

NATIONAL SECURITY GROUP INC  
Form 10-K  
March 26, 2010

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

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FORM 10-K

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x ANNUAL REPORT PURSUANT TO SECTION 13 or 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Fiscal Year Ended December 31, 2009

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

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

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Delaware

63-1020300

(State or Other Jurisdiction of  
Incorporation or Organization)

(IRS Employer  
Identification No.)

661 East Davis Street  
Elba, Alabama

36323

(Address of principal executive offices)

(Zip-Code)

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

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Securities registered pursuant to Section 12 (b) of the Act:

None

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock, par value \$1.00 per share

The NASDAQ

Global Market (EXCHANGE)

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer      Accelerated filer      Non-accelerated filer      Smaller Reporting Company

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of the last business day of the registrant's most recently completed second fiscal quarter, based upon the bid price of these shares on NASDAQ on such date, was \$15,850,514

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock, as of the close of the period covered by this report.

| Class                          | Outstanding March 26, 2010 |
|--------------------------------|----------------------------|
| Common Stock, \$1.00 par value | 2,466,600 shares           |

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DOCUMENTS INCORPORATED BY REFERENCE

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1. Definitive proxy statement for the 2010 Annual Meeting of Stockholders to be held May 14, 2010 is incorporated by reference into Part III of this report. The proxy statement will be filed no later than 120 days from December 31, 2009.
2. Current Report on Form 8-K for event occurring on February 26, 2010 is incorporated into Part IV of this report.

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## PART I

### Item 1. Business

#### Summary Description of The National Security Group, Inc.

The National Security Group, Inc. (the Company, NSG, we, us, our), an insurance holding company, was incorporated in Delaware on March 20, 1990. Our common stock is traded on the NASDAQ Global Market under the symbol NSEC.

Pursuant to regulations of the United States Securities and Exchange Commission (SEC), we are considered a “Smaller Reporting Company” as defined by SEC rules that became effective in the first quarter of 2008. We have elected to utilize an “a la carte” scaled disclosure which permits smaller reporting companies to elect to comply with scaled financial and non-financial disclosure requirements on an item by item basis. The most significant reporting difference permitted under the scaled disclosures which we have utilized is to include two years of audited financial statements.

The Company, through its three wholly owned subsidiaries, operates in two industry segments; property and casualty insurance and life insurance.

The property and casualty subsidiaries of the Company, National Security Fire and Casualty (NSFC), and Omega One Insurance Company (Omega), primarily write personal lines coverage including dwelling fire and windstorm, homeowners, mobile homeowners, and personal non-standard automobile lines of insurance in eleven states. Property and casualty insurance is the most significant industry segment accounting for 89% of total premium revenues.

The Company’s life insurance subsidiary, National Security Insurance Company, offers a basic line of life and health and accident insurance products in six states.

The majority of our assets and investments are held in the operating insurance companies.

The Company’s website address is: [www.nationalsecuritygroup.com](http://www.nationalsecuritygroup.com). The “Investors” section of our website (<http://www.nationalsecuritygroup.com/public/Investors/Investors.aspx>) provides numerous resources for investors seeking additional information about us. Our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K are made available on our website soon after filing with the SEC. Additionally, stock trades by insiders as filed on Forms 3, 4, and 5 are posted to the website after filing with the SEC. The website also provides information regarding corporate governance, stock quotes and press releases. Investors are encouraged to visit our website for additional information about the Company.

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.

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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.

## Industry Segment and Geographical Area Information

## Property and Casualty Insurance Segment

The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992. This segment will be referred to throughout this report as NSFC, property-casualty segment or P&C segment. NSFC is licensed to write insurance in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia, and operates on a surplus lines basis in the states of Louisiana, Missouri, and Texas. Omega is licensed to write insurance in Alabama and Louisiana. The following table indicates allocation percentages of direct written premium by state for the two years ended December 31, 2009 and 2008:

| State       | Percent of Direct<br>Written Premium |          |
|-------------|--------------------------------------|----------|
|             | 2009                                 | 2008     |
| Alabama     | 32.53 %                              | 36.39 %  |
| Arkansas    | 7.61 %                               | 9.62 %   |
| Georgia     | 6.34 %                               | 5.28 %   |
| Louisiana   | 14.24 %                              | 11.42 %  |
| Mississippi | 16.43 %                              | 19.22 %  |
| South       |                                      |          |
| Carolina    | 9.59 %                               | 8.16 %   |
| Florida     | 0.18 %                               | 0.21 %   |
| Missouri    | 0.93 %                               | 1.23 %   |
| Oklahoma    | 3.98 %                               | 3.11 %   |
| Tennessee   | 5.94 %                               | 3.71 %   |
| Texas       | 2.23 %                               | 1.65 %   |
|             | 100.00 %                             | 100.00 % |

In general, the property-casualty insurance business involves the transfer by the insured, to an insurance company of all or a portion of certain risks for the payment, by the insured, of a premium to the insurance company. A portion of such risks is often retained by the insured in the form of deductibles, which vary from policy to policy, but are typically in the range of \$500 to \$1,000 on NSFC and Omega's primary dwelling and automobile lines of business.

The premiums or payments to be made by the insured for direct products of the property and casualty subsidiaries are based upon expected costs of providing benefits, writing and administering the policies. In determining the premium to be charged, the property and casualty subsidiaries utilize data from past claims experience and anticipated claims estimates along with commissions and general expenses.

The operating results of the property-casualty insurance industry are subject to significant fluctuations from quarter-to-quarter and from year-to-year. These fluctuations are often due to the effect of competition on pricing, unpredictable losses incurred in connection with weather-related and other catastrophic events, general economic



conditions and other factors, such as changes in tax laws and the regulatory environment.

The following table sets forth the premiums earned and pre-tax income during the periods reported for the property and casualty insurance segment:

|               | Year Ended December |             |
|---------------|---------------------|-------------|
|               | 31                  |             |
|               | (Amounts In         |             |
|               | Thousands)          |             |
|               | 2009                | 2008        |
| Net           |                     |             |
| premiums      |                     |             |
| earned:       |                     |             |
| Fire, Allied  |                     |             |
| lines and     |                     |             |
| Homeowners    | \$ 49,310           | \$ 46,741   |
| Automobile    | 2,206               | 1,633       |
| Other         | 879                 | 934         |
|               | \$ 52,395           | \$ 49,308   |
| Income        |                     |             |
| (Loss) before |                     |             |
| taxes         | \$ 6,617            | \$ (5,649 ) |

#### Property and Casualty Loss Reserves

Our property and casualty insurance subsidiaries are required to maintain reserves to cover their ultimate liability for losses and adjustment expenses. Our staff periodically conducts reviews throughout the year of projected loss development information in order to adjust estimates. The liability for loss and adjustment expense reserves consists of an estimated liability for the ultimate settlement of claims that have been reported as well as an estimate of loss and adjustment expenses for incurred claims that have not yet been reported (IBNR). IBNR estimates are based primarily on historical development patterns using quantitative data generated from statistical information and qualitative analysis of legal developments, economic conditions and development caused by events deemed to be infrequent in occurrence. The reserves are based on an estimate made by management. Management estimates are based on an analysis of historical paid and incurred loss development patterns for the previous ten loss years. Prior year period-to-period loss development factors are applied to latest reported loss reserve estimates in order to estimate the ultimate incurred losses for each given loss year. The amount of loss reserves estimated in excess of current reported case losses are recorded as IBNR reserves.

In addition to loss and loss adjustment expense reserves for specific claims, both reported and unreported, we establish reserves for loss adjustment expenses that are not attributable to specific claims. These reserves consist of estimates for Defense and Cost Containment (DCC) and Adjusting and Other Expenses (AO). These reserves are established for the estimated expenses of internal claims staff and the cost of outside experts, such as attorneys representing our interest, in the final settlement of incurred claims that are still in process of settlement. We conduct annual and interim reviews over the course of each year in order to insure that no significant changes have occurred in our loss development that might adversely impact our loss reserving methodology.

The following Loss Reserve Re-estimates table illustrates the change over time of the net reserves established for property-liability insurance claims and claims expense at the end of the last 10 calendar years. The first section shows the reserves as originally reported at the end of the stated year. The second section, reading down, shows retroactive re-estimates of the original recorded reserve as of the end of each successive year. These re-estimates are the result of the Company's expanded awareness of additional facts and circumstances that pertain to the unsettled claims. The third section, reading down, shows the cumulative amounts paid as of the end of successive years with respect to that year's reserve liability. The last section compares the latest re-estimated reserve to the reserve originally established, and indicates whether the original reserve was adequate to cover the estimated costs of unsettled claims. The Loss Reserve Re-estimates table is cumulative and, therefore, ending balances should not be added since the amount at the end of each calendar year includes activity for both the current and prior years.

While the information in the table provides a historical perspective on the adequacy of unpaid losses and loss adjustment expenses established in previous years, it should not be assumed to be predictive of redundancies or deficiencies on current year unpaid losses in future periods. Company management believes that the reserves established at the end of 2009 are adequate. However, due to inherent uncertainties in the loss reserve estimation process, management cannot guarantee that current year reserve balances will prove to be adequate. Due to the short tail nature of the property and casualty subsidiaries' claim liabilities, the Company does not discount loss reserves for the time value of money. Dollar amounts are in thousands.

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|                             | 1999        | 2000     | 2001     | 2002     | 2003     | 2004     | 2005     | 2006     | 2007     | 2008     | 2009   |
|-----------------------------|-------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|--------|
| Gross unpaid losses per     |             |          |          |          |          |          |          |          |          |          |        |
| Consolidated                |             |          |          |          |          |          |          |          |          |          |        |
| Balance Sheet               | \$ 18,463\$ | 15,409\$ | 11,489\$ | 11,513\$ | 11,343\$ | 13,094\$ | 19,511\$ | 12,498\$ | 11,973\$ | 14,436\$ | 12,646 |
| Ceded reserves              | (3,899)     | (3,092)  | (2,396)  | (1,555)  | (1,232)  | (2,611)  | (8,560)  | (1,783)  | (555)    | (2,421)  | (549)  |
| Net unpaid losses           | \$ 14,564\$ | 12,317\$ | 9,093\$  | 9,958\$  | 10,111\$ | 10,483\$ | 10,951\$ | 10,715\$ | 11,418\$ | 12,015\$ | 12,097 |
| Cumulative net payments:    |             |          |          |          |          |          |          |          |          |          |        |
| 1 year later                | \$ 4,423\$  | 3,907\$  | 3,362\$  | 4,342\$  | 5,567\$  | 5,584\$  | 7,384\$  | 6,438    | 4,797    | 5636     |        |
| 2 years later               | 5,758       | 5,643    | 4,416    | 5,520    | 6,765    | 7,006    | 9,063    | 8,103    | 6,496    |          |        |
| 3 years later               | 7,266       | 6,359    | 5,076    | 5,865    | 7,038    | 7,521    | 10,198   | 9,652    |          |          |        |
| 4 years later               | 7,744       | 6,737    | 5,221    | 5,945    | 7,274    | 7,811    | 11,439   |          |          |          |        |
| 5 years later               | 8,039       | 6,837    | 5,106    | 6,136    | 7,351    | 8,018    |          |          |          |          |        |
| 6 years later               | 8,139       | 6,731    | 5,164    | 6,167    | 7,390    |          |          |          |          |          |        |
| 7 years later               | 8,028       | 6,773    | 5,180    | 6,183    |          |          |          |          |          |          |        |
| 8 years later               | 8,067       | 6,789    | 5,193    |          |          |          |          |          |          |          |        |
| 9 years later               | 8,088       | 6,822    |          |          |          |          |          |          |          |          |        |
| 10 years later              | 8,121       |          |          |          |          |          |          |          |          |          |        |
| Net Liability re-estimated: |             |          |          |          |          |          |          |          |          |          |        |
| 1 year later                | 11,067      | 8,847    | 6,805    | 7,334    | 9,186    | 9,042    | 11,844   | 11,817   | 9,046    | 9438     |        |
| 2 years later               | 9,261       | 7,863    | 6,017    | 7,165    | 8,607    | 9,118    | 11,827   | 11,061   | 8,739    |          |        |
|                             | 8,931       | 7,460    | 5,856    | 6,906    | 8,098    | 8,669    | 12,161   | 11,121   |          |          |        |

|  |            |         |         |         |         |         |           |         |       |       |
|--|------------|---------|---------|---------|---------|---------|-----------|---------|-------|-------|
| 3<br>years<br>later                          |            |         |         |         |         |         |           |         |       |       |
| 4<br>years<br>later                          | 8,556      | 7,236   | 5,699   | 6,509   | 7,863   | 8,404   | 12,337    |         |       |       |
| 5<br>years<br>later                          | 8,422      | 7,240   | 5,436   | 6,499   | 7,629   | 8,274   |           |         |       |       |
| 6<br>years<br>later                          | 8,519      | 6,995   | 5,413   | 6,313   | 7,570   |         |           |         |       |       |
| 7<br>years<br>later                          | 8,264      | 6,961   | 5,297   | 6,314   |         |         |           |         |       |       |
| 8<br>years<br>later                          | 8,245      | 6,897   | 5,308   |         |         |         |           |         |       |       |
| 9<br>years<br>later                          | 8,193      | 6,928   |         |         |         |         |           |         |       |       |
| 10<br>years<br>later                         | 8,227      |         |         |         |         |         |           |         |       |       |
| Net cumulative<br>redundancy<br>(deficiency) | \$ 6,337\$ | 5,389\$ | 3,785\$ | 3,644\$ | 2,541\$ | 2,209\$ | (1,386)\$ | (406)\$ | 2,679 | 2,577 |

Our reported results, financial position and liquidity would be affected by likely changes in key assumptions that determine our loss reserves. The table below illustrates the change to equity that would occur as a result of a change in loss reserves and reserves for loss adjustment expense:

|  | For the Years Ended December 31,        |                             |   |                             |  |
|--|---|-----------------------------|---|-----------------------------|--|
|  | 2009                                    |                             |   | 2008                        |  |
| Change<br>in Loss<br>and LAE<br>Reserves | Adjusted<br>Loss and<br>LAE<br>Reserves | %<br>Change<br>in<br>Equity | Adjusted<br>Loss and<br>LAE<br>Reserves | %<br>Change<br>in<br>Equity |  |
|  | *Loss and LAE reserves are in thousands |                             |   |                             |  |
| 10.0%                                    | \$ 11,381                               | 3.07%                       | \$ 12,992                               | 2.75%                       |  |
| 7.5%                                     | 11,698                                  | 2.30%                       | 13,353                                  | 2.06%                       |  |
| 5.0%                                     | 12,014                                  | 1.54%                       | 13,714                                  | 1.38%                       |  |
| 2.5%                                     | 12,330                                  | 0.77%                       | 14,075                                  | 0.68%                       |  |
| Reported                                 | 12,646                                  | -                           | 14,436                                  | -                           |  |
| 2.5%                                     | 12,962                                  | 0.77%                       | 14,796                                  | 0.69%                       |  |
| 5.0%                                     | 13,278                                  | 1.54%                       | 15,157                                  | 1.37%                       |  |
| 7.5%                                     | 13,594                                  | 2.30%                       | 15,519                                  | 2.06%                       |  |
| 10.0%                                    | 13,911                                  | 3.07%                       | 15,879                                  | 2.75%                       |  |

While our reserve estimates have had more significant variability in the past, we believe that the scenarios presented above are most reasonably likely as our methodology has become more seasoned and we have maintained continuity of staff involved in the reserving process.

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## Life Insurance Segment

National Security Insurance Company (NSIC), a wholly owned subsidiary organized in 1947, conducts the Company's life insurance business. This segment will be referred to throughout this report as NSIC, Life Company, or Life segment. NSIC is licensed to write insurance in six states: Alabama, Florida, Georgia, Mississippi, South Carolina, and Texas. The following table indicates NSIC's percentage of direct premiums collected by state for the two years ended December 31, 2009 and 2008:

| State          | Percentage of Total Direct Premiums |          |
|----------------|-------------------------------------|----------|
|                | 2009                                | 2008     |
| Alabama        | 57.02 %                             | 57.25 %  |
| Georgia        | 21.54 %                             | 21.79 %  |
| Mississippi    | 10.20 %                             | 10.13 %  |
| South Carolina | 7.09 %                              | 6.21 %   |
| Florida        | 2.56 %                              | 1.90 %   |
| Texas          | 1.59 %                              | 2.72 %   |
|                | 100.00 %                            | 100.00 % |

NSIC has two primary methods of distribution of insurance products, home service (career) agents and independent agents. The home service distribution method of life insurance products accounts for 33.4% of total premium revenues in the life insurance segment. Home service life products consist of products marketed directly at the home or other premises of the insured by an employee agent. The home service distribution method has been the Company's primary method of distribution since the founding of NSIC in 1947. However, over the past nine years, the Company has placed its primary emphasis for future growth on alternative methods of distribution. The Company employed 12 career agents and one regional manager at December 31, 2009. The independent agent distribution method accounts for 62% of total premium revenue in the life insurance segment. Since NSIC began marketing life, accident and health products through independent agents in 1999 this distribution channel has become the Company's fastest growing and primary method of distribution. Approximately 1,580 agents of the Company's independent agents produced new business during 2009. The remaining 4.6% of premium revenue consists of the following: a book of premium acquired from a state guaranty association in 2000 (1%), premium generated through direct sales of school accident insurance (1%), and other miscellaneous business serviced directly through the home office (3.9%).

NSIC's primary products are life insurance, both term and whole life, and health and accident insurance. NSIC does not sell annuities, interest sensitive whole life or universal life insurance products. Term life insurance policies provide death benefits if the insured's death occurs during the specific premium paying term of the policy. The policies generally do not provide a savings or investment element included as part of the policy premium. Whole-life insurance policies demand a higher premium than term life, but provide death benefits which are payable under effective policies regardless of the time of the insured's death and have a savings and investment element which may result in the accumulation of a cash surrender value. Our accident and health insurance policies provide coverage for losses sustained through sickness or accident and include individual hospitalization and accident policies, group supplementary health policies, and specialty products, such as cancer policies. Our line of health and accident products feature specified fixed benefits, so rapidly rising health care costs do not have as great an impact on our health and accident line as they do on comparable products offered by other companies.

The following table displays a schedule of 2009 life segment premium produced by product and distribution method (dollars in thousands):

| Line of Business               | Home Service Agent | Independent Agent | Other  |
|--------------------------------|--------------------|-------------------|--------|
| Industrial                     | \$ 100             | \$ -              | \$ 76  |
| Ordinary                       | 1,975              | 3,040             | 29     |
| Group Life                     | -                  | 14                | 73     |
| A&H Group                      | -                  | -                 | 90     |
| A&H Other                      | 332                | 1,405             | 65     |
| Total                          |                    |                   |        |
| Premium by Distribution Method | \$ 2,407           | \$ 4,459          | \$ 333 |



The following table sets forth certain information with respect to the development of the Life Company's business:

|   | Year Ended December<br>31 |            |
|---|---------------------------|------------|
|   | (Amounts In<br>Thousands) |            |
|   | 2009                      | 2008       |
| Life insurance<br>in force at end<br>of period: |                           |            |
| Ordinary-whole<br>life                          | \$ 168,400                | \$ 167,000 |
| Term life                                       | 25,000                    | 25,000     |
| Industrial life                                 | 21,600                    | 22,200     |
| Other   | -                         | -          |
|   | \$ 215,000                | \$ 214,200 |
| Life insurance<br>issued:                       |                           |            |
| Ordinary-whole<br>life                          | \$ 39,000                 | \$ 40,000  |
| Term life                                       | -                         | 4,300      |
| Industrial life                                 | -                         | -          |
| Other   | -                         | -          |
|   | \$ 39,000                 | \$ 44,300  |
| Net premiums<br>earned:                         |                           |            |
| Life insurance                                  | \$ 5,282                  | \$ 5,389   |
| Accident and<br>health<br>insurance             | 1,917                     | 1,567      |
|   | \$ 7,199                  | \$ 6,956   |

#### Life Insurance Segment Reserves

We engage Wakely Actuarial Services of Clearwater, Florida as consulting actuary to calculate our reserves for traditional life insurance products. The methodology used requires that the present value of future benefits to be paid under life insurance policies less the present value of future net premiums be calculated. The calculation uses assumptions including estimates of any adverse deviation, investment yields and changes in investment yields, mortality, maintenance expenses and any non-forfeiture options or termination benefits. The assumptions determine the level and sufficiency of reserves and reserves are calculated and reviewed by our consulting actuary at the end of each quarter. The independent consulting actuary also reviews our estimates for other insurance products including claims reserves under accident and health contracts. Management believes that the reserve amounts reflected in the accompanying consolidated financial statements are adequate.

## Investments

A significant percentage of the total income for the Company is tied to the performance of its investments. Assets that will eventually be used to pay reserve liabilities and other policyholder obligations along with Company capital are invested to generate investment income while held by the Company. Our investment income is comprised primarily of interest and dividend income on debt and equity securities and realized capital gains and losses generated by debt and equity securities. At December 31, 2009, investments comprise 78.2% of total assets and investment income (including realized gains) comprises 9% of total revenues evidencing the significant impact investments can have on financial results. Because the Company's insurance subsidiaries are regulated as to the types of investments they may make and the amount of funds they may maintain in any one type of investment, the Company has developed a conservative value oriented investment philosophy, in order to meet regulatory requirements. The Company's investment goals are to conserve capital resources and assets, obtain the necessary investment income threshold to meet reserves, and provide a reasonable return. Current yield from invested assets and capital appreciation of investments create this return.

## Marketing and Distribution

As mentioned earlier in this report, NSIC products are marketed through a field force of agents and career agents who are employees of the Life Company and through a network of independent agents. The Company's use of independent agents is expected to be more cost effective in the long term and has become the fastest growing method of distribution. In an effort to boost productivity and better educate agents on the products and services of NSIC, the Life Company marketing team travels extensively throughout our service areas holding training sessions for agents. We also offer our best agents the opportunity to attend annual retreats to network with the home office staff that help serve them and our policyholders. In addition, the retreat provides agents with additional knowledge of the products we offer, and serves as a forum for feedback on how we can better serve our agency force and policyholders.

NSFC and Omega products are marketed through a network of independent agents and brokers, who are independent contractors and generally maintain relationships with one or more competing insurance companies. NSFC employs three field marketing representatives who visit in the offices of our independent agent force regularly to give the agents opportunities for feedback. Our NSFC marketing representatives also host training seminars throughout our service area. The goal of these seminars is to educate the independent agent sales force about our products and services.

Agents receive compensation for their sales efforts. In the case of life insurance agents, compensation is paid in the form of sales commissions plus a servicing commission. Commissions paid by NSIC in 2009 averaged approximately 8% of premiums. Commissions paid by NSFC in 2009 averaged approximately 14% of premiums. During 2009, no one independent agent accounted for more than 10% of total net earned premium of the property-casualty insurance subsidiaries. NSFC also offers a "profit sharing bonus plan" to independent agents in order to promote better field underwriting and encourage retention of profitable business. This plan not only rewards our agents but also enhances profitability by giving the agent a vested interest in our success and also aids in maintaining price stability for all our customers as agents have a financial incentive to use good field underwriting practices when completing an application for insurance.

At December 31, 2009, NSIC employed 10 career agents and one regional manager. NSIC also had approximately 400 independent agents actively producing new business.

At December 31, 2009, NSFC had contracts with approximately 1,300 independent agencies in eleven states.

## Competition

In both of our insurance segments, we operate in a very competitive environment. There are numerous insurance companies competing in the various states in which we offer our products. Many of the companies with which we compete are much larger, have significantly larger volumes of business, offer much broader ranges of products and have more significant financial resources than we do. We compete directly with many of these companies, not only in the sale of products to consumers, but also in the recruitment and retention of qualified agents. We believe the main areas in which a smaller company, like us, can compete is in the areas of providing niche products in underserved areas of the insurance market at competitive prices while providing excellent service to our agents and policyholders during the entire insurance product lifecycle from policy issuance to final payment of a claim. We pride ourselves on being accessible to our independent agent force and maintain a presence through the efforts of a field marketing staff and easy access to any and all home office staff. We believe we have made significant advancements in developing a competitive advantage, especially over the last decade. We also have longstanding relationships with many of our agents. We believe we compete effectively within the markets we serve and continue to evolve our processes and

procedures in order to garner further competitive advantages.

NSFC and Omega's primary insurance products are dwelling fire, homeowners, including mobile homeowners, and private passenger auto coverage. Dwelling fire and homeowners, collectively referred to as the dwelling property line of business, is the largest segment of property and casualty operations composing 94% of total property and casualty premium revenue. We focus on providing niche insurance products within the markets we serve. We are in the top twenty dwelling property insurance carriers in our two largest states, Alabama and Mississippi. However, due to the large concentration of business among the top five carriers our total combined market share in these two states is less than 2%.

We have actively sought competitive advantages over the last seven years in the area of technological advancement. We have replaced our primary policy administration systems in both our property and casualty and life insurance subsidiaries. We replaced our legacy policy administration system in our life subsidiary in 2002. In late 2006 and throughout 2007 we began the process in transitioning to a new policy administration system in our property and casualty subsidiary. In 2008, we began development of the current property and casualty claims administration system.

The property and casualty administration system is an internally developed end-to-end system that we believe enhances our ability to compete with larger carriers in the market we serve. The system features a web based portal that allows our independent agents to rate, quote and issue policies directly in their office. The system streamlines the underwriting process with automation of many previous manual processes and enhances our agents' ability to provide excellent service to their clients. The system also enhances the efficiency of our underwriting process allowing for a more thorough evaluation of risks.

Our new property and casualty claims administration system was launched in early 2010 and consolidated eleven different legacy claims systems providing a consistent user interface for our claims examiners. The new claims system automates processes and workflows throughout the claims process and provides a single view of the activity that has occurred on a claim. The system also has an adjuster web portal, which allows adjusters to view policy limits, see reserve history and policy information, and view prior claims and loss history. Communications between adjusters and examiners is centralized on the web portal allowing for any messages to be viewed securely as part of the claims history. Computerized field checks for staff adjusters was also implemented enforcing reserve and policy limits while reducing the error rates of the previously used hand written checks issued in the field.

During 2010, we hope to automate ISO A+ Reports and MVR Reports as well as begin a salvage and subrogation recovery and tracking project. Mortgage companies will have a web portal in the first half of 2010 providing the important information they need while reducing call volume into our customer service center. Our Company has a clear vision of how technology can be utilized in our business. We hope to gain competitive advantage through technological improvements while providing superior service to our policyholders and agents.

## Regulation

Our insurance subsidiaries are directly regulated by the insurance department in our state of domicile, Alabama. We are subject to the Alabama Insurance Holding Company System Regulatory Act and report to the Alabama Department of Insurance. Consequently, we are subject to periodic examination and regulation under Alabama Insurance Laws.

Our insurance subsidiaries are also subject to licensing and supervision by the various governmental agencies in the jurisdictions in which we do business. The nature and extent of such regulation varies, but generally has its source in state statutes which bestow regulatory, supervisory and administrative authority to State Insurance Commissioners and their respective insurance departments. The regulations may require the Company to meet and maintain standards of solvency, comply with licensing requirements, periodically examine market conditions and financial activities and report on the condition of operations and finances. In addition, most of our insurance rates are subject to regulation and approval by regulatory authorities within the respective states in which we offer our products.

Our insurance subsidiaries are subject to various statutory restrictions and limitations relating to the payment of dividends or distributions to stockholders. The restrictions are generally based on certain levels of surplus, net income or operating income as determined by statutory accounting practices. Alabama law permits dividends in any year

which, together with other dividends made within the preceding 12 months that do not exceed the greater of (1) 10% of statutory surplus as of the end of the preceding year or (2) for property and casualty insurers, statutory net income for the preceding year or for life companies, statutory net gain from operations for the preceding year. Dividends in excess of the restricted amounts are payable only after obtaining regulatory approval. Future dividends from the insurance subsidiaries may be limited by business or regulatory considerations. The Company relies on the ability of the insurance subsidiaries to pay dividends to fund quarterly stockholder dividends and for payment of most operating expenses of the group, including interest and principal payments on debt. We are not currently under any regulatory dividend limitations that may limit our liquidity in the Company. Further discussion of dividend payment capacity of subsidiaries can be found in Note 13 of the Consolidated Financial Statements included herein.

Our insurance subsidiaries are subject to risk based capital requirements adopted by the National Association of Insurance Commissioners (NAIC). These requirements direct our insurance companies to calculate and report information according to a risk based formula which attempts to measure statutory capital and surplus needs based on the risk in our product mix and investment portfolio. The formula is designed to allow state insurance regulators to identify companies that are potentially inadequately capitalized. Under the formula, the Company calculates Risk Based Capital (RBC) by taking into account certain risks inherent in an insurer's assets, including investments and an insurer's liabilities. Risk based capital rules provide for different levels of action depending on the ratio of a company's total adjusted capital to its "authorized control level" RBC. Based on calculations made by each of our insurance subsidiaries at December 31, 2009, each subsidiary significantly exceeds any levels that would require regulatory actions.

#### A.M. Best Rating

A.M. Best Company is a leading provider of insurance company financial strength ratings and insurance company issuer credit ratings. Best's financial strength ratings and issuer credit ratings provide an independent opinion based on comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The property and casualty companies currently carry an A.M. Best group financial strength rating of B++ (Good) with a negative outlook. This rating of B++ has remained the same for the past twelve years. The property and casualty group maintains an issuer credit rating of "bbb" with a stable outlook. National Security Insurance Company maintains a company specific financial strength rating of B (Fair) with a stable outlook and an issuer credit rating of "bb" with a stable outlook. For the latest ratings, access [www.ambest.com](http://www.ambest.com).

#### Employees

The Company itself has no management or operational employees. Instead, all human resource activities are within subsidiary National Security Insurance Company. NSIC employed 134 staff members as of December 31, 2009. The Company and its property and casualty subsidiary have a Management Service Agreement ("Agreement") with The National Security Insurance Company whereby the Company and the property and casualty subsidiaries reimburse NSIC for salaries and expenses of employees provided under the Agreement. Involved are employees in the areas of Underwriting, Customer Service, Policy Services, Accounting, Marketing, Administration, Document Management, Data Processing, Programming, Personnel, Claims, and Management. The Company, through NSIC, is represented by 10 employee agents in Alabama. The Company's property and casualty subsidiaries had approximately 1,300 independent agents producing business at December 31, 2009. We consider our employee relations to be good.

#### Additional information with respect to The National Security Group's business

We maintain a website ([www.nationalsecuritygroup.com](http://www.nationalsecuritygroup.com)). The National Security Group, Inc.'s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to such reports that we file or furnish pursuant to Section 13(a) of the Securities Exchange Act of 1934 are available through our Internet website, free of charge, as soon as reasonably practical upon having been electronically filed or furnished to the Securities and Exchange Commission.

Our code of ethical conduct is also available on our website and in print to any stockholder who requests copies by contacting The National Security Group, Attn: Investor Relations, P. O. Box 703, Elba, AL 36323.

Any of the materials we file with the SEC may also be read and copied at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the SEC's Public Reference Room may be

obtained by calling the SEC at 1.800.SEC.0330. Our periodic reports filed with the SEC, which include Forms 3, 4 and 5, Form 10-K, Form 10-Q, Form 8-K and any amendments thereto may also be accessed free of charge from the SEC's website at [www.sec.gov](http://www.sec.gov).



## Item 1A. Risk Factors

As a “Smaller Reporting Company” we are not required to provide any disclosure under Item 1A. In providing these risk factors, we do not represent, and no inference should be drawn, that the disclosures so provided comply with all requirements of Item 1A if we were subject to them. Risk factors are events and uncertainties over which the Company has limited or no control and which can have a material adverse impact on our financial condition or results of operations. We are subject to a variety of risk factors. The following information sets forth our evaluation of the risk factors we deem to be most material. We work to actively manage these risks, but the reader should be cautioned that we are only able to mitigate the impact of most risk factors, not eliminate the risk. Also, there may be other risks which we do not presently deem material that may become material in the future.

### Underwriting and product pricing

The insurance subsidiaries maintain underwriting departments that seek to evaluate the risks associated with the issuance of an insurance policy. NSIC accepts standard risks and, to an extent, substandard risks and engages medical doctors who review certain applications for insurance. In the case of the property and casualty subsidiaries, the underwriting staff attempts to assess, in light of the type of insurance sought by an applicant, the risks associated with a prospective insured or insurance situation. Depending upon the type of insurance involved, the process by which the risks are assessed will vary. In the case of automobile liability insurance, the underwriting staff assesses the risks involved in insuring a particular driver, and in the case of dwelling insurance, the underwriting staff assesses the risks involved in insuring a particular dwelling. Where possible, the underwriting staff of the property-casualty insurance subsidiary utilizes standard procedures as guides that quantify the hazards associated with a particular occupancy. In general, the property and casualty subsidiaries specialize in writing nonstandard risks.

The nonstandard market in which the property and casualty subsidiaries operate reacts to general economic conditions in much the same way as the standard market. When insurers’ profits and equity are strong, companies sometimes cut rates or do not seek increases. Also, underwriting rules are less restrictive. As profit and/or capital fall, companies may tighten underwriting rules, and seek rate increases. Premiums in the nonstandard market are higher than the standard market because of the increased risk of the insured, which generally comprises more frequent claims. Drivers of autos who have prior traffic convictions are one such increased risk that warrants higher premiums. Lower valued dwellings and mobile homes also warrant higher premiums because of the nature of the risk. The costs of placing such nonstandard policies and making risk determinations are similar to those of the standard market. The added costs due to more frequent claims servicing is reflected in the generally higher premiums that are charged.

Our ability to maintain profitability is contingent upon our ability to actively manage our rates and underwriting procedures. Premium rate inadequacy may not become apparent quickly and we will incur lag-time to correct. If our rates or underwriting processes become inadequate, our results of operations and financial condition could be adversely impacted.

### Approval of rates

Most lines of business written by our property and casualty insurers are subject to prior approval of premium rates in the majority of the states in which we operate. The process of obtaining regulatory approval can be expensive and time consuming and can impair our ability to make necessary rate adjustments due to changes in loss experience, cost of reinsurance or other factors. If our requests to regulatory bodies for rate increases are not approved in an adequate or timely manner, our results of operations and financial condition may be adversely impacted.

## Reinsurance

Both insurance subsidiaries customarily reinsure with other insurers certain portions of the insurance risk. The primary purpose of such reinsurance arrangements is to enable the Company to limit its risk on individual policies, and in the case of property insurance, limit its risk in the event of a catastrophe in various geographic areas. A reinsurance arrangement does not discharge the issuing company from primary liability to the insured, and the issuing company is required to discharge its liability to the insured even if the reinsurer is unable to meet its obligations under the reinsurance arrangements. Reinsurance, however, does make the reinsurer liable to the issuing company to the extent of any reinsurance in force at the time of the loss. Reinsurance arrangements also decrease premiums retained by the issuing company since that company pays the reinsuring company a portion of total premiums based upon the amount of liability reinsured.

NSIC generally reinsures all risks in excess of \$50,000 with respect to any one insured. NSFC and Omega generally reinsure with third-parties any liability in excess of \$225,000 on any single policy. In addition, the property and casualty subsidiaries have catastrophe excess reinsurance, which provided protection in part with respect to aggregate property losses arising out of a single catastrophe, such as a hurricane. In 2009, the property and casualty subsidiaries had catastrophe protection up to a \$72.5 million loss. Under the property and casualty subsidiaries reinsurance arrangement in force during 2009, the Company retained the first \$3.5 million of insured losses from any single catastrophic event. The next \$17.5 million in insured losses from any single event was 95% reinsured with the Company's net retention being 5%. The third layer of reinsurance protection provided coverage for 100% of insured losses exceeding \$17.5 million and up to \$42.5 million. In July of 2009, the Company added an additional layer of coverage to the reinsurance program. The fourth layer of reinsurance protection provided coverage for 100% of insured losses in excess of \$42.5 million up to \$72.5 million. The amount of catastrophe reinsurance protection purchased by the Company was based on computer modeling of actual Company exposure. The Company generally seeks catastrophe protection for scenarios based on the computer modeling that mitigates losses up to a near term 1 in 100 year event, further described as an amount at which the probability of not exceeding is not less than 99%. NSFC and Omega had a provision for one reinstatement (coverage for two catastrophic events) during 2009.

Our inability to procure reinsurance, primarily catastrophe reinsurance, could adversely impact our ability to maintain our level of premium revenue. The increased frequency of catastrophic events also increases our cost of reinsurance pressuring the profit margins of our insurance products.

#### Risk of loss from catastrophic events and geographic concentration

As described above, we maintain catastrophe reinsurance in amounts that provides protection to the Company's financial condition in all but the most remote likelihood of occurrences. Our most critical catastrophe risk is from hurricanes due to our proximity to the Atlantic Ocean and the Gulf of Mexico. Our results of operations are very likely to be materially impacted in the event of the landfall of a major hurricane striking the Northern Gulf Coast or Southern Atlantic Coast in Georgia or South Carolina where we maintain significant concentrations of business. We are also exposed to the risk of significant tornado activity in many of the states in which we operate. Our most significant catastrophic event risk is the risk of a loss in excess of the Company's upper catastrophe limit which could adversely impact the Company's financial condition if such an event occurs. We are also subject to assessments from windstorm underwriting pools in various states. These risks are often difficult to measure and in the event of a major catastrophe, could exceed the upper limits of our available reinsurance protection. We also face risk from a high frequency of catastrophe events. While these events may not reach the lower limits of our catastrophe reinsurance protection, a large number of smaller events can materially impact our results of operations.

#### Climate change

Scientific evidence supports that there have been and continue to be significant changes in climate including temperature, precipitation and wind resulting from various natural factors, processes, and human activities. Rising temperatures and changes in weather patterns could impact storm frequency and severity in our coverage areas. Increases in storm frequency and severity could negatively impact reinsurance costs impacting product pricing and the areas in which we offer our products. With respect to our property and casualty segment, climate change may impact the types of storms that impact our coverage areas as well as the frequency and severity of storms thereby impacting reinsurance placement and affordability. With respect to our life insurance segment, climate change may impact life expectancies thereby influencing mortality assumptions used in pricing assumptions and reserve calculations. Climate change could impact future product offerings, exclusions and/or policy limitations.

The Company may be impacted by domestic legislation and regulation related to climate change. Governmental mandates could impede our ability to make a profit with our current product offerings, limit the products we can offer and/or impact the geographic locations in which we offer our products.

The impact of climate change cannot be quantified at this time.

## Reserve liabilities

NSIC maintains life insurance reserves for future policy benefits to meet future obligations under outstanding policies. These reserves are calculated to be sufficient to meet policy and contract obligations as they arise. Liabilities for future policy benefits are calculated using assumptions for interest, mortality, morbidity, expense and withdrawals determined at the time the policies were issued. As of December 31, 2009, the total reserves of NSIC (including the reserves for accident and health insurance) were approximately \$30.2 million. We believe that such reserves for future policy benefits are adequate to provide for future policy benefits.

The property and casualty subsidiaries are also required to maintain loss reserves (claim liabilities) for all lines of insurance. Such reserves are intended to cover the probable ultimate cost of settling all claims, including those incurred but not yet reported. The reserves of the property and casualty subsidiaries reflect estimates of the liability with respect to incurred claims and are determined by evaluating reported claims on an ongoing basis and by estimating liabilities for incurred but not reported claims. Such reserves include adjustment expenses to cover the cost of investigating losses and defending lawsuits. The establishment of accurate reserves is complicated by the fact that claims in some lines of insurance are settled many years after the policies have been issued, thus raising the possibility that inflation may have a significant effect on the amount of ultimate loss payment, especially when compared to initial loss estimates. The subsidiaries, however, attempt to restrict their writing to risks that settle within one to four years of issuance of the policy. As of December 31, 2009, the property and casualty subsidiaries had reserves for unpaid claims of approximately \$12.6 million before subtracting unpaid claims, due from reinsurers of \$549,000 leaving net unpaid claims of \$12.1 million. The reserves are not discounted for the time value of money. No changes were made in the assumptions used in estimating the reserves during the years ending December 31, 2009 or 2008. The Company believes such reserves are adequate to provide for settlement of claims.

We incur the risk that we may experience excessive losses due to unanticipated claims frequency, severity or both that may not be factored into our loss reserve liabilities. Unexpected frequency and severity can be adversely impacted by outcomes of claims litigation; adverse jury verdicts related to claims settlements and adverse interpretations of insurance policy provisions which results in increased liabilities. We are also subject to the risk of unanticipated assessments from state underwriting associations or windstorm pools related to losses in excess of the associations or pool's ability to pay. Such costs are often allocated to companies operating in the jurisdiction of the association or windstorm pool and the likelihood and amount of such assessments are difficult to predict. These events could adversely impact our historical loss reserving methodology and cause financial adjustments that could materially impact our financial condition and results of operations.

## Financial Ratings

The insurance subsidiaries are rated by AM Best Company, an insurance company-rating agency. NSFC is rated B++ (Good), Omega is rated B+ (Good) and NSIC is rated B (Fair) by AM Best Company. A downgrade in our AM Best ratings could adversely impact our ability to maintain existing business or generate new business.

## Regulation

The insurance subsidiaries are each subject to regulation by the insurance departments of those states in which they are licensed to conduct business. Although the extent of regulation varies from state to state, the insurance laws of the various states generally establish supervisory departments having broad administrative powers with respect to, among other matters: the granting and revocation of licenses to transact business, the licensing of agents, the establishment of standards of financial solvency (including reserves to be maintained), the nature of investments and in most cases premium rates, the approval of forms and policies, and the form and content of financial statements. The primary purpose of these regulations is the protection of policyholders. Compliance with regulations does not necessarily

confer a benefit upon shareholders.

Many states, in which the insurance subsidiaries operate, including Alabama, have laws requiring that insurers become members of guaranty associations. These associations guarantee that benefits due policyholders of insurance companies will continue to be provided even if the insurance company which wrote the business is financially unable to fulfill its obligations. To provide these benefits, the associations assess the insurance companies licensed in a state that write the line of insurance for which coverage is guaranteed. The amount of an insurer's assessment is generally based on the relationship between that company's premium volume in the state and the premium volume of all companies writing the particular line of insurance in the state. The Company has paid no material amounts to guaranty associations over the past three years. These payments, when made, are principally related to association costs incurred due to the insolvency of various insurance companies. Future assessments depend on the number and magnitude of insurance company insolvencies and such assessments are therefore difficult to predict.

Most states have enacted legislation or adopted administrative rules and regulations covering such matters as the acquisition of control of insurance companies, transactions between insurance companies and the persons controlling them. The National Association of Insurance Commissioners has recommended model legislation on these subjects and all states where the Company's subsidiaries transact business have adopted, with some modifications, that model legislation. Among the matters regulated by such statutes are the payments of dividends. These regulations have a direct impact on the Company since its cash flow is substantially derived from dividends from its subsidiaries. However, the Company has not had nor does it foresee a problem obtaining the necessary funds to operate because of the regulation. Statutory limitations of dividend payments by subsidiaries are disclosed in Note 13 of the accompanying Consolidated Financial Statements.

While most regulation is at the state level, the federal government has increasingly expressed an interest in regulating aspects of the insurance industry. All of these regulations at various levels of government increase the cost of conducting business through increased compliance expenses. Also, existing regulations are constantly evolving through administrative and court interpretations and new regulations are often adopted. It is difficult to predict what impact changes in regulation may have on the Company in the future. Changes in regulations could occur that might adversely impact our ability to achieve acceptable levels of profitability and limit our growth.

#### Competition

The insurance subsidiaries are engaged in a highly competitive business and compete with many insurance companies of substantially greater financial resources, including stock and mutual insurance companies. Mutual insurance companies return profits, if any, to policyholders rather than shareholders; therefore, mutual insurance companies may be able to charge lower net premiums than those charged by stock insurers. Accordingly, stock insurers must attempt to achieve competitive premium rates through greater volume, efficiency of operations and control of expenses.

NSIC primarily markets its life and health insurance products through the home service system and independent producers. Direct competition comes from home service companies and other insurance companies that utilize independent producers to sell insurance products, of which there are many. NSIC's life and health products also compete with products sold by ordinary life companies. NSIC writes policies primarily in Alabama, Georgia and Mississippi. The market share of the total life and health premiums written is small because of the number of insurers in this highly competitive field. The primary methods of competition in the field are service and price.

Because of the increased costs associated with a home service company, premium rates are generally higher than ordinary products; as a result competition from these ordinary insurers must be met through service. Initial costs of distribution through independent agents are generally more than through home service distribution methods, but lower commissions are paid in years subsequent to the first year of the policy so costs decline rapidly as policies renew after the first year. The primary factor in controlling cost under the independent agent distribution method is maintaining a high persistency rate. The persistency rate is the rate at which new business is maintained in renewal periods subsequent to the first year. If a high persistency rate can be maintained, the overall costs of distribution are lowered due to lower commission rate payments on policies in force subsequent to the first year.

The property and casualty subsidiaries market their products through independent agents and brokers, concentrating primarily on dwelling fire, homeowners and nonstandard auto coverage. NSFC, though one of the larger writers of lower value dwelling fire insurance in Alabama, nevertheless faces a number of competitors in this niche market. Moreover, larger general line insurers also compete with NSFC. The market share in states other than Alabama is small. Price is the primary method of competition. Because the Company utilizes independent agents, commission rates and service to the agent are also important factors in whether the independent agent agrees to offer NSFC products over those of its competitors.





Significant changes in the competitive environment in which we operate could materially impact our financial condition or results of operations.

#### Inflation

The Company shares the same risks from inflation as other companies. Inflation causes operating expenses to increase and erodes the purchasing power of the Company's assets. A large portion of the Company's assets is invested in fixed maturity investments. The purchasing power of these investments will be less at maturity because of inflation. This is generally offset by the reserves that are a fixed liability and will be paid with cheaper dollars. Also, inflation tends to increase investment yields, which may reduce the impact of the increased operating expenses caused by inflation.

#### Investment Risk and Liquidity

Our invested assets are managed by company personnel. The majority of these investments consist of fixed maturity securities. These securities are subject to price fluctuations due to changes in interest rates and unfavorable changes could materially reduce the market value of the Company's investment portfolio and adversely impact our financial condition and results of operations. Fixed maturity investments are managed in light of anticipated liquidity needs. Should we experience a significant change in liquidity needs for any reason, we may be forced to sell fixed maturity securities at a loss to cover these liquidity needs. Changes in general economic conditions, the stock market and various other external factors could also adversely impact the value of our investments and consequently our results of operations and financial condition.

#### Impact of economic and credit market conditions on our investments

Our investment portfolio is exposed to economic and financial market risks, including changes in interest rates, credit markets and prices of marketable equity and fixed-income securities. Events that have unfolded in the current economic crisis have had a material impact on the valuations of our investments. Recent economic and credit market conditions have adversely affected the ability of some issuers of investment securities to repay their obligations and have affected and may further affect the values of investment securities. If the carrying value of our investments exceeds the fair value, and the decline in fair value is deemed to be other-than-temporary, we will be required to write down the value of our investments, which could materially harm our results of operations and financial condition.

#### Dependence of the Company on Dividends from Insurance Subsidiaries

The Company is an insurance holding company with no significant operations. The primary asset of the Company is its stock in the insurance subsidiaries. The Company relies on dividends from the insurance subsidiaries in order to pay operating expenses and to provide liquidity for the payment of dividends to shareholders. The ability of the insurance subsidiaries to pay dividends is subject to regulatory restrictions discussed in detail in Note 13 of the consolidated financial statements included herein. Should the insurance subsidiaries become subject to restrictions imposed by insurance regulations regarding the payment of dividends, the ability of the Company to pay expenses, meet debt service requirements and pay cash dividends to shareholders could be adversely impacted. Additionally, should business conditions in the current economic environment persist, we could be forced to further limit or suspend dividend payments in order to protect our capital position.

#### Low common stock trading volume and liquidity limitations

We are a small public company with a large percentage of common stock outstanding owned by founding family members, employees, officers and directors. Consequently, our average daily trading volume is very low with no shares traded on some days and only a few hundred shares trading in a typical day. This low trading volume can lead

to significant volatility in our share price and limit a shareholders ability to dispose of large quantities of stock in a short period of time.

#### Debt covenants

Should we become unable to remain current on interest payments on our long term debt, under our debt covenants we would be forced to suspend the payment of dividends to stockholders until interest payments are again current.

#### Technology

Our insurance subsidiaries are dependent on computer technology and internet based platforms in the delivery of insurance products. Our ability to innovate and manage technological change is a key to remaining competitive in the insurance industry. A breakdown in major systems or failure to maintain up to date technology could adversely impact our ability to write new business and service existing policyholders which would adversely impact our results of operations and financial condition.

#### Key Personnel

As a small company within the insurance industry, we could be adversely impacted by the loss of key personnel. Our ability to remain competitive is contingent upon our ability to attract and retain qualified personnel in all aspects of our operations.

#### Accounting Standards

Our financial statements are prepared based upon generally accepted accounting standards issued by the Financial Accounting Standards Board along with standards set by other regulatory organizations. We are required to adopt newly issued or revised accounting standards that are issued periodically. Future changes could impact accounting treatment applied to financial statements and could have a material adverse impact on the Company's results of operations and financial conditions. Potential changes in accounting standards that are currently expected to impact the Company are disclosed in the Notes to Financial Statements included herein.

#### Item 1B. Unresolved Staff Comments

None

#### Item 2. Properties

Our principal executive offices, owned by NSIC, are located at 661 East Davis Street, Elba, Alabama. The executive offices are shared by the insurance subsidiaries. The building was constructed in 1977 with an addition added in 2008. The Company expansion and renovation project completed in early 2008, added an additional 4,684 square feet and renovated 3,017 square feet of the existing structure. The executive offices total approximately 30,700 square feet. The Company believes this space to be adequate for its immediate needs.

The Company's subsidiaries own certain real estate investment properties. We own approximately 2,950 acres of undeveloped timberland in Pike, Coffee and Covington counties in Alabama. The only depreciable improvements on this land include a small pavilion with current accumulated depreciation of \$18,000. The timber is accounted for as a natural resource and depleted in accordance with applicable accounting standards, which identify total costs as including acquisition costs, exploration costs, development costs, production costs and support equipment and facilities cost. We include in total costs timberland purchases and reforestation costs and other costs associated with the planting and growing of timber, such as site preparation, growing or purchases of seedlings, planting, fertilization, herbicide application and the thinning of tree stands to improve growth. We allocate total cost of the timberland over

periods benefited by means of depletion.

We also own approximately 101 acres of undeveloped commercial real estate in Greenville, Alabama. We sell undeveloped lots from this development and the development has no depreciable improvements.

Capitalized along with the cost of the timberland and the Greenville property are site preparation costs, including clearing, filling and leveling of land. There are no improvements such as paving, parking lots or fencing that would be recorded as land improvements and depreciated over the appropriate useful life.

## Item 3. Legal Proceedings

The Company and its subsidiaries are named as parties to litigation related to the conduct of their insurance operations. Further information regarding details of pending suits can be found in Note 16 to the consolidated financial statements.

## Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of security holders during the three months ended December 31, 2009.

## PART II

## Item 5. Market for Registrant's Common Equity and Related Stockholder Matters and Issuer Purchases of Equity Securities

The capital stock of the Company is traded in the NASDAQ Global Market. Quotations are furnished by the National Association of Security Dealers Automated Quotations System (NASDAQ). The trade symbol is NSEC.

The following table sets forth the high and low sales prices per share, as reported by NASDAQ during the period indicated:

|                | Stock Closing Prices |          |
|----------------|----------------------|----------|
|                | High                 | Low      |
| 2009           |                      |          |
| First Quarter  | \$ 7.14              | \$ 5.87  |
| Second Quarter | 10.85                | 6.76     |
| Third Quarter  | 9.08                 | 7.50     |
| Fourth Quarter | 11.10                | 7.61     |
| 2008           |                      |          |
| First Quarter  | \$ 17.74             | \$ 15.25 |
| Second Quarter | 16.76                | 14.77    |
| Third Quarter  | 16.73                | 13.67    |
| Fourth Quarter | 13.79                | 5.16     |

## Shareholders

The number of shareholders of the Company's common stock was approximately 1,300 and the Company had 2,466,600 shares of common stock outstanding on March 26, 2010.

## Dividends

The following table sets forth quarterly dividend payment information for the Company for the periods indicated:

|      | Dividends<br>Per Share |  |
|------|------------------------|--|
| 2009 |                        |  |

|                |         |
|----------------|---------|
| First Quarter  | \$ 0.15 |
| Second Quarter | \$ 0.15 |
| Third Quarter  | \$ 0.15 |
| Fourth Quarter | \$ 0.15 |

|                |          |
|----------------|----------|
| 2008           |          |
| First Quarter  | \$ 0.225 |
| Second Quarter | \$ 0.225 |
| Third Quarter  | \$ 0.225 |
| Fourth Quarter | \$ 0.225 |

Discussion regarding dividend restrictions may be found on page 36 of the Managements' Discussion and Analysis as well as in Note 13 of the consolidated financial statements.

The payment of shareholder dividends is subject to the discretion of our Board of Directors and is dependent upon many factors including our operating results, financial condition, capital requirements and general economic conditions. Total shareholder dividends paid in 2009 totaled \$1,480,000. Dividends from the insurance subsidiaries are subject to approval of the regulator in the state of domicile, the Alabama Department of Insurance.

There is a present expectation that dividends will continue to be paid in the future but future dividends are dependent on future earnings, the Company's financial condition and other factors evaluated periodically by management and the Board of Directors.

#### Item 6. Selected Financial Data

##### Five-Year Financial Information:

(Amounts in thousands, except per share)

| Operating results                      | 2009      | 2008        | 2007      | 2006      | 2005      |
|--|-----------|-------------|-----------|-----------|-----------|
| Net premiums earned                    | \$ 59,594 | \$ 56,264   | \$ 62,250 | \$ 58,874 | \$ 53,563 |
| Net investment income                  | 5,289     | 4,368       | 4,749     | 4,463     | 3,964     |
| Net realized investment (losses) gains | 357       | (1,049 )    | 1,493     | 2,565     | 3,493     |
| Other income                           | 764       | 1,107       | 1,071     | 1,211     | 1,416     |
| Total revenues                         | \$ 66,004 | \$ 60,690   | \$ 69,563 | \$ 67,113 | \$ 62,436 |
| Net income (loss)                      | \$ 4,224  | \$ (5,204 ) | \$ 6,040  | \$ 4,250  | \$ 1,558  |
| Net income (loss) per share            | \$ 1.71   | \$ (2.11 )  | \$ 2.45   | \$ 1.72   | \$ 0.63   |

| Other Selected Financial Data                       | 2009       | 2008        | 2007       | 2006       | 2005        |
|---|------------|-------------|------------|------------|-------------|
| Total shareholders' equity                          | \$ 41,168  | \$ 34,648   | \$ 48,447  | \$ 45,379  | \$ 43,556   |
| Book value per share                                | \$ 16.69   | \$ 14.04    | \$ 19.64   | \$ 18.39   | \$ 17.66    |
| Dividends per share                                 | \$ 0.600   | \$ 0.900    | \$ 0.900   | \$ 0.885   | \$ 0.865    |
| Net change in unrealized capital gains (net of tax) | \$ 3,520   | \$ (6,147 ) | \$ (664 )  | \$ (244 )  | \$ (2,544 ) |
| Total assets  | \$ 131,396 | \$ 124,890  | \$ 135,585 | \$ 134,911 | \$ 139,226  |

## Quarterly Information:

|      | Premiums  | Investment<br>& Other<br>Income | Realized<br>Investment<br>Gains (Losses) | Claims<br>and<br>Benefit<br>Payments | Net<br>Income<br>(Loss) | Net<br>Income<br>(Loss)<br>Per<br>Share |
|------|-----------|---------------------------------|--|--------------------------------------|-------------------------|---|
| 2009 |           |                                 |  |                                      |                         |   |
| 1st  |           |                                 |  |                                      |                         |   |
| QTR  | \$ 15,220 | \$ 1,378                        | \$ 1                                     | \$ 7,792                             | \$ 1,481                | \$ 0.60                                 |
| 2nd  |           |                                 |  |                                      |                         |   |
| QTR  | 15,373    | 1,566                           | (231 )                                   | 11,314                               | 92                      | 0.04                                    |
| 3rd  |           |                                 |  |                                      |                         |   |
| QTR  | 14,357    | 1,584                           | 79                                       | 9,131                                | 651                     | 0.26                                    |
| 4th  |           |                                 |  |                                      |                         |   |
| QTR  | 14,644    | 1,525                           | 508                                      | 7,602                                | 2,000                   | 0.81                                    |
|      | \$ 59,594 | \$ 6,053                        | \$ 357                                   | \$ 35,839                            | \$ 4,224                | \$ 1.71                                 |
| 2008 |           |                                 |  |                                      |                         |   |
| 1st  |           |                                 |  |                                      |                         |   |
| QTR  | \$ 16,586 | \$ 1,642                        | \$ 66                                    | \$ 10,560                            | \$ 782                  | \$ 0.32                                 |
| 2nd  |           |                                 |  |                                      |                         |   |
| QTR  | 13,968    | 1,593                           | 82                                       | 10,812                               | (36 )                   | (0.01 )                                 |
| 3rd  |           |                                 |  |                                      |                         |   |
| QTR  | 11,707    | 1,586                           | (1,452 )                                 | 15,795                               | (6,945)                 | (2.82 )                                 |
| 4th  |           |                                 |  |                                      |                         |   |
| QTR  | 14,003    | 654                             | 255                                      | 7,579                                | 995                     | 0.40                                    |
|      | \$ 56,264 | \$ 5,475                        | \$ (1,049 )                              | \$ 44,746                            | \$ (5,204)              | \$ (2.11 )                              |



## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

## Overview

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSG) and its subsidiaries. We are a "smaller reporting company" under Securities and Exchange Commission (SEC) regulations and therefore qualify for the scaled disclosure of smaller reporting companies. In general the same information is required to be disclosed in the management discussion and analysis by smaller reporting companies except that the discussion need only cover the latest two year period and disclosures relating to contractual obligations are not required. In accordance with the scaled disclosure requirements, this discussion covers the two year period ended December 31, 2009.

The National Security Group, Inc. is made up of two segments: the Life segment and the P&C segment. The Company's life, accident and health insurance business is conducted through National Security Insurance Company (NSIC), a wholly owned subsidiary of the Company organized in 1947. The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992.

This discussion and analysis of the consolidated results of operations and financial condition of the Company should be read in conjunction with the Selected Financial Data and Consolidated Financial Statements and related notes included in this Form 10-K. Please refer to our note regarding forward-looking statements on page 4 of this report.

## Summary of Consolidated Results of Operations

Condensed revenue and income information follows:

|            | Year               |                 |
|------------|--------------------|-----------------|
|            | Ended December 31, |                 |
|            | 2009               | 2008            |
| Premium    |                    |                 |
| Earned     | \$ 59,594,000      | \$ 56,264,000   |
| Investment |                    |                 |
| Income     | 5,289,000          | 4,368,000       |
| Realized   |                    |                 |
| Investment |                    |                 |
| Gains      |                    |                 |
| (Losses)   | 357,000            | (1,049,000 )    |
| Other      |                    |                 |
| Income     | 764,000            | 1,107,000       |
| Total      |                    |                 |
| Revenues   | 66,004,000         | 60,690,000      |
| Net Income |                    |                 |
| (Loss)     | \$ 4,224,000       | \$ (5,204,000 ) |
| Net Income |                    |                 |
| (Loss) Per |                    |                 |
| Share      | \$ 1.71            | \$ (2.11 )      |

For the year ended December 31, 2009 total revenues were \$66,004,000 compared to \$60,690,000 for the same period last year; an increase of 8.8%. Earned premium increases in the P&C segment and Life segment as well as the recovery of value in our overall investment portfolio were the primary contributing factors to the increase in total revenue for 2009 over 2008.

The Company ended 2009 with net income totaling \$4,224,000 compared to a net loss of \$5,204,000 in 2008. The Company ended 2009 with net income per share of \$1.71 compared to a net loss per share of \$2.11 in 2008. The significant decline in storm activity during 2009 in addition to the lack of any major catastrophes were primary reasons for improved operating results in the current year compared to the prior year. In addition, our investment portfolio made a noteworthy turnaround with market values of securities increasing and the reduction in other-than-temporary impairment losses recognized. Furthermore, as mentioned above, the Company also ended 2009 with increases in premiums earned in both the P&C segment and the Life segment compared to the same period last year.

Results of Operations for Years Ended December 31, 2009 and 2008

The Company ended 2009 with premiums earned totaling \$59,594,000 compared to \$56,264,000 for the same period last year. Premium revenue is generated from our two operating segments: P&C segment and Life segment. The P&C segment accounts for approximately 88% of total premium revenue production while our Life segment contributes the remaining 12%. The P&C segment operates in personal lines insurance products primarily generating premium revenue from dwelling fire, allied lines and homeowners policies. Our Life segment produces premium revenue primarily from life, accident and critical illness insurance policies.

Net investment income totaled \$5,289,000 in 2009 compared to \$4,368,000 in 2008; an increase of \$921,000. We currently hold \$5,000,000 in company owned life insurance (COLI). The change in value related to this investment lead to investment income totaling \$740,000 in 2009 compared to investment losses of \$543,000 for the same period last year. The COLI income was the primary reason for the overall increase in investment income.

Net realized investment gains totaled \$357,000 in 2009 compared to investment losses of \$1,049,000 in 2008. The primary reason for the improved results was the significant change in losses recognized from other-than-temporary impairment write-downs. During 2009, the Company recognized losses from other-than-temporary impairments totaling \$443,000 compared to \$2,973,000 during 2008. Realized investment gains increased \$369,000 from fixed maturities compared to 2008 while realized gains decreased by \$1,079,000 for equity securities compared to 2008.

Other income was \$764,000 as of December 31, 2009 compared to \$1,107,000 for the same period last year; a \$343,000 decrease. Other income consists primarily of billing, payment and policy fees related to the issuance of our property and automobile insurance policies as well as miscellaneous income.

Policyholder benefit expenses decreased 19.9%, ending 2009 at \$35,839,000 compared to \$44,746,000 for the same period last year. The primary reason for the \$8,907,000 decline was the reduction in claim activity in the P&C segment. During 2009, we did not incur any hurricane losses in any of our coverage areas while in 2008 we incurred net losses from Hurricane Gustav and Hurricane Ike totaling \$4,032,000 and \$3,539,000 respectively. Furthermore, catastrophe losses from tornado and windstorm activity were less frequent in 2009 leaving the P&C segment with losses from these events totaling \$2,328,000 compared to \$4,916,000 in 2008.

General and administrative expenses increased \$1,838,000 in 2009 compared to the same period last year. The single most significant factor contributing to the increase in general expenses was an increase in director's non-qualified deferred compensation at the holding company level. The phantom stock plan increased in value with the recovery in our stock price and led to an increase in expenses. We also incurred increased legal fees in the holding company in 2009.

Interest expense decreased \$21,000 in 2009 compared to 2008. The largest portion of interest expense relates to our non-insurance operations. Additional information regarding the long-term debt generating the interest expense can be found in Note 9 to the consolidated financial statements.

The Company incurred income tax expenses totaling \$1,252,000 compared to an income tax benefit of \$2,610,000 in 2008. The tax benefit from 2008 was fully recovered through the utilization of net operating loss carry backs applied to tax years 2007 and 2006.

Due to the decrease in storm activity as well as profitable underwriting results, the Company ended 2009 with net income totaling \$4,224,000 compared to a net loss in 2008 of \$5,204,000. The P&C and Life segments contributed \$5,151,000 and \$464,000, respectively to net income in 2009, while we incurred a net loss of \$1,391,000 from non-insurance operations.



### Stockholder Equity and Book Value per Share

Stockholders equity for the year ended December 31, 2009 was \$41,168,000 compared to \$34,648,000 at December 31, 2008, an increase of \$6,520,000 or 18.8%. The change in stockholders equity is composed of dividends paid to shareholders of \$1,480,000 and net income of \$4,224,000 as well as accumulated other comprehensive income totaling \$3,520,000 and unrealized gains on interest rate swap totaling \$256,000. The increase in accumulated income was primarily the result of increases in the value of our investment portfolio. Stockholders equity for the year ended December 31, 2008 was significantly reduced by underwriting losses in the property and casualty insurance operations and declines in investment portfolio fair value. Year end book value per share, defined as stockholders equity divided by common shares outstanding of 2,466,600, was \$16.69 at December 31, 2009 compared to \$14.04 at December 31, 2008.

### Industry Segment Data

Certain financial information for The National Security Group's two operating segments (Life segment, property and casualty segment) and holding company level expenses is summarized as follows (amounts in thousands):

| Premium revenues:                   | 2009      | %        | 2008      | %        |
|-------------------------------------|-----------|----------|-----------|----------|
| Life, accident and health insurance | \$ 7,199  | 12.08 %  | \$ 6,956  | 12.36 %  |
| Property and casualty insurance     | 52,395    | 87.92 %  | 49,308    | 87.64 %  |
|                                     | \$ 59,594 | 100.00 % | \$ 56,264 | 100.00 % |

The property and casualty segment composed 87.92% of total premium revenue in 2009 compared to 87.64% in 2008. The property and casualty segment is primarily composed of dwelling fire, allied lines and homeowners lines of business. The life segment composed 12.08% of premium revenue in 2009 compared to 12.36% in 2008 with revenue produced primarily from life insurance products.

The following discussion outlines more specific information with regard to the individual operating segments of the Company along with non-insurance related information (primarily administration expenses) associated with the insurance holding Company.

## Life and Accident and Health Insurance Operations:

Our life segment is the smaller of our insurance segments contributing 12.08% of total insurance premium revenue in 2009 and 12.36% in 2008. Premium revenues and operating income for the life segment for the years ended December 31, 2009 and 2008 are summarized below (amounts in thousands):

|   | 2009     | 2008     |
|---|----------|----------|
| <b>REVENUE</b>                                    |          |          |
| Net premiums earned                               | \$ 7,199 | \$ 6,956 |
| Net investment income                             | 2,114    | 1,940    |
| Net realized investment gains (losses)            | 234      | (1,423)  |
| Other income                                      | 3        | 60       |
|   | 9,550    | 7,533    |
| <b>BENEFITS AND EXPENSES</b>                      |          |          |
| Policyholder benefits paid or provided            | 4,931    | 5,027    |
| Amortization of deferred policy acquisition costs | 276      | 1,032    |
| Commissions                                       | 546      | 490      |
| General and administrative expenses               | 2,543    | 1,614    |
| Insurance taxes, licenses and fees                | 244      | 288      |
| Interest expense                                  | 49       | 61       |
|   | 8,589    | 8,512    |
| (Loss) Income Before Income Taxes                 | 961      | (979 )   |
| <b>INCOME TAX EXPENSE (BENEFIT)</b>               |          |          |
| Current   | 105      | (281 )   |

|            |        |           |
|------------|--------|-----------|
| Deferred   | 392    | 161       |
|            | 497    | (120 )    |
| NET INCOME |        |           |
| (LOSS)     | \$ 464 | \$ (859 ) |

Year Ended December 31, 2009 Compared to Year Ended December 31, 2008:

NSIC premium accounted for 12.08% of total consolidated premium revenue for 2009. As mentioned above, NSIC operates using two primary methods of distribution: home service employee agents and independent agents. While the company has used the traditional home service distribution method since its founding in 1947, the independent agent distribution method has become the largest source of renewal business and new business production over the past decade. For 2009, the home service and independent agent distribution methods accounted for 33.4% and 62%, respectively of NSIC premium revenue.

NSIC ended 2009 with premium revenue of \$7,199,000 compared to \$6,956,000 for the same period last year; an increase of 3.5%. The increase in premium revenue was primarily due to an increase of 11% in premiums in the independent agent's method of distribution compared to 2008. Premium revenue in the home service agent method of distribution declined 4.6% compared to 2008. The decline in premium revenue related to the home service agents distribution method was primarily the result of a shift in our primary focus to the independent agent distribution method.

Significant products contributing to the increase in premium revenue were our new cancer product launched in the fourth quarter of 2008 and renewal premiums from our ordinary life line of business. Minimum standards regarding retention rates have helped to increase our persistency in the independent method of distribution.

Net investment income totaled \$2,114,000 as of December 31, 2009 compared to \$1,940,000 for the same period last year. Investment income in NSIC is generated from securities held in our investment portfolio as well as mortgage and policy loan interest. Investment income increased \$174,000 in 2009 compared to 2008 primarily due to an overall increase in NSIC's invested assets.

NSIC ended 2009 with net realized investment gains totaling \$234,000 compared to realized losses of \$1,423,000 in 2008. The primary reason for the improved results in the current year was the reduced amount recognized for other-than-temporary impairment losses. During 2009 NSIC recognized \$293,000 in other-than-temporary impairment losses compared to \$1,358,000 for the same period last year.

Policyholder benefit expenses decreased \$96,000 ending 2009 at \$4,931,000 compared to \$5,027,000 for the same period last year. The reduction in policyholder benefits was primarily attributable to a \$167,000 reduction in benefit payments under accident and health contracts.

General and administrative expenses and deferred policy acquisition costs (DAC) increased a net \$173,000 in 2009 compared to 2008. While deferred policy acquisition costs in the Life segment decreased \$756,000 from 2008, general and administrative expenses increased \$929,000 from 2008. The primary reason for the change in the allocation between general expenses and DAC was a downward adjustment in the estimate of expenses capitalized as a component of DAC.

The Life segment incurred income tax expenses totaling \$497,000 compared to an income tax benefit of \$120,000 in 2008. Income tax expense as a percent of pretax income increased due to an increase in deferred taxes. The current tax benefit from 2008 was fully recovered through the utilization of net operating loss carry backs applied to tax years 2007 and 2006.

NSIC ended 2009 with year to date net income of \$464,000 compared to a year to date net loss of \$859,000 for the same period last year. The primary factor contributing to the increase in net income was the lack of impairment losses in the investment portfolio. Net realized capital gains totaled \$234,000 in 2009 compared to net realized capital losses, primarily associated with other than temporary impairments, of \$1,423,000 in 2008. A much improved investment climate was the primary factor contributing to the turnaround in realized capital gains.

#### Property & Casualty Operations:

Property and casualty operations constitute our largest segment composing 87.92% and 87.64% of our total premium revenue in 2009 and 2008, respectively. Premium revenues and operating income for the P&C segment for the years ended December 31, 2009 and 2008 are summarized below:

|                               | 2009      | 2008      |
|-------------------------------|-----------|-----------|
| <b>REVENUE</b>                |           |           |
| Net premiums earned           | \$ 52,395 | \$ 49,308 |
| Net investment income         | 3,125     | 2,852     |
| Net realized investment gains | 120       | 372       |
| Other income                  | 761       | 1,047     |
|                               | 56,401    | 53,579    |
| <b>BENEFITS AND EXPENSES</b>  |           |           |
| Policyholder benefits paid    | 30,908    | 39,719    |



|   |          |             |
|---|----------|-------------|
| or provided   |          |             |
| Amortization<br>of deferred<br>policy<br>acquisition<br>costs | 3,397    | 3,312       |
| Commissions   | 7,317    | 7,772       |
| General and<br>administrative<br>expenses                     | 6,775    | 7,265       |
| Insurance<br>taxes, licenses<br>and fees                      | 1,387    | 1,159       |
| Interest<br>expense   | -        | 1           |
|   | 49,784   | 59,228      |
| Income (Loss)<br>Before Income<br>Taxes                       | 6,617    | (5,649 )    |
| INCOME<br>TAX<br>EXPENSE<br>(BENEFIT)                         |          |             |
| Current   | 1,369    | (2,919 )    |
| Deferred  | 97       | 867         |
|   | 1,466    | (2,052 )    |
| NET INCOME<br>(LOSS)  | \$ 5,151 | \$ (3,597 ) |

Year Ended December 31, 2009 Compared to Year Ended December 31, 2008:

Property and casualty segment premium revenue for 2009 increased 6.3% compared to 2008. The stabilization of renewal rates, moderate rate increases in our largest states and a reduction in ceded reinsurance due to a lack of catastrophe reinstatement premium payments were the primary factors contributing to the 6.3% increase.

Production of premium revenue in the P&C segment is primarily driven by our dwelling fire, allied lines and homeowner lines of business. The following table provides net premiums earned by line of business:

| Line of Business | Net Premium   |          | Net Premium   |          |
|------------------|---------------|----------|---------------|----------|
|                  | Earned        | % of NPE | Earned        | % of NPE |
|                  | 2009          | 2009     | 2008          | 2008     |
| Dwelling         |               |          |               |          |
| Fire             | \$ 20,023,000 | 38.2 %   | \$ 20,572,000 | 41.7 %   |
| Allied Lines     | 5,501,000     | 10.5 %   | 5,113,000     | 10.4 %   |
| Homeowners       | 23,787,000    | 45.4 %   | 21,056,000    | 42.7 %   |
| Ocean            |               |          |               |          |
| Marine           | 879,000       | 1.7 %    | 934,000       | 1.9 %    |
| Private          |               |          |               |          |
| Passenger        |               |          |               |          |
| Automobile       | 1,586,000     | 3.0 %    | 976,000       | 2.0 %    |
| Commercial       |               |          |               |          |
| Automobile       | 619,000       | 1.2 %    | 657,000       | 1.3 %    |
|                  | \$ 52,395,000 | 100.0 %  | \$ 49,308,000 | 100.0 %  |

Improvement in operating results was a primary focus area during 2009. We took a critical look at our rating methodology in the dwelling line of business as well as the homeowners programs offered by the P&C companies. We made efforts to improve underwriting margins but continue to face regulatory hurdles to properly compensate for our risk, especially in coastal areas. In addition to our focus on improving property underwriting results, we expanded our tiered Medalist automobile program into Louisiana. The private passenger automobile program, though only 3% of total premium revenue in 2009, experienced a 62.5% increase in net premiums earned compared to the same period last year. Net premiums earned were down slightly in our dwelling fire program but the homeowners programs ended 2009 with net premium earned up 13% compared to 2008.

Net investment income totaled \$3,125,000 in 2009 compared to \$2,852,000 in 2008; an increase of \$273,000. The increase in investment income in the P&C segment was primarily attributable to the change in value of the company owned life insurance (COLI) investment.

The P&C segment ended 2009 with realized capital gains totaling \$120,000 compared to \$372,000 for the same period last year. A reduction in the number of securities sold at a gain during 2009 compared to 2008 was the primary reason for the decline in realized capital gains. The P&C segment was less impacted by the write-down of other than temporary impairments in 2009 versus 2008. During 2009, other-than-temporary impairment losses totaled \$151,000 compared to \$1,615,000 in 2008. For information regarding management's method of determining investment impairment, please see the other-than-temporary impairment and credit quality section under investments on page 30.

Other income, which primarily consists of billing, payment and policy fees related to our property and automobile business decreased \$286,000 from 2008. The decline in dwelling fire premium revenue led to a reduction in billing fees which caused the decrease in other income for 2009 compared to the same period last year.

The most significant improvement in the P&C segment was the significant improvement in our loss ratio. Policyholder benefit payments declined to 59% of premiums earned in 2009, compared to 80.6% in 2008. Policyholder benefit expenses decreased to \$30,908,000 in 2009 from \$39,719,000 in 2008, a decline of 22%. During 2008 the company incurred loss and loss adjustment expenses totaling \$14,140,000 (\$4,032,000 after reinsurance recoveries) from Hurricane Gustav and \$4,271,000 (\$3,539,000 after reinsurance recoveries) from Hurricane Ike. In addition, in 2008 the P&C segment experienced unusually high loss frequency from tornado and storm related activity totaling \$4,916,000. Fortunately, the storm activity affecting the Company during 2009 was substantially less amounting to \$2,268,000 in loss and loss adjustment expenses for the current year. The Company experienced no hurricane losses in 2009.

We routinely evaluate our claims frequency and severity statistics in order to better understand the nature of our risks and aid in the loss reserve liability evaluation process. Claims frequency is a measure of the number of claims incurred during a measurement period regardless of amount. Claims severity is a measure of the average dollar amount of claims during a measurement period. During 2009, tornado and storm related frequency was significantly below levels we experienced throughout 2008. Non-hurricane catastrophe losses totaled \$2,328,000 in 2009 compared to \$4,916,000 in 2008. The severity of claims related to catastrophes affecting the P&C companies during 2009 totaled approximately \$2500 per claim. The severity of claims related to the nineteen non-hurricane catastrophes affecting the P&C companies during 2008 totaled approximately \$2,400 per claim while the average severity of claims related to Hurricanes Gustav and Ike totaled \$2,900 and \$3,400, respectively.

The P&C segment continued to be involved in litigation pertaining to claims from Hurricane Katrina which impacted our coverage areas in Louisiana and Mississippi in August 2005. During 2008, the claims associated with Hurricane Katrina exceeded the \$37,500,000 million upper limit of the reinsurance agreement in affect during 2005. As of December 31, 2009, cumulative claims related to Hurricane Katrina exceeded the reinsurance upper limit by \$1,574,000. Although the reinsurance for this catastrophe has been exhausted and the ultimate outcome of these claims is unknown, the company believes it maintains adequate reserves for the open claims based on information available at the present time. Additional adverse development related to the claims in litigation is possible and therefore these claims are carefully monitored on a continuous basis. Adverse development related to the 53 remaining open Katrina claims increased 2009 incurred losses by \$579,000.

There was no significant change in deferred policy acquisition costs which totaled \$3,397,000 in 2009 (6.48% of premium revenue) compared to \$3,312,000 in 2008 (6.72% of premium revenue). Deferred policy acquisition cost consists of amortization of previously capitalized distribution costs, primarily commissions.

Commission expense for 2009 totaled 13.97% of premium revenue compared to 15.76% of premium revenue in 2008. Commission expenses totaled \$7,317,000 in 2009 compared to \$7,772,000 in 2008; a 5.8% decrease. Implementation of a new profit sharing bonus calculation during 2009 was the driver of the reduction in overall commission expenses. The company increased the threshold to be attained by agents in order to qualify for the bonus and altered the calculation base of the bonus to utilize earned as opposed to written premium. We did however open the profit sharing bonus to premium generated related to the automobile line of business.

General expenses totaled \$6,775,000, or 12.93% of premium revenue, in 2009 compared to \$7,265,000, or 14.73% of premium revenue, in 2008. Cost saving initiatives related to reductions in postage cost and salary expenses were the primary contributors to the decrease in general expenses. During 2009 we increased the amount of information available to our agents on our website and reduced routine mailings of this information, resulting in a 30% reduction in postage costs. We also continue to leverage the benefits of new technology investments in order to achieve greater levels of efficiency in our home office operations, thus reducing salary costs.

The combined ratio for 2009 was 96% compared to 120% for the same period last year. Improved operating results, less storm activity and the lack of hurricanes impacting our coverage areas were primary factors leading to the decline in 2009 compared to 2008. The combined ratio for 2008 was adversely impacted by losses incurred from hurricanes Gustav and Ike and a very active spring storm season. The components of this ratio are broken out in the table below under the section Property and Casualty Combined Ratio.

#### Property & Casualty Combined Ratio:

A measure used to analyze a property/casualty insurer's underwriting performance is the combined ratio. It is the sum of two ratios:

a.

The loss and loss expense ratio, which measures losses and loss adjustment expenses incurred as a percentage of premium revenue.

- b. The underwriting expense ratio, which measures underwriting expenses incurred (e.g., agents' commissions, premium taxes, and other administrative underwriting expenses) as a percentage of premium revenue.

The results of these ratios for the past two years were:

|                                  | 2009  | 2008   |
|----------------------------------|-------|--------|
| Loss and<br>LAE Ratio            | 59.0% | 80.5 % |
| Underwriting<br>Expense<br>Ratio | 36.0% | 39.5 % |
| Combined<br>Ratio                | 95.0% | 120.0% |

Maintaining a combined ratio below 100%, which indicates that the company is making an underwriting profit, depends upon many factors including hurricane activity in the Gulf of Mexico and the southern Atlantic coast, strict underwriting of risks, and adequate and timely premium rates. A major hurricane hitting the coast of Alabama, Georgia, South Carolina, Mississippi, Louisiana, or Texas could cause the combined ratio to fluctuate materially from prior years. The property and casualty subsidiaries maintain catastrophe reinsurance to minimize the effect of a major catastrophe.

During 2009, the P&C segment experienced improved results primarily due to the reduction in tornado and storm related losses as well as the lack of hurricane activity during the year. The \$2,328,000 in losses incurred from non-hurricane catastrophes during 2009 added 4.4 percentage points to our combined ratio. In comparison, tornado and windstorm losses totaling \$4,903,000 incurred in the first half of 2008 added 9.9 percentage points to the combined ratio. Losses, net of reinsurance recoveries, from Hurricane Gustav totaled \$4,032,000 and added 8.2 percentage points to the 2008 combined ratio. Losses, net of reinsurance recoveries, from Hurricane Ike totaled \$3,539,000 and added 7.2 percentage points to the 2008 combined ratio.

#### Non-insurance Operations:

|  | 2009 | 2008 |
|--|------|------|
| <b>REVENUE</b>                               |      |      |
| Net premiums<br>earned                       | \$ - | \$ - |
| Net investment<br>income                     | 50   | 119  |
| Net realized<br>investment<br>gains          | 3    | 2    |
| Other income                                 | -    | -    |
|  | 53   | 121  |
| <b>BENEFITS<br/>AND<br/>EXPENSES</b>         |      |      |
| Policyholder<br>benefits paid<br>or provided | -    | -    |
|  | -    | -    |

|   |            |           |
|---|------------|-----------|
| Amortization<br>of deferred<br>policy<br>acquisition<br>costs |            |           |
| Commissions   | -          | -         |
| General and<br>administrative<br>expenses                     | 1,078      | 222       |
| Insurance<br>taxes, licenses<br>and fees                      | -          | -         |
| Interest<br>expense   | 1,077      | 1,085     |
|   | 2,155      | 1,307     |
| Loss Before<br>Income Taxes                                   | (2,102)    | (1,186)   |
| INCOME<br>TAX<br>(BENEFIT)<br>EXPENSE                         |            |           |
| Current   | (338 )     | (295 )    |
| Deferred  | (373 )     | (143 )    |
|   | (711 )     | (438 )    |
| NET LOSS  | \$ (1,391) | \$ (748 ) |

The non-insurance operations of the Company consist of our parent company, The National Security Group, Inc. The National Security Group has no material sources of revenue and relies almost entirely on dividends and fees from subsidiaries to pay expenses. Dividends are eliminated upon consolidation of the subsidiaries in the audited financials included herein. The expenses of the group consist of expenses associated with the public listing of our stock, taxes and fees, and directors' fees. The most significant expense of the group is interest expense associated with \$12,372,000 in debt. This debt is composed of two trust preferred securities offerings, the first being \$9,279,000 issued in the December 2005 and the second being \$3,093,000 issued in June 2007. The primary use for these proceeds was to add capital to the property and casualty subsidiaries. Total interest expense for the Group associated with these borrowings in 2009 was \$1,077,000 compared to \$1,085,000 in 2008.

## Investments:

The life insurance and property/casualty subsidiaries primarily invest in highly liquid investment grade debt and equity securities. At December 31, 2009, the company's holdings in debt securities amounted to 74.9% of total investments and 58% of total assets. The following is a breakdown of the bond portfolio quality according to the nationally recognized rating organization equivalents of Standard and Poor's:

| Bond Portfolio Ratings    |                           |
|---------------------------|---------------------------|
| S&P or Equivalent Ratings | % of Total Bond Portfolio |
| AAA                       | 46.83%                    |
| AA+                       | 3.72%                     |
| AA                        | 3.68%                     |
| AA-                       | 4.71%                     |
| A+                        | 3.57%                     |
| A                         | 12.31%                    |
| A-                        | 5.49%                     |
| BBB+                      | 4.86%                     |
| BBB                       | 6.21%                     |
| BBB-                      | 5.15%                     |
| BB+                       | 0.83%                     |
| B+                        | 0.34%                     |
| B-                        | 1.31%                     |
| In default                | 0.99%                     |

A summary of debt and equity securities available for sale with unrealized losses as of December 31, 2009 along with related fair value, aggregated by length of time that the investments have been in a continuous unrealized loss position follows:

|                  | (Dollars in thousands) |                   |                     |                   |            |                   | December 31, 2009                   |  |
|------------------|------------------------|-------------------|---------------------|-------------------|------------|-------------------|-------------------------------------|--|
|                  | Less than 12 months    |                   | 12 months or longer |                   | Total      |                   | Total Securities in a Loss Position |  |
|                  | Gross                  |                   | Gross               |                   | Gross      |                   |                                     |  |
|                  | Fair Value             | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |                                     |  |
| Fixed maturities |                        |                   |                     |                   |            |                   |                                     |  |
| Corporate        | \$ 1,856               | \$ 21             | \$ 6,772            | \$ 498            | \$ 8,628   | \$ 519            | 23                                  |  |



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|   |           |        |           |          |           |          |    |
|---|-----------|--------|-----------|----------|-----------|----------|----|
| Mortgage backed securities  | 1,443     | 156    | 71        | 9        | 1,514     | 165      | 6  |
| Private label mortgage backed securities  | 2,660     | 72     | 4,651     | 738      | 7,311     | 810      | 15 |
| Obligations of state and political subdivisions                                       | 5,889     | 199    | 991       | 137      | 6,880     | 336      | 21 |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | 3,708     | 80     | -         | -        | 3,708     | 80       | 11 |
| Equity securities   | 78        | 13     | 2,283     | 793      | 2,361     | 806      | 13 |
|   | \$ 15,634 | \$ 541 | \$ 14,768 | \$ 2,175 | \$ 30,402 | \$ 2,716 | 89 |

## Other than temporary impairments and credit quality

At December 31, 2009, just under 3.5% of total investments in the fixed income portfolio were classified as below investment grade. When a fixed maturity security has a decline in value (where fair value is below amortized cost) an other-than-temporary impairment (OTTI) is triggered in circumstances where the Company has the intent to sell the security, it is more likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis, and/or the Company does not expect to recover the entire amortized cost basis of the security. If the Company intends to sell the security or if it is more-likely-than not the Company will be required to sell the security before recovery, an OTTI is recognized as a realized loss in the income statement equal to the difference between the security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more-likely-than not that the company will be required to sell the security before recovery, the OTTI is separated into an amount representing the credit loss, which is recognized as a realized loss in the income statement, and the amount related to all other factors, which is recognized in other comprehensive income. When an equity security has a decline in value, where fair value is below cost, that is deemed to be other than temporary, the Company reduces the book value of the security to its current fair value, recognizing the decline as a realized loss in the income statement. Any future increases in the market value of investments written down are reflected as changes in unrealized gains as part of accumulated other comprehensive income within stockholders' equity.

Management has evaluated each security in a significant unrealized loss position. For the year ended December 31, 2009, \$443,000 in OTTI were realized by the Company compared to \$2,973,000 in 2008. Of the remaining securities in loss positions, Management believes based on current information, that no ultimate loss will be realized on the securities. Most unrealized losses in the fixed income portfolio are interest rate and market driven as opposed to credit quality driven. The Company has no material direct exposure to sub-prime mortgage loans and less than 3.5% of the fixed income investment portfolio is rated below investment grade. With respect to equity securities in a loss position, Management evaluated financial information on each company and 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 remaining securities in an accumulated loss position in the portfolio were temporary impairments.

The amortized cost and aggregate fair value of debt securities at December 31, 2009, 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              | Fair      |
| Available-for-sale securities:         | Cost                   | Value     |
| Due in one year or less                | \$ 419                 | \$ 425    |
| Due after one year through five years  | 14,320                 | 15,551    |
| Due after five years through ten years | 24,013                 | 24,433    |
| Due after ten years                    | 31,044                 | 29,860    |
| Total                                  | \$ 69,796              | \$ 70,269 |

Held-to-maturity  
securities:

|  |          |          |
|--|----------|----------|
| Due in one year or less                | \$ 303   | \$ 309   |
| Due after one year through five years  | 802      | 828      |
| Due after five years through ten years | 1,929    | 1,991    |
| Due after ten years                    | 2,908    | 2,952    |
| Total                                  | \$ 5,942 | \$ 6,080 |

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The amortized cost and aggregate fair values of investments in securities at December 31, 2009 and December 31, 2008 are as follows:

| (Dollars in thousands)  |           |            |            |           |
|---|-----------|------------|------------|-----------|
| December 31, 2009   |           |            |            |           |
|   | Amortized | Gross      | Gross      | Fair      |
|   | Cost      | Unrealized | Unrealized | Value     |
|   |           | Gains      | Losses     |           |
| <b>Available-for-sale securities:</b>   |           |            |            |           |
| Corporate debt securities   | \$ 26,786 | \$ 1,557   | \$ 519     | \$ 27,824 |
| Mortgage backed securities  | 8,203     | 282        | 165        | 8,320     |
| Private label mortgage backed securities  | 9,634     | 72         | 810        | 8,896     |
| Obligations of states and political subdivisions                                      | 15,641    | 211        | 336        | 15,516    |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 9,532     | 261        | 80         | 9,713     |
| Total fixed maturities  | 69,796    | 2,383      | 1,910      | 70,269    |
| Equity securities   | 5,851     | 3,990      | 806        | 9,035     |
| Total   | \$ 75,647 | \$ 6,373   | \$ 2,716   | \$ 79,304 |
| <b>Held-to-maturity securities:</b>   |           |            |            |           |
| Mortgage backed securities  | \$ 3,175  | \$ 101     | \$ 25      | \$ 3,251  |
| Private label mortgage backed securities  | 187       | 5          | -          | 192       |
| Obligations of states and political subdivisions                                      | 2,139     | 51         | 8          | 2,182     |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 441       | 14         | -          | 455       |
| Total   | \$ 5,942  | \$ 171     | \$ 33      | \$ 6,080  |

| December 31, 2008                     |           |            |            |       |
|---------------------------------------|-----------|------------|------------|-------|
|                                       | Amortized | Gross      | Gross      | Fair  |
|                                       | Cost      | Unrealized | Unrealized | Value |
|                                       |           | Gains      | Losses     |       |
| <b>Available-for-sale securities:</b> |           |            |            |       |

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|   |                  |                 |                 |                  |
|---|------------------|-----------------|-----------------|------------------|
| Corporate debt securities   | \$ 21,153        | \$ 84           | \$ 2,277        | \$ 18,960        |
| Mortgage backed securities  | 11,101           | 257             | 24              | 11,334           |
| Private label mortgage backed securities  | 6,590            | 2               | 1,369           | 5,223            |
| Obligations of states and political subdivisions                                      | 13,401           | 81              | 875             | 12,607           |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 9,551            | 433             | 1               | 9,983            |
| <b>Total fixed maturities</b>   | <b>61,796</b>    | <b>857</b>      | <b>4,546</b>    | <b>58,107</b>    |
| Equity securities   | 5,467            | 3,130           | 1,028           | 7,569            |
| <b>Total</b>  | <b>\$ 67,263</b> | <b>\$ 3,987</b> | <b>\$ 5,574</b> | <b>\$ 65,676</b> |
| <b>Held-to-maturity securities:</b>   |                  |                 |                 |                  |
| Corporate debt securities   | \$ 88            | \$ -            | \$ 3            | \$ 85            |
| Mortgage backed securities  | 4,087            | 20              | 41              | 4,066            |
| Private label mortgage backed securities  | 249              | -               | 1               | 248              |
| Obligations of states and political subdivisions                                      | 2,141            | 34              | 14              | 2,161            |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 4,387            | 48              | -               | 4,435            |
| <b>Total</b>  | <b>\$ 10,952</b> | <b>\$ 102</b>   | <b>\$ 59</b>    | <b>\$ 10,995</b> |

Mortgage backed security investments

The insurance subsidiaries' fixed maturity securities include residential mortgage-backed securities (RMBS) of \$21.2 million and \$22 million at amortized value at December 31, 2009 and 2008 respectively. We own no commercial mortgage backed securities. We also have no material direct exposure in sub-prime mortgage loans in our private label RMBS portfolio.

The mortgage-backed bonds are subject to risks associated with variable prepayments of the underlying mortgage loans. Prepayments cause those securities to have different actual maturities than were expected at the time of purchase. Securities that are purchased at a premium to par value and prepay faster than expected will incur a reduction in yield or loss. Securities that are purchased at a discount to par value and prepay faster than expected will generate an increase in yield or gain. The degree to which a security is susceptible to either gains or losses is influenced by the difference between amortized cost and par value, the relative sensitivity of the underlying mortgages backing the assets to prepayments in a changing interest rate environment and the repayment priority of the securities in the overall securitization structure. In order to minimize risk associated with prepayments on collateralized mortgage obligations, the Company typically invests primarily in more predictable planned amortization class (PAC) structures of CMO's and typically avoids investment in CMO's priced at significant premiums above par value.

As for the composition of the RMBS portfolio, agency mortgage backed securities compose 52% and 69% of the RMBS portfolio at December 31, 2009 and 2008, respectively. The remainder of the RMBS portfolio is composed of private label mortgage backed securities. These securities consist primarily of conventional 15 and 30 year loans with an average borrower FICO score of 740. We own no mortgage backed securities with direct exposure to subprime loans and less than 1% of the RMBS portfolio is composed of loans subject to rate resets. Three securities in the private label mortgage backed security portfolio is rated below investment grade and it composes less than 1% of total invested assets.

#### Investment portfolio income

Investment returns with respect to the investment portfolio for the years ended December 31, 2009 and 2008 follows:

|   | Year Ended December<br>31, |            |
|---|----------------------------|------------|
|   | 2009                       | 2008       |
| Net investment<br>income  | \$ 5,289                   | \$ 4,368   |
| Average<br>current yield<br>on investments                                      | 5.5 %                      | 4.9 %      |
| Total return on<br>investments  | 11.5 %                     | -4.5 %     |
| Net realized<br>(losses) gains<br>on investments<br>(before taxes)              | \$ 357                     | \$ (1,049) |
| Change in<br>accumulated<br>net unrealized<br>gains<br>(before<br>income taxes) | \$ 5,339                   | \$ (8,335) |

The increase in the average current yield on investments in 2009 compared to 2008 was primarily due to opportunities created in early 2009 due to a significant increase in spreads and yields on corporate debt. We increased our allocation to corporate debt in early 2009, thus taking advantage of the improved yields in the market.

The total return on investments consists of return of current interest and dividend payments (current yield components) plus realized and unrealized appreciation or depreciation in asset market values. Due to improvement in overall market stability in 2009, we experienced a significant improvement in investment market values. This improvement in market values of long term holdings, along with increased allocation of new investments in corporate debt securities during the depressed market in early 2009, led to an 11.5% total return on our investment portfolio in 2009. The total return in 2009 was a significant turnaround from the 4.5% negative total return experienced in 2008. Significant reductions in market values of portfolio holdings due to a meltdown in credit markets were the primary driver of the negative total return experienced in 2008.

The most significant change in investment income in 2009 compared to 2008 was a decline in realized capital losses and an increase in net unrealized capital gains. The most significant component contributing to the realized capital losses in 2008 were other than temporary impairment charges totaling \$2,973,000. Details of the individual issuers composing the other-than-temporary impairment charges in 2009 and 2008 are as follows:

| Other-than-Temporary<br>Impairments |                |
|-------------------------------------|----------------|
| Issuer                              | OTTI Loss      |
| General                             |                |
| 2009Motors                          | \$ (88,000 )   |
| CIT-bond                            | (165,000 )     |
| CIT-stock                           | (21,000 )      |
| Harborview                          | (92,000 )      |
| Masco                               | (77,000 )      |
|                                     | \$ (443,000 )  |
| Lehman                              |                |
| 2008Brothers                        | \$ (583,000 )  |
| Washington                          |                |
| Mutual                              | (239,000 )     |
| Harborview                          |                |
| Mortgage                            | (234,000 )     |
| American                            |                |
| General                             | (961,000 )     |
| FHLMC                               |                |
| 5.66% PFD                           | (469,000 )     |
| FNMA                                |                |
| PFD                                 | (487,000 )     |
|                                     | \$ (2,973,000) |

#### Repurchase Agreements

The Company maintains a repurchase agreement under which the policy requires 102% (100% minimum) of the fair value of the securities purchased to be maintained as collateral. Cash collateral received is invested in short-term investments. The repurchase investments are limited to government securities that are highly liquid. The company does not have any reverse repurchase agreements.

#### Liquidity and Capital Resources

Due to regulatory restrictions, the majority of the Company's cash is required to be invested in investment-grade securities to provide ample protection for policyholders. The liabilities of the property and casualty insurance subsidiaries are of various terms and, therefore, those subsidiaries invest in securities with various maturities spread over periods usually not exceeding 10 years. The liabilities of the life insurance subsidiary are typically of a longer duration, and therefore, a higher percentage of securities in the life insurance subsidiary are invested for periods exceeding 10 years.

The liquidity requirements for the Company are primarily met by funds generated from operations of the life insurance and property/casualty insurance subsidiaries. Premium and investment income as well as maturities and sales of invested assets provide the primary sources of cash for both the life and property/casualty businesses, while



applications of cash are applied by both businesses to the payment of policy benefits, the cost of acquiring new business (principally commissions), operating expenses, purchases of new investments, and in the case of life insurance, policy loans.

As of December 31, 2009, the maturity schedule for all bonds and notes held by the Company, stated at amortized cost, was as follows:

(Amounts in thousands)

| Maturity                           | Available-<br>for-sale | Held-to-Maturity | Total     | Percentage<br>of Total |   |
|------------------------------------|------------------------|------------------|-----------|------------------------|---|
| Maturity in<br>less than 1<br>year | \$ 419                 | \$ 303           | \$ 722    | 1.0                    | % |
| Maturity in<br>1-5 years           | 14,320                 | 802              | 15,122    | 20.0                   | % |
| Maturity in<br>5-10 years          | 24,013                 | 1,929            | 25,942    | 34.3                   | % |
| Maturity<br>after 10<br>years      | 31,044                 | 2,908            | 33,952    | 44.7                   | % |
|                                    | \$ 69,796              | \$ 5,942         | \$ 75,738 | 100.0                  | % |

It should be noted that the above table represents maturities based on stated maturity. Due to call and prepayment features inherent in some debt securities, actual repayment will differ from stated maturities. The Company routinely evaluates the impact of changing interest rates on the projected maturities of bonds in the portfolio and actively manages the portfolio in order to minimize the impact of interest rate risk.

The National Security Group's consolidated statement of cash flows indicates that cash flow provided from operating activities was \$8,723,000 in 2009 compared to net uses from operating activities of \$5,892,000 in 2008. An improvement in underwriting results in our property and casualty insurance operations in 2009 was the primary source of operating cash flow in 2009. In 2008, the adverse impact of hurricanes Gustav and Ike was the primary contributor to increased uses of cash in operating activities.

In a typical year, cash flow from operating activities and cash flow from investing activities tend to have an inverse relationship. Cash flows from 2008 and 2009 are examples of this inverse relationship. In 2009, improved underwriting results in the property and casualty subsidiaries increased cash from operations. This increased cash from operations was then used to increase investments leading to a net increase in cash used in investing activities. Results for 2008 show a similar relationship between cash from operations and investments but in the opposite direction. Increased uses of cash in operating activities in 2008, primarily the payment of hurricane claims, led us to liquidate certain investments in order to provide more cash to pay claims. Therefore, cash provided from investments of \$8,705,000 was primarily used to support negative cash flow from operations of \$5,892,000.

The consolidated statement of cash flows also reflects a decrease in cash used in financing activities of \$(1,477,000) and \$(3,085,000), respectively. Cash flows from financing activities in 2009 reflect the revision in the Company's dividend policy in which quarterly dividends were reduced from 22.5 cents per share, per quarter to 15 cents per share, per quarter. A short-term loan was also repaid in 2008.

The following table reflects the anticipated cash flows associated with our short- and long-term contractual obligations as of December 31, 2009:

#### Contractual Obligations and Commitments

| Contractual Obligations                           | Total     | Payments due by period<br>(\$ in thousands) |           |           |                   |
|---|-----------|---|-----------|-----------|-------------------|
|   |           | Less than 1 year                            | 1-3 years | 4-5 years | More than 5 years |
| Debt obligations <sup>1</sup>                     | \$ 12,372 | \$ -  | \$ -      | \$ -      | \$ 12,372         |
| Interest on debt obligations <sup>1</sup>         | \$ 25,907 | \$ 1,036                                    | \$ 3,109  | \$ 2,073  | \$ 19,689         |
| Property and casualty claim reserves <sup>2</sup> | \$ 12,646 | \$ 7,714                                    | \$ 4,045  | \$ 632    | \$ 255            |
| Future life insurance obligations <sup>3</sup>    | \$ 73,679 | \$ 4,277                                    | \$ 11,108 | \$ 6,545  | \$ 51,749         |

\*to be calculated

<sup>1</sup> Long-term debt, consisting of two separate issues of trust preferred securities, is assumed to be settled at contractual maturity. Interest on long-term debt is calculated using the interest rates in effect at December 31, 2009 for each issue. Interest on long-term debt is accrued and settled quarterly. Therefore, the timing and amount of interest payments may vary from the calculated value included in the table above. These calculations do not take into account any potential prepayments. For additional information regarding long-term debt and interest on long-term debt, please see Note 9, Notes Payable and Long-term Debt, in the notes to consolidated financial statements.

2 The anticipated payout of property and casualty claim reserves, which includes loss and loss adjustment expenses, are based upon historical payout patterns. Both the timing and amount of these payments may vary from the payment indicated.

3 Future life insurance obligations consist primarily of estimated future contingent benefit payments and surrender benefits on policies inforce at December 31, 2009. These estimated payments are computed using assumptions for future mortality, morbidity and persistency. In contrast to this table, the majority of NSIC's obligations is recorded on the balance sheet at the current account values and do not incorporate an expectation of future market growth, interest crediting or future deposits. Therefore, the estimated future life insurance obligations presented in this table significantly exceed the liabilities recorded in the Company's consolidated balance sheet. Due to the significance of the assumptions used, the actual amount and timing of such payments may differ significantly from the estimated amounts. Management believes that current assets, future premiums and investment income will be sufficient to fund all future life insurance obligations.

Included in long-term debt held by the Company is the issuance of \$9,279,000 in subordinated debentures completed on December 15, 2005. The proceeds from the debentures were used to make a \$6,000,000 capital infusion in the P&C subsidiary National Security Fire and Casualty with the remainder to be held for general corporate purposes. The subordinated debentures mature December 15, 2035. It is anticipated that principal payments will not be made until the expiration of the fixed rate period on the debt in 2015. Also included in long-term debt is the issuance of \$3,093,000 in subordinated debentures completed June 21, 2007. The proceeds from the debentures were used to fund general corporate expenses thereby reducing the amount of dividends to the Group paid by the P&C subsidiary National Security Fire & Casualty thereby continuing to restore capital in the P&C subsidiary National Security Fire and Casualty to pre-hurricane levels. The second issue matures June 15, 2037 and may be redeemed following the fifth anniversary of issuance.

In estimating the time interval for payment of property and casualty claim reserves, the Company utilized historical payment patterns. By the nature of the insurance contracts under which these liabilities exist, there can be no certainty that actual payments will fall in the periods indicated above. However, management believes that current liquidity and capital resources are sufficient to pay these obligations as they come due. Also, due to the relatively short-tail nature of the majority of the Company's claim liabilities, management can conclude with a reasonable level of confidence that historical patterns indicate that approximately 70% of claim liabilities at the end of a given year are settled within the following two year period.

The ability of the Company to meet its commitments for timely payment of claims and other expenses depends, in addition to current cash flow, on the liquidity of its investments. The Company has relatively little exposure to lower grade fixed income investments which might be especially subject to liquidity problems due to thinly traded markets.

Except as discussed in Note 16 to the consolidated financial statements, the Company is aware of no 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.

As disclosed in Note 13 to the consolidated financial statements, in 2009, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company is limited to \$1,250,000 in the life insurance subsidiary and \$4,179,000 in the property/casualty insurance subsidiary. Improved capital positions and operating results have increased the ability of the subsidiaries to pay dividends to the parent company.

An operating line of credit was obtained by the holding company in December of 2009 to allow flexibility with respect to cash management at the holding company level.

#### Off-Balance Sheet Arrangements

The Company has no material off balance sheet arrangements.

#### Statutory Risk-Based Capital of Insurance Subsidiaries

The NAIC has adopted Risk-Based Capital (RBC) requirements for life/health and property/casualty insurance companies to evaluate the adequacy of statutory capital and surplus in relation to investment and insurance risks such as asset quality, mortality and morbidity, asset and liability matching, benefit and loss reserve adequacy, and other business factors. State insurance regulators will use the RBC formula as an early warning tool to identify, for the purpose of initiating regulatory action, insurance companies that potentially are inadequately capitalized. In addition,

the formula defines minimum capital standards that will supplement the current system of low fixed minimum capital and surplus requirements on a state-by-state basis. Regulatory compliance is determined by a ratio of the company's regulatory total adjusted capital, as defined by the NAIC, to its authorized control level RBC, as defined by the NAIC. Companies below specific trigger points or ratios are classified within levels, each of which requires corrective action.

The levels and ratios are as follows:

|                             | Ratio of<br>Total<br>Adjusted<br>Capital to<br>Authorized<br>Control Level<br>RBC<br>(Less Than or<br>Equal to) |
|-----------------------------|---|
| Regulatory<br>Event         |   |
| Company action<br>level     | 2.0   |
| Regulatory action<br>level  | 1.5   |
| Authorized control<br>level | 1.0   |
| Mandatory control<br>level  | 0.7   |

The ratios of Total Adjusted Capital to Authorized Control Level RBC for The National Security Group's life/health and property/casualty insurance subsidiaries are all in excess of 4.0 to 1 at December 31, 2009.

National Security Insurance Company (life insurer) has regulatory adjusted capital of \$9.6 million and \$8.4 million at December 31, 2009 and 2008, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 12.2 and 11.4 at December 31, 2009 and 2008, respectively. Accordingly, National Security Insurance Company exceeds the minimum RBC requirements.

National Security Fire & Casualty Company (property/casualty insurer) has regulatory adjusted capital of \$28.7 million and \$26.8 million at December 31, 2009 and 2008, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 4.6 and 4.0 at December 31, 2009 and 2008, respectively. Accordingly, National Security Fire & Casualty Company exceeds the minimum RBC requirements.

Omega One Insurance Company (property/casualty insurer), which began writing business in late 1995, has regulatory adjusted capital of \$9.6 million and \$9.1 million at December 31, 2009 and 2008, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 23.0 and 25.2 at December 31, 2009 and 2008, respectively. Accordingly, Omega One Insurance Company exceeds the minimum RBC requirements.

#### Application of Critical Accounting Policies

Our consolidated financial statements are based upon the development and application of accounting policies that require management to make significant estimates and assumptions. Accounting policies may be based on (including but not limited to) GAAP authoritative literature, statutory authoritative literature, regulations and industry standards. The Company's financial results would be directly impacted by changes in assumptions and judgments used to select and apply our accounting policies. It is management's opinion that the following are some of the more critical

judgment areas in regards to the application of our accounting policies and their effect on our financial condition and results of operations.

§ Reinsurance

§ Deferred Policy Acquisition Costs

§ Income Taxes

§ Fair Values of Financial Instruments

§ Claim Liabilities

§ Recognition of Revenue

§ Contingencies

§ Recently Issued Accounting Standards

## Reinsurance

Risk management involves ceding risks to reinsurers for policies underwritten based on contractual agreements. The reinsurance purchased helps provide protection by individual loss or catastrophic event when claims exceed specified amounts. Although the reinsurance protects our company in the event a loss penetrates into a particular reinsurance agreement; ultimate responsibility for claim settlement rests with our company if any reinsurer defaults on payments due. We record an asset for reinsurance recoverable on the financials for amounts due from reinsurers and monitor the balances due by reinsurer to ensure the asset is ultimately going to be collectible. If we discover an amount due may not be received we remove the balance and charge it to an allowance for doubtful accounts or charge it off to expense based on the information available at the time.

When a claim is made under a policy we have reinsured, we initially pay the full amount owed to the policyholder or claimant. Subsequently, we initiate the process to recover any amounts due from reinsurers in accordance with the terms of applicable reinsurance treaties.

Reinsurance is maintained by the life and accident and health segment for losses that exceed \$50,000 for any one insured.

NSFC and Omega generally reinsure with third parties any liability in excess of \$225,000 on any single policy. In addition, the property and casualty segment holds a catastrophe contract which covers losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeds the \$3.5 million retention stated in the contract, reinsurers will reimburse the company 95% (5% co-pay) of gross losses and loss adjustment expenses paid up to \$ 17.5 million (layer one and layer two of the contract). If losses exceed \$ 17.5 million, the contract allows for 100% reimbursement of losses and loss adjustment expenses up to \$72.5 million. Any losses above the \$72.5 million upper limit are the responsibility of our company. The contract in place during 2009 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed. The contract provided protection up to at least a 100 year "near term" event as depicted in catastrophe modeling results. The "near term" catastrophe modeling results reflect a predicted increase in storm activity given the current weather pattern and various factors projected to impact our weather patterns in the near term.

At December 31, 2009, the estimated reinsurance recoverable recorded was \$784,000 compared to \$4,146,000 for the same period last year. The Company does not anticipate any issues with collection of the recorded amount.

The reinsurance related amounts recorded have been estimated based upon management's interpretation of the related reinsurance treaty. Areas in which judgment has been used regarding said estimates include: assessing the financial viability and credit quality of each reinsurer as well as the ability of each reinsurer to pay amounts owed.

There is a possibility that the actual amounts recovered from reinsurers could be materially less than the estimates recorded. This possibility could result in a material adverse impact on our financial condition and results of operations. Reinsurers may dispute claims under reinsurance treaties, such as the calculated amount of reinsurance recoverable. Management does not anticipate any issues with recoverability of reinsurance balances based on current evaluations of collectibility.

For more information regarding reinsurance, please see the Notes to our consolidated financial statements.

## Deferred Policy Acquisition Costs

Deferred policy acquisition costs (DAC) are those costs incurred in connection with acquiring new business or renewing existing business. DAC is primarily comprised of commissions, premium taxes, and underwriting costs associated with issuing new policies. In accordance with generally accepted accounting principles, these costs are not



expensed in their entirety at policy inception, rather they are recorded as an asset and amortized over the lives of the policies.

A reduction in DAC is recognized if the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums and projected investment income. Management reviews DAC calculations throughout the year to establish and assess their recoverability. Changes in management's assumptions, estimates or judgment with respect to calculating DAC could materially impact our financial statements and financial condition. Changes in loss ratios, projected investment income, premium rates or overall expense levels could negatively impact the recoverability of DAC.

At December 31, 2009 and 2008, the Company recorded \$10,210,000 and \$9,825,000, respectively, as an asset for DAC in the financial statements. We do not foresee any issues related to recoverability of these capitalized costs. For more information regarding deferred policy acquisition costs, please see Note 1 to our financial statements.

#### Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Deferred income taxes arise from the recognition of temporary differences between financial statement carrying amounts and the tax bases of the Company's assets and liabilities and operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or are settled. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. The effect of a change in tax rates is recognized in the period the new rate is enacted.

At December 31, 2009, there is no evidence to suggest to management that any deferred tax asset is unrealizable. For more information regarding deferred income taxes, please see Note 8 to our financial statements.

The Company evaluates all tax positions taken on its U.S. federal income tax return. No material uncertainties exist for any tax positions taken by the Company

#### Fair Values of Financial Instruments

Investments are recorded at fair value based upon quoted prices when available. Quoted prices are available for most investment debt and equity securities included in the financial statements. Further discussion of fair value methodology is discussed in note 6 to the consolidated financial statements. Periodically, the carrying values of an individual investment may become temporarily impaired because of time value, volatility, credit quality and existing market conditions. Management evaluates investments to determine whether the impairment is other-than-temporary. Evaluation criteria include credit quality of security, severity of decrease between cost and market value, length of time of the impairment and likelihood that the impairment will reverse in the near future. This evaluation requires significant assumptions, estimates and judgments by management. If the impairment is determined to be other-than-temporary, the investment is written down to the current fair value and a realized loss is recorded on the income statement. We have very limited exposure to less liquid and difficult to value investments such as collateralized debt obligations.

#### Claim Liabilities

Property and casualty loss reserves are maintained to cover the estimated unpaid liability for losses and loss adjustment expenses with respect to reported and unreported incurred claims. Loss reserves are an estimation based on actuarial projection techniques common in the insurance industry. Reserves are management's expectations of what the settlement and administration of claims will cost. Management estimated reserves are based on historical settlement patterns, estimated salvage and subrogation, and an appraisal of the related facts and circumstances. Management's reserve estimates are reviewed by consulting actuaries to determine their adequacy and reasonableness. The reserve analysis performed by management is reviewed by the actuaries during the third quarter each year with a final comprehensive review and actuarial sign off performed at year-end.

At December 31, 2009 and 2008, the recorded liability for loss and loss and adjustment expense was \$12,646,000 and \$14,436,000, respectively. The decline in reserves is directly attributable to the absence of hurricanes during 2009. We believe the estimate of unpaid losses and loss adjustment expenses to be sufficient based on currently available information and a review of our historical reserving practices. For more information regarding loss and loss

adjustment expense, see Note 10 to our financial statements.

#### Recognition of Revenue

Life insurance premiums are recognized as revenues when due. Property and casualty insurance premiums include direct writings plus reinsurance assumed less reinsurance ceded and are recognized on a pro rata basis over the terms of the policies. Unearned premiums represent that portion of direct premiums written that are applicable to the unexpired terms of policies in force and is reported as a liability. Prepaid reinsurance premiums represent the unexpired portion of premiums ceded to reinsurers and is reported as an asset.

## Contingencies

Liabilities for loss contingencies arising from, but not limited to, litigation, claims, assessments, fines and penalties are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated. Additional details with respect to contingencies are disclosed in Note 16 to the accompanying Consolidated Financial Statements.

## Recently Issued Accounting Standards

In April 2009, a new accounting standard was issued which amends the recognition guidance for other-than-temporary impairments (OTTI) of debt securities and expands the financial statement disclosures for OTTI on debt and equity securities.

- This new accounting standard states that an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered in circumstances where (1) an entity has the intent to sell a security, (2) it is more-likely-than-not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more-likely-than-not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the difference between the security's amortized cost and its fair value. If an entity does not intend to sell the security or it is not more-likely-than-not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income.
- This new accounting standard requires that companies record, as of the beginning of the interim period of adoption, a cumulative-effect adjustment to reclassify the noncredit component of a previously recognized OTTI loss from retained earnings to other comprehensive income if the company does not intend to sell the security and it is more-likely-than-not that the company will not be required to sell the security before recovery of its amortized cost basis. The adoption had no impact on our financial position or results of operations. The Company had no cumulative-effect adjustment upon adoption at the beginning of the second quarter.

In April 2009, a new accounting standard was issued related to determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. Our adoption of this new accounting standard was effective April 1, 2009. The new accounting standard reaffirms that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The new accounting standard also reaffirms the need to use judgment in determining if a formerly active market has become inactive and in determining fair values when the market has become inactive. The implementation of the new guidance did not have a significant impact on our financial statements.

In April 2009, a new accounting standard was issued related to interim disclosures about fair value of financial instruments. The new accounting standard requires disclosing qualitative and quantitative information about the fair value of all financial instruments on a quarterly basis, including methods and significant assumptions used to estimate fair value during the period. These disclosures were previously only done annually. The disclosures required by the new accounting standard were effective for the quarter ending June 30, 2009. The implementation of the new guidance did not have a significant impact on our financial statements.

In June 2009, a new accounting standard was issued related to the accounting for transfers of financial assets, which updates accounting for securitizations and special-purpose entities. The new accounting standard is a revision of

previously issued accounting standards related to accounting for transfers and servicing of financial assets and extinguishments of liabilities, and will require additional information regarding financial asset transfers, including securitization transactions, and the presence of continuing exposure around the risks related to transferred financial assets. In addition, the new accounting standard removes the concept of a qualifying special-purpose entity and changes the requirements for de-recognizing financial assets. The new accounting standard was effective January 1, 2010. We do not expect the implementation of this new accounting standard to have a significant impact on our financial statements.

In June 2009, new consolidation guidance was issued which replaces the quantitative-based risks and rewards calculation for determining whether an enterprise is the primary beneficiary in a variable interest entity with an approach that is primarily qualitative, requires ongoing assessments whether an enterprise is the primary beneficiary of a variable interest entity, and requires additional disclosure about an enterprise's involvement in variable interest entities. This guidance is effective for financial statements issued for fiscal years beginning after November 15, 2009. We do not expect the adoption of this guidance to have a material impact on our financial statements.

Effective July 1, 2009, the Financial Accounting Standards Board (FASB) issued the Accounting Standards Codification (ASC), which combined and superseded all existing non-SEC accounting and reporting standards under GAAP and became the single official source for authoritative GAAP guidance combined with guidance issued by the U.S. Securities and Exchange Commission (SEC). The FASB no longer issues new standards in the previous formats. Instead, amendments to the Codification are made by issuing "Accounting Standards Updates" (ASU). The Codification did not change existing GAAP. Accordingly, the issuance of the codification did not impact the Company's consolidated results of operations or financial condition.

In August 2009, the FASB issued ASU 2009-05 "Measuring Liabilities at Fair Value" ("ASU 2009-05"). ASU 2009-05 updated ASC Section 820-10 ("Fair Value Measurements") to provide additional guidance on how to measure liabilities at fair value for which a quoted price in an active market is not available. In this situation a company can either use the quoted price of an identical liability when traded as an asset or the quoted price of similar liabilities when traded as assets. As of December 31, 2009, the only liability measured at fair value was an interest rate swap discussed in Note 7. The new guidance was effective for the company on October 1, 2009. The implementation of the new guidance did not have a significant impact on our financial statements.

#### Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Under smaller reporting company rules we are not required to disclose information required under Item 7A. 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.

Since the Company's assets and liabilities are largely monetary in nature, the Company's financial position and earnings are subject to risks resulting from changes in interest rates at varying maturities, changes in spreads over U.S. Treasuries on new investment opportunities and changes in the yield curve and equity pricing risks.

The Company is exposed to equity price risk on its equity securities. The Company holds common stock with a fair value of \$9 million. Our portfolio has historically been highly correlated to the S&P 500 with regard to market risk. Based on an evaluation of the historical risk measure of our portfolio relative to the S&P 500, if the market value of the S & P 500 Index decreased 10% from its December 31, 2009 value, the fair value of the Company's common stock would decrease by approximately \$900,000.

Certain fixed interest rate market risk sensitive instruments may not give rise to incremental income or loss during the period illustrated but may be subject to changes in fair values. Note 1 and 6 in the consolidated financial statements present additional disclosures concerning fair values of Financial Assets and Financial Liabilities and are incorporated by reference herein.



The Company limits the extent of its market risk by purchasing securities that are backed by stable collateral, the majority of the assets are issued by U.S. government sponsored entities. Also, the majority of all of the subsidiaries' CMO's are Planned Amortization Class (PAC) bonds. PAC bonds are typically the lowest risk CMO's, and provide greater cash flow predictability. Such securities with reduced risk typically have a lower yield, but higher liquidity, than higher-risk mortgage backed bonds. To reduce the risk of losing principal should prepayments exceed expectations, the Company does not purchase mortgage backed securities at significant premiums over par value.

The Company's investment approach in the equity markets is based primarily on a fundamental analysis of value. This approach requires the investment committee to invest in well managed, primarily dividend paying companies, which have a low debt to capital ratio, above average return on capital for a sustained period of time, and low volatility rating (beta) relative to the market. The dividends provide a steady cash flow to help pay current claim liabilities, and it has been the Company's experience that by following this investment strategy, long term investment results have been superior to those offered by bonds, while keeping the risk of loss of capital to a minimum relative to the overall equity market.

As for shifts in investment allocations, the company has moderately increased allocations to corporate and tax free bonds. The improved yield spreads on corporate bonds has made this segment more attractive and the risk of investing in corporate bonds versus government bonds is more appropriately priced in our opinion. We have also increased our allocation to tax free securities to further enhance after tax returns given our improved earnings performance over the last two years.



## Item 8. Financial Statements and Supplementary Data

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| All other Schedules are not required under related instructions or are not applicable and therefore have been omitted. |    |



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheet of The National Security Group, Inc. as of December 31, 2009, and the related consolidated statements of operations, shareholders' equity and cash flows for the year then ended. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of The National Security Group, Inc. as of December 31, 2008, were audited by other auditors whose report dated March 20, 2009 expressed an unqualified opinion on those statements.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement and financial statement schedules presentation. We believe that our audit provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The National Security Group, Inc. as of December 31, 2009, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the financial statement schedules listed in the accompanying index appearing under Item 8, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ Warren, Averett, Kimbrough & Marino, LLC

Birmingham, Alabama  
March 26, 2010

| The National Security Group, Inc.  |                        |                   |
|--|------------------------|-------------------|
| CONSOLIDATED BALANCE SHEETS  |                        |                   |
|  | (Dollars in thousands) |                   |
|  | December 31,           |                   |
| ASSETS   | 2009                   | 2008              |
| <b>Investments</b>   |                        |                   |
| Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2009 - \$6,080; 2008 - \$10,995) | \$ 5,942               | \$ 10,952         |
| Fixed maturities available-for-sale, at estimated fair value (cost: 2009 - \$69,796; 2008 - \$61,796)        | 70,269                 | 58,107            |
| Equity securities available-for-sale, at estimated fair value (cost: 2009 - \$5,851; 2008 - \$5,467)         | 9,035                  | 7,569             |
| Trading securities   | 374                    | 253               |
| Receivable for securities  | 96                     | 513               |
| Mortgage loans on real estate, at cost   | 1,041                  | 502               |
| Investment real estate, at book value (accumulated depreciation: 2009 - \$18; 2008 - \$18)                   | 4,815                  | 4,754             |
| Policy loans   | 1,018                  | 968               |
| Company owned life insurance   | 5,197                  | 1,957             |
| Other invested assets  | 3,933                  | 4,557             |
| <b>Total Investments</b>   | <b>101,720</b>         | <b>90,132</b>     |
| Cash   | 4,686                  | 3,027             |
| Accrued investment income  | 802                    | 804               |
| Policy receivables and agents' balances, less allowance (2009 - \$0; 2008 - \$59)                            | 9,700                  | 9,179             |
| Reinsurance recoverable  | 784                    | 4,146             |
| Deferred policy acquisition costs  | 10,210                 | 9,825             |
| Property and equipment, net  | 2,537                  | 2,844             |
| Deferred income tax asset  | -                      | 1,839             |
| Accrued income tax recoverable   | -                      | 2,321             |
| Other assets   | 957                    | 773               |
| <b>Total Assets</b>  | <b>\$ 131,396</b>      | <b>\$ 124,890</b> |

See accompanying notes to consolidated financial statements



| The National Security Group, Inc.  |                   |                   |
|--|-------------------|-------------------|
| CONSOLIDATED BALANCE SHEETS  |                   |                   |
| (Dollars in thousands)   |                   |                   |
| December 31,   |                   |                   |
| LIABILITIES AND SHAREHOLDERS' EQUITY   | 2009              | 2008              |
| Property and casualty benefit and loss reserves  | \$ 12,646         | \$ 14,436         |
| Accident and health benefit and loss reserves  | 1,612             | 1,222             |
| Life and annuity benefit and loss reserves   | 28,579            | 28,045            |
| Unearned premiums  | 27,381            | 27,764            |
| Policy and contract claims   | 535               | 503               |
| Other policyholder funds   | 1,347             | 1,344             |
| Long-term debt   | 12,372            | 12,372            |
| Accrued income taxes   | 111               | -                 |
| Deferred income tax liability  | 61                | -                 |
| Other liabilities  | 5,584             | 4,556             |
| <b>Total Liabilities</b>   | <b>90,228</b>     | <b>90,242</b>     |
| Contingencies  | -                 | -                 |
| Shareholders' Equity   |                   |                   |
| Preferred stock, \$1 par value, 500,000 shares authorized, none issued or outstanding  | -                 | -                 |
| Class A common stock, \$1 par value, 2,000,000 shares authorized, none issued or outstanding                                   | -                 | -                 |
| Common stock, \$1 par value, 3,000,000 and 10,000,000 shares authorized, respectively, 2,466,600 shares issued and outstanding | 2,467             | 2,467             |
| Additional paid-in capital   | 4,951             | 4,951             |
| Accumulated other comprehensive income (loss)  | 2,265             | (1,511 )          |
| Retained earnings  | 31,485            | 28,741            |
| <b>Total Shareholders' Equity</b>  | <b>41,168</b>     | <b>34,648</b>     |
| <b>Total Liabilities and Shareholders' Equity</b>  | <b>\$ 131,396</b> | <b>\$ 124,890</b> |

See accompanying notes to consolidated financial statements

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| The National Security Group, Inc.                  |           |             |
|--|-----------|-------------|
| CONSOLIDATED STATEMENTS OF OPERATIONS              |           |             |
| (Dollars in thousands<br>except per share amounts) |           |             |
| Year Ended December 31,                            |           |             |
|  | 2009      | 2008        |
| <b>REVENUES</b>                                    |           |             |
| Net premiums earned                                | \$ 59,594 | \$ 56,264   |
| Net investment income                              | 5,289     | 4,368       |
| Net realized investment gains (losses)             | 357       | (1,049 )    |
| Other income                                       | 764       | 1,107       |
|  | 66,004    | 60,690      |
| <b>BENEFITS AND EXPENSES</b>                       |           |             |
| Policyholder benefits paid or provided             | 35,839    | 44,746      |
| Amortization of deferred policy acquisition costs  | 3,673     | 4,344       |
| Commissions  | 7,863     | 8,262       |
| General and administrative expenses                | 10,396    | 8,558       |
| Taxes, licenses and fees                           | 1,631     | 1,447       |
| Interest expense                                   | 1,126     | 1,147       |
|  | 60,528    | 68,504      |
| Income (Loss) Before Income Tax Expense (Benefit)  | 5,476     | (7,814 )    |
| <b>INCOME TAX EXPENSE (BENEFIT)</b>                |           |             |
| Current  | 1,136     | (3,495 )    |
| Deferred   | 116       | 885         |
|  | 1,252     | (2,610 )    |
| Net Income(Loss)                                   | \$ 4,224  | \$ (5,204 ) |
| Net Earnings (Loss) Per Common Share               | \$ 1.71   | \$ (2.11 )  |

See accompanying notes to consolidated financial statements





## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Dollars in thousands)

|  |           |                                | Accumulated<br>Other | Common<br>Stock                | Paid-in<br>Capital |
|--|-----------|--------------------------------|----------------------|--------------------------------|--------------------|
|  | Total     | Comprehensive<br>Income (Loss) | Retained<br>Earnings | Comprehensive<br>Income (Loss) |                    |
| Balance at<br>December 31,<br>2007   | \$ 48,447 | \$ -                           | \$ 36,165            | \$ 4,864                       | \$ 4,951           |
| Comprehensive<br>loss:   |           |                                |                      |                                |                    |
| Net loss for<br>2008   | (5,204)   | (5,204)                        | (5,204)              | -                              | -                  |
| Other<br>comprehensive<br>loss, net of tax   |           |                                |                      |                                |                    |
| Unrealized loss<br>on securities,<br>net<br>of<br>reclassification<br>adjustment<br>of (\$978) | (6,147)   | (6,147)                        | -                    | (6,147)                        | -                  |
| Unrealized loss<br>on interest rate<br>swap  | (228)     | (228)                          | -                    | (228)                          | -                  |
| Comprehensive<br>loss  |           | (11,579)                       |                      |                                |                    |
| Cash dividends<br>(\$0.90 per<br>share)  | (2,220)   |                                | (2,220)              | -                              | -                  |
| Balance at<br>December 31,<br>2008   | 34,648    |                                | 28,741               | (1,511)                        | 4,951              |
| Comprehensive<br>income:   |           |                                |                      |                                |                    |
| Net income for<br>2009   | 4,224     | 4,224                          | 4,224                | -                              | -                  |
| Other<br>comprehensive<br>income, net of   |           |                                |                      |                                |                    |

|  |           |       |           |          |          |
|--|-----------|-------|-----------|----------|----------|
| tax  |           |       |           |          |          |
| Unrealized gain<br>on securities,<br>net<br>of<br>reclassification<br>adjustment<br>of \$282 | 3,520     | 3,520 | -         | 3,520    | -        |
| Unrealized gain<br>on interest rate<br>swap  | 256       | 256   | -         | 256      | -        |
| Comprehensive<br>income  |           | 8,000 |           |          |          |
| Cash dividends<br>(\$0.60 per<br>share)  | (1,480)   |       | (1,480)   | -        | -        |
| Balance at<br>December 31,<br>2009   | \$ 41,168 |       | \$ 31,485 | \$ 2,265 | \$ 4,951 |
|  |           |       |           | \$ 2,467 |          |

See accompanying notes to consolidated financial statements.

| The National Security Group, Inc.   |           |             |
|---|-----------|-------------|
| CONSOLIDATED STATEMENTS OF CASH FLOWS   |           |             |
| (Dollars in thousands)  |           |             |
| Year ended December 31,   |           |             |
|   | 2009      | 2008        |
| Cash flows from operating activities:   |           |             |
| Net income (loss)   | \$ 4,224  | \$ (5,204 ) |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |           |             |
| Depreciation expense and amortization/accretion, net  | 229       | 409         |
| Increase in cash surrender of company owned life insurance                                  | ( 740 )   | 543         |
| Net realized (gains) losses on investments  | ( 357 )   | 1,049       |
| Deferred income taxes   | 116       | ( 885 )     |
| Amortization of deferred policy acquisition costs   | 3,673     | 4,344       |
| Changes in assets and liabilities:  |           |             |
| Change in receivable for securities   | 417       | ( 513 )     |
| Change in accrued investment income   | 2         | ( 10 )      |
| Change in reinsurance recoverable   | 3,362     | ( 3,229 )   |
| Policy acquisition costs deferred   | ( 4,058 ) | ( 5,176 )   |
| Change in accrued income taxes  | 2,432     | ( 3,400 )   |
| Change in prepaid reinsurance premiums  | ( 10 )    | ( 2 )       |
| Change in net policy liabilities and claims   | ( 1,738 ) | 8,105       |
| Change in other liabilities   | 1,284     | ( 2,204 )   |
| Other, net  | ( 113 )   | 281         |
| Net cash provided by (used in) operating activities   | 8,723     | ( 5,892 )   |
| Cash flows from investing activities:   |           |             |
| Purchases of:   |           |             |
| Available-for-sale securities   | (30,594 ) | (22,514 )   |
| Trading securities and short-term investments   | ( 141 )   | ( 154 )     |
| Real estate held for investment   | ( 66 )    | ( 446 )     |
| Company owned life insurance  | ( 2,500 ) | ( 2,500 )   |
| Other invested assets   | ( 108 )   | ( 3,714 )   |
| Property and equipment  | ( 116 )   | ( 368 )     |
| Proceeds from sale or maturities of:  |           |             |
| Held-to-maturity securities   | 4,926     | 6,377       |
| Available-for-sale securities   | 22,830    | 28,938      |
|   | 20        | 1,165       |

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|   |           |           |
|---|-----------|-----------|
| Trading securities and short-term investments       |           |           |
| Real estate held for investment                     | 19        | 720       |
| Other invested assets                               | 732       | 1,259     |
| Other   | ( 589 )   | ( 58 )    |
| Net cash (used in) provided by investing activities |           |           |
|   | ( 5,587 ) | 8,705     |
| Cash flows from financing activities:               |           |           |
| (Repayment of) Proceeds from short-term debt        |           |           |
|   | -         | ( 900 )   |
| Change in other policyholder funds                  | 3         | 35        |
| Dividends paid                                      | ( 1,480 ) | ( 2,220 ) |
| Net cash used in financing activities               |           |           |
|   | ( 1,477 ) | ( 3,085 ) |
| Net increase (decrease) in cash                     |           |           |
|   | 1,659     | ( 272 )   |
| Cash at beginning of year                           |           |           |
|   | 3,027     | 3,299     |
| Cash at end of year                                 |           |           |
|   | \$ 4,686  | \$ 3,027  |

See accompanying notes to consolidated financial statements.

## NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

### Principles of Consolidation and Basis of Presentation

The accompanying 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 significant accounting policies followed by the Company and subsidiaries that materially affect financial reporting are summarized below.

### Description of Business

NSIC is licensed in the states of Alabama, Florida, Georgia, Mississippi, South Carolina and Texas and was organized in 1947 to provide life and burial insurance policies to the home service market. Business is now produced by both company and independent agents. Primary products include ordinary life, accident and health, supplemental hospital, and cancer insurance products.

NSFC is licensed in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia. In addition, NSFC operates on a surplus lines basis in Louisiana, Missouri, and Texas. NSFC operates in various property and casualty lines, the most significant of which are dwelling property fire and extended coverage, homeowners, mobile homeowners, ocean marine, private passenger automobile physical damage and liability and commercial auto liability.

Omega is licensed in the states of Alabama and Louisiana. Omega operates in property and casualty lines, the most significant of which are homeowners and private passenger automobile physical damage and liability.

The Company is incorporated under the laws of the State of Delaware. Its Common Stock is traded on the NASDAQ Global Market under the ticker symbol NSEC. Pursuant to the regulations of the United States Securities and Exchange Commission (SEC), the Company is considered a “Smaller Reporting Company” as defined by SEC Rule 12b-2 of the Exchange Act. The Company has elected to comply with the new scaled disclosure requirements of Regulation S-K and only two years of financial statements are included herein. The Company previously used a non-accelerated filer status.

### 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, and assessments of other than temporary impairments on investments. Actual results could differ from those estimates.

### Concentration of Risk

The Company’s property and casualty segment is licensed or operates on a surplus lines basis in 13 states. However, over 60% of segment revenue is generated in the states of Alabama, Mississippi and Louisiana, subjecting the Company to significant geographic concentration. Consequently, adverse weather conditions or changes in the legal,

regulatory or economic environment could adversely impact the Company.

The Company's life, accident and health insurance segment, composing nearly 12% of consolidated revenues, is licensed in six states. However, over 75% of segment revenue is generated in the states of Alabama and Georgia. Consequently, changes in the legal, regulatory or economic environment could adversely impact the Company.

For the year ended December 31, 2009 and 2008, there was one agency in the property and casualty segment that individually produced greater than 5% of the Company's direct written premium.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Investments

The Company's securities are classified as follows:

- **Securities Held-to-Maturity.** Bonds, notes and redeemable preferred stock for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.
- **Securities Available-for-Sale.** Bonds, notes, common stock and non-redeemable preferred stock not classified as either held-to-maturity, or trading are reported at fair value, and adjusted for other-than-temporary declines in fair value.
- **Trading Securities.** Trading securities are classified as such on the balance sheet and reported at fair value.

Unrealized gains and losses on investments, net of tax, on securities available-for-sale are reflected directly in shareholders' equity as a component of accumulated other comprehensive income, and accordingly, have no effect on net income until realized.

Changes in fair value of trading securities are recognized in net income.

Realized gains and losses on the sale of investments available-for-sale are determined using the specific-identification method and include write downs on available-for-sale investments considered to have other than temporary declines in market value.

When a fixed maturity security has a decline in value, where fair value is below amortized cost, an other-than-temporary impairment (OTTI) is triggered in circumstances where:

- the Company has the intent to sell the security
- it is more likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis
  - the Company does not expect to recover the entire amortized cost basis of the security.

If the Company intends to sell the security or if it is more-likely-than not the Company will be required to sell the security before recovery, an OTTI is recognized as a realized loss in the income statement equal to the difference between the security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more-likely-than not that the Company will be required to sell the security before recovery, the OTTI is separated into an amount representing the credit loss, which is recognized as a realized loss in the income statement, and the amount related to all other factors, which is recognized in other comprehensive income.

When an equity security has a decline in value, where fair value is below cost, that is deemed to be other than temporary, the Company reduces the book value of the security to its current fair value, recognizing the decline as a realized loss in the income statement. Any future increases in the market value of investments written down are reflected as changes in unrealized gains as part of accumulated other comprehensive income within stockholders' equity.



Interest on fixed income securities is credited to income as it accrues on the principal amounts outstanding adjusted for amortization of premiums and accretion of discounts computed utilizing the effective interest rate method. Premiums and discounts on mortgage backed securities are amortized or accreted using anticipated prepayments with changes in anticipated prepayments accounted for prospectively. The model used to determine anticipated prepayment assumptions for mortgage backed securities uses separate home sale, refinancing, curtailment and pay-off assumptions derived from a variety of industry sources. Mortgage-backed security valuations are subject to prospective adjustments in yield due to changes in prepayment assumptions. The utilization of the prospective method will result in a recalculated effective yield that will equate the carrying amount of the investment to the present value of the projected future cash flows. The recalculated yield is used to accrue income on investments for subsequent periods.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Mortgage loans and policy loans are stated at the unpaid principal balance of such loans.

Investment real estate is reported at cost, less allowances for depreciation computed on the straight-line basis. Investment real estate consists primarily of timberland and undeveloped commercial real estate. Real estate is carried at cost.

Other investments consist primarily of investments in notes and equity investments in limited liability companies and company owned life insurance. The Company has no influence or control over the operating or financial policies of the investee limited liability companies and consequently, these investments are accounted for using the cost method.

The Company owns life insurance contracts on certain management employees. The life insurance contracts are carried at their current cash surrender value. Changes in cash surrender values are included in income in the current period. Death proceeds from the contracts are recorded when the proceeds become payable under the terms of the policy.

Cash and short-term investments are carried at cost, which approximates market value.

Investments with other than temporary impairment in value are written down to estimated realizable values and losses recognized in the determination of net income. The fair value of the investment becomes its new cost basis.

Fair Values of Financial Instruments

The Company uses the following methods and assumptions to estimate fair values:

Investments – Fixed income security fair values are based on quoted market prices when available. If not available, fair values are based on values obtained from investment brokers and independent pricing services.

Equity security fair values are based on quoted market prices.

Multiple observable inputs are not available for certain of our investments, primarily private placements and limited partnerships. Management values these investments either using non-binding broker quotes or pricing models that utilize market based assumptions that have limited observable inputs.

Receivables and reinsurance recoverable – The carrying amounts reported approximate fair value.

Interest rate swaps – The estimated fair value of the interest rate swaps is based on valuations received from financial institution counterparties.

Trust preferred securities obligations and line of credit obligations – The carrying amounts reported for these instruments are equal to the principal balance outstanding and approximate their fair value.

Policy Receivables

Receivable balances are reported at unpaid balances, less a provision for credit losses.

Accounts Receivable

Accounts receivable are reported at net realizable value. Management determines the allowance for doubtful accounts based on historical losses and current economic conditions. On a continuing basis, management analyzes delinquent receivables and, once these receivables are determined to be uncollectible, they are written off through a charge

against an existing allowance account or against earnings.

#### Property and Equipment

Property and equipment is carried at cost less accumulated depreciation and includes expenditures that substantially increase the useful lives of existing property and equipment. Significant costs incurred for internally developed software are capitalized and amortized over estimated useful lives of 3 years. Maintenance, repairs, and minor renovations are charged to expense as incurred. Upon sale or retirement of property and equipment, the costs and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations. The Company provides for depreciation of property and equipment using the straight-line method designed to amortize costs over estimated useful lives. Estimated useful lives range up to 40 years for buildings and from 3-8 years

## NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

for electronic data processing equipment and furniture and fixtures. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

## Statement of Cash Flows

For purposes of reporting cash flows, cash includes cash-on-hand, demand deposits with banks and overnight investments.

## Premium Revenue

Life insurance premiums are recognized as revenues when due. Property and casualty insurance premiums include direct writings plus reinsurance assumed less reinsurance ceded and are recognized on a pro rata basis over the terms of the policies. Unearned premiums represent that portion of direct premiums written that are applicable to the unexpired terms of policies in force and is reported as a liability. Prepaid reinsurance premiums represent the unexpired portion of premiums ceded to reinsurers and is reported as an asset.

## Deferred Policy Acquisition Costs

The costs of acquiring new insurance business are deferred and amortized over the lives of the policies. Deferred costs include commissions, premium taxes, other agency compensation and expenses, and other underwriting expenses directly related to the level of new business produced.

Acquisition costs relating to life contracts are amortized over the premium paying period of the contracts, or the first renewal period of term policies, if earlier. Assumptions utilized in amortization are consistent with those utilized in computing policy liabilities.

The method of computing the deferred policy acquisition costs for property and casualty policies limits the amount deferred to a percentage of related unearned premiums.

## Policy Liabilities

The liability for future life insurance policy benefits is computed using a net level premium method including the following assumptions:

| Years of Issue | Interest Rate   |
|----------------|-----------------|
| 1947 - 1968    | 4%              |
| 1969 - 1978    | 6% graded to 5% |
| 1979 - 2003    | 7% graded to 6% |
| 2004 - 2009    | 5.25%           |

Mortality assumptions include various percentages of the 1955-60 and 1965-70 Select and Ultimate Basic Male Mortality Table. Withdrawal assumptions are based on the Company's experience.

## Claim Liabilities

The liability for unpaid claims represents the estimated liability for claims reported to the Company and its subsidiaries plus claims incurred but not yet reported and the related loss adjustment expenses. The liabilities for claims and related adjustment expenses are determined using case-basis evaluations and statistical analyses and represent estimates of the ultimate net cost of all losses incurred through December 31 of each year. Although considerable variability is inherent in such estimates, management believes that the liabilities for unpaid claims and related loss adjustment expenses are adequate. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in the period in which they are determined.

#### Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,466,600 (2,466,600 in 2008).

#### 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. In 2009, NSFC maintained a catastrophe reinsurance agreement to cover losses from catastrophic events, primarily hurricanes.

## NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Under the catastrophe reinsurance program, the Company retains the first \$3.5 million in losses from each event. Reinsurance is maintained in four layers as follows:

|        | Reinsurers' Limits      |
|--------|-------------------------|
| Layer  | of Liability            |
| First  | 95% of \$6,500,000 in   |
| Layer  | excess of \$3,500,000   |
| Second | 95% of \$7,500,000 in   |
| Layer  | excess of \$10,000,000  |
| Third  | 100% of \$25,000,000 in |
| Layer  | excess of \$17,500,000  |
| Fourth | 100% of \$30,000,000 in |
| Layer  | excess of \$42,500,000  |

Layers 1-3 cover events occurring from January 1-December 31 of the contract year. The Company placed the fourth layer in July allowing an interim review of exposure and projected storm patterns for the current contract year. The fourth layer covers events occurring from July 1-June 30 of the contract year. All significant reinsurers under the program carry A.M. Best ratings of A- (Excellent) or higher.

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.

#### Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Deferred income taxes arise from the recognition of temporary differences between financial statement carrying amounts and the tax bases of the Company's assets and liabilities and operating loss carry-forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. The effect of a change in tax rates is recognized in the period the new rate is enacted.

The Company evaluates all tax positions taken on its U.S. federal income tax return. No material uncertainties exist for any tax positions taken by the Company.

#### Contingencies

Liabilities for loss contingencies arising from, but not limited to, litigation, claims, assessments, fines and penalties are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

#### Reclassifications

Certain 2008 amounts have been reclassified from the prior year financial statements to conform to the 2009 presentation.

#### Advertising

The Company expenses advertising costs as incurred. Advertising costs charged to expense were \$109,000 for the year ended December 31, 2009 (\$186,000 for the year ended December 31, 2008). Advertising cost consists primarily of agent convention expense and print media.

#### Concentration of Credit Risk

The Company maintains cash depository accounts which, at times, may exceed federally insured limits. These amounts represent actual account balances held by financial institutions at the end of the period, and unlike the balance reported in the financial statements, the account balances do not reflect timing delays inherent in reconciling items such as outstanding checks and deposits in transit. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant credit risk on cash and cash equivalents.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At December 31, 2009 the single largest balance due from one agent totaled \$525,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At December 31, 2009 and 2008, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At December 31, 2009, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Recently Issued Accounting Standards

In April 2009, a new accounting standard was issued which amends the recognition guidance for other-than-temporary impairments (OTTI) of debt securities and expands the financial statement disclosures for OTTI on debt and equity securities.

- This new accounting standard states that an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered in circumstances where (1) an entity has the intent to sell a security, (2) it is more-likely-than-not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more-likely-than-not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the difference between the security's amortized cost and its fair value. If an entity does not intend to sell the security or it is not more-likely-than-not that it will be required to sell the security before recovery, the OTTI write-down is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income.
- This new accounting standard requires that companies record, as of the beginning of the interim period of adoption, a cumulative-effect adjustment to reclassify the noncredit component of a previously recognized OTTI loss from retained earnings to other comprehensive income if the Company does not intend to sell the security and it is more-likely-than-not that the Company will not be required to sell the security before recovery of its amortized cost basis. The adoption had no impact on our financial position or results of operations. The Company had no cumulative-effect adjustment upon adoption at the beginning of the second quarter.

In April 2009, a new accounting standard was issued related to determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. Our adoption of this new accounting standard was effective April 1, 2009. The new accounting standard reaffirms that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The new accounting standard also reaffirms the need to use judgment in determining if a formerly active market has become inactive and in determining fair values when the market has become inactive. The implementation of the new guidance did not have a significant impact on our financial statements.

In April 2009, a new accounting standard was issued related to interim disclosures about fair value of financial instruments. The new accounting standard requires disclosing qualitative and quantitative information about the fair value of all financial instruments on a quarterly basis, including methods and significant assumptions used to estimate



fair value during the period. These disclosures were previously only done annually. The disclosures required by the new accounting standard were effective for the quarter ending June 30, 2009. The implementation of the new guidance did not have a significant impact on our financial statements.

In June 2009, a new accounting standard was issued related to the accounting for transfers of financial assets, which updates accounting for securitizations and special-purpose entities. The new accounting standard is a revision of previously issued accounting standards related to accounting for transfers and servicing of financial assets and extinguishments of liabilities, and will require additional information regarding financial asset transfers, including

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

securitization transactions, and the presence of continuing exposure around the risks related to transferred financial assets. In addition, the new accounting standard removes the concept of a qualifying special-purpose entity and changes the requirements for de-recognizing financial assets. The new accounting standard was effective January 1, 2010. We do not expect the implementation of this new accounting standard to have a significant impact on our financial statements.

In June 2009, new consolidation guidance was issued which replaces the quantitative-based risks and rewards calculation for determining whether an enterprise is the primary beneficiary in a variable interest entity with an approach that is primarily qualitative, requires ongoing assessments whether an enterprise is the primary beneficiary of a variable interest entity, and requires additional disclosure about an enterprise's involvement in variable interest entities. This guidance is effective for financial statements issued for fiscal years beginning after November 15, 2009. We do not expect the adoption of this guidance to have a material impact on our financial statements.

Effective July 1, 2009, the Financial Accounting Standards Board (FASB) issued the Accounting Standards Codification (ASC), which combined and superseded all existing non-SEC accounting and reporting standards under GAAP and became the single official source for authoritative GAAP guidance combined with guidance issued by the U.S. Securities and Exchange Commission (SEC). The FASB no longer issues new standards in the previous formats. Instead, amendments to the Codification are made by issuing "Accounting Standards Updates" (ASU). The Codification did not change existing GAAP. Accordingly, the issuance of the codification did not impact the Company's consolidated results of operations or financial condition.

In August 2009, the FASB issued ASU 2009-05 "Measuring Liabilities at Fair Value" ("ASU 2009-05"). ASU 2009-05 updated ASC Section 820-10 ("Fair Value Measurements") to provide additional guidance on how to measure liabilities at fair value for which a quoted price in an active market is not available. In this situation a company can either use the quoted price of an identical liability when traded as an asset or the quoted price of similar liabilities when traded as assets. As of December 31, 2009, the only liability measured at fair value was an interest rate swap discussed in Note 7. The new guidance was effective for the company on October 1, 2009. The implementation of the new guidance did not have a significant impact on our financial statements.

NOTE 2 – VARIABLE INTEREST ENTITIES

The Company holds a passive interest in a limited partnership that is considered to be a Variable Interest Entity (VIE) under the provisions of FIN 46(R). The Company is not the primary beneficiary of the entity and is not required to consolidate under FIN 46(R). The entity is a private placement investment fund formed for the purpose of investing in private equity investments. The Company owns less than 1% of the limited partnership. The carrying value of the investment totals \$325,000 and is included as a component of Other Invested Assets.

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, \$9,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$9,300,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 9, are reported in the accompanying Consolidated Balance

Sheets as a component of long-term debt. The Company's equity investments in the Trust total \$279,000 and are included in Other Assets.

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, \$3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$3,093,000 unsecured junior subordinated deferrable interest debentures. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$2,995,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the Trust. The Subordinated Debentures, disclosed in Note 9, are reported in the accompanying Consolidated Balance

## NOTE 2 – VARIABLE INTEREST ENTITIES – CONTINUED

Sheets as a component of long-term debt. The Company's equity investments in the Trust total \$93,000 and are included in Other Assets.

## NOTE 3 – STATUTORY ACCOUNTING PRACTICES

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) which vary in certain respects from reporting practices prescribed or permitted by insurance regulatory authorities. The significant differences for statutory reporting include: (a) acquisition costs of acquiring new business are charged to operations as incurred, (b) life policy liabilities are established utilizing interest and mortality factors specified by regulatory authorities, (c) the Asset Valuation Reserve (AVR) and the Interest Maintenance Reserve (IMR) are recorded as liabilities, and (d) non-admitted assets (furniture and equipment, agents' debit balances and prepaid expenses) are charged directly to surplus.

Statutory net gains (losses) from operations and capital and surplus, excluding intercompany transactions, are summarized as follows:

|   | 2009      | 2008        |
|---|-----------|-------------|
| NSIC - including realized capital gains (losses) of \$234 and \$(1,509), respectively | \$ 1,314  | \$ (442 )   |
| NSFC - including realized capital gains of \$198 and \$615, respectively              | \$ 4,179  | \$ (5,730 ) |
| Omega - including realized capital (losses) of \$(78) and \$(231), respectively       | \$ 246    | \$ (344 )   |
| Statutory risk-based adjusted capital:  |           |             |
| NSIC - including AVR of \$517 and \$191, respectively                                 | \$ 9,642  | \$ 8,396    |
| NSFC  | \$ 28,742 | \$ 26,783   |
| Omega   | \$ 9,568  | \$ 9,087    |

The above amounts exclude allocation of overhead from the Company. NSIC, NSFC and Omega are in compliance with statutory restrictions with regard to minimum amounts of surplus and capital.

## NOTE 4 – INVESTMENT SECURITIES

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

| (Dollars in thousands)  |           |            |            |           |
|---|-----------|------------|------------|-----------|
| December 31, 2009   |           |            |            |           |
|   | Amortized | Gross      | Gross      | Fair      |
|   | Cost      | Unrealized | Unrealized | Value     |
|   |           | Gains      | Losses     |           |
| Available-for-sale securities:  |           |            |            |           |
| Corporate debt securities   | \$ 26,786 | \$ 1,557   | \$ 519     | \$ 27,824 |
| Mortgage backed securities  | 8,203     | 282        | 165        | 8,320     |
| Private label mortgage backed securities  | 9,634     | 72         | 810        | 8,896     |
| Obligations of states and political subdivisions                                      | 15,641    | 211        | 336        | 15,516    |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 9,532     | 261        | 80         | 9,713     |
| Total fixed maturities  | 69,796    | 2,383      | 1,910      | 70,269    |
| Equity securities   | 5,851     | 3,990      | 806        | 9,035     |
| Total   | \$ 75,647 | \$ 6,373   | \$ 2,716   | \$ 79,304 |
| Held-to-maturity securities:  |           |            |            |           |
| Mortgage backed securities  | \$ 3,175  | \$ 101     | \$ 25      | 3,251     |
| Private label mortgage backed securities  | 187       | 5          | -          | 192       |
| Obligations of states and political subdivisions                                      | 2,139     | 51         | 8          | 2,182     |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 441       | 14         | -          | 455       |
| Total   | \$ 5,942  | \$ 171     | \$ 33      | \$ 6,080  |
| December 31, 2008   |           |            |            |           |
|   |           | Gross      | Gross      |           |
|   |           |            |            |           |

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|   | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|---------------------|----------------------|---------------|
| Available-for-sale securities:  |                   |                     |                      |               |
| Corporate debt securities   | \$ 21,153         | \$ 84               | \$ 2,277             | \$ 18,960     |
| Mortgage backed securities  | 11,101            | 257                 | 24                   | 11,334        |
| Private label mortgage backed securities  | 6,590             | 2                   | 1,369                | 5,223         |
| Obligations of states and political subdivisions                                      | 13,401            | 81                  | 875                  | 12,607        |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 9,551             | 433                 | 1                    | 9,983         |
| Total fixed maturities  | 61,796            | 857                 | 4,546                | 58,107        |
| Equity securities   | 5,467             | 3,130               | 1,028                | 7,569         |
|   |                   |                     |                      |               |
| Total   | \$ 67,263         | \$ 3,987            | \$ 5,574             | \$ 65,676     |
| Held-to-maturity securities:  |                   |                     |                      |               |
| Corporate debt securities   | \$ 88             | \$ -                | \$ 3                 | \$ 85         |
| Mortgage backed securities  | 4,087             | 20                  | 41                   | 4,066         |
| Private label mortgage backed securities  | 249               | -                   | 1                    | 248           |
| Obligations of states and political subdivisions                                      | 2,141             | 34                  | 14                   | 2,161         |
| U.S. Treasury securities and obligations of U.S. Government corporations and agencies | 4,387             | 48                  | -                    | 4,435         |
|   |                   |                     |                      |               |
| Total   | \$ 10,952         | \$ 102              | \$ 59                | \$ 10,995     |

## NOTE 4 – INVESTMENT SECURITIES – CONTINUED

The amortized cost and aggregate fair value of debt securities at December 31, 2009, 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 | Fair      |
| Available-for-sale securities:         | Cost      | Value     |
| Due in one year or less                | \$ 419    | \$ 425    |
| Due after one year through five years  | 14,320    | 15,551    |
| Due after five years through ten years | 24,013    | 24,433    |
| Due after ten years                    | 31,044    | 29,860    |
|  |           |           |
| Total                                  | \$ 69,796 | \$ 70,269 |
| Held-to-maturity securities:           |           |           |
| Due in one year or less                | \$ 303    | \$ 309    |
| Due after one year through five years  | 802       | 828       |
| Due after five years through ten years | 1,929     | 1,991     |
| Due after ten years                    | 2,908     | 2,952     |
|  |           |           |
| Total                                  | \$ 5,942  | \$ 6,080  |

A summary of securities available-for-sale with unrealized losses as of December 31, 2009 and 2008 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:

| (Dollars in thousands) |            |                     |            |        |            |        | December 31, 2009 |            |
|------------------------|------------|---------------------|------------|--------|------------|--------|-------------------|------------|
| Less than 12 months    |            | 12 months or longer |            |        |            |        | Total             |            |
| Gross                  |            | Gross               |            |        |            |        | Gross             | Total      |
| Fair                   | Unrealized | Fair                | Unrealized | Fair   | Unrealized | Gross  | Unrealized        | Securities |
| Value                  | Losses     | Value               | Losses     | Value  | Losses     | Losses | Losses            | in a       |
|                        |            |                     |            |        |            |        |                   | Loss       |
|                        |            |                     |            |        |            |        |                   | Position   |
| Fixed maturities:      |            |                     |            |        |            |        |                   |            |
|                        | \$ 1,856   | \$ 21               | \$ 6,772   | \$ 498 | \$ 8,628   | \$ 519 |                   | 23         |

|   |           |        |           |          |           |          |    |
|---|-----------|--------|-----------|----------|-----------|----------|----|
| Corporate debt securities   |           |        |           |          |           |          |    |
| Mortgage backed securities  | 1,443     | 156    | 71        | 9        | 1,514     | 165      | 6  |
| Private label mortgage backed securities  | 2,660     | 72     | 4,651     | 738      | 7,311     | 810      | 15 |
| Obligations of state and political subdivisions                                       | 5,889     | 199    | 991       | 137      | 6,880     | 336      | 21 |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | 3,708     | 80     | -         | -        | 3,708     | 80       | 11 |
| Equity securities   | 78        | 13     | 2,283     | 793      | 2,361     | 806      | 13 |
|   | \$ 15,634 | \$ 541 | \$ 14,768 | \$ 2,175 | \$ 30,402 | \$ 2,716 | 89 |



## NOTE 4 – INVESTMENT SECURITIES – CONTINUED

|   | (Dollars in thousands) |                   |                     |                   |            |                   | December 31, 2008                   |  |
|---|------------------------|-------------------|---------------------|-------------------|------------|-------------------|-------------------------------------|--|
|   | Less than 12 months    |                   | 12 months or longer |                   | Total      |                   | Total Securities in a Loss Position |  |
|   | Gross                  |                   | Gross               |                   | Gross      | Unrealized        |                                     |  |
|   | Fair Value             | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |                                     |  |
| Fixed maturities:   |                        |                   |                     |                   |            |                   |                                     |  |
| Corporate debt securities   | \$ 9,904               | \$ 1,337          | \$ 4,396            | \$ 940            | \$ 14,300  | \$ 2,277          | 45                                  |  |
| Mortgage backed securities  | 315                    | 5                 | 1,868               | 19                | 2,183      | 24                | 9                                   |  |
| Private label mortgage backed securities  | 412                    | 87                | 4,354               | 1,282             | 4,766      | 1,369             | 11                                  |  |
| Obligations of state and political subdivisions                                       | 3,745                  | 332               | 4,812               | 543               | 8,557      | 875               | 25                                  |  |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | 295                    | 1                 | -                   | -                 | 295        | 1                 | 1                                   |  |
| Equity securities   | 981                    | 446               | 731                 | 582               | 1,712      | 1,028             | 12                                  |  |
|   | \$ 15,652              | \$ 2,208          | \$ 16,161           | \$ 3,366          | \$ 31,813  | \$ 5,574          | 103                                 |  |

For 2009, gross gains of \$1,102,000 (\$2,070,000 for 2008) and gross losses of \$319,000 (\$611,000 for 2008) were realized on sales of available-for-sale-securities.

A summary of securities held-to-maturity with unrealized losses as of December 31, 2009 and 2008 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:

|  | (Dollars in thousands) |                   |                     |                   |            |                   | December 31, 2009                   |  |
|--|------------------------|-------------------|---------------------|-------------------|------------|-------------------|-------------------------------------|--|
|  | Less than 12 months    |                   | 12 months or longer |                   | Total      |                   | Total Securities in a Loss Position |  |
|  | Gross                  |                   | Gross               |                   | Gross      | Unrealized        |                                     |  |
|  | Fair Value             | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |                                     |  |

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|   | Value               | Losses            | Value               | Losses            | Value      | Losses            | Loss Position                 |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|-------------------------------|
| Fixed maturities:   |                     |                   |                     |                   |            |                   |                               |
| Corporate debt securities   | \$ -                | \$ -              | \$ -                | \$ -              | \$ -       | \$ -              | -                             |
| Mortgage backed securities  | -                   | -                 | 333                 | 25                | 333        | 25                | 2                             |
| Private label mortgage backed securities  | -                   | -                 | -                   | -                 | -          | -                 | -                             |
| Obligations of state and political subdivisions                                       | 160                 | 4                 | 351                 | 4                 | 511        | 8                 | 2                             |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | -                   | -                 | -                   | -                 | -          | -                 | -                             |
|   | \$ 160              | \$ 4              | \$ 684              | \$ 29             | \$ 844     | \$ 33             | 4                             |
| (Dollars in thousands)  |                     |                   |                     |                   |            | December 31, 2008 |                               |
|   | Less than 12 months |                   | 12 months or longer |                   | Total      |                   |                               |
|   | Gross               |                   | Gross               |                   | Gross      | Total             |                               |
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses | Securities in a Loss Position |
| Fixed maturities:   |                     |                   |                     |                   |            |                   |                               |
| Corporate debt securities   | \$ 84               | \$ 3              | \$ -                | \$ -              | \$ 84      | \$ 3              | 1                             |
| Mortgage backed securities  | -                   | -                 | 2,408               | 41                | 2,408      | 41                | 7                             |
| Private label mortgage backed securities  | 249                 | 1                 | -                   | -                 | 249        | 1                 | 1                             |
| Obligations of state and political subdivisions                                       | -                   | -                 | 646                 | 14                | 646        | 14                | 2                             |
| U.S. Treasury securities and  |                     |                   |                     |                   |            |                   |                               |

obligations of  
U.S.  
government  
corporations  
and agencies

|        |      |          |       |          |       |    |
|--------|------|----------|-------|----------|-------|----|
| -      | -    | -        | -     | -        | -     | -  |
| \$ 333 | \$ 4 | \$ 3,054 | \$ 55 | \$ 3,387 | \$ 59 | 11 |

## NOTE 4 – INVESTMENT SECURITIES – CONTINUED

According to the most recent accounting guidance, for securities in an unrealized loss position, the Company is required to assess 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. For the year ended December 31, 2009, the Company realized \$443,000 in other than temporary impairments. The single largest accumulated loss was in the equity portfolio and totaled \$337,000. The second largest loss position was in the bond portfolio and totaled \$332,000. The third largest loss position was in the equity portfolio and totaled \$163,000. Most unrealized losses in the fixed income portfolio are interest rate driven as opposed to credit quality driven and management believes no ultimate loss will be realized. The Company has no material exposure to sub-prime mortgage loans and less than 2% 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 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 remaining securities in an accumulated loss position in the portfolio were temporary impairments.

## NOTE 5 – NET INVESTMENT INCOME

Major categories of investment income are summarized as follows:

|   | (Dollars in thousands)  |          |
|---|-------------------------|----------|
|   | Year ended December 31, |          |
|   | 2009                    | 2008     |
| Fixed maturities                          | \$ 4,075                | \$ 4,357 |
| Equity securities                         | 199                     | 364      |
| Mortgage loans on real estate             | 62                      | 32       |
| Investment real estate                    | 82                      | 65       |
| Policy loans                              | 73                      | 68       |
| Company owned life insurance              | 740                     | (543 )   |
| Other, principally short-term investments | 346                     | 367      |
|   | 5,577                   | 4,710    |
|   | 288                     | 342      |

|   |                         |            |
|---|-------------------------|------------|
| Less: Investment expenses                         |                         |            |
| Net investment income                             | \$ 5,289                | \$ 4,368   |
| An analysis of investment gains (losses) follows: |                         |            |
|   | Year ended December 31, |            |
|   | 2009                    | 2008       |
| Net realized investment gains (losses):           |                         |            |
| Fixed maturities                                  | \$ 548                  | \$ 179     |
| Equity securities                                 | 234                     | 1,313      |
| Other, principally real estate                    | 18                      | 432        |
| Other than temporary impairments                  | (443 )                  | (2,973)    |
|   | \$ 357                  | \$ (1,049) |

## NOTE 5 – NET INVESTMENT INCOME – CONTINUED

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

|  | (Dollars in thousands)  |            |
|--|-------------------------|------------|
|  | Year ended December 31, |            |
|  | 2009                    | 2008       |
| Net change in unrealized appreciation on available-for-sale securities before deferred tax | \$ 5,304                | \$ (8,335) |
| Deferred income tax  | (1,784)                 | 2,188      |
| Net change in unrealized appreciation on available-for-sale securities                     | \$ 3,520                | \$ (6,147) |

## NOTE 6 – 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 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.

## NOTE 6 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES – CONTINUED

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 December 31, 2009 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  |
| <b>Financial Assets</b> |   |           |           |          |
| Fixed maturities        |   |           |           |          |
| available-for-sale      | \$ 70,269                                       | \$ 9,214  | \$ 60,478 | \$ 577   |
| Short-term              |   |           |           |          |
| investments             | -   | -         | -         | -        |
| Trading securities      | 374   | 374       | -         | -        |
| Equity securities       |   |           |           |          |
| available-for-sale      | 9,035   | 8,373     | -         | 662      |
| <b>Total Financial</b>  |   |           |           |          |
| Assets                  | \$ 79,678                                       | \$ 17,961 | \$ 60,478 | \$ 1,239 |
| <b>Financial</b>        |   |           |           |          |
| <b>Liabilities</b>      |   |           |           |          |
| Interest rate swap      | \$ 60   | \$ -      | \$ -      | \$ 60    |
| <b>Total Financial</b>  |   |           |           |          |
| Liabilities             | \$ 60   | \$ -      | \$ -      | \$ 60    |

The table below presents reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2009:

|                   | For the year ended December 31, 2009 |                                      |                    |
|-------------------|--------------------------------------|--------------------------------------|--------------------|
|                   | Fixed Maturities Available for sale  | Equity Securities Available for Sale | Interest Rate Swap |
| (In Thousands)    |                                      |                                      |                    |
| Beginning balance | \$ 652                               | \$ 733                               | \$ (316 )          |



|  |        |        |          |
|--|--------|--------|----------|
| Total gains or losses (realized and unrealized):   |        |        |          |
| Included in earnings   | -      | -      | -        |
| Included in other comprehensive income   | (75 )  | (71 )  | 256      |
| Purchases, sales, issuances and settlements, net   | -      | -      | -        |
| Transfers in/(out) of Level 3  | -      | -      | -        |
| Ending balance   | \$ 577 | \$ 662 | \$ (60 ) |
| 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, 2009 | \$ -   | \$ -   | \$ -     |

For the year ended December 31, 2009, there were no assets or liabilities measured at fair values on a nonrecurring basis.

## NOTE 6 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES – CONTINUED

The table below presents reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the year ended December 31, 2008:

|  | For the year ended<br>December 31, 2008      |   |                       |
|--|--|---|-----------------------|
|  | Fixed<br>Maturities<br>Available<br>for sale | Equity<br>Securities<br>Available<br>for Sale | Interest<br>Rate Swap |
| (In Thousands)   |  |   |                       |
| Year ended December 31,<br>2008  |  |   |                       |
| Beginning balance  | \$ 702                                       | \$ 999  | \$ (88 )              |
| Total gains or losses<br>(realized and<br>unrealized):   |  |   |                       |
| Included in earnings   | -  | -   | -                     |
| Included in other<br>comprehensive income  | (50 )  | (266 )  | (228 )                |
| Purchases, sales, issuances<br>and settlements,<br>net   | -  | -   | -                     |
| Transfers in/(out) of Level<br>3   | -  | -   | -                     |
| Ending balance   | \$ 652                                       | \$ 733  | \$ (316 )             |
| The amount of total gains<br>or losses for the<br>period included in<br>earnings attributable to the<br>change in unrealized gains<br>or losses relating<br>to assets and liabilities still<br>held as of<br>December 31, 2008 | \$ -   | \$ -  | \$ -                  |

For the year ended December 31, 2008, 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. Please see Note 9 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 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 December 31, are as follows:

| In Thousands of Dollars at December 31,    |                |                      |                |                      |
|--|----------------|----------------------|----------------|----------------------|
|  | 2009           |                      | 2008           |                      |
|  | Carrying Value | Estimated Fair Value | Carrying Value | Estimated Fair Value |
| <b>Assets and related instruments</b>      |                |                      |                |                      |
| Mortgage loans                             | \$ 1,041       | \$ 1,041             | \$ 502         | \$ 502               |
| Policy loans                               | 1,018          | 1,018                | 968            | 968                  |
| Company owned life insurance               | 5,197          | 5,197                | 1,957          | 1,957                |
| Other invested assets                      | 3,933          | 3,933                | 4,557          | 4,557                |
| <b>Liabilities and related instruments</b> |                |                      |                |                      |
| Other policyholder funds                   | 1,347          | 1,347                | 1,344          | 1,344                |
| Long-term debt                             | 12,372         | 12,372               | 12,372         | 12,372               |

## NOTE 7 - PROPERTY AND EQUIPMENT

At December 31, property and equipment consisted of the following:

|                                      | (Dollars in Thousands) |          |
|--------------------------------------|------------------------|----------|
|                                      | 2009                   | 2008     |
| Building and improvements            | \$ 3,196               | \$ 3,196 |
| Electronic data processing equipment | 2,472                  | 2,549    |
| Furniture and fixtures               | 1,005                  | 1,085    |
|                                      | 6,673                  | 6,830    |
| Less accumulated depreciation        | 4,136                  | 3,986    |
|                                      | \$ 2,537               | \$ 2,844 |

Depreciation expense for the year ended December 31, 2009 was \$424,000 (\$454,000 for the year ended December 31, 2008).

## NOTE 8 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company incurred \$-0- in interest and penalties as of both December 31, 2009 and December 31, 2008. 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 2006. The Internal Revenue Service completed an examination during 2008 of the Company's 2005 Federal Income Tax Return. No material adjustments were made as a result of this examination. No income tax returns are currently under examination by the Internal Revenue Service or any state or local taxing authority. Tax returns have been filed through the year 2008.

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 a net deferred tax liability position of \$61,000 in 2009 and net deferred tax asset position of \$1,839,000 in 2008.

## NOTE 8 – INCOME TAXES

The tax effect of significant differences representing deferred tax assets and liabilities are as follows:

|  | (Dollars in Thousands)  |                         |
|--|-------------------------|-------------------------|
|  | December<br>31,<br>2009 | December<br>31,<br>2008 |
| General insurance expenses                           | \$ 1,135                | \$ 769                  |
| Unearned premiums                                    | 1,814                   | 1,885                   |
| Claims liabilities                                   | 298                     | 337                     |
| Unrealized losses on securities available-for-sale   | -                       | 392                     |
| Other than temporary impairments on securities owned | 501                     | 734                     |
| Deferred tax assets                                  | 3,748                   | 4,117                   |
| Depreciation   | (126 )                  | (118 )                  |
| Deferred policy acquisition costs                    | (2,291)                 | (2,160)                 |
| Unrealized gains on securities available-for-sale    | (1,392)                 | -                       |
| Deferred tax liabilities                             | (3,809)                 | (2,278)                 |
| Net deferred tax (liability) asset                   | \$ (61 )                | \$ 1,839                |

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)     |            |
|---|----------------------------|------------|
|   | Year ended December<br>31, |            |
|   | 2009                       | 2008       |
| Federal income tax rate applied to pre-tax income | \$ 1,862                   | \$ (2,657) |

|  |          |            |
|--|----------|------------|
| Dividends received deduction and tax-exempt interest | (201 )   | (137 )     |
| Company owned life insurance                         | (252 )   | 185        |
| Small life deduction                                 | (145 )   | (174 )     |
| Other, net   | (12 )    | 173        |
| Federal income tax expense (benefit)                 | \$ 1,252 | \$ (2,610) |

The appropriate income tax effects of changes in temporary differences are as follows:

|                                   | Year ended<br>December 31, |           |
|-----------------------------------|----------------------------|-----------|
|                                   | 2009                       | 2008      |
| Deferred policy acquisition costs | \$ 131                     | \$ (261 ) |
| Other-than-temporary impairments  | 233                        | 734       |
| Unearned premiums                 | 71                         | 362       |
| General insurance expenses        | (366 )                     | (69 )     |
| Depreciation                      | 8                          | 40        |
| Claim liabilities                 | 39                         | 79        |
|                                   | \$ 116                     | \$ 885    |

## NOTE 8 – INCOME TAXES – CONTINUED

Under pre-1984 life insurance company tax laws, a portion of NSIC's gain from operations was not subject to current income taxation, but was accumulated for tax purposes in a memorandum account designated "policyholders' surplus". The aggregate balance in this account, \$2,520,000 at December 31, 2009, would be taxed at current rates only if distributed to shareholders or if the account exceeded a prescribed minimum. The Deficit Reduction Act of 1984 eliminated additions to policyholders' surplus for 1984 and thereafter. Deferred taxes have not been provided on amounts designated as policyholders' surplus. The deferred income tax liability not recognized is approximately \$857,000 at December 31, 2009

## NOTE 9 – NOTES PAYABLE AND LONG-TERM DEBT

Long-term debt consisted of the following as of December 31, 2009 and December 31, 2008:

|  | (Dollars in thousands) |          |
|--|------------------------|----------|
|  | 2009                   | 2008     |
| 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  | 3,093                  | 3,093    |



redeemed at any time  
 following the fifth  
 anniversary of  
 issuance. Unsecured.

|  |           |           |
|--|-----------|-----------|
|  | \$ 12,372 | \$ 12,372 |
|--|-----------|-----------|

The \$9,279,000 of subordinated debentures is due in 2035 and \$3,093,000 of subordinated debentures is due in 2037.

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 (discussed in Note 2) 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.

## NOTE 9 – NOTES PAYABLE AND LONG-TERM DEBT – CONTINUED

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 pay interest at the three-month LIBOR rate plus 3.4% and receive 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 pay interest at the three-month LIBOR rate plus 3.4% and receive 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.

The swaps entered into in 2007 and 2009 have fair values of \$245,000 (liability) and \$185,000 (asset), respectively, for a net liability of \$60,000 at December 31, 2009 (\$316,000 at December 31, 2008) which is reported as a component of other liabilities on the consolidated balance sheets. A net valuation gain of \$256,000 is included in accumulated other comprehensive income related to the swap agreements for the current period. A net valuation loss of \$228,000 was included in accumulated other comprehensive income related to the swap in the prior year.

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 posted collateral of \$469,000. Please see Note 6 for additional information about the interest rate swaps.

In December of 2009, the Company obtained an unsecured line of credit for \$700,000, with an interest rate of 5%, to be made available for general corporate purposes. The line of credit matures December 25, 2010. No funds were drawn on this line at December 31, 2009.

## NOTE 10 – POLICY AND CLAIM RESERVES

The Company regularly updates its reserve estimates as new information becomes available and events occur that may impact the resolution of unsettled claims. Changes in prior years' reserve estimates are reflected in the results of operations in the year such changes are determined. The following table is a reconciliation of beginning and ending property and casualty reserve balances for claims and claim adjustment expense for the years ended December 31:

|                                     | (Dollars in thousands) |      |
|-------------------------------------|------------------------|------|
|                                     | 2009                   | 2008 |
| Claims and claim adjustment expense |                        |      |

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|   |           |           |
|---|-----------|-----------|
| reserves at beginning of year               | \$ 14,436 | \$ 11,973 |
| Less reinsurance recoverables on            |           |           |
| unpaid losses                               | 2,421     | 555       |
| Net balances at beginning of year           | 12,015    | 11,418    |
| Provision for claims and claim adjustment   |           |           |
| expenses for claims arising in current year | 34,239    | 43,284    |
| Estimated claims and claim adjustment       |           |           |
| expenses for claims arising in prior years  | (2,626 )  | (2,374 )  |
| Total increases                             | 31,613    | 40,910    |
| Claims and claim adjustment expense         |           |           |
| payments for claims arising in:             |           |           |
| Current year                                | 25,941    | 35,516    |
| Prior years                                 | 5,590     | 4,797     |
| Total payments                              | 31,531    | 40,313    |
| Net balance at end of year                  | 12,097    | 12,015    |
| Plus reinsurance recoverables on            |           |           |
| unpaid losses                               | 549       | 2,421     |
| Claims and claim adjustment expense         |           |           |
| reserves at end of year                     | \$ 12,646 | \$ 14,436 |

The 2009 decline in the provision for claims and claim adjustment expenses arising from claims in the current year and the ending reinsurance recoverable on unpaid losses are attributable to the absence of hurricane losses during the year. The decrease in provision for claims and claim adjustment expenses for prior years (net of reinsurance recoveries) for 2008 is primarily due to reductions in incurred but not reported loss reserves on dwelling property lines of business.

## NOTE 10 – POLICY AND CLAIM RESERVES – CONTINUED

The Company has a geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather, explosions and fires, and the incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophe losses are restricted to small geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. The Company generally seeks to reduce its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance. At December 31, 2009, the Company's estimate of unpaid losses and adjustment expenses for hurricane related claims incurred in prior years totaled \$787,000 before reinsurance (\$758,000 in 2008). Because the Company has exhausted its catastrophe coverage limits available for Hurricane Katrina any additional development will not be covered by reinsurance. The Company maintains case reserves of \$519,000 for losses in excess of catastrophe reinsurance (\$594,000 in 2008).

## NOTE 11 – REINSURANCE

The Company's insurance operations participate in reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term. Property and casualty reinsurance is placed on both a quota-share and excess of loss basis. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of reinsurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurers and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize their exposure to significant losses from reinsurance insolvencies.

At December 31, 2009, the largest reinsurance recoverable of a single reinsurer was \$95,000 (\$607,000 in 2008). The amounts of recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 2009 and 2008 were approximately \$-0- and \$12,582,000, respectively. The Company incurred no losses from covered events occurring in 2009. Amounts reported as ceded incurred losses in 2009 were related to development of losses from prior year catastrophes.

The effect of reinsurance on premiums written and earned was as follows:

| (Dollars in Thousands) |          |          |                     |           |  |
|------------------------|----------|----------|---------------------|-----------|--|
| 2009                   |          |          |                     |           |  |
| Life                   |          |          | Property & Casualty |           |  |
|                        | Written  | Earned   | Written             | Earned    |  |
| Direct                 | \$ 7,251 | \$ 7,247 | \$ 58,185           | \$ 59,213 |  |
| Assumed                | -        | -        | -                   | -         |  |
| Ceded                  | (48)     | (48)     | (6,660)             | (6,818)   |  |
| Net                    | \$ 7,203 | \$ 7,199 | \$ 51,525           | \$ 52,395 |  |

| 2008    |          |          |                     |           |  |
|---------|----------|----------|---------------------|-----------|--|
|         | Life     |          | Property & Casualty |           |  |
|         | Written  | Earned   | Written             | Earned    |  |
| Direct  | \$ 7,049 | \$ 7,003 | \$ 61,197           | \$ 55,866 |  |
| Assumed | -        | -        | -                   | -         |  |
| Ceded   | (47)     | (47)     | (6,487)             | (6,558)   |  |
| Net     | \$ 7,002 | \$ 6,956 | \$ 54,710           | \$ 49,308 |  |

NOTE 12 – EMPLOYEE BENEFIT PLANS

In 1989, the Company and its subsidiaries established a retirement savings plan (401K Plan) and transferred the assets from the defined contribution profit sharing plan into the new plan. All full-time employees who have completed six months of service at the beginning of any calendar quarter are eligible to participate and all employee contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for 2009 and 2008 amounted to \$219,000 and \$255,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limitations.

In 1987, the Company established a non-qualified deferred compensation plan for its Board of Directors. The Board members had an option of deferring their fees to a cash account or to a stock account and all share deferrals are recorded at the fair market value on the date of the award. The directors' non-qualified deferred compensation plan was frozen on December 31, 2004, and deferrals are no longer allowed. A new non-qualified plan became effective January 1, 2006 under which directors are allowed to defer all or a portion of directors' fees into various investment options. The supplemental executive retirement plan (SERP) became effective March 1, 2008 and covers named executive officers with the Company contributing 15% of executive compensation to the plan. Contributions to the plan are fully vested upon the earlier of death, disability, change in control, or ten years of participation in the plan. Costs for amounts credited of the non-qualified deferred compensation plans for 2009 and 2008 amounted to approximately 388,000 and (\$349,000), respectively.

NOTE 13 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

The amount of dividends paid from NSIC to the Company in any year may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2009, NSIC's retained earnings unrestricted for the payment of dividends in 2010 amounted to \$1,250,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. At December 31, 2009, NSFC's retained earnings unrestricted for the payment of dividends in 2010 amounted to \$4,179,000.

At December 31, 2009, securities with market values of \$3,530,000 (\$3,812,000 at December 31, 2008) were deposited with various states pursuant to statutory requirements.

Under applicable Alabama insurance laws and regulations, NSFC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of \$100,000.

Under applicable Alabama insurance laws and regulations, NSIC is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of \$200,000.

Under applicable Alabama insurance laws and regulations, Omega is required to maintain a minimum total surplus (to include both paid-in and contributed and unassigned surplus) of \$500,000.

NOTE 14 – SHAREHOLDERS' EQUITY

#### Preferred Stock

The Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference.

#### Common Stock

The holders of the Class A Common Stock will have one-twentieth of one vote per share, and the holders of the common stock will have one vote per share.

In the event of any liquidation, dissolution or distribution of the assets of the Company remaining after the payments to the holders of the Preferred Stock of the full preferential amounts to which they may be entitled as provided in the resolution or resolutions creating any series thereof, the remaining assets of the Company shall be divided and distributed among the holders of both classes of common stock, except as may otherwise be provided in any such resolution or resolutions.

An amendment changing the number of authorized shares of common stock from 10,000,000 to 3,000,000 was approved by the shareholders at the 2009 Annual Meeting on May 14, 2009.

## NOTE 15 – INDUSTRY SEGMENTS

The Company and its subsidiaries operate primarily in the insurance industry. Selected balance sheet information by industry segment for the years ended December 31, 2009 and 2008 is summarized below:

| (Dollars in thousands)               |            |                                |                                 |                             |
|--------------------------------------|------------|--------------------------------|---------------------------------|-----------------------------|
|                                      | Total      | P&C<br>Insurance<br>Operations | Life<br>Insurance<br>Operations | Non-Insurance<br>Operations |
| December 31,<br>2009                 |            |                                |                                 |                             |
| Selected Assets                      |            |                                |                                 |                             |
| Investments                          | \$ 101,720 | \$ 60,768                      | \$ 40,079                       | \$ 873                      |
| Reinsurance<br>recoverable           | \$ 784     | \$ 784                         | \$ -                            | \$ -                        |
| Deferred policy<br>acquisition costs | \$ 10,210  | \$ 3,915                       | \$ 6,295                        | \$ -                        |
| Total Assets                         | \$ 131,396 | \$ 79,321                      | \$ 49,872                       | \$ 2,203                    |
| Total Liabilities                    | \$ 90,228  | \$ 43,099                      | \$ 34,348                       | \$ 12,781                   |

| (Dollars in thousands)               |            |                                |                                 |                             |
|--------------------------------------|------------|--------------------------------|---------------------------------|-----------------------------|
|                                      | Total      | P&C<br>Insurance<br>Operations | Life<br>Insurance<br>Operations | Non-Insurance<br>Operations |
| December 31,<br>2008                 |            |                                |                                 |                             |
| Selected Assets                      |            |                                |                                 |                             |
| Investments                          | \$ 90,132  | \$ 56,422                      | \$ 33,200                       | \$ 510                      |
| Reinsurance<br>recoverable           | \$ 4,146   | \$ 4,146                       | \$ -                            | \$ -                        |
| Deferred policy<br>acquisition costs | \$ 9,825   | \$ 4,037                       | \$ 5,788                        | \$ -                        |
| Total Assets                         | \$ 124,890 | \$ 78,802                      | \$ 43,653                       | \$ 2,435                    |



|                   |           |           |           |           |
|-------------------|-----------|-----------|-----------|-----------|
| Total Liabilities | \$ 90,242 | \$ 45,476 | \$ 31,627 | \$ 13,139 |
|-------------------|-----------|-----------|-----------|-----------|

## NOTE 15 – INDUSTRY SEGMENTS – CONTINUED

Premium revenues and operating income by industry segment for the years ended December 31, 2009 and 2008 are summarized below:

| (Dollars in thousands)                            | Total     | P&C Insurance Operations | Life Insurance Operations | Non-Insurance Operations |
|---|-----------|--------------------------|---------------------------|--------------------------|
| Year ended December 31, 2009                      |           |                          |                           |                          |
| <b>REVENUE</b>                                    |           |                          |                           |                          |
| Net premiums earned                               | \$ 59,594 | \$ 52,395                | \$ 7,199                  | \$ -                     |
| Net investment income                             | 5,289     | 3,125                    | 2,114                     | 50                       |
| Net realized investment gains                     | 357       | 120                      | 234                       | 3                        |
| Other income                                      | 764       | 761                      | 3                         | -                        |
|   | 66,004    | 56,401                   | 9,550                     | 53                       |
| <b>BENEFITS AND EXPENSES</b>                      |           |                          |                           |                          |
| Policyholder benefits paid or provided            | 35,839    | 30,908                   | 4,931                     | -                        |
| Amortization of deferred policy acquisition costs | 3,673     | 3,397                    | 276                       | -                        |
| Commissions                                       | 7,863     | 7,317                    | 546                       | -                        |
| General and administrative expenses               | 10,396    | 6,775                    | 2,543                     | 1,078                    |
| Insurance taxes, licenses and fees                | 1,631     | 1,387                    | 244                       | -                        |
| Interest expense                                  | 1,126     | -                        | 49                        | 1,077                    |
|   | 60,528    | 49,784                   | 8,589                     | 2,155                    |
| Income (Loss) Before Income Taxes                 | 5,476     | 6,617                    | 961                       | (2,102 )                 |
| <b>INCOME TAX EXPENSE (BENEFIT)</b>               |           |                          |                           |                          |
| Current   | 1,136     | 1,369                    | 105                       | (338 )                   |

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|                   |          |          |        |             |
|-------------------|----------|----------|--------|-------------|
| Deferred          | 116      | 97       | 392    | (373 )      |
|                   | 1,252    | 1,466    | 497    | (711 )      |
| <b>NET INCOME</b> |          |          |        |             |
| <b>(LOSS)</b>     | \$ 4,224 | \$ 5,151 | \$ 464 | \$ (1,391 ) |

## NOTE 15 – INDUSTRY SEGMENTS – CONTINUED

(Dollars in thousands)

|   | Total     | P&C<br>Insurance<br>Operations | Life<br>Insurance<br>Operations | Non-Insurance<br>Operations |
|---|-----------|--------------------------------|---------------------------------|-----------------------------|
| Year ended<br>December 31,<br>2008                      |           |                                |                                 |                             |
| <b>REVENUE</b>  |           |                                |                                 |                             |
| Net premiums<br>earned                                  | \$ 56,264 | \$ 49,308                      | \$ 6,956                        | \$ -                        |
| Net investment<br>income                                | 4,368     | 2,309                          | 1,940                           | 119                         |
| Net realized<br>investment<br>(losses) gains            | (1,049 )  | 372                            | (1,423 )                        | 2                           |
| Other income  | 1,107     | 1,047                          | 60                              | -                           |
|   | 60,690    | 53,036                         | 7,533                           | 121                         |
| <b>BENEFITS AND<br/>EXPENSES</b>                        |           |                                |                                 |                             |
| Policyholder<br>benefits paid or<br>provided            | 44,746    | 39,719                         | 5,027                           | -                           |
| Amortization of<br>deferred policy<br>acquisition costs | 4,344     | 3,312                          | 1,032                           | -                           |
| Commissions   | 8,262     | 7,772                          | 490                             | -                           |
| General and<br>administrative<br>expenses               | 8,558     | 6,722                          | 1,614                           | 222                         |
| Insurance taxes,<br>licenses and fees                   | 1,447     | 1,159                          | 288                             | -                           |
| Interest expense  | 1,147     | 1                              | 61                              | 1,085                       |
|   | 68,504    | 58,685                         | 8,512                           | 1,307                       |
| Loss Before<br>Income Taxes                             | (7,814 )  | (5,649 )                       | (979 )                          | (1,186 )                    |
| <b>INCOME TAX<br/>EXPENSE<br/>(BENEFIT)</b>             |           |                                |                                 |                             |
| Current   | (3,495 )  | (2,919 )                       | (281 )                          | (295 )                      |
| Deferred  | 885       | 867                            | 161                             | (143 )                      |
|   | (2,610 )  | (2,052 )                       | (120 )                          | (438 )                      |

NET LOSS           \$ (5,204 ) \$ (3,597 ) \$ (859 ) \$ (748 )

## NOTE 16 – CONTINGENCIES

## Litigation

The Company and its subsidiaries continue to be named 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.

In 2007, the Company sold substantially all of its interest in a consolidated subsidiary, Mobile Attic, Inc. On July 9, 2009, the Company moved to intervene in a complaint filed by the purchaser of Mobile Attic against the founder and former president/CEO of Mobile Attic and others, regarding the plaintiff's purchase of shares of Mobile Attic. The Company filed a proposed 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 the former president/CEO of Mobile Attic and as a result of the negligence of Mobile Attic and its

NOTE 16 – CONTINGENCIES – CONTINUED

auditors in the preparation of Mobile Attic's financial statements. The Court has subsequently granted the Company's motion to intervene and the action is in the initial stages of discovery. No amount has been accrued in these financial statements since the outcome of this matter is uncertain and the amount of liability, if any, cannot be determined.

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. While a resolution of these matters may significantly impact consolidated earnings and the Company's consolidated financial position, it remains management's opinion, based on information presently available, that the ultimate resolution of these matters will not have a material impact on the Company's consolidated financial position.

NOTE 17 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during 2009 was \$1,077,000 (\$1,085,000 in 2008). Cash received from income taxes in 2009 was \$796,000 compared to cash paid for income taxes in 2008 was \$500,000.

NOTE 18 – SUBSEQUENT EVENTS

There were no subsequent events requiring adjustment to the condensed consolidated financial statements.

**THE NATIONAL SECURITY GROUP, INC.**  
**SCHEDULE I. SUMMARY OF INVESTMENTS (CONSOLIDATED)**  
(Dollars in Thousands)

|  | December 31, 2009 |               |                      | December 31, 2008 |               |                         |
|--|-------------------|---------------|----------------------|-------------------|---------------|-------------------------|
|  |                   |               | Amount<br>per        |                   |               | Amount<br>per           |
|  | Cost              | Fair<br>Value | the Balance<br>Sheet | Cost              | Fair<br>Value | the<br>Balance<br>Sheet |
| <b>Securities</b>  |                   |               |                      |                   |               |                         |
| <b>Held-to-Maturity:</b>   |                   |               |                      |                   |               |                         |
| <b>United States</b>   |                   |               |                      |                   |               |                         |
| government . . . . .   | \$ 441            | \$ 455        | \$ 441               | \$ 4,387          | \$ 4,435      | \$ 4,387                |
| States, municipalities<br>and<br>political subdivisions<br>. . . . . | 2,139             | 2,182         | 2,139                | 2,141             | 2,161         | 2,141                   |
| Mortgage backed<br>securities . . . . .                              | 3,175             | 3,251         | 3,175                | 4,087             | 4,066         | 4,087                   |
| Private label<br>mortgage backed<br>securities . . . . .             | 187               | 192           | 187                  | 249               | 248           | 249                     |
| Industrial and<br>Miscellaneous . . . . .                            | -                 | -             | -                    | 88                | 85            | 88                      |
| <b>Total Securities<br/>Held-to-Maturity . . . . .</b>               | <b>5,942</b>      | <b>6,080</b>  | <b>5,942</b>         | <b>10,952</b>     | <b>10,995</b> | <b>10,952</b>           |
| <b>Securities</b>  |                   |               |                      |                   |               |                         |
| <b>Available-for-Sale:</b>   |                   |               |                      |                   |               |                         |
| <b>Equity</b>  |                   |               |                      |                   |               |                         |
| <b>Securities:</b>   |                   |               |                      |                   |               |                         |
| Banks and insurance<br>companies . . . . .                           | 1,489             | 989           | 989                  | 1,256             | 1,699         | 1,699                   |
| Industrial and all<br>other . . . . .                                | 4,362             | 8,046         | 8,046                | 4,211             | 5,870         | 5,870                   |
| <b>Total equity<br/>securities . . . . .</b>                         | <b>5,851</b>      | <b>9,035</b>  | <b>9,035</b>         | <b>5,467</b>      | <b>7,569</b>  | <b>7,569</b>            |

|                         |        |        |           |        |        |        |
|-------------------------|--------|--------|-----------|--------|--------|--------|
| .....                   |        |        |           |        |        |        |
| Debt                    |        |        |           |        |        |        |
| Securities:             |        |        |           |        |        |        |
| United States           |        |        |           |        |        |        |
| government .....        |        |        |           |        |        |        |
| ...                     | 9,532  | 9,713  | 9,713     | 9,551  | 9,983  | 9,983  |
| States, municipalities  |        |        |           |        |        |        |
| and                     |        |        |           |        |        |        |
| political subdivisions  |        |        |           |        |        |        |
| ...                     | 15,641 | 15,516 | 15,516    | 13,401 | 12,607 | 12,607 |
| Mortgage backed         |        |        |           |        |        |        |
| securities .....        |        |        |           |        |        |        |
| .                       | 8,203  | 8,320  | 8,320     | 11,101 | 11,334 | 11,334 |
| Private label           |        |        |           |        |        |        |
| mortgage backed         |        |        |           |        |        |        |
| securities .....        | 9,634  | 8,896  | 8,896     | 6,590  | 5,223  | 5,223  |
| Public Utilities .....  |        |        |           |        |        |        |
| .....                   | -      | -      | -         | 549    | 554    | 554    |
| Industrial and          |        |        |           |        |        |        |
| Miscellaneous .....     |        |        |           |        |        |        |
| ...                     | 26,786 | 27,824 | 27,824    | 20,604 | 18,406 | 18,406 |
| Total Debt Securities   |        |        |           |        |        |        |
| .....                   | 69,796 | 70,269 | 70,269    | 61,796 | 58,107 | 58,107 |
| Total                   |        |        |           |        |        |        |
| Available-for-Sale ..   |        |        |           |        |        |        |
| .....                   | 75,647 | 79,304 | 79,304    | 67,263 | 65,676 | 65,676 |
| Total Securities .....  |        |        |           |        |        |        |
| .....                   | 81,589 | 85,384 | \$ 85,246 | 78,215 | 76,671 | 76,628 |
| Trading securities. . . |        |        |           |        |        |        |
| .....                   | 314    | 374    | 374       | 354    | 253    | 253    |
| Receivable for          |        |        |           |        |        |        |
| securities. ....        |        |        |           |        |        |        |
| ...                     | 96     | 96     | 96        | 513    | 513    | 513    |
| Mortgage loans on       |        |        |           |        |        |        |
| real estate .....       |        |        |           |        |        |        |
| ....                    | 1,041  | 1,041  | 1,041     | 502    | 502    | 502    |
| Investment real estate  |        |        |           |        |        |        |
| .....                   |        |        |           |        |        |        |
| ..                      | 4,815  | 4,815  | 4,815     | 4,754  | 4,754  | 4,754  |
| Policy loans .....      |        |        |           |        |        |        |
| .....                   | 1,018  | 1,018  | 1,018     | 968    | 968    | 968    |
| Company owned life      |        |        |           |        |        |        |
| insurance. ....         |        |        |           |        |        |        |
| ....                    | 5,000  | 5,197  | 5,197     | 2,500  | 1,957  | 1,957  |
| Other invested assets.  |        |        |           |        |        |        |
| .....                   | 3,933  | 3,933  | 3,933     | 4,557  | 4,557  | 4,557  |



|                         |           |            |            |           |           |           |
|-------------------------|-----------|------------|------------|-----------|-----------|-----------|
| Total investments . . . | \$ 97,806 | \$ 101,858 | \$ 101,720 | \$ 92,363 | \$ 90,175 | \$ 90,132 |
|-------------------------|-----------|------------|------------|-----------|-----------|-----------|

THE NATIONAL SECURITY GROUP, INC.  
(PARENT COMPANY)  
SCHEDULE II - CONDENSED FINANCIAL  
INFORMATION OF REGISTRANT  
BALANCE SHEETS  
(Amounts in thousands)

|  | December 31,     |                  |
|--|------------------|------------------|
|  | 2009             | 2008             |
| <b>Assets</b>  |                  |                  |
| Cash   | \$ 382           | \$ 454           |
| Investment in subsidiaries (equity method) eliminated upon consolidation | 51,658           | 45,380           |
| Other assets   | 2,866            | 2,269            |
| <b>Total Assets</b>  | <b>\$ 54,906</b> | <b>\$ 48,103</b> |
| <b>Liabilities and Shareholders' Equity</b>                              |                  |                  |
| Accrued general expenses   | \$ 1,366         | \$ 1,083         |
| Notes payable  | 12,372           | 12,372           |
| <b>Total Liabilities</b>   | <b>13,738</b>    | <b>13,455</b>    |
| <b>Total Shareholders' Equity</b>  | <b>41,168</b>    | <b>34,648</b>    |
| <b>Total Liabilities and Shareholders' Equity</b>                        | <b>\$ 54,906</b> | <b>\$ 48,103</b> |



| THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)                                     |              |            |
|--|--------------|------------|
| SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF REGISTRANT                            |              |            |
| STATEMENTS OF INCOME (LOSS)  |              |            |
| (Amounts in thousands)   |              |            |
|  | Years Ended  |            |
|  | December 31, |            |
|  | 2009         | 2008       |
| Income   |              |            |
| Dividends (eliminated upon consolidation)  | \$ 2,800     | \$ -       |
| Other income   | 52           | 119        |
|  | 2,852        | 119        |
| Expenses   |              |            |
| State taxes  | 1            | 1          |
| Other expenses   | 2,154        | 1,300      |
|  | 2,155        | 1,301      |
| Income before income taxes and equity in undistributed earnings (loss) of subsidiaries | 697          | (1,182)    |
| Income tax (benefit) expense   | (711 )       | (437 )     |
| Income (loss) before equity in undistributed earnings (loss) of subsidiaries           | 1,408        | (745 )     |
| Equity in undistributed (losses) earnings of subsidiaries                              | 2,816        | (4,459)    |
| Net (loss) income  | \$ 4,224     | \$ (5,204) |

| THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)                                       |              |            |
|--|--------------|------------|
| SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF REGISTRANT                              |              |            |
| STATEMENTS OF CASH FLOWS   |              |            |
| (Amounts in thousands)   |              |            |
|  | Years Ended  |            |
|  | December 31, |            |
|  | 2009         | 2008       |
| Cash flows from operating activities:  |              |            |
| Net income (loss)  | \$ 4,224     | \$ (5,204) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |              |            |
| Equity in undistributed loss (income) of subsidiaries                                    | (2,816)      | 4,459      |
| Change in other assets   | (539 )       | 3,246      |
| Change in accrued general expenses   | 539          | (659 )     |
| Net cash provided by operating activities  | 1,408        | 1,842      |
| Cash flows from investing activities:  |              |            |
| Net cash provided by investing activities  | -            | -          |
| Net cash provided by investing activities  | -            | -          |
| Cash flows from financing activities:  |              |            |
| Cash dividends   | (1,480)      | (2,220)    |
| Net cash used in financing activities  | (1,480)      | (2,220)    |
| Net (decrease) increase in cash and cash equivalents                                     |              |            |
|  | (72 )        | (378 )     |
| Cash at beginning of year  | 454          | 832        |



|                     |        |        |
|---------------------|--------|--------|
| Cash at end of year | \$ 382 | \$ 454 |
|---------------------|--------|--------|

THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)

Notes to Condensed Financial Information of Registrant

Note 1-Basis of Presentation

Pursuant to the rules and regulations of the Securities and Exchange Commission, the Condensed Financial

Information of the Registrant does not include all of the information and notes normally included with financial

statements prepared in accordance with generally accepted accounting principles. It is, therefore, suggested

that this Condensed Financial Information be read in conjunction with the Consolidated Financial Statements

and Notes thereto included in the Registrant's Annual Report as referenced in Form 10-K, Part II, Item 8, page 44.

Note 2-Cash Dividends from Subsidiaries

In 2009, dividends of \$2.8 million were paid to the Registrant by its subsidiaries. No dividends were received from subsidiaries

during 2008.

**THE NATIONAL SECURITY GROUP, INC.**  
**SCHEDULE III SUPPLEMENTARY INSURANCE INFORMATION (CONSOLIDATED)**  
(Amounts in thousands)

|  | Deferred<br>Acquisition<br>Costs | Future<br>Policy<br>Benefits | Unearned<br>Premiums |
|--|----------------------------------|------------------------------|----------------------|
| At December 31,<br>2009:                         |                                  |                              |                      |
| Life and accident and health insurance . . . . . | \$ 6,295                         | \$ 30,726                    | \$ 16                |
| Property and casualty insurance . . . . .        | 3,915                            | -                            | 27,365               |
| Total . . . . .                                  | \$ 10,210                        | \$ 30,726                    | \$ 27,381            |

|  |          |           |           |
|--|----------|-----------|-----------|
| At December 31,<br>2008:                         |          |           |           |
| Life and accident and health insurance . . . . . | \$ 5,788 | \$ 29,770 | \$ 44     |
| Property and casualty insurance . . . . .        | 4,037    | -         | 27,720    |
| Total . . . . .                                  | \$ 9,825 | \$ 29,770 | \$ 27,764 |

|   | Premium<br>Revenue | Net<br>Investment<br>Income | Other<br>Income | Benefits,<br>Claims,<br>Losses and<br>Settlement<br>Expenses | Commissions,<br>Amortization<br>of<br>Deferred<br>Policy<br>Acquisition<br>Costs | General<br>Expenses,<br>Taxes,<br>Licenses<br>and Fees |
|---|--------------------|-----------------------------|-----------------|--|--|--|
| For the year<br>ended December<br>31, 2009:     |                    |                             |                 |  |  |  |
| Life and accident<br>and health<br>insurance    | \$ 7,199           | \$ 2,114                    | \$ 3            | \$ 4,931   | \$ 822   | \$ 2,787   |
| Property and<br>casualty<br>insurance . . . . . | 52,395             | 3,125                       | 761             | 30,908   | 10,714   | 8,162  |
| Other . . . . .                                 | -                  | 50                          | -               | -  | -  | 1,078  |
| Total . . . . .                                 | \$ 59,594          | \$ 5,289                    | \$ 764          | \$ 35,839  | \$ 11,536  | \$ 12,027  |

|   |          |          |       |          |          |          |
|---|----------|----------|-------|----------|----------|----------|
| For the year<br>ended December<br>31, 2008: |          |          |       |          |          |          |
| Life and accident<br>and health             | \$ 6,956 | \$ 1,940 | \$ 60 | \$ 5,027 | \$ 1,522 | \$ 1,614 |



insurance

Property and  
casualty

|                     |           |          |          |           |           |           |
|---------------------|-----------|----------|----------|-----------|-----------|-----------|
| insurance . . . . . | 49,308    | 2,309    | 1,047    | 39,719    | 11,084    | 6,722     |
| Other . . . . .     | -         | 119      | -        | -         | -         | 222       |
| Total . . . . .     | \$ 56,264 | \$ 4,368 | \$ 1,107 | \$ 44,746 | \$ 12,606 | \$ 10,005 |

Note: Investment income and other operating expenses are reported separately by segment and not allocated.

THE NATIONAL SECURITY GROUP, INC.  
SCHEDULE IV. REINSURANCE (CONSOLIDATED)  
(Amounts in thousands)

|  | Gross<br>Amount | Ceded<br>to Other<br>Companies | Assumed<br>from<br>Other<br>Companies | Net<br>Amount | Percentage<br>of<br>Amount<br>Assumed<br>to Net |
|--|-----------------|--------------------------------|---------------------------------------|---------------|---|
| For the year ended   |                 |                                |                                       |               |   |
| December 31, 2009  |                 |                                |                                       |               |   |
| Life insurance in<br>force .....                             |                 |                                |                                       |               |   |
| .....  | \$ 215,028      | \$ 12,034                      | \$ -                                  | \$ 202,994    | 0.00 %  |
| Premiums:  |                 |                                |                                       |               |   |
| Life insurance and<br>accident and health<br>insurance ..... |                 |                                |                                       |               |   |
| ...  | 7,247           | 48                             | -                                     | 7,199         | 0.00 %  |
| Property and casualty<br>insurance .....                     |                 |                                |                                       |               |   |
| .....  | 59,213          | 6,818                          | -                                     | 52,395        | 0.00 %  |
| Total premiums ..<br>.....<br>.....                          | \$ 66,460       | \$ 6,866                       | \$ -                                  | \$ 59,594     | 0.00 %  |
| For the year ended   |                 |                                |                                       |               |   |
| December 31, 2008  |                 |                                |                                       |               |   |
| Life insurance in<br>force .....                             |                 |                                |                                       |               |   |
| .....  | \$ 214,160      | \$ 10,115                      | \$ -                                  | \$ 204,045    | 0.00 %  |
| Premiums:  |                 |                                |                                       |               |   |
| Life insurance and<br>accident and health<br>insurance ..... |                 |                                |                                       |               |   |
| ...  | 7,003           | 47                             | -                                     | 6,956         | 0.00 %  |
| Property and casualty<br>insurance .....                     |                 |                                |                                       |               |   |
| .....  | 55,866          | 6,558                          | -                                     | 49,308        | 0.00 %  |

|                    |           |          |      |           |      |   |
|--------------------|-----------|----------|------|-----------|------|---|
| Total premiums . . |           |          |      |           |      |   |
| .....              |           |          |      |           |      |   |
| .....              |           |          |      |           |      |   |
| .                  | \$ 62,869 | \$ 6,605 | \$ - | \$ 56,264 | 0.00 | % |
| For the year ended |           |          |      |           |      |   |
| December 31, 2006  |           |          |      |           |      |   |

The National Security Group, Inc

Schedule V. Valuation and Qualifying  
Accounts

Years ended December 31, 2009 and 2008

|                         | 2009                   | 2008   |
|-------------------------|------------------------|--------|
|                         | (Dollars in thousands) |        |
| Balance,<br>January 1   | \$ 59                  | \$ 110 |
| Additions               | 0                      | 0      |
| Deletions               | 59                     | 51     |
| Balance,<br>December 31 | \$ 0                   | \$ 59  |

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

Company management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this annual report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

Management's Report on Internal Control over Financial Reporting

Management of The National Security Group, Inc. is responsible for establishing and maintaining effective internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP).

The Company's internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, management concluded that the company's internal control over financial reporting was effective as of December 31, 2009.

This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report.

Item 9B. Other Information

None



### PART III

#### Item 10. Directors, Executive Officers and Corporate Governance

##### Executive Officers

JACK E. BRUNSON (52) has served as a director since 1999 and as President of NSFC since 1997. He also serves on the Boards of Directors of NSFC and Omega. He joined the Company in 1982. Mr. Brunson is a Chartered Property and Casualty Underwriter.

W. L. BRUNSON, JR. (51) has served as a director since 1999 and as President and Chief Executive Officer of the Company since 2000. He also holds the position of President of NSIC. He joined the Company in 1983. Mr. Brunson is also a director of NSFC, NATSCO, NSIC, and Omega. Mr. Brunson is a member of the Alabama State Bar.

BRIAN R. MCLEOD (41) currently serves as Vice President of Finance & Operations, CFO and Treasurer of the Company. From 1992-2002 he served as Controller. He joined the Company in 1992. Mr. McLeod is a Director of NSIC, NSFC, Omega and NATSCO. Mr. McLeod is also a member of the Board of Directors for Trinity Bank, a community bank in Dothan, Alabama. Mr. McLeod is a Certified Public Accountant.

The information contained in The National Security Group's definitive proxy statement for the 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 12, 2010 with respect to directors of the Company and Corporate Governance, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 12, 2010 with respect to Audit Committee and Audit Committee financial expert, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 12, 2010 with respect to information on the beneficial ownership reporting for directors and executive officers, is incorporated herein by reference in response to this item.

#### Item 11. Executive Compensation

The information contained in The National Security Group's definitive proxy statement for the 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 12, 2010, with respect to executive compensation and transactions, is incorporated herein by reference in response to this item.

#### Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information contained in The National Security Group's definitive proxy statement for the 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 12, 2010, with respect to security ownership of certain beneficial owners and management is incorporated herein by reference to this item.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information contained in The National Security Group's definitive proxy statement for the 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 12, 2010, with respect to certain relationships and related transactions, is incorporated herein by reference in response to this item.



Item 14. Principal Accounting Fees and Services

The information contained in The National Security Group's definitive proxy statement for the 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 12, 2010, with respect to principal accountant fees and services, is incorporated herein by reference in response to this item.

PART IV

Item 15. Exhibits and Financial Statement Schedules

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

1. Consolidated financial statements, notes thereto and related information of The National Security Group, Inc. (the "Company") are included in Item 8 of Part II of this report:

Report of Independent Registered Public Accounting Firm

Consolidated Statements of Operation – Years ended December 31, 2009 and 2008

Consolidated Balance Sheets – December 31, 2009 and 2008

Consolidated Statements of Shareholders' Equity – Years ended December 31, 2009 and 2008

Consolidated Statements of Cash Flows – Years ended December 31, 2009 and 2008

Consolidated Notes to the Financial Statements

2. Additional financial statement schedules and report of independent registered accounting firm are furnished herewith pursuant to the requirements of Form 10-K:

The National Security Group, Inc.

|              |  |
|--------------|--|
| Schedule I   | Summary of Investments Other Than Investments in Related Parties |
| Schedule II  | Condensed Financial Information of Registrant                    |
| Schedule III | Supplementary Insurance Information (Consolidated)               |
| Schedule IV  | Reinsurance (Consolidated)                                       |
| Schedule V   | Valuation and Qualifying Accounts                                |

3. Exhibits filed as part of this Form 10-K:

11. Computation of Earnings Per Share Filed Herewith, See Note 1 to Consolidated Financial Statements.

14. Code of Ethics, see additional information in Part 1, Item 1 of this report.
21. Subsidiaries of the registrant.
- 31.1 Certification of Chief Executive Officer Pursuant to 18 U. S. C. Section 1350, as Adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32. Certification Chief Executive Officer and Chief Financial Officer Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) During the last fiscal quarter of the period covered by this Report, the Company filed the following Current Reports on Form 8-K:

| Date of Report       | Date Filed           | Description   |
|----------------------|----------------------|---|
| November 13,<br>2009 | November 13,<br>2009 | Press release announcing financial results for period ended September 30, 2009. |
| October 16, 2009     | October 19,<br>2009  | Press release announcing quarterly dividend.                                    |

SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

THE NATIONAL SECURITY GROUP, INC.

/s/ Brian R. McLeod

Brian R. McLeod  
Chief Financial  
Officer and  
Treasurer

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

Date: March 26, 2010

POWER OF ATTORNEY

Know all by these present, that the undersigned hereby constitutes and appoints Brian R. McLeod, with full power of substitution and/or revocation, the undersigned's true and lawful attorney-in-fact: to execute for and on behalf of the undersigned, in the undersigned's capacity as a director of National Security Group, inc. (the "Company"), any and all forms (including, without limitation Form 10-K) required or desired to be executed by or on behalf of the Company pursuant to section 13 or 15(D) of the Securities Exchange Act of 1934, as amended, after said form has been approved by the Company's audit committee; to do and perform any and all acts for and on behalf of the undersigned which may be necessary or desirable to complete and execute any such Form and timely file such Form with the appropriate governmental authority (including, without limitation, the United States Securities and Exchange Commission) and any stock exchange or similar authority; and Take any other action of any type whatsoever in connection with the foregoing which, in the opinion of such attorney-in-fact, may be of benefit to, in the best interest of, or legally required by, the undersigned, it being understood that the documents executed by any such attorney-in-fact on behalf of the undersigned pursuant to this Power of Attorney shall be in such form and shall contain such terms and conditions as such attorney-in-fact may approve in such attorney-in-fact's discretion.

The undersigned hereby grants to each such attorney-in-fact full power and authority to do and perform any and every act and thing whatsoever requisite, necessary, or proper to be done in the exercise of any of the rights and powers herein granted, as fully to all intents and purposes as the undersigned might or could do if personally present, with full power of substitution or revocation, hereby ratifying and confirming all that such attorney-in-fact, or such attorney-in-fact's substitute or substitutes, shall lawfully do or cause to be done by virtue of this Power of Attorney and the rights and powers herein granted. The undersigned acknowledges that the foregoing attorneys-in-fact, and each of them, in serving in such capacity at the request of the undersigned, are not assuming, nor is the Company assuming, any of the undersigned's responsibilities to comply with section 13 or 15(D) of the Securities Exchange Act of 1934, as amended.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in their capacity as a Director of The National Security Group, Inc. on March 26, 2010.

/s/ Winfield Baird

SIGNATURE

/s/ Mickey L. Murdock

/s/ Fleming Brooks

/s/ Jack E. Brunson

/s/ William L. Brunson, Jr.

/s/ Fred D. Clark, Jr.

/s/ Frank B. O'Neil

/s/ Donald Pittman

/s/ Paul C. Wesch

/s/ L. Brunson White

/s/ Walter P. Wilkerson

