

NATIONAL SECURITY GROUP INC  
Form 10-Q  
May 14, 2012  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

---

FORM 10-Q

---

(Mark One)

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

For Quarterly Period Ended March 31, 2012

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 0-18649

---

The National Security Group, Inc.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

63-1020300  
(IRS Employer  
Identification No.)

661 East Davis Street  
Elba, Alabama  
(Address of principal executive offices)

36323  
(Zip-Code)

Registrant's Telephone Number including Area Code (334) 897-2273

---

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in rule 12b-2 of the Act). (Check One) : Large accelerated filer  Accelerated filer  Non-accelerated filer  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

As of May 14, 2012, there were 2,466,600 shares, \$1.00 par value, of the registrant's common stock outstanding.

---

1

---

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

INDEX

PART I. FINANCIAL INFORMATION

Page No.

Item 1. Financial Statements (unaudited)

Condensed Consolidated Balance Sheets 4

Condensed Consolidated Statements of Income 5

Condensed Consolidated Statements of Comprehensive Income 5

Condensed Consolidated Statement of Shareholders' Equity 5

Condensed Consolidated Statements of Cash Flows 5

Notes to Condensed Consolidated Financial Statements 6

Review Report of Independent Registered Public Accounting Firm 7

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations 8

Item 3. Quantitative and Qualitative Disclosures about Market Risk 12

Item 4. Controls and Procedures 12

PART II. OTHER INFORMATION

Item 1. Legal Proceedings 12

Item 1A. Risk Factors 13

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds 13

Item 3. Defaults Upon Senior Securities 13

Item 4. Mine Safety Disclosures 13

Item 5. Other Information 13

Item 6. Exhibits 14

SIGNATURE 15

Table of Contents

Cautionary Statement Regarding Forward-Looking Statements

Any statement contained in this report which is not a historical fact, or which might otherwise be considered an opinion or projection concerning the Company or its business, whether expressed or implied, is meant as and should be considered a forward-looking statement as that term is defined in the Private Securities Litigation Reform Act of 1995. The following report contains forward-looking statements that are not strictly historical and that involve risks and uncertainties. Such statements include any statements containing the words “expect,” “plan,” “estimate,” “anticipate” or other words of a similar nature. Management cautions investors about forward-looking statements. Forward-looking statements involve certain evaluation criteria, such as risks, uncertainties, estimates, and/or assumptions made by individuals informed of the Company and industries in which we operate. Any variation in the preceding evaluation criteria could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These risks and uncertainties include, without limitation, the following:

The insurance industry is highly competitive and the Company encounters significant competition in all lines of business from other insurance companies. Many of the competing companies have more abundant financial resources than the Company.

Insurance is a highly regulated industry. It is possible that legislation may be enacted which would have an adverse effect on the Company’s business.

The Company is subject to regulation by state governments for each of the states in which it conducts business. The Company cannot predict the subject of any future regulatory initiative(s) or its (their) impact on the Company’s business.

The Company is rated by various insurance rating agencies. If a rating is downgraded from its current level by one of these agencies, sales of the Company’s products and stock could be adversely impacted.

The Company’s financial results are adversely affected by increases in policy claims received by the Company. While a manageable risk, this fluctuation is often unpredictable.

The Company’s investments are subject to a variety of risks. Investments are subject to defaults and changes in market value. Market value can be affected by changes in interest rates, market performance and the economy.

The Company mitigates risk associated with life policies through implementing effective underwriting and reinsurance strategies. These factors mitigate, not eliminate, risk related to mortality and morbidity exposure. The Company has established reserves for claims and future policy benefits based on amounts determined by independent actuaries. There is no assurance that these estimated reserves will prove to be sufficient or that the Company will not incur claims exceeding reserves, which could result in operating losses.

The Company mitigates risk associated with property and casualty policies through implementing effective underwriting and reinsurance strategies. The Company obtains reinsurance which increases underwriting capacity and limits the risk associated with policy claims. The Company is subject to credit risk with regard to reinsurers as reinsurance does not alleviate the Company’s liability to its insured’s for the ceded risks. The Company utilizes a third-party to develop a reinsurance treaty with reinsurers who are reliable and financially stable. However, there is no guarantee that booked reinsurance recoverable will actually be recovered. A reinsurer’s insolvency or inability to make payments due could have a material adverse impact on the financial condition of the Company.

The Company’s ability to continue to pay dividends to shareholders is contingent upon profitability and capital adequacy of the insurance subsidiaries. The insurance subsidiaries operate under regulatory restrictions that could limit the ability to fund future dividend payments of the Company. An adverse event or series of events could materially impact the ability of the insurance subsidiaries to fund future dividends and consequently the Board of Directors would have to suspend the declaration of dividends to shareholders.

The Company is subject to the risk of adverse settlements or judgments resulting from litigation. It is difficult to predict or quantify the expected results of litigation because the outcome depends on decisions of the court and jury that are based on facts and legal arguments presented at the trial.



Table of Contents

## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

	March 31, 2012 (unaudited)	December 31, 2011
<b>ASSETS</b>		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2012 - \$3,075; 2011 - \$3,497)	\$2,906	\$3,303
Fixed maturities available-for-sale, at estimated fair value (cost: 2012 - \$70,905; 2011 - \$69,980)	73,994	73,074
Equity securities available-for-sale, at estimated fair value (cost: 2012 - \$4,931; 2011 - \$4,931)	8,971	8,547
Trading securities	20	80
Mortgage loans on real estate, at cost	388	390
Investment real estate, at book value	5,757	5,745
Policy loans	1,223	1,244
Company owned life insurance	5,777	5,660
Other invested assets	3,886	3,929
Total Investments	102,922	101,972
Cash	2,243	3,393
Accrued investment income	835	706
Policy receivables and agents' balances, net	8,669	8,805
Reinsurance recoverable	2,670	2,778
Deferred policy acquisition costs	9,533	9,558
Property and equipment, net	2,527	2,528
Accrued income tax recoverable	1,640	1,669
Other assets	1,067	1,045
Total Assets	\$132,106	\$132,454
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Property and casualty benefit and loss reserves	\$13,255	\$14,386
Accident and health benefit and loss reserves	2,131	2,122
Life and annuity benefit and loss reserves	29,638	29,605
Unearned premiums	24,798	25,232
Policy and contract claims	676	652
Other policyholder funds	1,424	1,408
Short-term notes payable	700	485
Long-term debt	12,372	12,372
Deferred income tax liability	269	86
Other liabilities	8,182	8,091
Total Liabilities	93,445	94,439
Contingencies		

Shareholders' equity		
Common stock	2,467	2,467
Additional paid-in capital	4,951	4,951
Accumulated other comprehensive income	4,002	3,640
Retained earnings	27,241	26,957
Total Shareholders' Equity	38,661	38,015
Total Liabilities and Shareholders' Equity	\$132,106	\$132,454

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(In thousands, except per share amounts)

	Quarter Ended	
	March 31,	
	2012	2011
REVENUES		
Net premiums earned	\$13,496	\$14,870
Net investment income	1,135	1,142
Net realized investment gains	206	770
Other income	197	255
Total revenues	15,034	17,037
EXPENSES		
Policyholder benefits paid	7,845	9,322
Policy acquisition costs	2,772	2,924
General expenses	3,077	2,563
Taxes, licenses and fees	492	480
Interest expense	292	285
Total expenses	14,478	15,574
Income Before Income Taxes	556	1,463
INCOME TAX (BENEFIT) EXPENSE		
Current	28	350
Deferred	(3	) 118
	25	468
Net Income	\$531	\$995
EARNINGS PER COMMON SHARE	\$0.22	\$0.40
DIVIDENDS DECLARED PER SHARE	\$0.10	\$0.15

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(In thousands, except per share amounts)

	Three Months Ended	
	March 31,	
	2012	2011
Net income:	\$531	\$995



Other comprehensive income (loss), net of tax			
Changes in:			
Unrealized gains (losses) on securities	277	(180	)
Unrealized gain on interest rate swap	85	48	
Other comprehensive income (loss), net of tax	362	(132	)
Comprehensive income	\$893	\$863	

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)  
(In thousands, except per share amounts)

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital
Balance at December 31, 2011	\$38,015	\$26,957	\$3,640	\$2,467	\$4,951
Comprehensive income					
Net income three months ended 3/31/2012	531	531			
Other comprehensive income, net of tax					
Unrealized gain on securities, net of reclassification adjustment of \$136	277		277		
Unrealized gain on interest rate swap	85		85		
Total comprehensive income	893				
Cash dividends	(247	)	(247	)	
Balance at March 31, 2012 (Unaudited)	\$38,661	\$27,241	\$4,002	\$2,467	\$4,951

The Notes to the Condensed Consolidated Financial Statements are an integral part of these statements.

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(In thousands)

Quarter Ended  
March 31,  
2012                      2011

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Cash Flows from Operating Activities			
Net income	\$531	\$995	
Adjustments to reconcile net income to net cash (used in) provided by operating activities:			
Change in accrued investment income	(129	) (3	)
Change in reinsurance recoverable	108	62	
Change in deferred policy acquisition costs	25	(31	)
Change in accrued income tax recoverable	29	111	
Change in deferred income taxes	(3	) 118	
Depreciation expense	127	93	
Change in policy liabilities and claims	(1,383	) 583	
Other, net	(106	) (1,247	)
Net cash (used in) provided by operating activities	(801	) 681	
Cash Flows from Investing Activities			
Cost of investments acquired	(8,910	) (8,172	)
Sale and maturity of investments	8,674	10,050	
Purchase of property and equipment	(97	) (12	)
Net cash (used in) provided by investing activities	(333	) 1,866	
Cash Flows from Financing Activities			
Change in other policyholder funds	16	17	
Change in short-term notes payable	215	(500	)
Dividends paid	(247	) (370	)
Net cash used in financing activities	(16	) (853	)
Net change in cash and cash equivalents	(1,150	) 1,694	
Cash and cash equivalents, beginning of period	3,393	1,572	
Cash and cash equivalents, end of period	\$2,243	\$3,266	

The Notes to the Condensed Consolidated Financial Statements are an integral part of these statements.

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying condensed consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary - Omega One Insurance Company (Omega) . The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). All significant intercompany transactions and accounts have been eliminated. The financial information presented herein should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2011, which includes information and disclosures not presented herein.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these financial statements are reserves for future policy benefits, liabilities for losses and loss adjustment expenses, reinsurance recoverable asset on associated loss and loss adjustment expense liabilities, deferred policy acquisition costs, deferred income tax assets and liabilities, assessments of other-than-temporary impairments on investments and accruals for contingencies. Actual results could differ from those estimates.

Recently Adopted Accounting Standards

Presentation of Comprehensive Income

In June and December 2011, the Financial Accounting Standards Board (FASB) issued guidance amending the presentation of comprehensive income and its components. Under the new guidance, a reporting entity has the option to present comprehensive income in a single continuous statement or in two separate but consecutive statements. The Company adopted the new guidance in the first quarter of 2012. The Company opted to present the total of comprehensive income, the components of net income, and the components of other comprehensive income in two separate but consecutive statements. The Unaudited Condensed Consolidated Financial Statements included herein reflect the adoption of this updated guidance. The new guidance affects presentation only and therefore had no impact on the Company's results of operations or financial position.

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

In October 2010, the FASB issued guidance modifying the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal insurance contracts. The guidance specifies that the costs must be directly related to the successful acquisition of insurance contracts. The guidance also specifies that advertising costs should be included as deferred acquisition costs ("DAC") only when the direct-response advertising accounting criteria are met. Under the new guidance, only acquisition costs associated with "successful sales" are allowed to be deferred. Successful sales ratios will be reviewed quarterly and the new guidance will reduce the amount of acquisition cost that can be deferred to future periods. The Company adopted the new guidance on a prospective basis as of January 1, 2012.

#### Amendments to Fair Value Measurement and Disclosure Requirements

In May 2011, the FASB issued guidance that clarifies the application of existing fair value measurement and disclosure requirements and amends certain fair value measurement principles, requirements and disclosures. The guidance is to be applied prospectively for reporting periods beginning after December 15, 2011. The adoption of this guidance as of January 1, 2012 had no impact on the Company's results of operations or financial position. The expanded disclosures required by this guidance are included in Note 9.

#### Accounting Changes Not Yet Adopted

#### Disclosures about Offsetting Assets and Liabilities for Financial Instruments and Derivative Instruments

In December 2011, the FASB issued guidance requiring expanded disclosures, including both gross and net information, for financial instruments and derivative instruments that are either offset in the reporting entity's financial statements or those that are subject to an enforceable master netting arrangement or similar agreement. The guidance is effective for reporting periods beginning on or after January 1, 2013 and is to be applied retrospectively. The new guidance affects disclosures only and will have no impact on the Company's results of operations or financial position.

#### NOTE 2 – REINSURANCE

In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. NSFC maintains a catastrophe reinsurance agreement to cover losses from catastrophic events, primarily hurricanes.

Under the catastrophe reinsurance program, the Company retains the first \$4 million in losses from each event. Reinsurance is maintained in four layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	95% of \$6,000,000 in excess of \$4,000,000
Second Layer	95% of \$7,500,000 in excess of \$10,000,000
Third Layer	100% of \$25,000,000 in excess of \$17,500,000
Fourth Layer	100% of \$30,000,000 in excess of \$42,500,000

Layers 1-4 cover events occurring from January 1-December 31 of the contract year. All significant reinsurers under the program carry A.M. Best ratings of A- (Excellent) or higher, or equivalent ratings.

Amounts recoverable from reinsurers are estimated in a manner consistent with the claim liability associated with the reinsured policy. Amounts paid for prospective reinsurance contracts are reported as prepaid reinsurance premiums and amortized over the remaining contract period.

In the normal course of business, NSIC seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid by ceding reinsurance to other insurance enterprises or reinsurers under excess coverage contracts. NSIC retains a maximum of \$50,000 of coverage per individual life. The cost of reinsurance is amortized over the contract period of the reinsurance.

#### NOTE 3 – CALCULATION OF EARNINGS PER SHARE

Earnings per share were based on net income divided by the weighted average common shares outstanding. The weighted average number of shares outstanding for the three month periods ending March 31, 2012 and March 31, 2011 were 2,466,600.

#### NOTE 4 – CHANGES IN SHAREHOLDERS' EQUITY

During the three month periods ended March 31, 2012 and March 31, 2011, there were no changes in shareholders' equity except for a net income of \$531,000 and \$995,000, respectively; dividends paid of \$247,000 in 2012 and \$370,000 in 2011; changes in accumulated other comprehensive income, net of applicable taxes, of \$362,000 in 2012 and \$132,000 in 2011. Other comprehensive income consists of accumulated unrealized gains and losses on securities and unrealized gains and losses on interest rate swaps.

## NOTE 5 – INVESTMENTS

The amortized cost and aggregate fair values of investments in securities are as follows:

March 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	\$26,509	\$1,585	\$184	\$27,910
Trust preferred securities	537	—	9	528
Mortgage backed securities	6,539	243	44	6,738
Private label mortgage backed securities	9,018	184	31	9,171
Obligations of states and political subdivisions	16,815	984	22	17,777
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	11,487	433	50	11,870
Total fixed maturities	70,905	3,429	340	73,994
Equity securities	4,931	4,582	542	8,971
Total	\$75,836	\$8,011	\$882	\$82,965
Held-to-maturity securities:				
Mortgage backed securities	\$1,831	\$118	\$—	\$1,949
Private label mortgage backed securities	47	1	—	48
Obligations of states and political subdivisions	815	32	—	847
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	213	18	—	231
Total	\$2,906	\$169	\$—	\$3,075
December 31, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	\$19,907	\$1,340	\$267	\$20,980
Trust preferred securities	537	—	58	479
Mortgage backed securities	7,587	307	23	7,871
Private label mortgage backed securities	9,716	199	62	9,853
Obligations of states and political subdivisions	18,355	1,142	15	19,482
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	13,878	534	3	14,409
Total fixed maturities	69,980	3,522	428	73,074
Equity securities	4,931	4,206	590	8,547
Total	\$74,911	\$7,728	\$1,018	\$81,621
Held-to-maturity securities:				
Mortgage backed securities	\$2,026	\$125	\$—	\$2,151

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Private label mortgage backed securities	55	1	—	56
Obligations of states and political subdivisions	996	50	—	1,046
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	226	18	—	244
Total	\$3,303	\$194	\$—	\$3,497

The amortized cost and aggregate fair value of debt securities at March 31, 2012, by contractual maturity, are as follows. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(Dollars in Thousands)	
	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	\$927	\$950
Due after one year through five years	13,127	13,953
Due after five years through ten years	21,857	23,232
Due after ten years	34,994	35,859
Total	\$70,905	\$73,994
Held-to-maturity securities:		
Due in one year or less	\$300	\$301
Due after one year through five years	516	547
Due after five years through ten years	578	619
Due after ten years	1,512	1,608
Total	\$2,906	\$3,075

A summary of securities available-for-sale with unrealized losses as of March 31, 2012 and December 31, 2011 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
March 31, 2012							
Fixed maturities							
Corporate debt securities	\$8,027	\$127	\$1,743	\$57	\$9,770	\$184	22
Trust preferred securities	—	—	528	9	528	9	1
Mortgage backed securities	1,415	44	—	—	1,415	44	4
Private label mortgage backed securities	1,026	1	1,267	30	2,293	31	6
Obligations of state and political subdivisions	90	15	917	7	1,007	22	4
	2,569	50	—	—	2,569	50	6

	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	91	8	948	534	1,039	542	5
Equity securities	\$13,218	\$245	\$5,403	\$637	\$18,621	\$882	48
December 31, 2011							
Fixed maturities							
Corporate debt securities	\$4,703	\$166	\$899	\$101	\$5,602	\$267	15
Trust preferred securities	479	58	—	—	479	58	1
Mortgage backed securities	883	21	198	2	1,081	23	3
Private label mortgage backed securities	1,860	15	1,094	47	2,954	62	9
Obligations of state and political subdivisions	—	—	1,803	15	1,803	15	5
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	260	3	—	—	260	3	1
Equity securities	391	49	802	541	1,193	590	6
	\$8,576	\$312	\$4,796	\$706	\$13,372	\$1,018	40

There were no securities held-to-maturity with unrealized losses as of March 31, 2012 and December 31, 2011.

The Company conducts periodic reviews to identify and evaluate securities in an unrealized loss position in order to identify other-than-temporary-impairments. For securities in an unrealized loss position, the Company assesses whether the Company has the intent to sell the security or more likely than not will be required to sell the security before the anticipated recovery. If either of these conditions is met, the Company is required to recognize an other-than-temporary impairment with the entire unrealized loss reported in earnings. For securities in an unrealized loss position that do not meet these conditions, the Company assesses whether the impairment of a security is other-than-temporary. If the impairment is determined to be other-than-temporary, the Company is required to separate the other-than-temporary impairments into two components: the amount representing the credit loss and the amount related to all other factors. The credit loss is the portion of the amortized book value in excess of the net present value of the projected future cash flows discounted at the effective interest rate implicit in the debt security prior to impairment. The credit loss component of other-than-temporary impairments is reported in earnings, whereas the amount relating to factors other than credit losses are recorded in other comprehensive income, net of taxes.

Management has evaluated each security in a significant unrealized loss position. The Company has no material exposure to sub-prime mortgage loans and less than 4% of the fixed income investment portfolio is rated below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, Management evaluated financial information on each company and where available reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the securities in an accumulated loss position in the portfolio were temporary impairments.

For the quarter ended March 31, 2012, the Company realized no additional other-than-temporary impairments. The single largest accumulated loss was in the equity portfolio and totaled \$499,000. The second largest loss position was in the bond portfolio and totaled \$33,000. The third largest loss position was in the equity portfolio and totaled \$31,000.

For the year ended December 31, 2011, the Company realized \$398,000 in other-than-temporary impairments. The single largest accumulated loss was in the equity portfolio and totaled \$501,000. The second largest loss position was in the bond portfolio and totaled \$70,000. The third largest loss position was in the bond portfolio and totaled \$58,000.

An analysis of the net change in unrealized appreciation on available-for-sale securities follows:

	(Dollars in thousands)	
	Quarter Ended	Year Ended
	March 31, 2012	December 31, 2011
	(unaudited)	
Net change in unrealized appreciation on available-for-sale securities before deferred tax	\$419	\$1,792
Deferred income tax	(142)	(534)
Net change in unrealized appreciation on available-for-sale securities	\$277	\$1,258

#### NOTE 6 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company incurred \$6,000 in interest and penalties as of March 31, 2012 and \$1,000 as of December 31, 2011. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2007. Tax returns have been filed through the year 2010. Extensions have been filed for 2011 tax returns.

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax assets. The Company recognized net deferred tax liability positions of \$269,000 at March 31, 2012 and \$86,000 at December 31, 2011.

The tax effect of significant differences representing deferred tax assets and liabilities are as follows (dollars in thousands):

	March 31, 2012	December 31, 2011
	(unaudited)	
General insurance expenses	\$1,719	\$1,576
Unearned premiums	1,684	1,714



Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Claims liabilities	258	271	
NOL carry forward	1,248	1,363	
Other-than-temporary impairments on securities owned	257	258	
Unrealized loss on interest rate swaps	363	407	
Deferred tax assets	5,529	5,589	
Depreciation	(134	) (144	)
Deferred policy acquisition costs	(3,241	) (3,250	)
Unrealized gains on securities available-for-sale	(2,423	) (2,281	)
Deferred tax liabilities	(5,798	) (5,675	)
Net deferred tax liability	\$(269	) \$(86	)

The appropriate income tax effects of changes in temporary differences are as follows (dollars in thousands):

	For the three-months ended March 31,		
	2012	2011	
Deferred policy acquisition costs	\$(9	) \$158	
Other-than-temporary impairments	1	(34	)
Trading securities	—	10	
Unearned premiums	30	4	
General insurance expenses	(143	) (8	)
Depreciation	(10	) (9	)
Claim liabilities	13	(3	)
NOL carry forward	115	—	
Deferred income tax (benefit) expense	\$(3	) \$118	

Total income tax expense varies from amounts computed by applying current federal income tax rates to income before income taxes. The reason for these differences and the approximate tax effects are as follows (dollars in thousands):

	For the three-months ended March 31,		
	2012	2011	
Federal income tax rate applied to pre-tax income	\$189	\$497	
Dividends received deduction and tax-exempt interest	(47	) (50	)
Company owned life insurance	(40	) (22	)
Small life deduction	(55	) (110	)
Other, net	(22	) 153	
Federal income tax expense	\$25	\$468	

NOTE 7 –NOTES PAYABLE AND LONG-TERM DEBT

Short-term notes payable consisted of the following as of March 31, 2012 and December 31, 2011:

(Dollars in thousands)	
2012	2011
\$700	\$485

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 5.0% floor. Interest payments due quarterly. Unsecured.

Long-term debt consisted of the following as of March 31, 2012 and December 31, 2011:

	(Dollars in thousands)	
	2012	2011
Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-month LIBOR plus 3.75% applied to the outstanding principal; maturity December 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured.	\$9,279	\$9,279
Subordinated debentures issued on June 21, 2007 with a floating interest rate equal to the 3 Month LIBOR plus 3.40% applied to the outstanding principal; maturity June 15, 2037. Interest payments due quarterly. All may be redeemed at any time following the fifth anniversary of issuance. Unsecured.	3,093	3,093
	\$12,372	\$12,372

The subordinated debentures (debentures) have the same maturities and other applicable terms and features as the associated trust preferred securities (TPS). Payment of interest may be deferred for up to 20 consecutive quarters; however, stockholder dividends cannot be paid during any extended interest payment period or any time the debentures are in default. All have stated maturities of thirty years. None of the securities require the Company to maintain minimum financial covenants. The Company has guaranteed that amounts paid to the Trusts will be remitted to the holders of the associated TPS. This guarantee, when taken together with the obligations of the Company under the debentures, the Indentures pursuant to which the debentures were issued, and the related trust agreement (including obligations to pay related trust fees, expenses, debt and other obligations with respect to the TPS), provides a full and unconditional guarantee of amounts due the Trusts. The amount guaranteed is not expected to at any time exceed the obligations of the TPS, and no additional liability has been recorded related to the guarantee.

On September 13, 2007, the Company entered into a 5 year swap effective September 17, 2007, with a notional amount of \$3,000,000 and designated the swap as a hedge against changes in cash flows attributable to changes in the benchmark interest rate (LIBOR) associated with the subordinated debentures issued on June 21, 2007. Commencing December 17, 2007, under the terms of the swap, the Company will receive interest at the three-month LIBOR rate plus 3.4% and pay interest at the fixed rate of 8.34%.

On March 19, 2009, the Company entered into a forward swap effective September 17, 2012, which will also hedge against changes in cash flows following the termination of the 5 year swap agreement discussed previously. Commencing September 17, 2012, under the terms of the forward swap, the Company will receive interest at the three-month LIBOR rate plus 3.4% and pay interest at the fixed rate of 7.02%. This forward swap will effectively fix the interest rate on \$3,000,000 in debt until September of 2019.

On May 26, 2010, the Company entered into a forward swap with a notional amount of \$9,000,000 effective December 15, 2015, which will hedge against changes in cash flows following the termination of the fixed rate period. Quarterly, commencing March 16, 2016 under the terms of the forward swap, the Company will pay interest at a fixed rate of 8.49% until March 15, 2020.

The swaps entered into in 2007, 2009 and 2010 have fair values of \$34,000 (liability), \$367,000 (liability) and \$667,000 (liability), respectively, for a total liability of \$1,068,000 at March 31, 2012 (\$1,196,000 at December 31, 2011). The swap liability is reported as a component of other liabilities on the condensed consolidated balance

sheets. A net valuation gain of \$85,000 is included in accumulated other comprehensive income related to the swap agreements for the current period. A net valuation loss of \$640,000 was included in accumulated other comprehensive income related to the swap at December 31, 2011.

We use dollar offset at the hedge's inception and for each reporting period thereafter to assess whether the derivative used in a hedging transaction is expected to be, and has been, effective in offsetting changes in the fair value of the hedged item. Since inception, no portion of the hedged item has been deemed ineffective. For all hedges, we discontinue hedge accounting if it is determined that a derivative is not expected to be, or has ceased to be, effective as a hedge.

The Company's interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. The Company has securities on deposit with fair market values of \$1,194,000 (all of which is posted as collateral). At December 31, 2011, the Company has cash collateral on deposit of \$310,000 in addition to securities on deposit with fair market values of \$877,000, all of which is posted as collateral. See Note 9 for additional information about the interest rate swaps.

In January 2012, the Company renewed an unsecured line of credit for \$700,000, with an interest rate of 5%, to be made available for general corporate purposes. As of March 31, 2012, \$700,000 was drawn on this line (\$485,000 at December 31, 2011).

#### NOTE 8 – CONTINGENCIES

##### Litigation

The Company and its subsidiaries continue to be named individually as parties to litigation related to the conduct of their insurance operations. These suits involve alleged breaches of contracts, torts, including bad faith and fraud claims based on alleged wrongful or fraudulent acts of agents of the Company's subsidiaries, and miscellaneous other causes of action. Most of these lawsuits include claims for punitive damages in addition to other specified relief.

The Company's property & casualty subsidiaries are defending a number of matters filed in the aftermath of Hurricanes Katrina and Rita in Mississippi, Louisiana and Alabama. These actions include individual lawsuits and purported statewide class action lawsuits, although to date no class has been certified in any action. These actions make a number of allegations of underpayment of hurricane-related claims, including allegations that the flood exclusion found in the Company's subsidiaries' policies, and in certain actions other insurance companies' policies, is either ambiguous, unenforceable as unconscionable or contrary to public policy, or inapplicable to the damage sustained.

The various suits seek a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief. All of these matters are in various stages of development and the Company's subsidiaries intend to vigorously defend them. The outcome of these disputes is currently uncertain.

The Company has been sued in a putative class action in the State of Alabama. The Plaintiff alleges entitlement to, but did not receive, payment for general contractor overhead and profit ("GCOP") in the proceeds received from the Company concerning the repair of the Plaintiff's home. Plaintiff alleges that said failure to include GCOP is a material breach by the Company of the terms of its contract of insurance with Plaintiff and seeks monetary damages in the form of contractual damages. A class certification hearing was held on March 1, 2010 with the trial court taking the Plaintiff's motion for class certification under advisement. On May 10, 2010, the trial court issued its ruling granting Plaintiff's motion to certify the class. The Company filed its Appellant Brief on October 5, 2010. The Company denies Plaintiff's allegations and intends to vigorously defend this lawsuit. On November 18, 2011, the Supreme Court of Alabama ruled the trial court exceeded its discretion in granting Plaintiff's motion for class certification. Accordingly, the Alabama Supreme Court vacated the trial court's order granting class certification and remanded this case for

proceedings consistent with the opinion. On May 2, 2012, this matter was settled and a Joint Stipulation for Dismissal with Prejudice was submitted to the trial court effectively ending this litigation.

In April 2007, the Company sold substantially all of its 50% interest in Mobile Attic, Inc., to Bagley Family Revocable Trust (the "Purchaser"). The Company, Peter L. Cash and Russell L. Cash (collectively the "Sellers") sold to Purchaser 61% of the outstanding stock of Mobile Attic under the terms of a Stock Purchase Agreement dated April 5, 2007, executed by Sellers, Mobile Attic and Purchaser's assignor, James W. Bagley (the "Stock Purchase Agreement").

Under the terms of the Stock Purchase Agreement, the Purchaser paid the Company \$2,700,000 for 45% of the total outstanding stock of Mobile Attic and paid the other Sellers \$960,000 for an additional 16% of the total outstanding stock in Mobile Attic, thus obtaining a controlling interest of 61% of the outstanding stock. The Stock Purchase Agreement provided that Purchaser was to use his best efforts to cause the Company to be released from its guaranty of a bank loan to Mobile Attic having an outstanding principal balance of approximately \$9,400,000. The bank loan was secured by portable storage containers of Mobile Attic. The Sellers made certain warranties to the Purchaser in the Stock Purchase Agreement regarding the financial condition of Mobile Attic and agreed to jointly and severally indemnify the Purchaser for any damages resulting from a breach of any of the warranties.

On January 9, 2009, Mobile Attic Inc., MA Manufacturing Company, Inc., and Purchaser initiated an action against Peter Cash, Cash Brothers Leasing, Inc., Bridgeville Trailers, Inc., and Barfield, Murphy, Shank & Smith, P.C. in the United States District Court for the Middle District of Alabama. In the complaint, Plaintiffs asserted, among other claims, a claim for damages resulting from a breach of certain of the warranties regarding the financial statements of Mobile Attic and other financial information provided by Mobile Attic. Purchaser then notified the Company of its claim for breach of warranty under the Stock Purchase Agreement and requested indemnity from the Company.

The Purchaser has alleged that Mobile Attic's assets were misstated on its audited financial statements, which were physically attached as schedules to the Stock Purchase Agreement. The Sellers further warranted and represented that those financial statements were a correct statement of Mobile Attic's financial condition. The Stock Purchase Agreement also contained an indemnification clause under which the Company agreed to be jointly and severally liable with the other Sellers (whom the Company believes have limited resources) for all losses suffered by Purchaser as a result of any breach of the warranties and representations regarding Mobile Attic's financial condition. Purchaser claims that such losses should be the value paid for the stock of Mobile Attic, Inc., the losses suffered on the assumption of Mobile Attic's bank loan, the operating losses funded by Purchaser after the stock purchase, and attorneys' fees incurred by Purchaser to enforce its claim for indemnity.

On July 9, 2009, the Company filed a complaint in intervention requesting the Court to find that the Company is not liable for indemnity under the Stock Purchase Agreement, or in the alternative, to award damages to the Company for any loss suffered as a result of the fraudulent actions of Peter Cash and as a result of the negligence of Mobile Attic and its auditors in the preparation of Mobile Attic's financial statements. [Mobile Attic, Inc., MA Manufacturing Company, Inc., and Bagley Family Revocable Trust, plaintiffs, v. Peter L. Cash, Cash Brothers Leasing, Inc., Bridgeville Trailers, Inc., and Barfield, Murphy, Shank & Smith, P.C, defendants, v. The National Security Group, Inc., intervenor plaintiff, v. Peter L. Cash, Barfield, Murphy, Shank & Smith, P.C. and Bagley Family Revocable Trust, intervenor defendants, U.S. District Court, Middle District of Alabama, Eastern Division, Civil Action No. 09-cv-00024.]

On August 13, 2009, the Court granted the Company's motion to intervene. At the request of the Court, each party filed an amended complaint on or before August 23, 2010. The Purchaser has asserted counterclaims against the Company seeking indemnification of Purchaser's losses and damages as a result of the breach of representations and warranties regarding Mobile Attic's financial condition, as set forth in the Stock Purchase Agreement.

The Company has denied the allegations supporting Purchaser's claims. The financial records of Mobile Attic have been in the possession of Purchaser since Purchaser acquired the stock of Mobile Attic in early 2007 and are only available to the Company through discovery in the litigation. The Company actively conducted discovery in defense of Purchaser's claims and has requested Purchaser to provide the financial information supporting the allegations made in its complaint. Fact-based and expert discovery has concluded, but pre-trial investigation continues with the case set for trial in June 2012. The Company believes that the Purchaser's claim for damages is unreasonable and excessive even if the Purchaser is able to prove that certain assets were overstated in Mobile Attic's financial statements. The Company believes that if any damages are applicable due to any alleged breach of warranty in the Stock Purchase Agreement, those damages are limited to a diminished value of the stock price paid by the Purchaser. The Company has filed motions for summary judgment requesting a court ruling, among others, as to how damages should be measured as a matter of law. On April 24, 2012, the Court heard oral arguments on the motions for summary judgment and took the matter under advisement. Given the difficulty in obtaining access to the Mobile Attic financial records, continuing pre-trial investigation, and the outstanding legal issues, the Company is unable to predict the amount of the ultimate liability that the Company may have if the Purchaser is successful in this litigation. Management has recorded an estimate of aggregate litigation related defense costs associated with these actions as of March 31, 2012 and December 31, 2011, and the amounts are included in other liabilities in the accompanying condensed consolidated financial statements.

The Company establishes and maintains reserves on contingent liabilities. In many instances, however, it is not feasible to predict the ultimate outcome with any degree of accuracy.

#### NOTE 9 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Our securities available-for-sale consists of fixed maturity and equity securities which are recorded at fair value in the accompanying condensed consolidated balance sheets. The change in the fair value of these investments, unless deemed to be other than temporarily impaired, is recorded as a component of other comprehensive income.

We are permitted to elect to measure financial instruments and certain other items at fair value, with the change in fair value recorded in earnings. We elected not to measure any eligible items using the fair value option. Accounting standards define fair value as the price that would be received to sell an asset or would be paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework to make the measurement of fair value more consistent and comparable. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets.

The Company categorizes assets and liabilities carried at their fair value based upon a fair value hierarchy:

Level 1 – Quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 1 assets and liabilities consist of money market fund deposits and certain of our marketable debt and equity instruments, including equity instruments offsetting deferred compensation, that are traded in an active market with sufficient volume and frequency of transactions.

Level 2 - Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which all significant inputs are observable or can be derived principally from or corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 2 assets include certain of our marketable debt and equity instruments with quoted market prices that are traded in less active markets or priced using a quoted market price for similar instruments. Level 2 assets also include marketable equity instruments with security-specific restrictions that would transfer to the buyer, marketable debt

instruments priced using indicator prices which represent non-binding market consensus prices that can be corroborated by observable market quotes, as well as derivative contracts and debt instruments priced using inputs that are observable in the market or can be derived principally from or corroborated by observable market data. Marketable debt instruments in this category generally include commercial paper, bank time deposits, repurchase agreements for fixed-income instruments, and a majority of floating-rate notes, corporate bonds, and municipal bonds.

Level 3 - Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

Level 3 assets and liabilities include marketable debt instruments, non-marketable equity investments, derivative contracts, and company issued debt whose values are determined using inputs that are both unobservable and significant to the values of the instruments being measured. Level 3 assets also include marketable debt instruments that are priced using indicator prices that we were unable to corroborate with observable market quotes.

Marketable debt instruments in this category generally include asset-backed securities and certain of our floating-rate notes, corporate bonds, and municipal bonds.

#### Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2012 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	\$27,910	\$—	\$27,910	\$—
Trust preferred securities	528	—	528	—
Mortgage backed securities	6,738	—	6,738	—
Private label mortgage backed securities	9,171	—	9,171	—
Obligations of states and political subdivisions	17,777	—	17,777	—
U.S. Treasury securities and obligations of				
U.S. Government corporations and agencies	11,870	11,870	—	—
Trading securities	20	20	—	—
Equity securities available-for-sale	8,971	8,329	—	642
Total Financial Assets	\$82,985	\$20,219	\$62,124	\$642
Financial Liabilities				
Interest rate swap	\$1,068	\$—	\$—	\$1,068
Total Financial Liabilities	\$1,068	\$—	\$—	\$1,068

The methods and assumptions the Company uses to estimate the fair value of assets and liabilities measured at fair value on a recurring basis are summarized below.

Fixed maturities available-for-sale—The fair values of the Company's public fixed maturity securities are generally based on prices obtained from independent pricing services. Consistent with the fair value hierarchy described above, securities with validated quotes from pricing services are generally reflected within Level 2, as they are primarily based on observable pricing for similar assets and/or other market observable inputs.

Trading securities—Trading securities consist primarily of mutual funds whose fair values are determined consistent with similar instruments described above under "Fixed Maturity Securities" and below under "Equity Securities" and "Derivative Instruments."

Equity securities—Equity securities consist principally of investments in common and preferred stock of publicly traded companies and privately traded securities. The fair values of our publicly traded equity securities are based on quoted market prices in active markets for identical assets and are classified within Level 1 in the fair value hierarchy.

Estimated fair values for our privately traded equity securities require a substantial level of judgment. Privately traded equity securities are classified within Level 3.

Interest rate swaps—Interest rate swaps are recorded at fair value either as assets, within other assets or as liabilities, within other liabilities. The fair values of our interest rate swaps are provided by a third party broker and are classified within Level 3.

As of March 31, 2012, Level 3 fair value measurements of assets include \$642,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

As of March 31, 2012, Level 3 fair value measurements of liabilities include \$1,068,000 net fair value of various interest rate swaps whose value is based on analysis provided by a third party broker. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swaps is provided in Note 7.

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the quarter ended March 31, 2012:

For the quarter ended March 31, 2012	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$642	\$(1,196 )
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	—	128
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$642	\$(1,068 )
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 and liabilities still held as of March 31, 2012:	\$—	\$—

For the quarter ended March 31, 2012, there were no assets or liabilities measured at fair values on a nonrecurring basis.

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2011 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	\$20,980	\$—	\$20,980	\$—
Trust preferred securities	479	—	479	—
Mortgage backed securities	7,871	—	7,871	—
Private label mortgage backed securities	9,853	—	9,853	—

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Obligations of states and political subdivisions	19,482	—	19,482	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	14,409	14,409	—	—
Trading securities	80	80	—	—
Equity securities available-for-sale	8,547	7,905	—	642
Total Financial Assets	\$81,701	\$22,394	\$58,665	\$642
Financial Liabilities				
Interest rate swap	\$1,196	\$—	\$—	\$1,196
Total Financial Liabilities	\$1,196	\$—	\$—	\$1,196

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2011:

For the year ended December 31, 2011	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$787	\$(227 )
Total gains or losses (realized and unrealized):		
Included in earnings	(145 )	—
Included in other comprehensive income	—	(969 )
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$642	\$(1,196 )
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 and liabilities still held as of December 31, 2011:	\$—	\$—

For the year ended December 31, 2011, there were no assets or liabilities measured at fair values on a nonrecurring basis.

The Company is exposed to certain risks in the normal course of its business operations. The primary risk that is managed through the use of derivatives is interest rate risk on floating rate borrowings. This risk is managed through the use of interest rate swaps which are designated as cash flow hedges. For cash flow hedges, the effective portion of the gain or loss on the interest rate swap is included as a component of other comprehensive income and reclassified into earnings in the same period during which the hedged transaction is recognized in earnings. The Company does not hold or issue derivatives that are not designated as hedging instruments. See Note 7 for additional information about the interest rate swaps.

The following methods and assumptions were used to estimate fair value of each class of financial instrument for which it is practical to estimate that value:

Cash and cash equivalents—the carrying amount is a reasonable estimate of fair value.

Mortgage receivables—the carrying amount is a reasonable estimate of fair value due to the restrictive nature and limited marketability of the mortgage notes.

Other invested assets—the carrying amount is a reasonable estimate of fair value.



Other policyholder funds—the carrying amount is a reasonable estimate of fair value.

Debt—the carrying amount is a reasonable estimate of fair value.

The carrying amount and estimate fair value of the Company's financial instruments as of March 31, 2012 and December 31, 2011 are as follows:

	In Thousands of Dollars			
	March 31, 2012		December 31, 2011	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Assets and related instruments</b>				
Mortgage loans	\$388	\$388	\$390	\$390
Policy loans	1,223	1,223	1,244	1,244
Company owned life insurance	5,777	5,777	5,660	5,660
Other invested assets	3,886	3,886	3,929	3,929
<b>Liabilities and related instruments</b>				
Other policyholder funds	1,424	1,424	1,408	1,408
Short-term debt	700	700	485	485
Long-term debt	12,372	12,372	12,372	12,372

#### NOTE 10 – SEGMENTS

The Company's property and casualty insurance operations comprise one business segment. The property and casualty insurance segment consists of seven lines of business: dwelling fire and extended coverage, homeowners (including mobile homeowners), ocean marine, other liability, private passenger auto liability, commercial auto liability and auto physical damage. Management organizes the business utilizing a niche strategy focusing on lower valued dwellings as well as non-standard automobile products. Our chief decision makers (President, Chief Financial Officer and Chief Executive Officer) review results and operating plans making decisions on resource allocations on a company-wide basis. The Company's products are primarily produced through agents within the states in which we operate. The Company's life and accident and health operations comprise the second business segment. The life and accident and health insurance segment consists of two lines of business: traditional life insurance and accident and health insurance. Premium revenues and operating income by industry segment for the quarters ended March 31, 2012 and 2011 (unaudited) are summarized below (dollars in thousands):

Quarter ended March 31, 2012	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
<b>REVENUE</b>				
Net premiums earned	\$13,496	\$11,744	\$1,752	\$—
Net investment income	1,135	611	508	16
Net realized investment gains	206	132	72	2
Other income	197	196	1	—
	15,034	12,683	2,333	18
<b>BENEFITS AND EXPENSES</b>				
Policyholder benefits paid	7,845	6,413	1,432	—
Policy acquisition costs	2,772	2,544	228	—
General and administrative expenses	3,077	1,829	448	800
Taxes, licenses and fees	492	430	62	—
Interest expense	292	—	19	273
	14,478	11,216	2,189	1,073
Income Before Income Taxes	\$556	\$1,467	\$144	\$(1,055)
Quarter ended March 31, 2011	Total			

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

		P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
<b>REVENUE</b>				
Net premiums earned	\$14,870	\$13,001	\$1,869	\$—
Net investment income	1,142	627	497	18
Net realized investment gains	770	386	354	30
Other income	255	255	—	—
	17,037	14,269	2,720	48
<b>BENEFITS AND EXPENSES</b>				
Policyholder benefits paid	9,322	7,811	1,511	—
Policy acquisition costs	2,924	2,740	184	—
General and administrative expenses	2,563	1,451	580	532
Taxes, licenses and fees	480	360	120	—
Interest expense	285	—	15	270
	15,574	12,362	2,410	802
Income (Loss) Before Income Taxes	\$1,463	\$1,907	\$310	\$(754 )

The following table presents the Company's gross and net premiums written for the property and casualty segment and the life and accident and health segment for the three month period ended March 31, 2012 and 2011, respectively:

	Quarter Ended March 31,	
	2012	2011
Premiums written:		
Life, accident and health operations:		
Traditional life insurance	\$1,210	\$1,305
Accident and health insurance	464	484
Total life, accident and health	1,674	1,789
Property and Casualty operations:		
Dwelling fire & extended coverage	6,927	6,697
Homeowners (Including mobile homeowners)	5,487	6,007
Ocean marine	84	119
Other liability	357	334
Private passenger auto liability	69	854
Commercial auto liability	6	119
Auto physical damage	36	336
Total property and casualty	12,966	14,466
Gross premiums written	14,640	16,255
Reinsurance premium ceded	(1,683	) (1,529 )
Net premiums written	\$12,957	\$14,726

The following table presents the Company's gross and net premiums earned for the property and casualty segment and the life and accident and health segment for the three month periods ended March 31, 2012 and 2011, respectively:

Quarter Ended  
March 31,

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

	2012	2011
Premiums earned:		
Life, accident and health operations:		
Traditional life insurance	\$ 1,288	\$ 1,386
Accident and health insurance	464	483
Total life, accident and health	1,752	1,869
Property and Casualty operations:		
Dwelling fire & extended coverage	6,547	6,499
Homeowners (Including mobile homeowners)	5,904	6,244
Ocean marine	268	319
Other liability	340	310
Private passenger auto liability	235	756
Commercial auto liability	6	119
Auto physical damage	107	297
Total property and casualty	13,407	14,544
Gross premiums earned	15,159	16,413
Reinsurance premium ceded	(1,663	) (1,543
Net premiums earned	\$ 13,496	\$ 14,870

NOTE 11 – PREFERRED AND COMMON STOCK

The table below provides information regarding the Company's preferred and common stock as of March 31, 2012 and December 31, 2011:

	March 31, 2012			December 31, 2011		
	Authorized	Issued	Outstanding	Authorized	Issued	Outstanding
Preferred Stock, \$1 par value	500,000	—	—	500,000	—	—
Class A Common Stock, \$1 par value	2,000,000	—	—	2,000,000	—	—
Common Stock, \$1 par value	3,000,000	2,466,600	2,466,600	3,000,000	2,466,600	2,466,600

Table of Contents

REVIEW REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders  
The National Security Group, Inc.

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. as of March 31, 2012, and condensed consolidated statements of income, comprehensive income and cash flows for the three-month periods ended March 31, 2012 and 2011, and the related condensed consolidated statement of shareholders' equity for the three-month period ended March 31, 2012. These condensed consolidated financial statements are the responsibility of the company's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the consolidated financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying condensed consolidated financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of The National Security Group, Inc. as of December 31, 2011, and the related consolidated statements of income (loss), shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 26, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2011, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Warren Averett, LLC

Birmingham, Alabama  
May 14, 2012

Table of Contents

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion addresses the financial condition of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) as of March 31, 2012, compared with December 31, 2011 and its results of operations and cash flows for the quarter ending March 31, 2012, compared with the same period last year. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part I, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2011.

This discussion will primarily consist of an analysis of the two segments of our operations. The life segment consists of the operations of our life insurance subsidiary, National Security Insurance Company (NSIC). The property and casualty (P&C) segment consists of the operations of our two property and casualty insurance subsidiaries, National Security Fire & Casualty Company (NSFC) and Omega One Insurance Company (Omega).

This discussion contains forward-looking statements that are not historical facts, including statements about our beliefs and expectations. These statements are based upon current plans, estimates and projections. Our actual results may differ materially from those projected in these forward-looking statements as a result of various factors. See "Cautionary Statement Regarding Forward-Looking Statements" contained on Page 3 of this report.

The reader is assumed to have access to the Company's 2011 Annual Report. This discussion should be read in conjunction with the Annual Report and with condensed consolidated financial information on pages 4 through 25 of this form 10-Q.

Information in this discussion is presented in whole dollars rounded to the nearest thousand.

The National Security Group operates in the property and casualty and life, accident and supplemental health insurance businesses and markets products primarily through independent agents. The Company operates in eleven states with just under 48.3% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment, accounting for 87.0% of total insurance premium revenue during the first three months of 2012. Revenue generated from the life segment accounted for 13.0% of total insurance premium revenue.

National Security Insurance Company (NSIC) is a life, accident and health insurance company founded in 1947 and is the oldest subsidiary of the Company. The premium revenue produced in NSIC from the traditional life products and accident and health products accounted for 9.6% and 3.5%, respectively, of total premium revenue. All references to NSIC in the remainder of this management discussion and analysis will refer to the combined life, accident and health insurance operations and will compose the life segment of the Company. NSIC is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina and Texas.

Omega One Insurance Company (Omega) is a property and casualty insurance company incorporated in 1992. Omega is a wholly owned subsidiary of National Security Fire and Casualty Company (NSFC) and is the smallest of the insurance subsidiaries, accounting for approximately 4.1% of consolidated premium revenue. Omega is licensed and underwrites property and casualty insurance in the states of Alabama and Louisiana. There is no material product differentiation between those products underwritten by NSFC and Omega as both primarily underwrite personal lines of insurance.

National Security Fire and Casualty Company (NSFC) is a property and casualty insurance company and is the largest of the insurance subsidiaries, accounting for over 82.9% of total premium revenue of the Company. NSFC operates primarily in the personal lines segment of the property and casualty insurance market. NSFC has been in operation since 1959. NSFC is licensed and underwrites property and casualty insurance in the states of Alabama, Arkansas, Florida, Georgia, Mississippi, Oklahoma, South Carolina and Tennessee. NSFC is licensed, but does not currently underwrite any business, in the states of Kentucky and West Virginia. NSFC also underwrites insurance on a non-admitted or surplus lines basis in the states of Louisiana, Missouri and Texas.

All of the insurance subsidiaries are Alabama domiciled insurance companies; therefore, the Alabama Department of Insurance is the primary insurance regulator. However, each subsidiary is subject to regulation by the respective insurance regulators of each state in which it is licensed to transact business. Insurance rates charged by each of the insurance subsidiaries are typically reviewed and approved by each insurance department for the respective state to which the rates will apply.

## Table of Contents

All of our insurance companies have been assigned ratings by A.M. Best. The property and casualty group has been assigned a group rating of “B++” (Good) with a negative outlook. In addition, A.M. Best has assigned an issuer credit rating of “bbb” with a negative outlook. NSFC, the largest of the insurance subsidiaries, carries the same A.M. Best ratings as the group. Omega carries an A.M. Best rating of “B+” (Good) with a stable outlook and an issuer credit rating of “bbb-” with a stable outlook. The life insurance subsidiary, NSIC, has been assigned a rating of “B” (Fair) with a stable outlook and an issuer credit ratio of “bb+” with a stable outlook. All ratings are reviewed at least annually by A.M. Best with the latest ratings effective date of December 19, 2011.

The two primary segments in which we report insurance operations are the personal lines property and casualty segment (NSFC) and the life, accident and health insurance segment (NSIC). Please note that due to the small amount of premium revenue produced by Omega and the fact that Omega is a wholly owned subsidiary of NSFC underwriting similar lines of business, all references to NSFC in the remainder of this management discussion and analysis will include the insurance operations of both NSFC and Omega. Our income is principally derived from net underwriting profits and investment income. Net underwriting profit is principally derived from earned premiums received less claims paid, sales commissions to agents, costs of underwriting and insurance taxes and fees. Investment income includes interest and dividend income and gains and losses on investment holdings.

## CONSOLIDATED RESULTS OF OPERATIONS

### Summary:

The Company ended the first quarter of 2012 with net income of \$531,000 compared to net income of \$995,000 for the same period last year; a decrease of 46.6%. For the three-months ended March 31, 2012, the Company had net income per share of \$0.00 compared to net income per share of \$0.00 for the three-months ended March 31, 2011. The primary reasons for the \$464,000 decrease in net income in the current year compared to the prior year were a 73.3% decrease in net realized investment gains in addition to a 20.1% increase in general expenses. For the three-months ended March 31, 2012, net realized investment gains were \$206,000 compared to \$770,000 for the same period last year. The decrease in realized investment gains was primarily associated with a decline in trading activity in the investment portfolios. General expenses were up \$514,000 ending the first quarter of 2012 at \$3,077,000 compared to \$2,563,000 for the first quarter of 2011. The increase in general expenses was primarily due to litigation expenses incurred at the holding company level, which further reduced net income in 2012 compared to 2011.

The P&C segment is primarily comprised of personal lines insurance products consisting of dwelling fire, homeowners and personal automobile lines of business. While the Company does maintain a small portion of commercial business (ocean marine and commercial automobile), these lines of business contributed only 2.3% and 3.4%, respectively of total earned premium for the P&C segment in 2012 and 2011 and, therefore, are not separately distinguished from the personal lines in this discussion.

Policyholder benefits paid (claims) were \$7,845,000 (58.2% of net premiums earned) for the three-months ended March 31, 2012 compared to \$9,322,000 (62.7% of net premiums earned) for the same period last year. Policyholder benefits paid were down \$1,477,000 or 15.9% for the first quarter of 2012 compared to the same period last year. The primary reason for the 4.5 percentage point decline in the loss ratio was a reduction in incurred losses and loss adjustment expenses (LAE) from our automobile programs which were discontinued in the fourth quarter of 2011. Incurred losses and LAE from the automobile programs decreased \$714,000; accounting for 48.3% of the total decline in claims in 2012 compared to 2011.

Shareholders' equity as of March 31, 2012 was \$38,661,000, up \$646,000 compared to \$38,015,000 as of December 31, 2011. Book value per share increased \$0.26 per share for the period ended March 31, 2012 to \$15.67 per share compared to \$15.41 per share at December 31, 2011. Factors contributing to the change in equity were a

year to date net income of \$531,000, increase in market values of fixed maturities and equity securities of \$277,000, a net gain on interest rate swaps of \$85,000 and dividends paid of \$247,000.

#### Premium Revenue:

The table below provides earned premium revenue by segment for the quarter ended March 31, 2012 and 2011:

	Quarter Ended		Percent increase (decrease)	
	2012	2011		
Life, accident and health operations:				
Traditional life insurance	\$1,288,000	\$1,386,000	(7.1	)%
Accident and health insurance	464,000	483,000	(3.9	)%
Total life, accident and health	1,752,000	1,869,000	(6.3	)%
Property and Casualty operations:				
Dwelling fire & extended coverage	6,547,000	6,499,000	0.7	%
Homeowners (Including mobile homeowners)	5,904,000	6,244,000	(5.4	)%
Ocean marine	268,000	319,000	(16.0	)%
Other liability	340,000	310,000	9.7	%
Private passenger auto liability	235,000	756,000	(68.9	)%
Commercial auto liability	6,000	119,000	(95.0	)%
Auto physical damage	107,000	297,000	(64.0	)%
Reinsurance premium ceded	(1,663,000	) (1,543,000	) 7.8	%
Total property and casualty	11,744,000	13,001,000	(9.7	)%
Total earned premium revenue	\$13,496,000	\$14,870,000	(9.3	)%

Consolidated premium revenue was \$13,496,000 for the quarter-ended March 31, 2012 compared to \$14,870,000 for the same period last year; a decrease of \$1,374,000 or 9.2%. In late 2011, we made the decision to exit all automobile lines of business due to a lack of underwriting profitability in these programs. Due to this decision, the automobile programs are now in runoff which has resulted in an \$824,000 decline in earned premium for all automobile lines, accounting for 60% of the total decline in premium revenue. Our homeowners line of business was the next most significant contributor to the decline in premium revenue. In an effort to improve profitability in the homeowners line of business, we have tightened underwriting guidelines in several states, which contributed to a 5.4% decline in homeowners earned premium for the first quarter of 2012 compared to the same period last year. The decline in homeowners premium revenue of \$339,000 accounted for 24.7% of the total decline in consolidated premium



revenue.

Investment income:

Investment income decreased \$7,000 to \$1,135,000 for the quarter-ended March 31, 2012 from \$1,142,000 for the same period last year. A decrease in average invested assets in the first quarter of 2012 compared to the first quarter of 2011 was the primary factor contributing to the moderate decline in investment income.

Realized investment gains and losses:

For the quarter-ended March 31, 2012, realized investment gains totaled \$206,000 compared to \$770,000 for the same period last year; a decrease of \$564,000. Realized investment gains and losses in the life and P&C segments are primarily related to the sale of bonds and common stock investments. The decline in realized capital gains is primarily associated with a decline in trading activity in the investment portfolios.

Other income:

Other income was \$197,000 for the period ended March 31, 2012 compared to \$255,000 for the period ended March 31, 2011; a decrease of 22.8%. Other income is primarily composed of billing, payment and policy fees associated with residential property and automobile policies issued in the P&C segment. Due to the discontinuance of the automobile program, billing, payment and policy fees decreased \$58,000; this decrease was the primary reason for the overall reduction in other income for the current year.

Table of Contents

Policyholder benefits paid:

Policyholder benefits (claims) as a percent of net premiums earned were 58.2% for the three-months ended March 31, 2012 compared to 62.7% for the three-months ended March 31, 2011. Policyholder benefits for the quarter-ended March 31, 2012 were \$7,845,000 compared to \$9,322,000 for the same period last year; a decrease of 15.8%. The \$1,477,000 decrease in claims was primarily associated with declines in year to date losses and LAE incurred in the P&C segment. Year to date incurred losses and LAE in the P&C segment decreased \$1,417,000 in 2012 compared to 2011 and accounted for 96.0% of the total reduction in claims of the Company.

The primary reason for the decrease in P&C segment year to date incurred losses and LAE was the discontinuance of the automobile programs. For the quarter-ended March 31, 2012, incurred losses and incurred LAE in the automobile programs totaled \$428,000 compared to \$1,142,000 for the same period last year; a decrease of \$714,000 or 62.5%. The reduction in claims from the automobile programs accounted for 48.3% of the total decrease in claims in 2012 compared to 2011. While the discontinuance of the programs will continue to contribute to premium revenue declines, it is expected to positively impact the overall underwriting results going forward.

Another factor contributing to the decrease in incurred losses and incurred LAE for the quarter-ended March 31, 2012 compared to the quarter-ended March 31, 2011 was a decrease in fire losses in the P&C segment. Year to date fire losses were down \$295,000 in 2012 compared to the same period last year. While the severity per claim remained comparable for both years, the frequency decreased by 25 claims in the first quarter of 2012 compared to the first quarter of 2011.

Although claims were down \$1,477,000 in 2012 compared to 2011, the P&C segment was impacted by two storm systems classified as "catastrophes" by Property Claims Service (PCS) [referred to as cat events throughout the remainder of this discussion] during the first quarter of 2012. PCS generally deems a cat event to be a single storm system or other natural disaster which causes in excess of \$25 million in industry losses. Wind and hail claims incurred from cat events contributed \$480,000 to year to date incurred losses and LAE and added 4.1 percentage points to the current year loss ratio. In comparison, the P&C segment was impacted by five cat events during the first quarter of 2011, but the events were relatively minor for us, totaling only \$207,000 in incurred losses and incurred LAE and adding 1.6 percentage points to the prior year loss ratio.

Policy acquisition cost:

For the three-months ended March 31, 2012, policy acquisition costs were \$2,772,000 compared to \$2,924,000 for the same period last year. Policy acquisition costs were 20.6% of premium revenue for the first quarter of 2012 compared to 19.7% for the same period last year. The slight increase was primarily associated with an increase in accrual estimates for agent contingent commission payments.

General Expenses:

General expenses were up \$514,000 for the quarter-ended March 31, 2012 at \$3,077,000 compared to \$2,563,000 for the same period last year. One primary reason for the increase was related to litigation expenses in our holding company. Litigation expenses were \$589,000 through March 31, 2012 compared to \$307,000 for the same period last year; an increase of \$282,000 [See Note 8 to the condensed consolidated financial statements for further discussion regarding litigation]. The remainder of the increase in general expenses was related to various non-recurring expenses in the P&C segment.

Taxes, licenses and fees:

Edgar Filing: NATIONAL SECURITY GROUP INC - Form 10-Q

Taxes, licenses and fees for the three-months ended March 31, 2012 and 2011 were \$492,000 and \$480,000, respectively. Taxes, licenses and fees as a percentage of earned premiums were 3.7% for the quarter-ended March 31, 2012 and 3.3% for the same period last year.

Interest expense:

Interest expense was comparable at \$292,000 through March 2012 compared to \$285,000 for the same period last year.

Income taxes:

For the period ended March 31, 2012 and 2011, income tax expense was \$25,000 and \$468,000, respectively. The primary components which reduced income tax expense in 2012 were the small life deduction, tax-exempt interest, dividends received deduction and company owned life insurance which reduced expenses \$55,000, \$39,000, \$8,000 and \$40,000, respectively. Income

Table of Contents

tax expense was composed of current taxes totaling \$28,000 and \$350,000 for the first three months of 2012 and 2011, respectively, while deferred tax (benefit)/expense totaled \$(3,000) and \$118,000, for the same periods, respectively.

Net income:

The Company ended the first three months of 2012 with year to date net income of \$531,000 compared to net income of \$995,000 for the same period last year. As mentioned previously, the primary reasons for the \$464,000 decrease in net income in 2012 compared to 2011 were a 73.3% decrease in net realized investment gains and a 20.1% increase in general expenses. Realized investment gains were down due to a reduction in sells in the current year compared to the same period last year. In addition, general expenses were up \$514,000 or 20.1% primarily due to litigation expenses incurred at the holding company level, which further reduced net income in 2012 compared to 2011.

Liquidity and capital resources:

At March 31, 2012, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$38,661,000 up \$646,000 compared to \$38,015,000 at December 31, 2011. Components of the change in equity were a net income of \$531,000, net unrealized gains on investments of \$277,000 and a net unrealized gain of \$85,000 related to interest rate swaps and cash dividends paid totaling \$247,000.

The Company has \$12,372,000 in debt outstanding consisting of long-term debt from the proceeds of two separate trust preferred securities issuances, the latest of which totaled \$3,000,000 and was completed in June 2007. The Company has an operating line of credit to allow flexibility with respect to cash management at the holding company level. The outstanding balance on the line, at March 31, 2012, was \$700,000.

The Company had \$2,243,000 in cash and cash equivalents at March 31, 2012, compared to \$3,266,000 at March 31, 2011. Cash used in operations in the first quarter of 2012 totaled \$801,000 compared to cash provided in the same period last year totaling \$681,000. A reduction in net income coupled with an increase in claim liabilities during the first quarter of 2012 was the primary reason for the negative operating cash flow in the first quarter of 2012.

Net cash used in investing activities totaled \$333,000 in the first quarter of 2012 compared to cash provided of \$1,866,000 in first quarter of last year. A slight increase in new investments in the first quarter of 2012 was the primary reason for the net use of cash in the first quarter of 2012. The increased net cash provided in the first quarter of 2011 was primarily associated with timing differences in the reinvestment of portfolio maturities and resulted in a higher cash balance as of March 31, 2011 compared to March 31, 2012. Virtually all cash maintained at March 31, 2012 was held by the insurance subsidiaries.

The Company's liquidity requirements are primarily met by funds provided from operations of the insurance subsidiaries. The Company receives funds from its subsidiaries through payments for federal income taxes and reimbursement of expenses incurred at the corporate level for the subsidiaries. These funds are used to pay stockholder dividends, interest on debt, corporate administrative expenses, federal income taxes, and for funding investments in subsidiaries. The Company maintains minimal liquidity in order to maximize liquidity within the insurance subsidiaries in order to support ongoing insurance operations. The Company has no separate source of revenue other than dividends and fees from the insurance subsidiaries. Also, dividends from the insurance subsidiaries are subject to regulatory restrictions and, therefore, are limited depending on capital levels and earnings of the subsidiaries.

Our P&C segment, which composes the largest segment of our insurance operations, incurred substantial operating losses in 2011. These operating losses contributed to a decline of over 16% in capital levels in the segment. These reduced capital levels, while adequate to operate our existing business, have substantially reduced our ability to pay

dividends upstream to the holding company in the near term. Dividends paid from the insurance subsidiaries are subject to regulatory restrictions and prior approval of the Alabama Department of Insurance. As disclosed in Note 12 to the Consolidated Financial Statements filed in the 2011 Form 10-K, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company during 2012 is limited to \$1,039,000 in the life insurance subsidiary and \$2,546,000 in the property/casualty insurance subsidiary.

Regulators consider dividends paid within the preceding twelve months when calculating evaluating the available dividend. As of March 31, 2012, the total amount available to dividend up to the holding company was \$2,185,000 (\$739,000 in the life insurance subsidiary and \$1,446,000 in the property/casualty insurance subsidiary). The payment of any subsidiary dividend requires prior notice to the regulatory authorities who may disallow the dividend if, in their judgment, payment of the dividend would have an adverse effect on the surplus of the subsidiary.

As disclosed in Note 8 to these Condensed Consolidated Financial Statements regarding contingencies, the Company is involved

## Table of Contents

in litigation related to the sale of Mobile Attic, Inc. Defense related costs are expected to exceed \$2,000,000 before trial, set for June of 2012. This litigation related defense cost has further reduced cash reserves in the holding company. The uncertainty related to the pending litigation could also temporarily impair our ability to raise new debt or equity capital until this matter is resolved. The Company is vigorously defending the allegations raised in this litigation and is unable to determine a potential liability at this time which limits our ability to predict the ultimate impact on our liquidity and capital resources.

The Company filed a claim for coverage under a liability policy having aggregate limits of \$5,000,000, but the insurer has denied coverage and no provision for any recovery has been made in the accompanying condensed consolidated financial statements. In the event of an adverse judgment related to the litigation against the Company, we could face limitations in our ability to fund shareholder dividends and service interest payments on outstanding debt.

The Company's subsidiaries require cash in order to fund policy acquisition costs, claims, other policy benefits, interest expense, general expenses, and dividends to the Company. Premium and investment income, as well as maturities, calls, and sales of invested assets, provide the primary sources of cash for both subsidiaries. A significant portion of the Company's investment portfolio, which is held by the insurance subsidiaries, consists of readily marketable securities, which can be sold for cash.

Except as discussed above and in Note 8 to these Condensed Consolidated Financial Statements, the Company is unaware of any known trends, events, or uncertainties reasonably likely to have a material effect on its liquidity, capital resources, or operations. Additionally, the Company has not been made aware of any recommendations of regulatory authorities, which if implemented, would have such an effect.

The Company maintains an operating line of credit, with a \$700,000 limit, to allow flexibility with respect to cash management at the holding company level. The outstanding balance at March 31, 2012 was \$700,000.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Under smaller reporting company rules, we are not required to disclose information required under Item 3. However, in order to provide information to our investors, we have elected to provide information related to market risk.

The Company's primary objectives in managing its investment portfolio are to maximize investment income and total investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including changes in interest rates, overall market conditions, underwriting results, regulatory requirements, and tax position. Investment decisions are made by management and reviewed by the Board of Directors. Market risk represents the potential for loss due to adverse changes in fair value of securities. The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk, and default risk. The primary risk related to the Company's equity portfolio is equity price risk. The Company has not incurred material losses in its investment portfolio in the quarter ended March 31, 2012 related to interest rate changes, defaults on certain securities and changes in value of equity investments. Changes are discussed in detail under Item 2 of this Form 10-Q. For further information regarding market risk, reference is made to the Company's Form 10-K for the year ended December 31, 2011.

### Item 4. Controls and Procedures

Our management carried out an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as of March 31, 2012. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit

under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There has not been any change in our internal control over financial reporting in connection with the evaluation required by Rule 13A-15(d) under the Exchange Act that occurred during the three-month period ended March 31, 2012, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## Part II. OTHER INFORMATION

### Item 1. Legal Proceedings

Please refer to Note 8 to the condensed consolidated financial statements included herein, and the 2011 Annual Report filed on Form 10-K.

Table of Contents

Item 1A. Risk Factors

There has been no material change in risk factors previously disclosed under Item 1A. of the Company's annual report for 2011 on Form 10-K.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

None

Item 5. Other Information

None



Table of Contents

Item 6. Exhibits

a. Exhibits

31.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

b. Reports on Form 8-K during the quarter ended March 31, 2012

Date of Report	Date Filed	Description
January 20, 2012	January 23, 2012	Press release, dated January 23, 2012, issued by The National Security Group, Inc.
March 26, 2012	March 26, 2012	Press release, dated March 26, 2012 issued by The National Security Group, Inc.

Table of Contents

SIGNATURE

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

The National Security Group, Inc.

/s/ William L. Brunson, Jr.  
William L. Brunson, Jr.  
President and Chief Executive Officer

/s/ Brian R. McLeod  
Brian R. McLeod  
Vice President and Chief Financial Officer

Dated: May 14, 2012