 40,797 | 38,564 | 2,233 | 5.8% |
| Hawaii and Alaska | 13,393 | 13,075 | 318 | 2.4% |
| Other | 4,237 | 5,172 | (935) | (18.1%) |
| Total premiums earned | \$ 214,521 | \$ 189,742 | \$ 24,779 | 13.1% |

Our net premiums earned increased \$24.8 million, or 13.1%, to \$214.5 million during the nine months ended September 30, 2008 compared to \$189.7 million for the same period in 2007. This increase is primarily attributable to the alternative risk transfer component, which accounts for approximately 88% of the overall total premiums earned growth. The \$21.7 million increase in this component is mainly due to expanded insurance offerings in two of our products during 2007 and the first half of 2008, as well as new participants in our captive programs. The specialty personal lines and CV component increased \$2.2 million, or 5.8%, in the first nine months of 2008 compared to the same period in 2007, due primarily to an increase in policies in force in the CV product during the last half of 2007 and first half of 2008. The transportation component increased \$1.4 million, or 2.6%, the first nine months of 2008 compared to the same period in 2007 primarily due to an increase in the number of policies in force mainly from our community and medical transportation product and truck products. In the transportation component, we are still experiencing a modest decline in year over year renewal rates due to the current softening market.

Underwriting and Loss Ratio Analysis

Underwriting profitability, as opposed to overall profitability or net earnings, is measured by the combined ratio. The combined ratio is the sum of the loss and LAE ratio and the underwriting expense ratio. A combined ratio under 100% is indicative of an underwriting profit. Our underwriting approach is to price our products to achieve an underwriting profit even if we forgo volume as a result. For the three and nine months ended September 30, 2008, we experienced single digit decreases to our rate levels on our renewal business.

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

| | Three Months Ended | | Nine Months Ended | |
|---|-------------------------------|----------------------|-------------------------------|----------------------|
| | September 30, | September 30, | September 30, | September 30, |
| | 2008 | 2007 | 2008 | 2007 |
| | (Dollars in thousands) | | (Dollars in thousands) | |
| Gross premiums written | \$ 77,451 | \$ 72,057 | \$ 312,247 | \$ 274,870 |
| Ceded reinsurance | (15,036) | (12,786) | (72,674) | (61,837) |
| Net premiums written | 62,415 | 59,271 | 239,573 | 213,033 |
| Change in unearned premiums, net of ceded | 12,643 | 6,916 | (25,052) | (23,291) |
| Net premiums earned | \$ 75,058 | \$ 66,187 | \$ 214,521 | \$ 189,742 |

| | | | | |
|---|-------|-------|-------|-------|
| Combined Ratios: | | | | |
| Loss and LAE ratio ⁽¹⁾ | 69.3% | 60.2% | 67.2% | 59.3% |
| Underwriting expense ratio ⁽²⁾ | 28.2% | 22.7% | 25.3% | 22.1% |
| Combined ratio | 97.5% | 82.9% | 92.5% | 81.4% |

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

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

Table of Contents

Three months ended September 30, 2008 compared to September 30, 2007. Losses and LAE are a function of the amount and type of insurance contracts we write and of the loss experience of the underlying risks. We seek to establish case reserves at the maximum probable exposure based on our historical claims experience. Our ability to estimate losses and LAE at the time of pricing our contracts is a critical factor in determining our profitability. The amount reported under losses and LAE in any period includes payments in the period net of the change in reserves for unpaid losses and LAE between the beginning and the end of the period. The loss and LAE ratio for the third quarter of 2008 increased 9.1 percentage points to 69.3% compared to 60.2% in the same period in 2007. The loss and LAE ratio for the third quarter of 2008 reflects an increase in claims severity primarily in our charter passenger transportation products and includes a \$0.3 million, or 0.4 percentage points, reduction for favorable development of losses from prior years compared to favorable development of \$0.4 million, or 0.5 percentage points, in the third quarter of 2007. During the third quarter of 2008 these large losses from the charter passenger transportation products contributed approximately 4 percentage points to the loss ratio. The increase in the loss and LAE ratio during the third quarter of 2008 from 2007 also reflects the impact of modestly lower renewal rates that we have been experiencing from the softening market and frequency associated with the seasonality of our RV product.

Our underwriting expense ratio includes commissions and other underwriting expenses and other operating and general expenses, offset by other income. Commissions and other underwriting expenses consist principally of brokerage and agent commissions reduced by ceding commissions received from assuming reinsurers, and vary depending upon the amount and types of contracts written and, to a lesser extent, premium taxes. The underwriting expense ratio for the third quarter of 2008 increased 5.5 percentage points to 28.2% compared to 22.7% for the same period in 2007. A one-time state guarantee fund charge contributed 1.7 percentage points increase to the expense ratio for the third quarter 2008. During the third quarter of 2007, we received a \$0.8 million lease buyout from a tenant that leased space at our corporate campus. This buyout increased rental income by approximately \$0.8 million and reduced the 2007 third quarter expense ratio by 1.2 percentage points. The remainder of the change in the expense ratio in the third quarter of 2008 is attributable to increased commission expenses due to a change in our overall mix of business.

Nine months ended September 30, 2008 compared to September 30, 2007. The loss and LAE ratio for the nine months ended September 30, 2008 increased 7.9 percentage points to 67.2% compared to 59.3% in the same period in 2007. The loss and LAE ratio for the nine months ended September 30, 2008 includes a \$0.8 million, or 0.4 percentage points, increase for unfavorable development of losses from prior years compared to a reduction to the loss and LAE ratio for favorable development of \$5.0 million, or 2.6 percentage points, in the first nine months of 2007.

Additionally in the first nine months of 2008, we experienced increased claims severity primarily in our charter passenger transportation products, which accounted for approximately a 5 percentage point increase to the loss ratio. We are currently focusing our attention on our small fleet passenger transportation product to ensure that our high underwriting standards are still in place. Initiatives centered on risk selection and pricing adequacy have been implemented to address the unusually high losses that we have encountered.

The underwriting expense ratio for the nine months ended September 30, 2008 increased 3.2 percentage points to 25.3% compared to 22.1% for the same period in 2007. The increase in our year-to-date 2008 expense ratio is primarily due to a change in our overall mix of business, including high premium growth in products that tend to have higher commission rates.

Net Investment Income

2008 compared to 2007. Net investment income remained relatively constant at \$5.4 million for the three months ended September 30, 2008 compared to \$5.7 million in the same period in 2007 as a result of higher average cash and invested assets offset by lower yields. For the nine months ended September 30, 2008 compared to the same period in 2007, net investment income increased \$0.4 million, or 2.6%, to \$16.8 million. We have experienced lower interest rates on cash and short-term investments and flat rates on our fixed income investments.

Net Realized Gains (Losses) on Investments

2008 compared to 2007. Net realized losses were \$8.4 million and \$0.3 million for the third quarter of 2008 and 2007, respectively. For the nine months ended September 30, 2008 and 2007, net realized losses were \$10.8 million and \$0.1 million, respectively. Continuing turmoil in investment markets has caused market declines in our investment portfolio, particularly in the financial and real estate related holdings. This has had an adverse impact on our

investment portfolio in 2008, as we recognized other-than-temporary impairment charges on investments of \$8.0 million and \$10.5 million for the third quarter and first nine months of 2008, respectively. Of the \$8.0 million, \$5.8 million related to securities issued by Fannie Mae, Freddie Mac and Lehman Brothers Holdings Inc. and \$1.6 million related to securities in the financial and real estate sector. The others are in insurance and asset backed. For both the quarter and nine months ended September 30, 2007, we recognized a \$0.2 million other-than-temporary impairment charge.

Realized gains are taken when opportunities arise. When evaluating fixed maturity sales opportunities, we consider multiple factors, such as reinvestment alternatives and specific circumstances of the investment currently held. Credit quality, portfolio allocation and other-than-temporary impairment are additional factors that may encourage us to sell a fixed maturity security, at a gain or loss, prior to maturity. Historically, we have not had the need to sell our investments to generate liquidity.

Table of Contents***Commissions and Other Underwriting Expenses***

2008 compared to 2007. During the third quarter of 2008, commissions and other underwriting expenses increased \$4.7 million, or 34.2%, to \$18.5 million from \$13.8 million in the comparable period in 2007. For the first nine months of 2008 and 2007, commissions and other underwriting expenses were \$46.7 and \$36.3 million, respectively, increasing \$10.3 million, or 28.4%. Both the quarter and year-to-date increases relate to an increase in net commission expense due to growth and a change in our business mix. Our various products have different commission rates, therefore the quarterly and year-to-date commission expense can vary based on the product mix written during the period. During both the third quarter of 2008 and year-to-date 2008 results, our premium growth has typically been in products that have higher commission rates. In addition to a change in our overall mix of business, we recorded an approximate \$1.3 million charge for a one-time state guarantee fund in the third quarter of 2008, which was also a contributing factor to the increase in our commissions and other underwriting expenses.

Other Operating and General Expenses

2008 compared to 2007. For the three and nine months ended September 30, 2008, other operating and general expenses were \$3.2 million and \$9.8 million, respectively, as compared to \$2.8 million and \$9.0 million in the comparable periods in 2007. Other operating and general expenses for both the quarter and year-to-date results increased mainly as a result of an increase in employee headcount over prior year.

Expense on Amounts Withheld

2008 compared to 2007. For the three and nine months ended September 30, 2008, the expense on amounts withheld were \$1.0 million and \$3.3 million, respectively, as compared to \$1.0 million and \$2.6 million in the comparable periods in 2007. The increases in the expense on amounts withheld during the first nine months of 2008 are a direct result of continued growth in our alternative risk transfer component. The expense on amounts withheld remained relatively constant for the third quarter 2008 compared to third quarter 2007 primarily due to the current market turmoil.

Income Taxes

2008 compared to 2007. The effective tax rate was (92.6%) and 33.6% for the three-month period ended September 30, 2008 and 2007, respectively. The 2008 year-to-date effective tax rate increased 14.6 percentage points to 46.7% compared to 32.1% rate for the same period in 2007. The change in the effective tax rate is due to a valuation allowance of \$3.2 million that was taken on our realized investment losses, which increased both the 2008 third quarter and year-to-date income tax provision and increased the year-to-date 2008 effective tax rate 17.5 percentage points.

Financial Condition***Investments and Securities Lending Collateral***

At September 30, 2008, our investment portfolio contained \$432.9 million in fixed maturity securities, \$46.4 million in equity securities and \$78.0 million in securities lending collateral, all carried at fair value with unrealized gains and losses reported as a separate component of shareholders' equity on an after-tax basis. At September 30, 2008, we had pretax net unrealized loss of \$9.3 million on fixed maturities, \$7.8 million on securities lending collateral and \$10.7 million on equity securities. Our investment portfolio allocation is driven by our investment policy, which is weighted towards high quality fixed maturity investments. Although our current holdings and investment policy are focused on maintaining a high quality portfolio, we remain exposed to future market fluctuations, especially given the current global financial crisis.

At September 30, 2008, 99.6% of our fixed maturities were rated investment grade (credit rating of AAA to BBB-) by Standard & Poor's Corporation. At September 30, 2008, 91.6% of the securities lending collateral was rated investment grade by Standard & Poor's Corporation or invested in overnight repurchase agreements. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated or non-investment grade. Summarized information for the unrealized gains and losses recorded in the Company's investment portfolio on the Balance Sheet at September 30, 2008, is shown in the following table. Approximately \$1.8 million of available for sale Fixed maturities and \$13.5 million of Equity securities had no unrealized gains or losses at September 30, 2008.

Table of Contents

| | Securities with Unrealized Gains (Dollars in thousands) | Securities with Unrealized Losses |
|---|--|--|
| Fixed Maturities: | | |
| Fair value of securities | \$ 187,839 | \$ 243,278 |
| Amortized cost of securities | \$ 186,010 | \$ 254,374 |
| Gross unrealized gain or (loss) | \$ 1,829 | \$ (11,096) |
| Fair value as a % of amortized cost | 101.0% | 95.6% |
| Number of security positions held | 171 | 201 |
| Number individually exceeding \$50,000 gain or loss | 4 | 46 |
| Concentration of gains or (losses) by type or industry: | | |
| US Government and government agencies | \$ 1,060 | \$ (928) |
| State, municipalities and political subdivisions | 235 | (3,544) |
| Mortgage-backed securities | 391 | (427) |
| Banks, insurance and brokers | 121 | (5,679) |
| Industrial and other | 22 | (518) |
| Percentage rated investment grade ⁽¹⁾ | 99.6% | 99.6% |
| Equity Securities: | | |
| Fair value of securities | \$ 3,244 | \$ 29,679 |
| Cost of securities | \$ 3,054 | \$ 40,572 |
| Gross unrealized gain or (loss) | \$ 190 | \$ (10,893) |
| Fair value as a % of cost | 106.2% | 73.2% |
| Number individually exceeding \$50,000 gain or (loss) | 1 | 40 |

(1) Investment grade of AAA to BBB- by Standard & Poor's Corporation.

Summarized information for the unrealized gains and losses recorded in the Company's security lending collateral on the Balance Sheet at September 30, 2008, is shown in the following table. Approximately \$27.4 million of fixed maturity investments had no unrealized gains or losses at September 30, 2008.

| | Unrealized Losses |
|---|------------------------------|
| Fixed Maturities: | |
| Fair value of securities | \$ 50,580 |
| Amortized cost of securities | \$ 58,331 |
| Gross unrealized gain or (loss) | \$ (7,751) |
| Fair value as a % of amortized cost | 86.7% |
| Number of security positions held | 16 |
| Number individually exceeding \$50,000 gain or loss | 11 |
| Concentration of gains or (losses) by type: | |
| Repurchase agreements - overnight | |
| Mortgage-backed securities | (6,854) |

| | |
|--|-------|
| Banks, insurance and brokers | (897) |
| Percentage rated investment grade ⁽¹⁾ | 96.0% |

(1) Investment
grade of AAA
to BBB- by
Standard &
Poor's
Corporation.

Table of Contents

The table below sets forth the scheduled maturities of available for sale fixed maturity securities at September 30, 2008, based on their fair values. Actual maturities may differ from contractual maturities because certain securities may be called or prepaid by the issuers.

| | Securities with Unrealized Gains | Securities with Unrealized Losses |
|------------------------------------|---|--|
| Maturity: | | |
| One year or less | 3.9% | 4.9% |
| After one year through five years | 69.9% | 31.8% |
| After five years through ten years | 6.8% | 45.0% |
| After ten years | 1.1% | 5.2% |
| | 81.7% | 86.9% |
| Mortgage-backed securities | 18.3% | 13.1% |
| | 100.0% | 100.0% |

The table below sets forth the scheduled maturities for securities lending collateral at September 30, 2008, based on their fair values:

| | Securities with Unrealized Losses |
|-----------------------------------|--|
| Maturity: | |
| One year or less | 48.7% |
| After one year through five years | 6.9% |
| | 55.6% |
| Mortgage-backed securities | 44.4% |
| | 100.0% |

The table below summarizes the unrealized gains and losses on our investment portfolio fixed maturities and equity securities by dollar amount:

| | September 30, 2008 | |
|--|-------------------------------|--------------------------|
| | Aggregate | Fair Value as |
| | Aggregate | % of Cost |
| | Fair | Basis |
| | Value | (Loss) |
| | (Dollars in thousands) | |
| Fixed Maturities: | | |
| Securities with unrealized gains: | | |
| Exceeding \$50,000 and for: | | |

Edgar Filing: National Interstate CORP - Form 10-Q

| | | | |
|---------------------------------|------------|----------|--------|
| Less than one year (4 issues) | \$ 7,037 | \$ 281 | 104.2% |
| More than one year (0 issues) | | | |
| Less than \$50,000 (167 issues) | 180,802 | 1,548 | 100.9% |
| | \$ 187,839 | \$ 1,829 | |

Securities with unrealized losses:

Exceeding \$50,000 and for:

| | | | |
|---------------------------------|------------|-------------|-------|
| Less than one year (39 issues) | \$ 55,478 | \$ (4,409) | 92.6% |
| More than one year (7 issues) | 8,834 | (4,157) | 68.0% |
| Less than \$50,000 (155 issues) | 178,966 | (2,530) | 98.6% |
| | \$ 243,278 | \$ (11,096) | |

Equity Securities:

Securities with unrealized gains:

Exceeding \$50,000 and for:

| | | | |
|-------------------------------|----------|--------|--------|
| Less than one year (0 issue) | \$ | \$ | |
| More than one year (1 issues) | 2,150 | 150 | 107.5% |
| Less than \$50,000 (2 issues) | 1,094 | 40 | 103.8% |
| | \$ 3,244 | \$ 190 | |

Securities with unrealized losses:

Exceeding \$50,000 and for:

| | | | |
|--------------------------------|-----------|-------------|-------|
| Less than one year (36 issues) | \$ 23,138 | \$ (8,465) | 73.2% |
| More than one year (4 issues) | 3,517 | (1,942) | 64.4% |
| Less than \$50,000 (19 issues) | 3,024 | (486) | 86.2% |
| | \$ 29,679 | \$ (10,893) | |

Table of Contents

The table below summarizes the unrealized gains and losses on the securities lending collateral by dollar amount:

| | September 30, 2008 | | |
|---|---------------------------|-------------------------------|-------------------|
| | Aggregate | Aggregate | Fair Value |
| | Fair | Unrealized | as |
| | Value | Gain | % of Cost |
| | | (Loss) | Basis |
| | | (Dollars in thousands) | |
| Fixed Maturities: | | | |
| Securities with unrealized losses: | | | |
| Exceeding \$50,000 and for: | | | |
| Less than one year (9 issues) | \$ 18,335 | \$ (6,396) | 74.1% |
| More than one year (2 issues) | 5,046 | (1,269) | |
| Less than \$50,000 (5 issues) | 27,199 | (86) | 99.7% |
| | \$ 50,580 | \$ (7,751) | |

When a decline in the value of a specific investment is considered to be other-than-temporary, a provision for impairment is charged to earnings (accounted for as a realized loss) and the cost basis of that investment is reduced. The determination of whether unrealized losses are other-than-temporary requires judgment based on subjective as well as objective factors. Factors considered and resources used by management include those discussed in

Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies - Other Than-Temporary Impairment.

Premiums and Reinsurance

In the alternative risk transfer component, under most captive programs, all members of the group share a common renewal date. These common renewal dates are scheduled throughout the year. However, we have several large captives that renew during the first six months of a given fiscal year. The captive renewals in the first six months result in a large increase in premiums receivable, unearned premiums, prepaid reinsurance premiums and reinsurance balances payable during the first six months of a given fiscal year. These increases continually decrease through the year.

Premiums receivable increased \$34.0 million, or 40.2%, and unearned premiums increased \$40.3 million, or 27.7%, from December 31, 2007 to September 30, 2008. The increase in premiums receivable and unearned premiums is primarily due to an increase in direct written premiums in our alternative risk transfer component.

Prepaid reinsurance premiums increased \$15.3 million, or 62.7%, and reinsurance balances payable increased \$9.8 million, or 129.6%, from December 31, 2007 to September 30, 2008. The increase in prepaid reinsurance premiums and reinsurance balances payable is primarily due to an increase in ceded premiums written mainly in the alternative risk transfer component.

Liquidity and Capital Resources

The liquidity requirements of our insurance subsidiaries relate primarily to the liabilities associated with their products as well as operating costs and payments of dividends and taxes to us from insurance subsidiaries. Historically, and during the first nine months of 2008, cash flows from premiums and investment income have provided more than sufficient funds to meet these requirements, without requiring the sale of investments. Although we have been impacted by the current market conditions, we still believe that our unrealized investment losses will not impact our liquidity. If our cash flows change dramatically from historical patterns, for example as a result of a decrease in premiums or an increase in claims paid or operating expenses, we may be required to sell securities before their maturity and possibly at a loss. Our insurance subsidiaries generally hold a significant amount of cash and cash equivalents, short-term investments and highly liquid securities to meet their liquidity needs. Funds received in excess

of cash requirements are generally invested in additional marketable securities. Our historic pattern of using receipts from current premium writings for the payment of liabilities incurred in prior periods has enabled us to extend slightly the maturities of our investment portfolio beyond the estimated settlement date of our loss reserves.

We believe that our insurance subsidiaries maintain sufficient liquidity to pay claims and operating expenses, as well as meet commitments in the event of unforeseen events such as reserve deficiencies, inadequate premium rates or reinsurer insolvencies.

Our principal sources of liquidity are our existing cash, cash equivalents and short-term investments. Cash, cash equivalents and short-term investments of \$64.8 million at September 30, 2008 remained relatively constant compared to \$64.0 million at December 31, 2007. Net cash provided by operating activities was \$81.3 million during the nine-month period ended September 30, 2008, compared to \$69.9 million during the comparable period in 2007.

Table of Contents

Net cash used in investing activities was \$56.9 million and \$59.7 million for the nine months ended September 30, 2008 and 2007, respectively. The \$2.8 million decrease in cash used in investing activities was primarily related to an increase in the purchases of fixed maturities of \$215.1 offset by the maturity and redemptions of fixed maturities of \$167.2 million and a decrease in the purchases of equity securities of \$53.7 million, as compared to prior year. The increase in both purchases and redemptions of fixed maturities during 2008, compared to the prior period was directly influenced by current market conditions. As interest rates continued to decline, many of our high yielding U.S. government agency bonds were called and replaced with purchases of lower yielding agency bonds. Additionally, the decrease in the purchases of equity securities is directly related to the current turmoil in the market.

We utilized net cash of \$2.7 million and \$2.2 million from financing activities for the nine months ended September 30, 2008 and 2007, respectively. Our financing activities include those related to stock option activity and dividends paid on our common shares.

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

On December 19, 2007 we replaced our \$2.0 million credit agreement with a \$50 million five-year unsecured Credit Agreement (the "Credit Agreement"), which includes a sublimit of \$10 million for letters of credit. We have the ability to increase the line of credit to \$75 million subject to the Credit Agreement's accordion feature. Amounts borrowed bear interest at either (1) a rate per annum equal to the greater of the administrative agent's prime rate or 0.5% in excess of the federal funds effective rate or (2) rates ranging from 0.45% to 0.90% over LIBOR based on our A.M. Best insurance group rating, or 0.65% at September 30, 2008. Commitment fees on the average daily unused portion of the Credit Agreement also vary with our A.M. Best insurance group rating and range from 0.090% to 0.175%, or 0.125% at September 30, 2008.

The Credit Agreement requires us to maintain specified financial covenants measured on a quarterly basis, including consolidated net worth, fixed charge coverage ratio and debt to capital ratio. In addition, the Credit Agreement contains certain affirmative and negative covenants, including negative covenants that limit or restrict our ability to, among other things, incur additional indebtedness, effect mergers or consolidations, make investments, enter into asset sales, create liens, enter into transactions with affiliates and other restrictions customarily contained in such agreements. As of September 30, 2008, we were in compliance with all financial covenants. The Credit Agreement will terminate on December 19, 2012.

On May 23, 2008, we drew \$15 million from our Credit Agreement to redeem in full our outstanding junior subordinated debentures, replacing higher variable rate debt of LIBOR plus 420 basis points with lower variable rate debt.

We believe that funds generated from operations, including dividends from insurance subsidiaries, parent company cash and funds available under our Credit Agreement will provide sufficient resources to meet our liquidity requirements for at least the next 12 months. However, if these funds are insufficient to meet fixed charges in any period, we would be required to generate cash through additional borrowings, sale of assets, sale of portfolio securities or similar transactions. If we were required to sell portfolio securities early for liquidity purposes rather than holding them to maturity, we would recognize gains or losses on those securities earlier than anticipated. If we were forced to borrow additional funds in order to meet liquidity needs, we would incur additional interest expense, which could have a negative impact on our earnings. Since our ability to meet our obligations in the long term (beyond a 12-month period) is dependent upon factors such as market changes, insurance regulatory changes and economic conditions, no assurance can be given that the available net cash flow will be sufficient to meet our operating needs.

Critical Accounting Policies

The preparation of financial statements in conformity with U.S. generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change and thus impact amounts reported in the future. Management believes that the establishment of losses and LAE reserves and the determination of other-than-temporary impairment on investments are the two areas where the degree of judgment required in determining amounts recorded in the financial statements make the accounting policies critical. For a more detailed

discussion of these policies, see Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2007.

Losses and Loss Adjustment Expense Reserves

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of that loss to us and our final payment of that loss, and its related LAE. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities. At September 30, 2008 and December 31, 2007, we had \$388.7 million and \$302.1 million, respectively, of gross loss and LAE reserves, representing

Table of Contents

management's best estimate of the ultimate loss. Management records, on a monthly and quarterly basis, its best estimate of loss reserves. For purposes of computing the recorded reserves, management utilizes various data inputs, including analysis that is derived from a review of prior quarter results performed by actuaries employed by Great American. On an annual basis, actuaries from Great American, utilizing current period data, review the recorded reserves for NIIC, NIIC-HI and TCC. The actuaries provide a Statement of Actuarial Opinion, required annually in accordance with state insurance regulations, on the statutory reserves recorded by these U.S. insurance subsidiaries. The actuarial analysis of NIIC's, NIIC-HI's and TCC's net reserves for the year ending December 31, 2007 reflected point estimates that were within 1% of management's recorded net reserves as of such date. Using this actuarial data along with its other data inputs, management concluded that the recorded reserves appropriately reflect management's best estimates of the liability as of September 30, 2008 and December 31, 2007.

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

the Case Incurred Development Method;

the Paid Development Method;

the Bornhuetter-Ferguson Method; and

the Incremental Paid LAE to Paid Loss Methods.

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

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

open and closed claim counts;

average case reserves and average incurred on open claims;

closure rates and statistics related to closed and open claim percentages;

average closed claim severity;

ultimate claim severity;

reported loss ratios;

projected ultimate loss ratios; and

loss payment patterns.

Other-Than-Temporary Impairment

Our principal investments are in fixed maturities, all of which are exposed to at least one of three primary sources of investment risk: credit, interest rate and market valuation risks. The financial statement risks are those associated with the recognition of impairments and income, as well as the determination of fair values. Recognition of income ceases

when a bond goes into default. We evaluate whether other-than-temporary impairments have occurred on a case-by-case basis. Management considers a wide range of factors about the security issuer and uses its best judgment in evaluating the cause and amount of decline in the estimated fair value of the security and in assessing the prospects for near-term recovery.

Table of Contents

Inherent in management's evaluation of the security are assumptions and estimates about the operations of the issuer and its future earnings potential. Considerations we use in the impairment evaluation process include, but are not limited to:

the length of time and the extent to which the market value has been below amortized cost;

whether the issuer is experiencing significant financial difficulties;

economic stability of an entire industry sector or subsection;

whether the issuer, series of issuers or industry has a catastrophic type of loss;

the extent to which the unrealized loss is credit-driven or a result of changes in market interest rates;

historical operating, balance sheet and cash flow data;

internally generated financial models and forecasts;

our ability and intent to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value; and

other subjective factors, including concentrations and information obtained from regulators and rating agencies.

We closely monitor each investment that has a market value that is below its amortized cost and make a determination each quarter for other-than-temporary impairment for each of those investments. During the quarter and nine months ended September 30, 2008, we recorded \$8.0 million and \$10.5 million, respectively, in other-than-temporary impairments. Of the \$8.0 million of other-than-temporary impairments taken during the third quarter of 2008, \$5.8 million related to securities issued by Fannie Mae, Freddie Mac and Lehman Brothers Holdings Inc. and \$1.6 million related to other securities in the financial and real estate sector. The remainder of the impairment charge related to other preferred stock holdings. These charges were directly related to adverse market conditions that began in the last half of 2007 and continued into the first nine months of 2008. We recorded a \$0.2 million impairment adjustment for the quarter and nine months ended September 30, 2007. We will continue to monitor our portfolio to assess the impact of the recent government actions, including the Troubled Asset Relief Program and its impact on market valuations. While it is not possible to accurately predict if or when a specific security will become impaired, given the current turmoil and uncertainty in the market, charges for other-than-temporary impairment could be material to net income in subsequent quarters. Management believes it is not likely that future impairment charges will have a significant effect on our liquidity. See Management's Discussions and Analysis of Financial Condition and Results of Operations—Investments.

Contractual Obligations/Off-Balance Sheet Arrangements

During the first nine months of 2008, our total contractual obligations did not change materially from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2007.

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

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

There were no material changes in our identified market risk components as described in its December 31, 2007 Annual Report on Form 10-K. However, during the quarter ended September 30, 2008, there were significant disruptions in the financial markets. A number of large financial institutions failed, were supported by the United States government or were merged into other organizations. The market disruption has resulted in a lack of liquidity in the credit markets and a widening of credit spreads. As a result of these effects, we had a net unrealized loss of \$6.0

Edgar Filing: National Interstate CORP - Form 10-Q

million in our fixed maturities portfolio at September 30, 2008, compared with a net unrealized gain of \$0.2 million at December 31, 2007. Our securities lending portfolio had net unrealized losses of \$5.0 million and \$1.3 million as of September 30, 2008 and December 31, 2007, respectively. Our equity securities had net unrealized losses of \$10.7 million at September 30, 2008 compared to \$4.2 million at December 31, 2007.

Table of Contents

ITEM 4. *Controls and Procedures*

Our management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. Our management, with participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15) as of September 30, 2008. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2008 in alerting them on a timely basis to material information relating to us (including our consolidated subsidiaries) required to be included in our periodic filings under the Exchange Act. There have been no significant changes in our internal controls over financial reporting or in other factors that have occurred during the quarter ended September 30, 2008 that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

ITEM 1. Legal Proceedings

There are no material changes from the legal proceedings previously reported in our Annual Report on Form 10-K for the year ended December 31, 2007. For more information regarding such legal matters please refer to Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2007, Note 17 to the Consolidated Financial Statements included therein and Note 8 to the Consolidated Financial Statements contained in this quarterly report.

ITEM 1A. Risk Factors.

There are no material changes to the risk factors previously reported in our Annual Report on Form 10-K for the year ended December 31, 2007. For more information regarding such risk factors, please refer to Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2007.

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

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Submission of Matters to a Vote of Security Holders

None.

ITEM 5. Other Information

None.

ITEM 6. Exhibits

3.1 Amended and Restated Articles of Incorporation (1)

3.2 Amended and Restated Code of Regulations (1)

31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) These exhibits are incorporated by reference to our Registration Statement on Form S-1, as amended (Registration No. 333-119270) filed on November 12, 2004.

Table of Contents

SIGNATURES

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

NATIONAL INTERSTATE CORPORATION

Date: November 4, 2008

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

Date: November 4, 2008

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

26