

NATIONAL SECURITY GROUP INC  
Form 10-Q  
May 14, 2010

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

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FORM 10-Q

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(Mark One)

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

For Quarterly Period Ended March 31, 2010

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  
(State or Other Jurisdiction of  
Incorporation or Organization)

63-1020300  
(IRS Employer  
Identification No.)

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

36323  
(Zip-Code)

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

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

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

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

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

As of May 14, 2010, there were 2,466,600 shares, \$1.00 par value, of the registrant's common stock outstanding.

THE NATIONAL SECURITY GROUP, INC

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## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

ASSETS	March 31, 2010 (unaudited)	December 31, 2009
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2010 - \$5,941; 2009 - \$6,080)	\$ 5,777	\$ 5,942
Fixed maturities available-for-sale, at estimated fair value (cost: 2010 - \$73,978; 2009 - \$69,796)	74,858	70,269
Equity securities available-for-sale, at estimated fair value (cost: 2010 - \$5,309 2009 - \$5,851)	9,212	9,035
Trading securities	548	374
Receivable for securities	169	96
Mortgage loans on real estate, at cost	1,037	1,041
Investment real estate, at book value (accumulated depreciation: 2010 - \$18; 2009 - \$18)	4,871	4,815
Policy loans	1,023	1,018
Company owned life insurance	5,285	5,197
Other invested assets	3,900	3,933
Total Investments	106,680	101,720
Cash	2,062	4,686
Accrued investment income	862	802
Policy receivables and agents' balances	9,787	9,700
Reinsurance recoverable	671	784
Deferred policy acquisition costs	10,483	10,210
Property and equipment, net	2,480	2,537
Other assets	1,130	957
Total Assets \$	134,155 \$	131,396

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## The National Security Group, Inc.

## CONSOLIDATED BALANCE SHEETS

	(Dollars in thousands)	
LIABILITIES AND SHAREHOLDERS' EQUITY	March 31, 2010	December 31, 2009
Property and casualty benefit and loss reserves	\$ 12,312	\$ 12,646
Accident and health benefit and loss reserves	1,656	1,612
Life and annuity benefit and loss reserves	28,668	28,579
Unearned premiums	27,213	27,381
Policy and contract claims	535	535
Other policyholder funds	1,353	1,347
Long-term debt	12,372	12,372
Accrued income taxes	563	111
Deferred income tax liability	700	61
Other liabilities	5,348	5,584
Total Liabilities	90,720	90,228
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 authorized, 2,466,600 shares issued and outstanding	2,467	2,467
Additional paid-in capital	4,951	4,951
Accumulated other comprehensive income	3,008	2,265
Retained earnings	33,009	31,485
Total Shareholders' Equity	43,435	41,168
Total Liabilities and Shareholders' Equity	\$ 134,155	\$ 131,396

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

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## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(In thousands, except per share amounts)

	Three Months Ended March 31	
	2010	2009
<b>REVENUES</b>		
Net premiums earned	\$ 15,038	\$ 15,220
Net investment income	1,326	1,045
Net realized investment gains	669	1
Other income	299	141
Total Revenues	17,332	16,407
<b>EXPENSES</b>		
Policyholder benefits paid or provided	8,473	7,727
Policy acquisition costs	2,748	3,092
General expenses	2,585	2,577
Taxes, licenses and fees	487	457
Interest expense	258	277
Total Expenses	14,551	14,130
Income Before Income Taxes	2,781	2,277
<b>INCOME TAX EXPENSE</b>		
Current	602	712
Deferred	285	84
	887	796
Net Income	1,894	1,481
EARNINGS PER COMMON SHARE	\$ 0.77	\$ 0.60
DIVIDENDS DECLARED PER SHARE	\$ 0.150	\$ 0.150

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

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## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (UNAUDITED)

(In thousands, except per share amounts)

	Total	Retained Earnings	Accumulated Other Comprehensive Income	Common Stock	Additional Paid-in Capital
Balance at December 31, 2009	\$ 41,168	\$ 31,485	\$ 2,265	\$ 2,467	\$ 4,951
Comprehensive Income					
Net income three months ended 3/31/2010	1,894	1,894			
Other comprehensive income (net of tax)					
Unrealized gain on securities, net of reclassification adjustment of \$442	749		749		
Unrealized loss on interest rate swap	(6 )		(6 )		
Total Comprehensive Income	2,637				
Cash dividends	(370 )	(370 )			
Balance at March 31, 2010 (Unaudited)	\$ 43,435	\$ 33,009	\$ 3,008	\$ 2,467	\$ 4,951

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

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## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

	Three Months Ended March 31,	
	2010	2009
<b>Cash Flows from Operating Activities</b>		
Net income	\$ 1,894	\$ 1,481
Adjustments to reconcile income from continuing operations to net cash provided by (used in) operating activities:		
Change in receivable for securities sold	(73 )	513
Change in accrued investment income	(60 )	(95 )
Change in reinsurance recoverables	113	(247 )
Change in deferred policy acquisition costs	(273 )	(129 )
Change in accrued income taxes	452	714
Change in deferred income taxes	285	84
Depreciation expense	74	141
Change in policy liabilities and claims	(458 )	(2,058 )
Other, net	(1,236 )	1,810
Net cash provided by operating activities	718	2,214
<b>Cash Flows from Investing Activities</b>		
Cost of investments acquired	(13,372 )	(11,600 )
Sale and maturity of investments	10,411	7,238
(Purchase) sale of property and equipment	(17 )	(9 )
Net cash provided by used in investing activities	(2,978 )	(4,371 )
<b>Cash Flows from Financing Activities</b>		
Change in other policyholder funds	6	16
Change in notes payable	-	-
Dividends paid	(370 )	(370 )
Net cash used in financing activities	(364 )	(354 )
Net change in cash and cash equivalents	(2,624 )	(2,511 )
Cash and cash equivalents, beginning of period	4,686	3,027
Cash and cash equivalents, end of period	\$ 2,062	\$ 516

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

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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 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, 2009, 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, and assessments of other than temporary impairments on investments. Actual results could differ from those estimates.

#### Reclassifications

Certain 2009 amounts have been reclassified from the prior year financial statements to conform to the 2010 presentation.

#### Recently Issued Accounting Standards

##### Fair Value Measurements

Effective for interim and annual reporting periods beginning after December 15, 2009 or December 15, 2010, as specified, the FASB revised GAAP guidance related to fair value measurement to require additional disclosures and to clarify certain existing disclosure requirements. The guidance is intended to improve the disclosures and increase transparency in financial reporting. We adopted the revised guidance on January 1, 2010 except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements which are effective for interim and annual reporting periods beginning on or after December 15, 2010; adoption had no effect on our results of operations or financial position.

##### Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance

Effective for interim and annual reporting periods beginning on or after December 15, 2009 for outstanding arrangements and effective otherwise for reporting periods beginning on or after June 15, 2009, the FASB issued guidance related to share-lending arrangements for an entity's own shares executed in contemplation of a convertible debt offering or other financing. We adopted the guidance on January 1, 2010; adoption had no effect on our results of operations or financial position.

#### Consolidation of Variable Interest Entities

Effective at the start of a reporting entity's first fiscal year beginning after November 15, 2009, the FASB revised guidance which changes how a reporting entity determines whether or not to consolidate its interest in an entity that is insufficiently capitalized or is not controlled through voting (or similar) rights. The determination of whether a reporting entity is required to consolidate another entity will now be based on, among other things, the other entity's purpose and design and the reporting entity's ability to direct the activities of the other entity that most significantly impact the other entity's economic performance. The revised guidance also requires the reporting entity to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A reporting entity will be required to disclose how its involvement with a variable interest entity affects the reporting entity's financial statements. We adopted the revised guidance on January 1, 2010; adoption had no effect on our results of operations or financial position.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

Transfers and Servicing-Accounting for Transfers of Financial Assets

Effective at the start of a reporting entity's first fiscal year beginning after November 15, 2009, the FASB revised guidance that requires additional disclosure regarding transfers of financial assets, including securitization transactions, where entities have continuing exposure to risks related to the transferred financial assets. We adopted the revised guidance on January 1, 2010; adoption had no effect on our results of operations or financial position.

Investments—Disclosure Requirements; Other-than-temporary Impairments

Effective for interim and annual reporting periods ending on or after June 15, 2009, the FASB revised GAAP to require expanded disclosures related to investments in debt and equity securities. Guidance regarding other-than-temporary impairments was also revised. Previous investment guidance required that an impairment of a debt security be considered as other-than-temporary unless management could assert both the intent and the ability to hold the impaired security until recovery of value. The revised impairment guidance specifies that an impairment be considered as other-than-temporary unless an entity can assert that it has no intent to sell the security and that it is not more likely than not that the entity will be required to sell the security before recovery of its anticipated amortized cost basis.

The new guidance also establishes the concept of credit loss. Credit loss is defined as the difference between the present value of the cash flows expected to be collected from a debt security and the amortized cost basis of the security. The new guidance states that “in instances in which a determination is made that a credit loss exists but the entity does not intend to sell the debt security and it is not more likely than not that the entity will be required to sell the debt security before the anticipated recovery of its remaining amortized cost basis” an impairment is to be separated into (a) the amount of the total impairment related to the credit loss and (b) the amount of total impairment related to all other factors. The credit loss component of the impairment is to be recognized in income of the current period. The non-credit component is to be recognized as a part of other comprehensive income. Transition provisions require a cumulative effect adjustment to reclassify the noncredit component of a previously recognized other-than-temporary impairment from retained earnings to accumulated other comprehensive income “if an entity does not intend to sell and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis”. We adopted the revised guidance as of the beginning of the quarter ended June 30, 2009. We have no non-credit losses.

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.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(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 1-4 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.

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 period ending March 31, 2010 and 2009 were 2,466,600.

NOTE 4 – CHANGES IN SHAREHOLDER'S EQUITY

During the three months ended March 31, 2010 and 2009, there were no changes in shareholders' equity except for net income of \$1,894,000 and \$1,481,000, respectively; dividends paid of \$370,000 in 2010 and 2009; changes in accumulated other comprehensive income (loss), net of applicable taxes of \$743,000 and \$(714,000), respectively. Other comprehensive income consists of accumulated unrealized gains and losses on securities and unrealized gains and losses on interest rate swaps.

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

## NOTE 5 – INVESTMENTS

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

	(Dollars in thousands)			
	March 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	\$ 24,645	\$ 1,795	\$ 289	\$ 26,151
Mortgage backed securities	7,329	297	35	7,591
Private label mortgage backed securities	14,766	141	1,252	13,655
Obligations of states and political subdivisions	14,365	215	273	14,307
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	12,873	337	56	13,154
Total fixed maturities	73,978	2,785	1,905	74,858
Equity securities	5,309	4,421	518	9,212
Total	\$ 79,287	\$ 7,206	\$ 2,423	\$ 84,070
Held-to-maturity securities:				
Corporate debt securities	\$ -	\$ -	\$ -	\$ -
Mortgage backed securities	3,050	129	27	3,152
Private label mortgage backed securities	174	4	-	178
Obligations of states and political subdivisions	2,139	52	13	2,178
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	414	19	-	433
Total	\$ 5,777	\$ 204	\$ 40	\$ 5,941

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

	(Dollars in thousands)			
	December 31, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
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

The amortized cost and aggregate fair value of debt securities at March 31, 2010, by contractual maturity, are as follows. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(Dollars in Thousands)	
	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	\$ 1,664	\$ 1,677
Due after one year through five years	11,219	12,413
Due after five years through ten years	28,371	29,223
Due after ten years	32,724	31,545
Total \$	73,978	\$ 74,858
Held-to-maturity securities:		
Due in one year or less	\$ 302	\$ 307
Due after one year through five years	801	825
Due after five years through ten years	1,871	1,946
Due after ten years	2,803	2,863
Total \$	5,777	\$ 5,941

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

A summary of securities available-for-sale with unrealized losses as of March 31, 2010 and December 31, 2009 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)				March 31, 2010		
	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	\$2,190	\$26	\$2,768	\$263	\$4,958	\$289	12
Mortgage backed securities	1,406	35	-	-	1,406	35	6
Private label mortgage backed securities	4,402	406	4,441	846	8,843	1,252	17
Obligations of state and political subdivisions	4,890	155	2,384	118	7,274	273	20
U.S. Treasury securities and obligations of U.S. government corporations and agencies	5,233	56	-	-	5,233	56	11
Equity securities	432	2	1,524	516	1,956	518	7
	\$18,553	\$680	\$11,117	\$1,743	\$29,670	\$2,423	73

	(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 debt securities	\$1,856	\$21	\$6,772	\$498	\$8,628	\$519	23
	1,443	156	71	9	1,514	165	6

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Mortgage backed securities							
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

A summary of securities held-to-maturity with unrealized losses as of March 31, 2010 and December 31, 2009 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)						March 31, 2010	
	Less than 12 months		12 months or longer		Total		Total Securities in a Loss Position	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses		
Fixed maturities								
Corporate	\$-	\$-	\$-	\$-	\$-	\$-	-	
Mortgage backed securities	-	-	303	27	303	27	1	
Private label mortgage backed Securities	-	-	-	-	-	-	-	
Obligations of state and political subdivisions	155	11	352	2	507	13	2	
U.S. Treasury securities and obligations of U.S. government corporations and agencies	-	-	-	-	-	-	-	
Equity securities	-	-	-	-	-	-	-	
	\$155	\$11	\$655	\$29	\$810	\$40	3	

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## THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
(Continued)

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

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 quarter ended March 31, 2010, the Company realized no additional other-than-temporary impairments. For year ended December 31, 2009, the

Company realized \$443,000 in other-than-temporary impairments. The single largest accumulated loss at March 31, 2010 was in the bond portfolio and totaled \$371,000. The second largest loss position was in the equity portfolio and totaled \$320,000. The third largest loss position was in the bond portfolio and totaled \$213,000. 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.

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## THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
(Continued)

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

	(Dollars in thousands)	
	March 31 ,2010	December 31, 2009
	(unaudited)	
Net change in unrealized appreciation on available-for-sale securities before deferred tax	\$ 1,126	\$ 5,304
Deferred income tax	(377 )	(1,784 )
Net change in unrealized appreciation on available-for-sale securities	\$ 749	\$ 3,520

The increase in unrealized appreciation is directly attributable to recoveries in the market values of available-for-sale debt securities.

## NOTE 6 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company incurred \$- in interest and penalties as of both March 31, 2010 and December 31, 2009. 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 with extensions filed for 2009.

Net deferred tax liabilities are determined based on the estimated future tax effects of differences between the financial statement and tax basis of assets and liabilities given the provisions of the enacted tax laws. Management believes that, based on its historical pattern of taxable income, the Company will produce sufficient income in the future to realize its deferred tax assets. The Company recognized net deferred tax liability positions of \$700,000 at March 31, 2010 and \$61,000 at December 31, 2009.

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

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	March 31, 2010	December 31, 2009
General insurance expenses	\$ 1,080	\$ 1,135
Unearned premiums	1,849	1,814
Claims liabilities	288	298
Other than temporary impairments on securities owned	482	501
Deferred tax assets	\$ 3,699	\$ 3,748
Depreciation	\$ (122 )	\$ (126 )
Deferred policy acquisition costs	(2,531 )	(2,291 )
Unrealized gains on securities available-for-sale	(1,746 )	(1,392 )
Deferred tax liabilities	\$ (4,399 )	\$ (3,809 )
Net deferred tax liability	\$ (700 )	\$ (61 )

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

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

	Quarter ended March 31,	
	2010	2009
Deferred policy acquisition costs	\$ 240	\$ (3 )
Other-than-temporary-impairments	19	-
Unearned premiums	(35 )	58
General insurance expenses	55	5
Depreciation	(4 )	(17 )
Claim liabilities	10	41
	\$ 285	\$ 84

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)	
	Quarter ended March 31,	
	2010	2009
Federal income tax rate applied to pre-tax income	\$ 946	\$ 774
Dividends received deduction and tax-exempt interest	(55 )	(63 )
Company owned life insurance	(30 )	192
Small life deduction	(97 )	46
Other, net	123	(153 )
Federal income tax expense	\$ 887	\$ 796

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

## NOTE 7 –LONG-TERM DEBT

Long-term debt consisted of the following as of March 31, 2010 and December 31, 2009:  
( in thousands)

	2010	2009
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 \$ 12,372	3,093 \$ 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 will be remitted to the holders of the associated TPS. This guarantee, when taken together with the obligations of the Company under the debentures, the Indentures pursuant to which the debentures were issued, and the related trust agreement (including obligations to pay related trust fees, expenses, debt and other obligations with respect to the TPS), provides a full and unconditional guarantee of amounts due the Trusts. The amount guaranteed is not expected to at any time exceed the obligations of the TPS, and no additional liability has been recorded related to the guarantee.

On September 13, 2007, the Company entered into a 5 year swap effective September 17, 2007 with a notional amount of \$3,000,000 and designated the swap as a hedge against changes in cash flows attributable to changes in the benchmark interest rate (LIBOR) associated with the subordinated debentures issued on June 21, 2007. Commencing December 17, 2007, under the terms of the swap, the Company will 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 \$250,000 (liability) and \$150,000 (asset), respectively, for a net liability of \$100,000 at March 31, 2010 (\$60,000 at December 31, 2009). The net swap liability is reported as a component of other liabilities on the consolidated balance sheets. A net valuation loss of \$6,000 is included in accumulated other comprehensive income related to the swap agreements for the current period. A net valuation gain of \$256,000 was included in accumulated other comprehensive income related to the swap at December 31, 2009.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

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 9 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 March 31, 2010 and December 31, 2009.

NOTE 8 – CONTINGENCIES

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.

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

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

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 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 9 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Our securities available-for-sale consists of fixed maturity and equity securities which are recorded at fair value in the accompanying 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.

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

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

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

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

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

Financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2010 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	\$ 74,858	\$ 12,655	\$ 61,615	\$ 588
Short-term investments	-	-	-	-
Trading securities	548	548	-	-
Equity securities available-for-sale	9,212	8,543	-	669
Total Financial Assets	\$ 84,618	\$ 21,746	\$ 61,615	\$ 1,257
Financial Liabilities				
Interest rate swap	\$ 100	\$ -	\$ -	\$ 100
Total Financial Liabilities	\$ 100	\$ -	\$ -	\$ 100

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

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 three months ended March 31, 2010:

(In Thousands)	For the three-months ended March 31, 2010		
	Fixed Maturities Available-for-Sale	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$ 577	\$ 662	\$ (60 )
Total gains or losses (realized and unrealized):			
Included in earnings	-	-	-
Included in other comprehensive income	11	7	(40 )
Purchases, sales, issuances and settlements,			
Net	-	-	-
Transfers in/(out) of Level 3	-	-	-
Ending balance	\$ 588	\$ 669	\$ (100 )
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of March 31, 2010	\$ -	\$ -	\$ -

For the quarter ended March 31, 2010, 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 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 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.

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

The carrying amount and estimate fair value of the Company's financial instruments as of March 31, 2010 and December 31, 2009 are as follows:

	In Thousands of Dollars			
	March 31, 2010		December 31, 2009	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Assets and related instruments</b>				
Mortgage loans	\$ 1,037	\$ 1,037	\$ 1,041	\$ 1,041
Policy loans	1,023	1,023	1,018	1,018
Company owned life insurance	5,285	5,197	5,197	5,197
Other invested assets	3,900	3,933	3,933	3,933
<b>Liabilities and related instruments</b>				
Other policyholder funds	1,353	1,353	1,347	1,347
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 higher risk automobile products. Our chief operating 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.

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

The following table presents the Company's gross premiums written and earned for the property and casualty segment and the life and accident and health segment for the three months ended March 31, 2010 and 2009, respectively:

	Three Months Ended March 31,	
	2010	2009
Gross premiums written:		
Life, accident and health operations:		
Traditional life insurance	\$ 1,315	\$ 1,348
Accident and health insurance	491	431
Total life, accident and health	1,806	1,779
Property and Casualty operations:		
Dwelling fire & extended coverage	6,591	6,662
Homeowners (Including mobile homeowners)	6,401	6,503
Ocean marine	100	111
Other liability	326	315
Private passenger auto liability	1,187	206
Commercial auto liability	133	129
Auto physical damage	470	122
Reinsurance premium ceded	(1,528 )	(1,528 )
Total property and casualty	13,680	12,520
 Total premiums written	 \$ 15,486	 \$ 14,299
Gross premiums earned:		
Life, accident and health operations:		
Traditional life insurance	\$ 1,364	\$ 1,397
Accident and health insurance	498	444
Total life, accident and health	1,862	1,841
Property and Casualty operations:		
Dwelling fire & extended coverage	6,382	7,028
Homeowners (Including mobile homeowners)	6,594	6,841
Ocean marine	320	294
Other liability	310	355
Private passenger auto liability	675	144
Commercial auto liability	132	158
Auto physical damage	302	91
Reinsurance premium ceded	(1,539 )	(1,532 )
Total property and casualty	13,176	13,379

Total premiums earned	\$ 15,038	\$ 15,220
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REVIEW OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have reviewed the condensed consolidated balance sheet of The National Security Group, Inc. as of March 31, 2010, and the related condensed consolidated statements of income, shareholders' equity and cash flows for the three-month periods ended March 31, 2010 and 2009. 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, 2009, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 26, 2010, 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, 2009, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Warren Averett Kimbrough & Marino, LLC

Birmingham, Alabama  
May 14, 2010

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Item 2.

MANAGEMENTS' DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion addresses the financial condition of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) as of March 31, 2010, compared with December 31, 2009 and its results of operations and cash flows for the quarter ending March 31, 2010, compared with the same period last year. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes thereto included in Part I, Item 1 of this report and with our audited consolidated financial statements and related notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2009.

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 4 included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 filed with the Securities and Exchange Commission.

The reader is assumed to have access to the Company's 2009 Annual Report. This discussion should be read in conjunction with the Annual Report and with consolidated financial statements on pages 3 through 23 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 over 46% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment accounting for 87.6% of total insurance premium revenue during the first three months of 2010. Revenue generated from the life segment accounted for 12.4% 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 the accident and health products accounted for 9.1% and 3.3%, 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 8% of 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. 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 and composes the property and casualty (P&C) segment.

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 80% 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, 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.

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All of the insurance subsidiaries are Alabama domiciled insurance companies and 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.

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 rating of "bb+" with a stable outlook. All ratings are reviewed at least annually by A.M. Best with the latest ratings effective date of April 16, 2010.

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). Our income is principally derived from earned premiums received less claims paid, sales commissions to agents, costs of underwriting and insurance taxes and fees. We also derive income from investments which includes interest and dividend income and gains and losses on investment holdings.

## CONSOLIDATED RESULTS OF OPERATIONS

### Summary:

The Company ended the first quarter of 2010 with net income of \$1,894,000 compared to \$1,481,000 for the same period last year. The increases in investment income and realized investment gains, in addition to the decreases in general expenses, were the primary factors contributing to the improved results compared to the first quarter of 2009.

### Premium revenue:

Premium revenue totaled \$15,038,000 as of March 2010 compared to \$15,220,000 as of March 2009; a decrease of \$182,000 or 1.2%. We continue to limit new business production in our dwelling lines of business in areas with high concentrations of coastal exposure along the Alabama, Mississippi and Louisiana coast. These efforts have reduced the rate of new business production which has led to a short term stagnation in revenue growth. To offset these reductions, we are increasing marketing efforts in areas with less concentration of risk and are diversifying risk by increasing auto production. However, because some of these areas are less established markets for us we expect only moderate (low single digit) percentage increases in year over year revenue for the full year 2010.

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The table below provides earned premium revenue by segment for the three months ended March 31, 2010 and 2009:

	Three months ended March 31,		Percent increase (decrease)
	2010	2009	
Life, accident and health operations:			
Traditional life insurance	\$ 1,364,000	\$ 1,397,000	(2.36 ) %
Accident and health insurance	498,000	444,000	12.16 %
Total life, accident and health	1,862,000	1,841,000	1.14 %
Property and Casualty operations:			
Dwelling fire & extended coverage	6,382,000	7,028,000	(9.19 ) %
Homeowners (Including mobile homeowners)	6,594,000	6,841,000	(3.61 ) %
Ocean marine	320,000	294,000	8.84 %
Other liability	310,000	355,000	(12.68 ) %
Private passenger auto liability	675,000	144,000	368.75 %
Commercial auto liability	132,000	158,000	(16.46 ) %
Auto physical damage	302,000	91,000	231.87 %
Reinsurance premium ceded	(1,539,000 )	(1,532,000 )	0.46 %
Total property and casualty	13,176,000	13,379,000	(1.52 ) %
Total earned premium revenue	\$ 15,038,000	\$ 15,220,000	(1.20 ) %

#### Investment income:

Investment income increased \$281,000 to \$1,326,000 as of March 2010 from \$1,045,000 in March 2009. The increase in investment income was primarily driven by an increase in fixed income investments held during the first quarter of 2010 compared to the same period last year.

#### Realized investment gains and losses:

For the first quarter of 2010 realized investment gains totaled \$669,000 compared to \$1,000 for the same period last year. Investment gains realized on the sale of other bonds and common stock totaled \$341,000 in the P&C segment and \$328,000 in the life segment. There were no sales during the first quarter of 2009 to produce any significant realized gains.

#### Other income:

Other income was \$299,000 as of March 2010 compared to \$141,000 for the same period last year; an increase of 112%. Other income is primarily composed of billing, payment and policy fees associated with the residential property and automobile policies issued in the P&C segment. Our automobile program was expanded into Louisiana late in the first quarter of 2009. The expansion created an increase in volume in our automobile program and was the

primary reason for the increase in other income during 2010. In addition, \$40,000 charged off as bad debt in prior years was recovered during the first quarter of 2010 and accounted for approximately 25% of the increase in other income from the prior year.

Policyholder benefits:

Policyholder benefits for the quarter ending March 31, 2010 totaled \$8,473,000; up \$746,000 from the same period last year. Losses incurred in the P&C segment from the homeowners and automobile programs was the primary reason for the increase compared to the prior year. The Company was not affected during 2010 by any losses from storms classified as catastrophes. In contrast, during the first quarter of 2009, the property and casualty segment was impacted by two catastrophe related wind and tornado events which added an additional \$546,000 to incurred losses. Without the impact of the catastrophe wind losses in 2009, incurred losses were up over \$1,200,000. Fire related incurred losses were the primary contributor to the increase in policyholder benefits in the first quarter of 2010. The P&C segment was impacted by current year fire losses totaling of \$3,700,000 compared to fire losses incurred during the first quarter of 2009 which totaled just over \$2,700,000.

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While the Company did not incur any losses from catastrophe related events during the first quarter of 2010 (\$546,000 during the first quarter of 2009), the P&C segment did experience a moderate increase in fire related total loss claims compared to the first quarter of 2009.

Policy acquisition cost:

For the three months ended March 31, 2010, policy acquisition costs were \$2,748,000 compared to \$3,092,000 for the same period last year. Reduced accruals for contingent commission payments to property and casualty segment agents was the primary contributor to the reduction in policy acquisition costs.

General Expenses:

General expenses as of March 2010 were up \$8,000 totaling \$2,585,000 compared to \$2,577,000 as of March 2009. The Company continues to conduct comprehensive, critical reviews of all general expense items to ensure costs are minimized. Although this remains an ongoing review area, several cost saving measures were implemented over the last twelve months leading to large reductions in general expenses. One of the more significant areas of cost savings was postage expense. We have made concerted efforts to increase utilization of our website for agent communications which led to over a 30% reduction in postage costs.

Taxes, licenses and fees:

Taxes, licenses and fees remained comparable to the prior year ending March 2010 at \$487,000 compared to \$457,000 for the same period last year.

Income taxes:

For the three months ended March 31, 2010, income tax expense was \$887,000 compared to \$796,000 for the same period last year. Income tax expense was composed of current taxes totaling \$602,000 and \$712,000 for 2010 and 2009, respectively, while deferred tax expense totaled \$285,000 and \$84,000, respectively, for the same time periods. The effective tax rate as of March 2010 was 31.89% compared to 34.96% as of March 2009. The primary contributors to the decrease in effective tax rate was an increase in tax exempt interest income and higher profit contributions from the life segment increasing benefits associated with the small life deduction.

Liquidity and capital resources:

The Company ended the first quarter of 2010 with aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$43,435,000 up \$2,267,000 compared to December 31, 2009. The increase consisted of net income totaling \$1,894,000, unrealized gains of \$749,000 and an unrealized loss of \$6,000 related to an interest rate swap. Cash dividends paid totaled \$370,000 for the period. The primary reasons for the increase in retained earnings were the improved operating results which led to higher net income as well as the improvement in our investment portfolio leading to unrealized capital gains on securities as opposed to the unrealized losses experienced over the past year.

The Company has \$12,372,000 in debt outstanding consisting of long-term debt from the proceeds of two separate trust preferred securities issuances, the latest of which totaled \$3,000,000 and was completed in June 2007. The Company currently does not anticipate any new borrowings.

The Company had \$2,062,000 in cash and cash equivalents at March 31, 2010 compared to \$516,000 at March 31, 2009. Net cash provided by operating activities totaled \$718,000 and \$2,214,000 in the first quarter of 2010 and 2009, respectively. The decrease in cash flow from operations was due to the decrease in receivable for securities sold as well as the first installment of the non-qualified director's deferred compensation plan totaling \$258,000. In addition, the P&C segment settled balances under a prior year catastrophe reinsurance agreement totaling \$609,000. Finally the life segment paid accrued vacation related to the retirement of an officer totaling over \$80,000.

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The liquidity requirements of the Company are primarily met by funds provided from operations of the life insurance and property/casualty subsidiaries. The Company receives funds from its subsidiaries consisting of dividends, payments for federal income taxes, and reimbursement of expenses incurred at the corporate level for the subsidiaries. These funds are used to pay stockholder dividends, corporate interest, corporate administrative expenses, federal income taxes, and for funding investments in subsidiaries.

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

The Company's business is concentrated primarily in the Southeastern United States. Accordingly, unusually severe storms or other disasters in the Southeastern United States might have a more significant effect on the Company than on a more geographically diversified insurance company. Unusually severe storms, other natural disasters and other events could have an adverse impact on the Company's financial condition and operating results. However, the Company maintains a catastrophe reinsurance program to limit the effect of such catastrophic events on the Company's financial condition.

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

The Company's primary objectives in managing its investment portfolio are to maximize investment income and total investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including changes in interest rates, overall market conditions, underwriting results, regulatory requirements, and tax position. Investment decisions are made by management and reviewed by the Board of Directors. Market risk represents the potential for loss due to adverse changes in fair value of securities. The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk, and default risk. The primary risk related to the Company's equity portfolio is equity price risk. The Company has not incurred material losses in its investment portfolio in the first three months of 2010 related to interest rate changes, defaults on certain securities and changes in value of equity investments. These changes are discussed in detail under Item 2 of this Form 10-Q. For further information reference is made to the Company's Form 10-K for the year ended December 31, 2009.

For further information regarding market risk, reference is made to the Company's Form 10-K for the year ended December 31, 2009.

### Item 4. Controls and Procedures

Our management carried out an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as of March 31, 2010. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There has not been any change in our internal control over financial reporting in connection with the evaluation required by Rule 13A-15(d) under the Exchange Act that occurred during the three month period ended March 31, 2010, that has materially affected, or is reasonably likely to materially affect, our internal control over financial



reporting.

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Part II. OTHER INFORMATION

Item 1. Legal Proceedings

Please refer to Note 8 to the financial statements.

Item 1A. Risk Factors

There has been no material change in risk factors previously disclosed under Item 1A. of the Company's annual report for 2009 on Form 10-K.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 5. Other Information

None

Item 6. Exhibits

a. Exhibits

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

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

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

b. Reports on Form 8-K during the quarter ended March 31, 2010

Date of Report	Date Filed	Description
January 22, 2010	January 25, 2010	Press release, dated January 25, 2010, issued by The National Security Group, Inc.
January 22, 2010	January 25, 2010	Item 5.02 Departure of Director notification issued by The National Security Group, Inc.

February 26, 2010	February 26, 2010	Press release, dated February 26, 2010, issued by The National Security Group, Inc.
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SIGNATURE

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

The National Security Group, Inc.

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

/s/ Brian R. McLeod  
Brian R. McLeod  
Treasurer and Chief Financial  
Officer

Dated: May 14, 2010

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