

NATIONAL SECURITY GROUP INC
Form 10-Q
August 07, 2012
Table of Contents

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

FORM 10-Q

(Mark One)

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

For Quarterly Period Ended June 30, 2012

or

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

For the transition period from _____ to _____.

Commission File Number 0-18649

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

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

63-1020300
(IRS Employer
Identification No.)

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

36323
(Zip-Code)

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

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

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

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

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

As of August 6, 2012, there were 2,466,600 shares, \$1.00 par value, of the registrant's common stock outstanding.

1

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

INDEX

PART I. FINANCIAL INFORMATION

Page No.

Item 1. Financial Statements (unaudited)

<u>Condensed Consolidated Balance Sheets</u>	<u>4</u>
<u>Condensed Consolidated Statements of Income</u>	<u>4</u>
<u>Condensed Consolidated Statements of Comprehensive Income</u>	<u>5</u>
<u>Condensed Consolidated Statement of Shareholders' Equity</u>	<u>6</u>
<u>Condensed Consolidated Statements of Cash Flows</u>	<u>6</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>7</u>
<u>Review Report of Independent Registered Public Accounting Firm</u>	<u>14</u>

<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>15</u>
--	-----------

<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	<u>25</u>
---	-----------

<u>Item 4. Controls and Procedures</u>	<u>25</u>
--	-----------

PART II. OTHER INFORMATION

<u>Item 1. Legal Proceedings</u>	<u>25</u>
<u>Item 1A. Risk Factors</u>	<u>25</u>
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>25</u>
<u>Item 3. Defaults Upon Senior Securities</u>	<u>25</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>25</u>
<u>Item 5. Other Information</u>	<u>25</u>
<u>Item 6. Exhibits</u>	<u>26</u>

<u>SIGNATURE</u>	<u>27</u>
------------------	-----------

Table of Contents

Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	June 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2012 - \$2,501; 2011 - \$3,497)	\$2,336	\$3,303
Fixed maturities available-for-sale, at estimated fair value (cost: 2012 - \$68,936; 2011 - \$69,980)	72,446	73,074
Equity securities available-for-sale, at estimated fair value (cost: 2012 - \$4,559; 2011 - \$4,931)	7,875	8,547
Trading securities	40	80
Mortgage loans on real estate, at cost	386	390
Investment real estate, at book value	5,774	5,745
Policy loans	1,241	1,244
Company owned life insurance	5,831	5,660
Other invested assets	3,848	3,929
Total Investments	99,777	101,972
Cash	6,345	3,393
Accrued investment income	776	706
Policy receivables and agents' balances, net	10,109	8,805
Reinsurance recoverable	1,960	2,778
Deferred policy acquisition costs	9,703	9,558
Property and equipment, net	2,482	2,528
Accrued income tax recoverable	1,496	1,669
Deferred income tax asset	4,282	—
Other assets	1,200	1,045
Total Assets	\$138,130	\$132,454
LIABILITIES AND SHAREHOLDERS' EQUITY		
Property and casualty benefit and loss reserves	\$12,369	\$14,386
Accident and health benefit and loss reserves	2,172	2,122
Life and annuity benefit and loss reserves	29,813	29,605
Unearned premiums	26,906	25,232
Policy and contract claims	686	652
Other policyholder funds	1,429	1,408
Short-term notes payable	625	485
Litigation settlement	13,000	—
Long-term debt	12,372	12,372
Deferred income tax liability	—	86
Other liabilities	8,095	8,091

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

Total Liabilities	107,467	94,439
Contingencies		
Shareholders' equity		
Common stock	2,467	2,467
Additional paid-in capital	4,951	4,951
Accumulated other comprehensive income	3,557	3,640
Retained earnings	19,688	26,957
Total Shareholders' Equity	30,663	38,015
Total Liabilities and Shareholders' Equity	\$138,130	\$132,454

The Notes to Condensed Consolidated Financial Statements are an integral part of these statements.
THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(In thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
REVENUES				
Net premiums earned	\$12,533	\$13,321	\$26,029	\$28,191
Net investment income	1,066	1,171	2,201	2,228
Net realized investment gains	865	261	1,071	1,031
Other income	193	256	390	511
Total revenues	14,657	15,009	29,691	31,961
EXPENSES				
Policyholder benefits paid	7,976	15,682	15,821	25,004
Policy acquisition costs	2,933	3,071	5,705	5,995
General expenses	1,835	2,418	4,323	4,589
Litigation settlement and defense costs	12,670	482	13,259	789
Taxes, licenses and fees	438	622	930	1,102
Interest expense	288	285	580	570
Total expenses	26,140	22,560	40,618	38,049
Loss Before Income Taxes	(11,483	) (7,551	) (10,927	) (6,088
INCOME TAX (BENEFIT) EXPENSE				
Current	145	(2,515	) 173	(2,165
Deferred	(4,322	) (91	) (4,325	) 27
	(4,177	) (2,606	) (4,152	) (2,138
Net Loss	\$(7,306	) \$(4,945	) \$(6,775	) \$(3,950
LOSS PER COMMON SHARE	\$(2.96	) \$(2.00	) \$(2.75	) \$(1.60
DIVIDENDS DECLARED PER SHARE	\$0.10	\$0.15	\$0.20	\$0.30

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net loss:	\$ (7,306	) \$ (4,945	) \$ (6,775	) \$ (3,950
Other comprehensive income (loss), net of tax				
Changes in:				
Unrealized gains (losses) on securities	(201	) 465	76	285
Unrealized loss on interest rate swap	(244	) (103	) (159	) (55
Other comprehensive income (loss), net of tax	(445	) 362	(83	) 230
Comprehensive loss	\$ (7,751	) \$ (4,583	) \$ (6,858	) \$ (3,720

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (UNAUDITED)
(In thousands)

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital
Balance at December 31, 2011	\$38,015	\$26,957	\$3,640	\$2,467	\$4,951
Comprehensive income					
Net loss six months ended 6/30/2012	(6,775	) (6,775)		
Other comprehensive income, net of tax:					
Unrealized gain on securities, net of reclassification adjustment of \$704	76		76		
Unrealized gain on interest rate swap	(159	)	(159)	
Total comprehensive loss	(6,858)			
Cash dividends	(494	) (494)		
Balance at June 30, 2012 (Unaudited)	\$30,663	\$19,688	\$3,557	\$2,467	\$4,951

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

THE NATIONAL SECURITY GROUP, INC.

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

	Six Months Ended June 30,	
	2012	2011
Cash Flows from Operating Activities		
Net loss	\$(6,775	) \$(3,950
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Change in accrued investment income	(70	) 109
Change in reinsurance recoverable	818	(1,832
Change in deferred policy acquisition costs	(145	) (27
Change in accrued income tax recoverable	173	(2,604
Change in deferred income taxes	(4,325	) (27
Depreciation expense	286	187
Change in policy liabilities and claims	(1,376	) 2,195
Change in litigation settlement	13,000	—

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

Other, net	(1,569	) (1,660)
Net cash provided (used) by operating activities	17	(7,609)
Cash Flows from Investing Activities			
Cost of investments acquired	(15,267	) (11,777)
Sale and maturity of investments	18,690	19,847)
Purchase of property and equipment	(155	) (31)
Net cash provided by investing activities	3,268	8,039)
Cash Flows from Financing Activities			
Change in other policyholder funds	21	28)
Change in short-term notes payable	140	(325)
Dividends paid	(494	) (740)
Net cash used in financing activities	(333	) (1,037)
Net change in cash and cash equivalents	2,952	(607)
Cash and cash equivalents, beginning of period	3,393	1,572)
Cash and cash equivalents, end of period	\$6,345	\$965)

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

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

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

Use of Estimates

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

Recently Adopted Accounting Standards

Presentation of Comprehensive Income

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

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

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

Amendments to Fair Value Measurement and Disclosure Requirements

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

Accounting Changes Not Yet Adopted

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

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

NOTE 2 – REINSURANCE

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

Under the catastrophe reinsurance program, the Company retains the first \$4,000,000 in losses from each event. Reinsurance is maintained in four layers as follows:

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

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

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

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

NOTE 3 – CALCULATION OF EARNINGS PER SHARE

Earnings per share were based on net income divided by the weighted average common shares outstanding. The weighted average number of shares outstanding for the three-month and six-month periods ending June 30, 2012 and 2011 were 2,466,600.

NOTE 4 – CHANGES IN SHAREHOLDERS' EQUITY

During the six month periods ended June 30, 2012 and 2011, there were no changes in shareholders' equity except for a net loss of \$6,775,000 and \$3,950,000, respectively; dividends paid of \$494,000 in 2012 and \$740,000 in 2011; changes in accumulated other comprehensive loss, net of applicable taxes, \$83,000 in 2012 and changes in accumulated other comprehensive income of \$230,000 in 2011. Other comprehensive income/loss consists of accumulated unrealized gains and losses on securities and unrealized gains and losses on interest rate swaps.

NOTE 5 – INVESTMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of June 30, 2012 are as follows:

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$30,876	\$1,703	\$233	\$32,346
Trust preferred securities	537	—	2	535
Mortgage backed securities	6,640	215	22	6,833
Private label mortgage backed securities	8,354	212	5	8,561
Obligations of states and political subdivisions	14,334	1,187	—	15,521
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	8,195	465	10	8,650
Total fixed maturities	68,936	3,782	272	72,446
Equity securities	4,559	3,859	543	7,875
Total	\$73,495	\$7,641	\$815	\$80,321

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of June 30, 2012 are as follows:

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$1,619	\$121	\$—	\$1,740
Private label mortgage backed securities	—	—	—	—
Obligations of states and political subdivisions	515	27	—	542
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	202	17	—	219
Total	\$2,336	\$165	\$—	\$2,501

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2011 are as follows:

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$19,907	\$1,340	\$267	\$20,980
Trust preferred securities	537	—	58	479
Mortgage backed securities	7,587	307	23	7,871
Private label mortgage backed securities	9,716	199	62	9,853
Obligations of states and political subdivisions	18,355	1,142	15	19,482
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	13,878	534	3	14,409
Total fixed maturities	69,980	3,522	428	73,074

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

Equity securities	4,931	4,206	590	8,547
Total	\$74,911	\$7,728	\$1,018	\$81,621

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2011 are as follows:

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$2,026	\$125	\$—	\$2,151
Private label mortgage backed securities	55	1	—	56
Obligations of states and political subdivisions	996	50	—	1,046
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	226	18	—	244
Total	\$3,303	\$194	\$—	\$3,497

The amortized cost and aggregate fair value of debt securities at June 30, 2012, by contractual maturity, are presented in the following table. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(Dollars in Thousands)	
	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	\$1,115	\$1,134
Due after one year through five years	14,420	15,489
Due after five years through ten years	21,148	22,329
Due after ten years	32,253	33,494
Total	\$68,936	\$72,446
Held-to-maturity securities:		
Due in one year or less	\$—	\$—
Due after one year through five years	516	544
Due after five years through ten years	473	507
Due after ten years	1,347	1,450
Total	\$2,336	\$2,501

A summary of securities available-for-sale with unrealized losses as of June 30, 2012, 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:

June 30, 2012	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
Fixed maturities							
Corporate debt securities	\$8,368	\$81	\$2,647	\$152	\$11,015	\$233	27
Trust preferred securities	—	—	535	2	535	2	1
	1,155	22	—	—	1,155	22	4

Mortgage backed securities							
Private label mortgage backed securities	—	—	117	5	117	5	1
Obligations of state and political subdivisions	—	—	—	—	—	—	0
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	608	2	254	8	862	10	3
Equity securities	184	8	1,050	535	1,234	543	5
	\$10,315	\$113	\$4,603	\$702	\$14,918	\$815	41

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

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

There were no securities held-to-maturity with unrealized losses as of June 30, 2012 and December 31, 2011.

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

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

For the quarter ended June 30, 2012, the Company realized no additional other-than-temporary impairments. The single largest accumulated loss was in the equity portfolio and totaled \$498,000. The second largest loss position was in the bond portfolio and totaled \$75,000. The third largest loss position was in the bond portfolio and totaled \$25,000.

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

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

	(Dollars in thousands)	
	Six-month period ended June 30, 2012 (unaudited)	Year Ended December 31, 2011
Net change in unrealized appreciation on available-for-sale securities before deferred tax	\$ 115	\$ 1,792
Deferred income tax	(39	) (534
Net change in unrealized appreciation on available-for-sale securities	\$ 76	\$ 1,258

NOTE 6 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company has not incurred any income tax related interest and penalties as of June 30, 2012 and \$1,000 as of December 31, 2011. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2006. Tax returns have been filed through the year 2011.

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

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax assets. The Company recognized net deferred tax asset position of \$4,282,000 at June 30, 2012, and net deferred tax liability position of \$86,000 at December 31, 2011.

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

	June 30, 2012 (unaudited)	December 31, 2011
General expenses	\$1,211	\$1,576
Unearned premiums	1,827	1,714
Claims liabilities	249	271
Litigation settlement	4,420	—
NOL carry forward	1,594	1,363
Other-than-temporary impairments on securities owned	231	258
Unrealized loss on interest rate swaps	489	407
Deferred tax assets	10,021	5,589
Depreciation	(120	) (144
Deferred policy acquisition costs	(3,299	) (3,250
Unrealized gains on securities available-for-sale	(2,320	) (2,281
Deferred tax liabilities	(5,739	) (5,675
Net deferred tax asset (liability)	\$4,282	\$(86

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

	Six Months Ended June 30,	
	2012	2011
Deferred policy acquisition costs	\$49	\$304
Other-than-temporary impairments	27	(69)
Trading securities	—	10
Unearned premiums	(113)	(102)
General expenses	(61)	(98)
Depreciation	(24)	(16)
Claim liabilities	22	(2)
Litigation settlement	(3,995)	—
NOL carry forward	(230)	—
Deferred income tax (benefit) expense	\$ (4,325)	\$ 27

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

	Six Months Ended June 30,		
	2012	2011	
Federal income tax rate applied to pre-tax income/loss	34.00	% 34.00	%
Dividends received deduction and tax-exempt interest	0.80	% 1.70	%
Company owned life insurance	0.50	% 0.70	%
Small life deduction	2.10	% 3.10	%
Other, net	0.60	% (4.40))%
Effective federal income tax rate	38.00	% 35.10	%

NOTE 7 –NOTES PAYABLE AND LONG-TERM DEBT

Short-term notes payable consisted of the following as of June 30, 2012 and December 31, 2011:

	(Dollars in thousands)	
	2012	2011
Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 5.0% floor; maturity January 2013. Interest payments due quarterly. Unsecured.	\$625	\$485

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Long-term debt consisted of the following as of June 30, 2012 and December 31, 2011:

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

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

The Company has entered into various swap agreements related to the trust preferred securities. On March 19, 2009, the Company entered into a forward swap effective September 17, 2012, 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 June 21, 2007. Commencing September 17, 2012, under the terms of the forward swap, the Company will receive interest at the three-month LIBOR rate plus 3.4% and pay interest at the fixed rate of 7.02%. This forward swap will effectively fix the interest rate on \$3,000,000 in debt until September of 2019.

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

The swaps entered into in 2009 and 2010 have fair values \$469,000 (liability) and \$968,000 (liability), respectively, for a total liability of \$1,437,000 at June 30, 2012 (\$1,196,000 at December 31, 2011). The swap liability is reported as a component of other liabilities on the condensed consolidated balance sheets. A net valuation loss of \$159,000 is included in accumulated other comprehensive income related to the swap agreements for the current period. A net

valuation loss of \$640,000 was included in accumulated other comprehensive income related to the swap at December 31, 2011.

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

The Company's interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. The Company has cash collateral on deposit of \$100,000, in addition to securities on deposit with fair market values of \$1,335,000 (all of which is posted as collateral). At December 31, 2011, the Company had cash collateral on deposit of \$310,000 in addition to securities on deposit with fair market values of \$877,000, all of which is posted as collateral. See Note

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

9 for additional information about the interest rate swaps.

In January 2012, the Company renewed an unsecured line of credit for \$700,000, with an interest rate of 5%, to be made available for general corporate purposes. As of June 30, 2012, \$625,000 was drawn on this line (\$485,000 at December 31, 2011).

NOTE 8 – CONTINGENCIES

Litigation

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

The Company's property & casualty subsidiaries are defending a limited number of matters filed in the aftermath of Hurricanes Katrina and Rita in Mississippi, Louisiana and Alabama. These actions include individual lawsuits with 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 April 2007, the Company sold substantially all of its 50% interest in Mobile Attic, Inc., to Bagley Family Revocable Trust (the "Purchaser"). The Company, Peter L. Cash and Russell L. Cash (collectively the "Sellers") sold to Purchaser 61% of the outstanding stock of Mobile Attic under the terms of a Stock Purchase Agreement dated April 5, 2007, executed by Sellers, Mobile Attic and Purchaser's assignor, James W. Bagley (the "Stock Purchase Agreement").

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

As previously disclosed, the Company and the Purchaser have been involved in litigation regarding this transaction. The Purchaser asserted claims against the Company seeking indemnification of Purchaser's losses and damages as a result of the breach of representations and warranties regarding Mobile Attic's financial condition, as set forth in the Stock Purchase Agreement.

On June 20, 2012, the Company and Bagley Trust reached a settlement agreement to dispose of this action. Under the terms of the settlement the Company agreed to pay Bagley Trust \$13,000,000. The terms of the agreement are to be formalized in the form of a promissory note in accordance with the following payment schedule: \$2.5 million on September 18, 2012, and the balance payable in 9 equal annual installments on November 15 each year beginning in 2013 with a final payment in 2021. The unpaid principal will bear interest at Wall Street Journal prime rate plus 1% per annum. The settlement will allow the ability to defer payments in years in which the Company's P&C subsidiaries incur substantial catastrophe losses thus allowing capital management flexibility in the P&C subsidiaries. Under the expected terms of the agreement, annual debt service payments on the note must equal or exceed any payment of dividends to shareholders in the preceding twelve months.

NOTE 9 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

We are permitted to elect to measure financial instruments and certain other items at fair value, with the change in fair value recorded in earnings. We elected not to measure any eligible items using the fair value option.

Accounting standards define fair value as the price that would be received to sell an asset or would be paid to transfer a liability in an orderly transaction between market participants at the measurement date, and establishes a framework to make the measurement of fair value more consistent and comparable. In determining fair value, we primarily use prices and other relevant information generated by market transactions involving identical or comparable assets.

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

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

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

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

Level 2 assets include certain of our marketable debt and equity instruments with quoted market prices that are traded in less active markets or priced using a quoted market price for similar instruments. Level 2 assets also include marketable equity instruments with security-specific restrictions that would transfer to the buyer, marketable debt instruments priced using indicator prices which represent non-binding market consensus prices that can be corroborated by observable market quotes, as well as derivative contracts and debt instruments priced using inputs that are observable in the market or can be derived principally from or corroborated by observable market data. Marketable debt instruments in this category generally include commercial paper, bank time deposits, repurchase agreements for fixed-income instruments, and a majority of floating-rate notes, corporate bonds, and municipal bonds.

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

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

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

Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2012 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	\$32,346	\$—	\$32,346	\$—
Trust preferred securities	535	—	535	—
Mortgage backed securities	6,833	—	6,833	—
Private label mortgage backed securities	8,561	—	8,561	—
Obligations of states and political subdivisions	15,521	—	15,521	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	8,650	8,650	—	—
Trading securities	40	40	—	—
Equity securities available-for-sale	7,875	7,087	—	788
Total Financial Assets	\$80,361	\$15,777	\$63,796	\$788
Financial Liabilities				
Interest rate swap	\$1,437	\$—	\$—	\$1,437
Total Financial Liabilities	\$1,437	\$—	\$—	\$1,437

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

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

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

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

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

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

As of June 30, 2012, Level 3 fair value measurements of assets include \$788,000 of equity securities in a local community bank whose value is based on an evaluation of the financial statements of the entity. The Company does not develop the unobservable inputs used in measuring fair value.

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

As of June 30, 2012, Level 3 fair value measurements of liabilities include \$1,437,000 net fair value of various interest rate swaps whose value is based on analysis provided by a third party broker. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swaps is provided in Note 7.

The table below presents a reconciliation for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the quarter ended June 30, 2012 (in thousands):

For the quarter ended June 30, 2012	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$642	\$(1,196)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	3	(241)
Purchases:	143	—
Sales:	—	—
Issuances:	—	—
Settlements	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$788	\$(1,437)
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 June 30, 2012:	\$—	\$—

For the quarter ended June 30, 2012, there were no assets or liabilities measured at fair values on a nonrecurring basis.

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

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	\$20,980	\$—	\$20,980	\$—
Trust preferred securities	479	—	479	—
Mortgage backed securities	7,871	—	7,871	—
Private label mortgage backed securities	9,853	—	9,853	—
Obligations of states and political subdivisions	19,482	—	19,482	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	14,409	14,409	—	—
Trading securities	80	80	—	—
Equity securities available-for-sale	8,547	7,905	—	642
Total Financial Assets	\$81,701	\$22,394	\$58,665	\$642
Financial Liabilities				
Interest rate swap	\$1,196	\$—	\$—	\$1,196
Total Financial Liabilities	\$1,196	\$—	\$—	\$1,196

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

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

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

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

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

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

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

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

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

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

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

The carrying amount and estimate fair value of the Company's financial instruments as of June 30, 2012 and December 31, 2011 are as follows (in thousands):

	June 30, 2012		December 31, 2011	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related instruments				
Mortgage loans	\$386	\$386	\$390	\$390
Policy loans	1,241	1,241	1,244	1,244
Company owned life insurance	5,831	5,831	5,660	5,660
Other invested assets	3,848	3,848	3,929	3,929

Liabilities and related instruments

Other policyholder funds	1,429	1,429	1,408	1,408
Short-term debt	625	625	485	485
Long-term debt	12,372	12,372	12,372	12,372

NOTE 10 – SEGMENTS

The Company's property and casualty insurance operations comprise one business segment. The property and casualty insurance segment consists of seven lines of business: dwelling fire and extended coverage, homeowners (including mobile homeowners), ocean marine, other liability, private passenger auto liability, commercial auto liability and auto physical damage. Management organizes the business utilizing a niche strategy focusing on lower valued dwellings as well as non-standard automobile products. Our chief decision makers (President, Chief Financial Officer and Chief Executive Officer) review results and operating plans making decisions on resource allocations on a company-wide basis. The Company's products are primarily produced through agents within the states in which we operate. The Company's life and accident and health operations comprise the second business segment. The life and accident and health insurance segment consists of two lines of business: traditional life insurance and accident and health insurance. Premium revenues and operating income by industry segment for the three and six-month periods ended June 30, 2012, and 2011 (unaudited) are summarized below (dollars in thousands):

Three-Month Period Ended June 30, 2012	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	\$12,533	\$10,814	\$1,719	\$—
Net investment income	1,066	529	520	17
Net realized investment gains	865	75	790	—
Other income	193	192	1	—
	14,657	11,610	3,030	17
BENEFITS AND EXPENSES				
Policyholder benefits paid	7,976	6,763	1,213	—
Policy acquisition costs	2,933	2,594	339	—
General and administrative expenses	1,835	1,111	644	80
Litigation settlement and defense costs	12,670	—	—	12,670
Taxes, licenses and fees	438	385	53	—
Interest expense	288	—	35	253
	26,140	10,853	2,284	13,003
Income (Loss) Before Income Taxes	\$(11,483)	) \$757	\$746	\$(12,986)

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Three-Month Period Ended June 30, 2011	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	\$13,321	\$11,544	\$1,777	\$—
Net investment income	1,171	606	461	104
Net realized investment gains	261	257	4	—
Other income	256	254	2	—
	15,009	12,661	2,244	104
BENEFITS AND EXPENSES				
Policyholder benefits paid	15,682	14,386	1,296	—
Policy acquisition costs	3,071	2,751	320	—
General and administrative expenses	2,418	1,601	594	223
Litigation settlement and defense costs	482	—	—	482
Taxes, licenses and fees	622	516	106	—
Interest expense	285	—	16	269
	22,560	19,254	2,332	974
Loss Before Income Taxes	\$(7,551)	\$(6,593)	\$(88)	\$(870)
Six-Month Period Ended June 30, 2012	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	\$26,029	\$22,558	\$3,471	\$—
Net investment income	2,201	1,140	1,028	33
Net realized investment gains	1,071	207	862	2
Other income	390	388	2	—
	29,691	24,293	5,363	35
BENEFITS AND EXPENSES				
Policyholder benefits paid	15,821	13,176	2,645	—
Policy acquisition costs	5,705	5,138	567	—
General and administrative expenses	4,323	2,940	1,092	291
Litigation settlement and defense costs	13,259	—	—	13,259
Taxes, licenses and fees	930	815	115	—
Interest expense	580	—	37	543
	40,618	22,069	4,456	14,093
Income (Loss) Before Income Taxes	\$(10,927)	\$2,224	\$907	\$(14,058)

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Six-Month Period Ended June 30, 2011	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
REVENUE				
Net premiums earned	\$28,191	\$24,545	\$3,646	\$—
Net investment income	2,228	1,233	958	37
Net realized investment gains	1,031	643	358	30
Other income	511	509	2	—
	31,961	26,930	4,964	67
BENEFITS AND EXPENSES				
Policyholder benefits paid	25,004	22,197	2,807	—
Policy acquisition costs	5,995	5,491	504	—
General and administrative expenses	4,589	3,052	1,174	363
Litigation settlement and defense costs	789	—	—	789
Taxes, licenses and fees	1,102	876	226	—
Interest expense	570	—	31	539
	38,049	31,616	4,742	1,691
Income (Loss) Before Income Taxes	\$(6,088)	\$(4,686)	\$222	\$(1,624)

The following table presents the Company's gross and net premiums written for the property and casualty segment and the life and accident and health segment for the three and six-month periods ended June 30, 2012 and 2011, respectively:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Life, accident and health operations premiums written:				
Traditional life insurance	\$1,248	\$1,226	2,458	\$2,531
Accident and health insurance	455	474	919	958
Total life, accident and health	1,703	1,700	3,377	3,489
Property and Casualty operations premiums written:				
Dwelling fire & extended coverage	7,825	7,271	14,752	13,968
Homeowners (Including mobile homeowners)	6,745	7,439	12,232	13,446
Ocean marine	363	397	447	516
Other liability	409	377	766	711
Private passenger auto liability	(12)	) 393	57	1,247
Commercial auto liability	—	92	6	211
Auto physical damage	(5)	) 175	31	511
Total property and casualty	15,325	16,144	28,291	30,610
Gross premiums written	17,028	17,844	31,668	34,099
Reinsurance premium ceded	(2,443)	) (3,039)	) (4,126)	) (4,568)
Net premiums written	\$14,585	\$14,805	27,542	\$29,531

Table of Contents

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the Company's gross and net premiums earned for the property and casualty segment and the life and accident and health segment for the three and six-month periods ended June 30, 2012 and 2011, respectively:

	Three Months Ended		Six Months Ended	
	June 30, 2012	2011	June 30, 2012	2011
Life, accident and health operations premiums earned:				
Traditional life insurance	\$ 1,270	\$ 1,302	\$ 2,558	\$ 2,688
Accident and health insurance	449	475	913	958
Total life, accident and health	1,719	1,777	3,471	3,646
Property and Casualty operations premiums earned:				
Dwelling fire & extended coverage	6,665	6,666	13,212	13,165
Homeowners (Including mobile homeowners)	5,790	6,227	11,694	12,471
Ocean marine	275	300	543	619
Other liability	343	321	683	631
Private passenger auto liability	93	685	328	1,441
Commercial auto liability	—	92	6	211
Auto physical damage	44	274	151	571
Total property and casualty	13,210	14,565	26,617	29,109
Gross premiums earned	14,929	16,342	30,088	32,755
Reinsurance premium ceded	(2,396	) (3,021	) (4,059	) (4,564
Net premiums earned	\$ 12,533	\$ 13,321	\$ 26,029	\$ 28,191

NOTE 11 – PREFERRED AND COMMON STOCK

The table below provides information regarding the Company's preferred and common stock as of June 30, 2012 and December 31, 2011:

	June 30, 2012			December 31, 2011		
	Authorized	Issued	Outstanding	Authorized	Issued	Outstanding
Preferred Stock, \$1 par value	500,000	—	—	500,000	—	—
Class A Common Stock, \$1 par value	2,000,000	—	—	2,000,000	—	—
Common Stock, \$1 par value	3,000,000	2,466,600	2,466,600	3,000,000	2,466,600	2,466,600

Table of Contents

REVIEW REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. as of June 30, 2012, and condensed consolidated statements of income and comprehensive income for the three and six-month periods ended June 30, 2012 and 2011, the condensed consolidated statement of shareholders' equity for the six-month period ended June 30, 2012 and cash flows for the six-month period ended June 30, 2012 and 2011. These condensed consolidated financial statements are the responsibility of the company's management.

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

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

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

/s/ Warren Averett, LLC

Birmingham, Alabama
August 7, 2012

Table of Contents

Item 2.

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

The following discussion addresses the financial condition of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) as of June 30, 2012, compared with December 31, 2011 and its results of operations for the three-month period ending June 30, 2012 and its statements of shareholders' equity and cash flows for the six-month period ended June 30, 2012, all compared with the same periods last year. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part I, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2011.

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

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

The reader is assumed to have access to the Company's 2011 Annual Report. This discussion should be read in conjunction with the Annual Report and with the condensed consolidated financial information on pages 4 through 26 of this form 10-Q.

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

The National Security Group operates in the property and casualty and life, accident and supplemental health insurance businesses and markets products primarily through independent agents. The Company operates in eleven states with just under 48.6% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment, accounting for 86.7% of total insurance premium revenue during the first six months of 2012. Revenue generated from the life segment accounted for 13.3% of total insurance premium revenue.

National Security Insurance Company (NSIC) is a life, accident and health insurance company founded in 1947 and is the oldest subsidiary of the Company. The premium revenue produced in NSIC from the traditional life products and accident and health products accounted for 9.9% and 3.4%, respectively, of total premium revenue. All references to NSIC in the remainder of this management discussion and analysis will refer to the combined life, accident and health insurance operations and will compose the life segment of the Company. NSIC is licensed to underwrite life and accident and health insurance in Alabama, Florida, Georgia, Mississippi, South Carolina and Texas.

Omega One Insurance Company (Omega) is a property and casualty insurance company incorporated in 1992. Omega is a wholly owned subsidiary of National Security Fire and Casualty Company (NSFC) and is the smallest of the insurance subsidiaries, accounting for approximately 3.7% of consolidated premium revenue. Omega is licensed and underwrites property and casualty insurance in the states of Alabama and Louisiana. There is no material product differentiation between those products underwritten by NSFC and Omega as both primarily underwrite personal lines of insurance.

National Security Fire and Casualty Company (NSFC) is a property and casualty insurance company and is the largest of the insurance subsidiaries, accounting for over 83.0% of total premium revenue of the Company. NSFC operates primarily in the personal lines segment of the property and casualty insurance market. NSFC has been in operation since 1959. NSFC is licensed and underwrites property and casualty insurance in the states of Alabama, Arkansas, Florida, Georgia, Mississippi, Oklahoma, South Carolina and Tennessee. NSFC is licensed, but does not currently underwrite any business, in the states of Kentucky and West Virginia. NSFC also underwrites insurance on a non-admitted or surplus lines basis in the states of Louisiana, Missouri and Texas.

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

Table of Contents

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

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

CONSOLIDATED RESULTS OF OPERATIONS

Summary:

For the three-months ended June 30, 2012, the Company had a net loss of \$7,306,000, \$2.96 per share, compared to a net loss of \$4,945,000, \$2.00 per share, for the same period last year. The primary factor contributing to the net loss for the quarter-ended June 30, 2012 was the settlement of longstanding litigation related to the Company's sale of an investment in Mobile Attic, Inc. The litigation was settled for \$13,000,000 on June 18, 2012. The June 30, 2012 condensed consolidated financial statements reflect the remaining charge for this settlement. Additional discussion related to the settlement can be found in the liquidity and capital resources section of Management Discussion and Analysis and in Note 8 to the condensed consolidated financial statements. Related to the three-months ended June 30, 2011, the net loss included a significant increase in policyholder benefits paid resulting from tornado and wind claims related to a series of severe weather events occurring during the month of April 2011.

For the three-months ended June 30, 2012, claims were down \$7,706,000 at \$7,976,000 compared to \$15,682,000 for the same period last year. Incurred losses and loss adjustment expenses (LAE) in the P&C segment decreased \$6,695,000 in 2012 compared to 2011. P&C segment losses were substantially elevated in 2011 as the Company incurred a record number of claims for a spring storm season. Most notable was the impact of tornado outbreaks in Mississippi, Alabama and Georgia from April 25-27, 2011 (formally assigned catastrophe number 46 by the Property Claims Service) which caused widespread damage and led to \$9,936,000 in gross incurred losses and LAE (\$3,822,000 net of reinsurance) in the P&C segment.

For the three-months ended June 30, 2012, earned premium revenue was \$12,533,000 compared to \$13,321,000 for the three-months ended June 30, 2011; a \$788,000 or 5.9% decrease. The P&C segment was the primary contributor to the decrease accounting for \$730,000 or 92.6% of the decline. Earned premium revenue in the P&C segment property programs was down \$438,000 or 3.4% for the three-months ended June 30, 2012 compared to the same period last year. Also contributing to the decline in earned premium revenue was the termination of the automobile programs. Earned premium revenue for these program was \$137,000 for the quarter-ended June 30, 2012; down 87.0% from \$1,051,000 for the same period last year.

For the six-months ended June 30, 2012, the Company had a net loss of \$6,775,000, \$2.75 per share, compared to a net loss of \$3,950,000, \$1.60 per share, for the same period last year. As discussed previously, charges related to the litigation settlement was the primary factor impacting the first six months of 2012. The first six months of 2011 were adversely impacted by the unprecedented increase in tornado and wind related losses during the month of April, the most significant of which was the April 27th, 2011 tornado outbreak that ripped through the Southeastern United States.

Claims were \$15,821,000 (60.8% of net premiums earned) for the six-months ended June 30, 2012 compared to \$25,004,000 (88.7% of net premiums earned) for the same period last year. Policyholder benefits paid were down \$9,183,000 or 36.7% for the six-months ending June 30, 2012 compared to the same period last year. The primary reason for the decline was the lack of storm activity in the current year and the large increase in incurred losses and LAE in our property programs in the prior year due to the significant storm activity. In addition, our automobile programs were discontinued in the fourth quarter of 2011 which reduced incurred losses and LAE in 2012 compared to 2011. Incurred losses and LAE from the automobile programs decreased \$1,780,000; accounting for 19.4% of the total decline in claims in 2012 compared to 2011.

Table of Contents

Year-to-date earned premium revenue was \$26,029,000 for the six-months ended June 30, 2012 compared to \$28,191,000 for the same period last year. The life segment accounted for \$175,000 or 8.1% of the decline in premium revenue with decreases in both the traditional life and A&H lines of business. The P&C segment accounted for the remaining \$1,987,000 of the \$2,162,000 premium revenue decline. As mentioned above, decreases in premium revenue from the P&C segment related to the property programs coupled with the reduction in premium revenue from the discontinuation of the automobile programs were the primary reasons for the overall decline in premium revenue in 2012 compared to 2011 in the P&C segment.

Shareholders' equity as of June 30, 2012 was \$30,663,000, down \$7,352,000 compared to \$38,015,000 as of December 31, 2011. Book value per share decreased \$2.98 per share for the period ended June 30, 2012 to \$12.43 per share compared to \$15.41 per share at December 31, 2011. Factors contributing to the change in equity were a year to date net loss of \$6,775,000, increase in market values of fixed maturities and equity securities of \$76,000, a net loss on interest rate swaps of \$159,000 and dividends paid of \$494,000.

Three-months ended June 30, 2012 compared to three-months ended June 30, 2011:

Premium Revenue:

The table below provides earned premium revenue by segment for the three-months ended June 30, 2012 and 2011:

	Three-Months Ended		Percent increase (decrease)	
	2012	2011		
Life, accident and health segment:				
Traditional life insurance	\$1,270,000	\$1,302,000	(2.5)%
Accident and health insurance	449,000	475,000	(5.5)%
Total life, accident and health	1,719,000	1,777,000	(3.3)%
Property and Casualty segment:				
Dwelling fire & extended coverage	6,665,000	6,666,000	—	%
Homeowners (Including mobile homeowners)	5,790,000	6,227,000	(7.0)%
Ocean marine	275,000	300,000	(8.3)%
Other liability	343,000	321,000	6.9	%
Private passenger auto liability	93,000	685,000	(86.4)%
Commercial auto liability	—	92,000		