

NATIONAL SECURITY GROUP INC

Form 10-Q

November 13, 2009

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 September 30, 2009

or

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

For the transition period from to .

Commission File Number 0-18649

The National Security Group, Inc.

(Exact name of registrant as specified in its charter)

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| | |
|--|------------------------------------|
| Delaware (State or Other Jurisdiction of | 63-1020300 (IRS Employer |
| Incorporation or Organization) | 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

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

| Class | Outstanding November 13, 2009 |
|---------------------------------------|--------------------------------------|
| Common Stock, \$1.00 par value | 2,466,600 shares |

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 (UNAUDITED)

(In thousands, except share amounts)

| | September 30, 2009 | December 31, 2008 |
|--|-----------------------|----------------------|
| ASSETS | | |
| | <i>(unaudited)</i> | |
| Investments | | |
| Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2009 - \$6,304; 2008 - \$10,995) | \$ 6,119 | \$ 10,952 |
| Fixed maturities available-for-sale, at estimated fair value (cost: 2009 - \$68,211; 2008 - \$61,796) | 69,490 | 58,107 |
| Equity securities available-for-sale, at estimated fair value (cost: 2009 - \$5,467; 2008 - \$5,467) | 8,662 | 7,569 |
| Trading securities | 322 | 253 |
| Receivable for securities sold | - | 513 |
| Mortgage loans on real estate, at cost | 1,044 | 502 |
| Investment real estate, at book value (accumulated depreciation: 2009 - \$18; 2008 - \$18) | 4,808 | 4,754 |
| Policy loans | 999 | 968 |
| Company owned life insurance | 5,115 | 1,957 |
| Other invested assets | 4,045 | 4,557 |
| Total Investments | 100,604 | 90,132 |
| Cash | 1,825 | 3,027 |
| Accrued investment income | 961 | 804 |
| Policy receivables, less allowance for credit losses (2009 - \$33; 2008 - \$59) | 10,420 | 9,179 |
| Reinsurance recoverable | 2,098 | 4,146 |
| Deferred policy acquisition costs | 10,394 | 9,825 |
| Property and equipment, net | 2,506 | 2,844 |

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| | | |
|--------------------------------|-------------------|-------------------|
| Deferred tax asset | 467 | 1,839 |
| Accrued income tax recoverable | 2,401 | 2,321 |
| Other assets | 1,041 | 773 |
| Total Assets | \$ 132,717 | \$ 124,890 |

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

| | September 30, 2009 | December 31, 2008 |
|---|-----------------------|----------------------|
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| | <i>(unaudited)</i> | |
| Property and casualty benefit and loss reserves | \$ 13,473 | \$ 14,436 |
| Accident and health benefit and loss reserves | 1,277 | 1,222 |
| Life and annuity benefit and loss reserves | 28,463 | 28,045 |
| Unearned premiums | 29,249 | 27,764 |
| Policy and contract claims | 497 | 503 |
| Other policyholder funds | 1,357 | 1,344 |
| Long-term debt | 12,372 | 12,372 |
| Other liabilities | 5,604 | 4,556 |
| Total Liabilities | 92,292 | 90,242 |
| Contingencies | - | - |
| Shareholders' Equity | | |
| Preferred stock, \$1 par value, 500,000 shares authorized, none issued or outstanding | - | - |
| Class A common stock, \$1 par value, 2,000,000 shares authorized, none issued or outstanding | - | - |
| Common stock, \$1 par value, 3,000,000 and 10,000,000 shares authorized, respectively, 2,466,600 shares issued and outstanding | 2,467 | 2,467 |
| Additional paid-in capital | 4,951 | 4,951 |
| Accumulated other comprehensive income (loss) | 3,152 | (1,511) |
| Retained earnings | 29,855 | 28,741 |
| Total Shareholders' Equity | 40,425 | 34,648 |
| Total Liabilities and Shareholders' Equity | \$ 132,717 | \$ 124,890 |

The Notes to the 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 | | Nine Months | |
|---|--------------------|-------------------|--------------------|-------------------|
| | Ended September 30 | | Ended September 30 | |
| | 2009 | 2008 | 2009 | 2008 |
| REVENUES | | | | |
| Net premiums earned | \$ 14,357 | \$ 11,707 | \$ 44,950 | \$ 42,261 |
| Net investment income | 1,376 | 1,332 | 4,214 | 3,616 |
| Net realized investment gains (losses) | 79 | (1,452) | (151) | (1,026) |
| Other Income | 208 | 254 | 541 | 927 |
| Total Revenues | 16,020 | 11,841 | 49,554 | 45,778 |
| BENEFITS AND EXPENSES | | | | |
| Policyholder benefits paid or provided | 9,131 | 15,795 | 28,237 | 37,167 |
| Policy acquisition costs | 3,485 | 3,437 | 9,862 | 9,323 |
| General expenses | 2,203 | 2,099 | 6,816 | 6,578 |
| Taxes, licenses and fees | 376 | 540 | 1,356 | 1,298 |
| Interest expense | 277 | 282 | 842 | 860 |
| Total Expenses | 15,472 | 22,153 | 47,113 | 55,226 |
| Income (Loss) Before Income Taxes | 548 | (10,312) | 2,441 | (9,448) |
| INCOME TAX (BENEFIT) EXPENSE | | | | |
| Current | (107) | (3,220) | 318 | (2,695) |
| Deferred | 4 | (147) | (101) | (554) |
| | (103) | (3,367) | 217 | (3,249) |
| Net Income (Loss) | \$ 651 | \$ (6,945) | \$ 2,224 | \$ (6,199) |
| NET EARNINGS (LOSS) PER COMMON SHARE | \$ 0.26 | \$ (2.82) | \$ 0.90 | \$ (2.51) |
| DIVIDENDS DECLARED PER SHARE | \$ 0.150 | \$ 0.225 | \$ 0.450 | \$ 0.675 |

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

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (UNAUDITED)

(In thousands)

| | Total | Retained Earnings | Accumulated | | Additional Paid-in Capital |
|---|-----------|----------------------|---|-----------------|----------------------------------|
| | | | Other Comprehensive Income (Loss) | Common Stock | |
| Balance at December 31, 2008 | \$ 34,648 | \$ 28,741 | \$ (1,511) | \$ 2,467 | \$ 4,951 |
| Comprehensive Income | | | | | |
| Net income nine months ended 9/30/2009 | 2,224 | 2,224 | | | |
| Other comprehensive income (net of tax of \$1,528) | | | | | |
| Unrealized gain on securities, net of reclassification adjustment of (\$138) | 4,533 | | 4,533 | | |
| Unrealized gain on interest rate swap | 130 | | 130 | | |
| Total Comprehensive Income | 6,887 | | | | |
| Cash dividends | (1,110) | (1,110) | | | |
| Balance at September 30, 2009 (Unaudited) | \$ 40,425 | \$ 29,855 | \$ 3,152 | \$ 2,467 | \$ 4,951 |

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

THE NATIONAL SECURITY GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

| | Nine Months | |
|---|---------------------|------------|
| | Ended September 30, | |
| | 2009 | 2008 |
| Cash Flows from Operating Activities | | |
| Net income (loss) | \$ 2,224 | \$ (6,199) |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Change in accrued investment income | (157) | (73) |
| Change in reinsurance recoverable | 2,048 | (5,063) |
| Change in deferred policy acquisition costs | (569) | (1,171) |
| Change in accrued income tax recoverable | (80) | (4,318) |
| Deferred tax asset | 101 | (554) |
| Depreciation expense | 359 | 343 |
| Change in policy liabilities and claims | (252) | 11,907 |
| Other, net | 262 | 5,066 |
| Net cash provided by (used in) operating activities | 3,936 | (62) |
| Cash Flows from Investing Activities | | |
| Cost of investments acquired | (24,613) | (25,141) |
| Sale and maturity of investments | 20,584 | 27,567 |
| Purchase of property and equipment | (13) | (239) |
| Sale of property and equipment | 1 | - |
| Net cash (used in) provided by investing activities | (4,041) | 2,187 |
| Cash Flows from Financing Activities | | |
| Change in other policyholder funds | 13 | 25 |
| Change in notes payable | - | (900) |
| Dividends paid | (1,110) | (1,665) |
| Net cash used in financing activities | (1,097) | (2,540) |
| Net change in cash and cash equivalents | (1,202) | (415) |
| Cash and cash equivalents, beginning of period | 3,027 | 3,299 |
| Cash and cash equivalents, end of period | \$ 1,825 | \$ 2,884 |

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

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1 – Significant Accounting Policies

(a) Principles of Consolidation

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). All significant inter-company transactions and accounts have been eliminated. These condensed consolidated financial statements have been prepared in accordance with United States Generally Accepted Accounting Principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for fair presentation have been included. The accompanying condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes contained in the December 31, 2008 Form 10-K of the Company.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingencies at the date of the financial statements. Estimates and assumptions are of most significance in determining reserves for future policyholder benefits, reserves for losses and adjustment expenses payable, capitalization and amortization of deferred policy acquisition costs, valuation of assets, and litigation reserves. Actual results could differ from those estimates.

Certain reclassifications have been made in the prior period consolidated financial statements to conform to the current period presentation. These reclassifications had no effect on total assets, total liabilities, total shareholders' equity or net income as previously reported.

(b) Recently Issued Accounting Standards

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

In August 2009, the FASB issued ASU 2009-05 "Measuring Liabilities at Fair Value" ("ASU 2009-05"). ASU 2009-05 updated ASC Section 820-10 ("Fair Value Measurements") to provide additional guidance on how to measure liabilities at fair value for which a quoted price in an active

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market is not available . In this situation a company can either use the quoted price of an identical liability when traded as an asset or the quoted price of similar liabilities when traded as assets. As of September 30, 2009, the only liability measured at fair value was an interest rate swap discussed in Note 7. The Company does not expect the adoption of ASU 2009-05 to have a material impact on the Company's results of operations or financial position.

Note 2 – Reinsurance

NSFC, Omega and NSIC, wholly-owned subsidiaries of the Company, reinsure certain portions of insurance risk which exceed various retention limits. NSFC, OMEGA, and NSIC are liable for these amounts in the event assuming companies are unable to meet their obligations. The most significant of our reinsurance contracts, our catastrophe reinsurance protection, was renewed on January 1, 2009. An expanded fourth layer with coverage up to \$72.5 million was renewed in July 2009. We maintain a \$3.5 million deductible under the property catastrophe reinsurance program with single event coverage up to \$72.5 million with one reinstatement.

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

We maintain reinsurance in four layers as follows:

| Layer | Reinsurers' Limits of Liability |
|----------------|--|
| First Layer | 95% of \$ 6,500,000 in excess of \$ 3,500,000 |
| 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 |
| Total Coverage | \$72,500,000 |

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 September 30, 2009 and 2008 was 2,466,600.

Note 4 – Changes in Shareholders' Equity

During the nine months ended September 30, 2009 and 2008, there were no changes in shareholders' equity except for net income/(loss) of \$2,224,000 and (\$6,199,000), respectively; dividends paid of \$1,110,000 and \$1,665,000 respectively; and reductions of accumulated other comprehensive income (loss), net of applicable taxes, of \$4,663,000 and (\$5,477,000), 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 CONDENSED 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) | | | | |
|--|------------------|-----------------|-----------------|------------------|
| September 30, 2009 | | | | |
| | Amortized | Gross | Gross | Fair |
| | Cost | Unrealized | Unrealized | Value |
| | | Gains | Losses | |
| Available-for-sale securities: | | | | |
| Corporate debt securities | \$ 29,852 | \$ 1,790 | \$ 874 | \$ 30,768 |
| Mortgage backed securities | 7,574 | 328 | 45 | 7,857 |
| Private label mortgage backed securities | 7,384 | 56 | 876 | 6,564 |
| Obligations of states and political subdivisions | 15,051 | 571 | 53 | 15,569 |
| U.S. Treasury securities and obligations of | | | | |
| U.S. Government corporations and agencies | 8,350 | 386 | 4 | 8,732 |
| Total fixed maturities | 68,211 | 3,131 | 1,852 | 69,490 |
| Equity securities | 5,467 | 3,931 | 736 | 8,662 |
| Total | \$ 73,678 | \$ 7,062 | \$ 2,588 | \$ 78,152 |
| Held-to-maturity securities: | | | | |
| Corporate debt securities | \$ - | \$ - | \$ - | \$ - |
| Mortgage backed securities | 3,320 | 105 | 19 | 3,406 |
| Private label mortgage backed securities | 203 | 3 | - | 206 |
| Obligations of states and political subdivisions | 2,140 | 83 | 2 | 2,221 |
| U.S. Treasury securities and obligations of | | | | |
| U.S. Government corporations and agencies | 456 | 15 | - | 471 |
| Total | \$ 6,119 | \$ 206 | \$ 21 | \$ 6,304 |
| December 31, 2008 | | | | |
| | Amortized | Gross | Gross | Fair |
| | Cost | Unrealized | Unrealized | Value |
| | | Gains | Losses | |
| Available-for-sale securities: | | | | |
| Corporate debt securities | \$ 21,153 | \$ 84 | \$ 2,277 | \$ 18,960 |
| Mortgage backed securities | 11,101 | 257 | 24 | 11,334 |
| Private label mortgage backed securities | 6,590 | 2 | 1,369 | 5,223 |
| Obligations of states and political subdivisions | 13,401 | 81 | 875 | 12,607 |
| U.S. Treasury securities and obligations of | | | | |
| U.S. Government corporations and agencies | 9,551 | 433 | 1 | 9,983 |
| Total fixed maturities | 61,796 | 857 | 4,546 | 58,107 |
| Equity securities | 5,467 | 3,130 | 1,028 | 7,569 |
| Total | \$ 67,263 | \$ 3,987 | \$ 5,574 | \$ 65,676 |
| Held-to-maturity securities: | | | | |
| Corporate debt securities | \$ 88 | \$ - | \$ 3 | \$ 85 |
| Mortgage backed securities | 4,087 | 20 | 41 | 4,066 |
| Private label mortgage backed securities | 249 | - | 1 | 248 |
| Obligations of states and political subdivisions | 2,141 | 34 | 14 | 2,161 |
| U.S. Treasury securities and obligations of | | | | |

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| | | | | |
|---|------------------|---------------|--------------|------------------|
| U.S. Government corporations and agencies | 4,387 | 48 | - | 4,435 |
| Total | \$ 10,952 | \$ 102 | \$ 59 | \$ 10,995 |

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

The amortized cost and aggregate fair value of debt securities at September 30, 2009, by contractual maturity, are as follows. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in Thousands) | | |
|--|------------------|------------------|
| | Amortized | Fair |
| | Cost | Value |
| Available-for-sale securities: | | |
| Due in one year or less | \$ 986 | \$ 903 |
| Due after one year through five years | 16,875 | 17,757 |
| Due after five years through ten years | 22,109 | 23,068 |
| Due after ten years | 28,241 | 27,762 |
| Total | \$ 68,211 | \$ 69,490 |
| Held-to-maturity securities: | | |
| Due in one year or less | \$ - | \$ - |
| Due after one year through five years | 1,106 | 1,142 |
| Due after five years through ten years | 1,974 | 2,055 |
| Due after ten years | 3,039 | 3,107 |
| Total | \$ 6,119 | \$ 6,304 |

A summary of securities available-for-sale with unrealized losses as of September 30, 2009 and December 31, 2008 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

| (Dollars in thousands) | | | | | | | |
|---|---------------------|-------------------------------|---------------------|-------------------------------|--------------------|--------|-------------------------------|
| | Less than 12 months | | 12 months or longer | | September 30, 2009 | | |
| | | | | | Total | | Gross Unrealized Losses |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | | |
| Fixed maturities | | | | | | | |
| Corporate | \$ 2,930 | \$ 101 | \$ 6,920 | \$ 773 | \$ 9,850 | \$ 874 | 26 |
| Mortgage backed securities | 312 | 16 | 89 | 29 | 401 | 45 | 2 |
| Private label mortgage backed securities | 484 | 8 | 3,990 | 868 | 4,474 | 876 | 12 |
| Obligations of state and political subdivisions | - | - | 1,313 | 53 | 1,313 | 53 | 4 |
| U.S. Treasury securities and obligations of U.S. government | | | | | | | |

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| | | | | | | | |
|---------------------------|----------|--------|-----------|----------|-----------|----------|----|
| corporations and agencies | 560 | 4 | - | - | 560 | 4 | 2 |
| Equity securities | - | - | 2,357 | 736 | 2,357 | 736 | 11 |
| | \$ 4,286 | \$ 129 | \$ 14,669 | \$ 2,459 | \$ 18,955 | \$ 2,588 | 57 |

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

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

A summary of securities held-to-maturity with unrealized losses as of September 30, 2009 and December 31, 2008 along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

| (Dollars in thousands) | | | | | | | |
|---|---------------------|------------|---------------------|------------|--------------------|--------|---------------|
| | Less than 12 months | | 12 months or longer | | September 30, 2009 | | |
| | Gross | | Gross | | Fair | Gross | Total |
| | Fair | Unrealized | Fair | Unrealized | | | |
| | Value | Losses | Value | Losses | Value | Losses | Loss Position |
| Fixed maturities | | | | | | | |
| Corporate | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | - |
| Mortgage backed securities | - | - | 399 | 19 | 399 | 19 | 2 |
| Private label mortgage backed securities | - | - | - | - | - | - | - |
| Obligations of state and political subdivisions | - | - | 355 | 2 | 355 | 2 | 1 |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | - | - | - | - | - | - | - |
| Equity securities | - | - | - | - | - | - | - |

| | | | | | | | | | | | | |
|----|---|----|---|----|-----|----|----|----|-----|----|----|---|
| \$ | - | \$ | - | \$ | 754 | \$ | 21 | \$ | 754 | \$ | 21 | 3 |
|----|---|----|---|----|-----|----|----|----|-----|----|----|---|

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

| (Dollars in thousands) | | | | | | | |
|---|---------------------|------------|---------------------|------------|----------|------------|-----------------|
| December 31, 2008 | | | | | | | |
| | Less than 12 months | | 12 months or longer | | Total | | |
| | Gross | | Gross | | Gross | | Total |
| | Fair | Unrealized | Fair | Unrealized | Fair | Unrealized | Securities in a |
| | Value | Losses | Value | Losses | Value | Losses | Loss Position |
| Fixed maturities | | | | | | | |
| Corporate | \$ 84 | \$ 3 | - | - | \$ 84 | \$ 3 | 1 |
| Mortgage backed securities | - | - | 2,408 | 41 | 2,408 | 41 | 7 |
| Private label mortgage backed securities | 249 | 1 | - | - | 249 | 1 | 1 |
| Obligations of state and political subdivisions | - | - | 646 | 14 | 646 | 14 | 2 |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | - | - | - | - | - | - | - |
| Equity securities | - | - | - | - | - | - | - |
| | \$ 333 | \$ 4 | \$ 3,054 | \$ 55 | \$ 3,387 | \$ 59 | 11 |

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 debt security or more likely than not will be required to sell the debt 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. 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. For the nine months ended September 30, 2009, \$286,000 in other-than-temporary impairments were realized by the Company. All of the other-than-temporary impairments are deemed credit losses and recorded in earnings. Impairment losses of \$1,722,000 were realized in the first nine months of 2008.

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

| (Dollars in thousands) | |
|-----------------------------------|-------------------|
| September 30, 2009 (unaudited) | December 31, 2008 |
| | |

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| | | |
|--|----------|------------|
| Net change in unrealized appreciation on available-for-sale securities before deferred tax | \$ 6,061 | \$ (8,335) |
| Deferred income tax | (1,528) | 2,188 |
| Net change in unrealized appreciation on available-for-sale securities | \$ 4,533 | \$ (6,147) |

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

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

Note 6 – Income Taxes

The Company recognizes tax-related interest and penalties as a component of tax expense. The Company incurred \$-0- in interest and penalties as of both September 30, 2009 and December 31, 2008. The Company files income tax returns in the U.S. federal jurisdiction and various states. The Company is not subject to examinations by authorities related to its U.S. federal or state income tax filings for years prior to 2006. The Internal Revenue Service completed an examination during 2008 of the Company's 2005 Federal Income Tax Return. No material adjustments were made as a result of this examination. No income tax returns are currently under examination by the Internal Revenue Service or any state or local taxing authority.

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) | |
|--|---------------------------------|------------|
| | Nine months ended September 30, | |
| | 2009 | 2008 |
| Federal income tax rate applied to pre-tax income | \$ 830 | \$ (3,212) |
| Dividends received deduction and tax-exempt interest | (180) | (191) |
| Company owned life insurance | (223) | 95 |
| Small life deduction | (204) | - |
| Other, net | (6) | 59 |
| Federal income tax expense | \$ 217 | \$ (3,249) |

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.

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

(in thousands)

| | September 30, 2009 | January 1, 2009 |
|--|-----------------------|--------------------|
| General insurance expenses | \$ 875 | \$ 769 |
| Unearned premiums | 1,988 | 1,885 |
| Claims liabilities | 320 | 337 |
| Unrealized losses on securities available-for-sale | - | 392 |
| Other than temporary impairments on securities owned | 772 | 734 |
| Deferred tax assets | \$ 3,955 | \$ 4,117 |
| Depreciation | \$ (104) | \$ (118) |
| Deferred policy acquisition costs | (2,303) | (2,160) |
| Unrealized gains on securities available-for-sale | (1,081) | - |
| Deferred tax liabilities | \$ (3,488) | \$ (2,278) |
| Net deferred tax asset (liability) | \$ 467 | \$ 1,839 |

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

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

(in thousands)

| | Quarter ended September 30, | |
|-----------------------------------|-----------------------------|----------|
| | 2009 | 2008 |
| Deferred policy acquisition costs | \$ 143 | \$ 363 |
| Unearned premiums | (103) | (803) |
| General insurance expenses | (106) | 43 |
| Depreciation | (14) | (45) |
| Claim liabilities | 17 | (112) |
| Other than temporary impairments | (38) | - |
| | \$ (101) | \$ (554) |

Note 7 – Long-Term Debt

Long-term debt consisted of the following as of September 30, 2009 and December 31, 2008:

(in thousands)

| | 2009 | 2008 |
|--|-----------|-----------|
| Subordinated debentures issued on December 15, 2005 with fixed interest rate of 8.83% each distribution period thereafter until December 15, 2015 when the coupon rate shall equal the 3-month LIBOR plus 3.75% applied to the outstanding principal; maturity December, 2035. Interest payments due quarterly. All may be redeemed at any time following the tenth anniversary of issuance. Unsecured. Due in 2035. | \$ 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. Due in 2037. | 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

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

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 \$270,000 (liability) and \$84,000 (asset), respectively, for a net liability of \$186,000 which is reported as a component of other liabilities on the balance sheet. A net valuation gain of \$130,000 is included in accumulated other comprehensive income related to the swap agreements for the current period.

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.

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,

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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 Company 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.

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

Note 9 – Fair Value of Financial Assets and Financial Liabilities

The Company has adopted recently issued accounting standards related to fair value measurements. These standards define fair value, establish a framework for measuring fair value, outline a fair value hierarchy based on inputs used to measure fair value, and enhance disclosure requirements for fair value measurements. These standards do not change existing guidance as to whether or not an instrument is carried at fair value. The Company has determined that its fair value measurements are in accordance with the requirements of these new accounting standards. The implementation of the new accounting standards has not had any impact on the Company's consolidated financial condition or results of operations.

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.

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

Assets/Liabilities Measured at Fair Value on a Recurring Basis

Financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2009 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

| Description | Fair Value Measurements at Reporting Date Using Quoted Prices | | | |
|--------------------------------------|---|--|---|---|
| | September 30, 2009 | In Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial Assets | | | | |
| Investments | | | | |
| Fixed maturities available-for-sale | \$ 69,490 | \$ 8,734 | \$ 60,171 | \$ 585 |
| Trading Securities | 322 | 322 | - | - |
| Equity securities available-for-sale | 8,662 | 7,929 | - | 733 |
| Total Financial Assets | \$ 78,474 | \$ 16,985 | \$ 60,171 | \$ 1,318 |
| Financial Liabilities | | | | |
| Other Liabilities | | | | |
| Interest rate swap | \$ 186 | \$ - | \$ - | \$ 186 |
| Total Financial Liabilities | \$ 186 | \$ - | \$ - | \$ 186 |

The table below presents a reconciliation for all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2009:

| (In Thousands) | For the nine-months ended September 30, 2009 | | |
|--|--|--------------------------------------|--------------------|
| | Fixed Maturities Available-for-Sale | Equity Securities Available-for-Sale | Interest Rate Swap |
| Beginning balance | \$ 652 | \$ 733 | (316) |
| Total gains or losses (realized and unrealized): | | | |

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| | | | |
|---|--------|--------|----------|
| Included in earnings | - | - | - |
| Included in other comprehensive income | (67) | - | 130 |
| Purchases, sales, issuances and settlements, net | - | - | - |
| Transfers in/(out) of Level 3 | - | - | - |
| Ending balance | \$ 585 | \$ 733 | \$ (186) |
| 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 September 30, 2009 | \$ | -\$ | -\$ |

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

For the quarter ended September 30, 2009, 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.

The Company's interest rate swaps include provisions requiring the Company to post collateral when the derivative is in a net liability position. The aggregate fair value of interest rate swaps in a net liability position on September 30, 2009 was \$186,000 for which the Company has posted collateral of \$501,000. The fair value of the interest rate swap in a net liability position is included in Other Liabilities on the balance sheet.

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 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.

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 and nine months ended September 30, 2009 and 2008, respectively:

| Three Months Ended September 30, | Nine Months Ended September 30, |
|---|--|
|---|--|

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| | 2009 | 2008 | 2009 | 2008 |
|--|-----------|-----------|-----------|-----------|
| Gross premiums written: | | | | |
| Life, accident and health operations: | | | | |
| Traditional life insurance | \$ 1,343 | \$ 1,346 | \$ 3,996 | \$ 4,090 |
| Accident and health insurance | 511 | 396 | 1,408 | 1,142 |
| Total life, accident and health | 1,854 | 1,742 | 5,404 | 5,232 |
| Property and Casualty operations: | | | | |
| Dwelling fire & extended coverage | 6,636 | 6,626 | 20,724 | 25,480 |
| Homeowners (Including mobile homeowners) | 6,927 | 6,382 | 21,321 | 24,755 |
| Ocean Marine | 478 | 437 | 1,100 | 921 |
| Other liability | 315 | 374 | 982 | 1,277 |
| Private passenger auto liability | 459 | 4 | 910 | 485 |
| Commercial auto liability | 134 | 275 | 408 | 565 |
| Auto physical damage | 229 | (20) | 501 | 149 |
| Reinsurance premium ceded | (2,254) | (2,771) | (4,987) | (4,939) |
| Total property and casualty | 12,924 | 11,307 | 40,959 | 48,693 |
| Total premiums written | \$ 14,778 | \$ 13,049 | \$ 46,363 | \$ 53,925 |
| Gross premiums earned: | | | | |
| Life, accident and health operations: | | | | |
| Traditional life insurance | \$ 1,336 | \$ 1,374 | \$ 4,078 | \$ 4,229 |
| Accident and health insurance | 515 | 403 | 1,426 | 1,148 |
| Total life, accident and health | 1,851 | 1,777 | 5,504 | 5,377 |
| Property and Casualty operations: | | | | |
| Dwelling fire & extended coverage | 7,015 | 6,185 | 21,045 | 19,528 |
| Homeowners (Including mobile homeowners) | 6,437 | 5,526 | 19,835 | 18,794 |
| Ocean Marine | 338 | 308 | 955 | 1,033 |
| Other liability | 345 | 366 | 1,050 | 1,067 |
| Private passenger auto liability | 300 | 77 | 663 | 644 |
| Commercial auto liability | 149 | 275 | 483 | 565 |
| Auto physical damage | 179 | (33) | 381 | 186 |
| Reinsurance premium ceded | (2,257) | (2,774) | (4,966) | (4,933) |
| Total property and casualty | 12,506 | 9,930 | 39,446 | 36,884 |
| Total premiums earned | \$ 14,357 | \$ 11,707 | \$ 44,950 | \$ 42,261 |

THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Continued)

Note 11 – Subsequent Events

There were no subsequent events requiring adjustment to the condensed consolidated financial statements or disclosure through November 13, 2009, the date that the Company's condensed consolidated financial statements were issued.

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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 September 30, 2009, and the related condensed consolidated statements of income for the three and nine-month periods ended September 30, 2009, shareholders' equity for the nine-month period ended September 30, 2009 and cash flows for the nine-month period ended September 30, 2009. The condensed consolidated statements of income for the three and nine-month periods ended September 30, 2008 and cash flows for the nine-month period ended September 30, 2008 were reviewed by other auditors whose report dated November 13, 2008 was included in the Form 10-Q for the period ended September 30, 2008. These consolidated financial statements are the responsibility of the company's management.

We conducted our review 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 financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, 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.

The consolidated balance sheet of The National Security Group, Inc. and subsidiary as of December 31, 2008, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended (not presented herein); have previously been audited in accordance with auditing standards of the Public Company Accounting Oversight Board by another firm whose report dated March 27, 2009, 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, 2008, is fairly stated, in all material respects, in relation to the balance sheet from which it has been derived.

/s/ Warren Averett Kimbrough & Marino, LLC

Birmingham, Alabama

November 13, 2009

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 September 30, 2009, compared with December 31, 2008 and its results of operations for the three- and nine-month periods ending September 30, 2009 and cash flows for the nine-month period ended September 30, 2009, compared with the same periods last year. This discussion and analysis should be read in conjunction with the unaudited condensed 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 fiscal year ended December 31, 2008.

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, 2008 filed with the Securities and Exchange Commission.

The reader is assumed to have access to the Company's 2008 Annual Report. This discussion should be read in conjunction with the Annual Report and with consolidated financial statements on pages 3 through 20 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 60% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment accounting for 87.8% of total insurance premium revenue during the first nine months of 2009. Life segment revenue accounts for 12.2% of total insurance premium revenue.

National Security Insurance Company (NSIC) is a life, accident and health insurance company. The underwriting of life insurance products in NSIC accounts for 9.1% of our total premium revenue and the underwriting of accident and health insurance products accounts for 3.2% of our total premium revenue. Due to the relatively small amount of premium revenue in each line of business produced by NSIC, all references in the remainder of this management discussion and analysis to NSIC will include the combined life, accident and health insurance operations and 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 NSFC and is the smallest of the insurance subsidiaries accounting for less than 5% 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

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products underwritten by NSFC and Omega as both primarily underwrite personal lines 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 report 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. 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 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 April 22, 2009.

The two primary segments in which we report insurance operations are the personal lines property and casualty insurance 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:

For the quarter ended September 30, 2009, the Company had net income of \$651,000 compared to a net loss of \$6,945,000 for the same period last year. The most significant factor contributing to the improvement in 2009 was the lack of hurricane activity. Third quarter of 2008 results were adversely impacted by losses incurred from Hurricanes Gustav and Ike.

For the nine-months ended September 30, 2009, the Company had net income of \$2,224,000 compared to a net loss of \$6,199,000 for the same period last year. Third quarter 2008 hurricane losses coupled with a high frequency of non-hurricane related catastrophe losses in the first nine months of 2008 were the primary factors contributing to the poor results in 2008.

Three months ended September 30, 2009 compared to three months ended September 30, 2008:

Premium revenue:

Premium revenue increased \$2.65 million to \$14,357,000 compared to \$11,707,000 for the three months ended September 30, 2008. Catastrophe reinsurance premium ceded decreased 2008 net premium revenue in the third quarter by an additional \$1.6 million due to catastrophe reinstatement premium payments triggered by Hurricane Gustav.

Investment income:

Investment income in the third quarter of 2009 was \$1,376,000, an increase of \$44,000 compared to the same period last year.

Realized investment gains and losses:

Realized investment gains totaled \$79,000 compared to realized investment losses of \$1,452,000 for the three months ended September 30, 2008.

Other income:

For the three months ended September 30, 2009 other income was \$208,000 compared to \$254,000 for the same period last year; a decrease of \$46,000. The primary reason for the decrease in other income was the decline in policy and payment fees related to the automobile program in the P&C segment. In addition, billing fees related to the property lines of business declined with the largest decreases in our two largest states; Alabama and Mississippi.

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Policyholder benefits:

For the three months ended September 30, 2009, the Company incurred policyholder benefits and settlement expenses totaling \$9,131,000 compared to \$15,795,000 for the same period last year. Incurred losses in the third quarter of 2008 were significantly higher than the current year due to the impact of Hurricanes Gustav and Ike which both struck the Gulf Coast during September 2008. The Company incurred no hurricane related losses in the three months ended September 30, 2009.

Policy acquisition cost:

For the three-month period ended September 30, 2009, policy acquisition cost was 24.3% of premium revenue compared to 29.4% for the same period last year. The primary factor contributing to the elevated ratio of policy acquisition cost to earned premium in 2008 was the increase in ceded premium associated with catastrophe reinstatement cost triggered by Hurricane Gustav.

General expenses:

General expenses for the three months ended September 30, 2009 totaled \$2,203,000 or 15.3% of premium revenue compared to \$2,099,000 or 17.9% of premium revenue for the same period last year. The decline in general expenses as a percentage of premium revenue is directly related to the reduction of earned premium for catastrophe reinstatement cost incurred related to Hurricane Gustav for the quarter ended September 30, 2008. The dollar increase is directly related to expenses of the holding company, most significantly expenses related to deferred compensation and legal fees.

Taxes, licenses and fees:

Taxes, licenses and fees totaled \$376,000 compared to \$540,000 for the quarter ended September 30, 2008. An adjustment in accrual estimates for the year is the primary reason for the decline in taxes, licenses and fees for the quarter.

Interest expense:

Interest expense is \$277,000 for the quarter ended September 30, 2009, virtually unchanged for the same period last year.

Income taxes:

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For the three-month period ended September 30, 2009, the Company generated an income tax benefit of \$103,000 compared to an income tax benefit of \$3,367,000 in the same period last year. Pre-tax income of \$548,000 included a non-taxable increase in value of company owned life insurance of \$208,000. Also, an adjustment in expense allocation during the quarter between the life insurance subsidiary and the P&C subsidiaries resulted in a decline in the effective tax rate on a consolidated basis for the quarter due to the effects of the small life deduction. These two items resulted in a decrease in the Company's current income tax accrual for the quarter.

Nine months ended September 30, 2009 compared to nine months ended September 30, 2008 Premium revenues:

For the nine months ended September 30, 2009, premiums earned were \$44,950,000 compared to \$42,261,000 for the same period last year; an increase of 6.4%. NSIC ended the first nine months of 2009 with premium revenue of \$5,504,000 compared to \$5,377,000 for the same period last year. Year-to-date premiums earned for NSIC were up due to a \$278,000 increase related to increased production related to a new cancer product launched in July 2008. The P&C segment ended the first nine months of 2009 with year-to-date earned premiums of \$39,446,000 compared to \$36,884,000 for the same period last year; an increase of 6.9%. An increase in production associated with dwelling property lines of business and a decrease in ceded earned premium were the primary factors contributing to the increase in earned premium.

Investment income:

Investment income for the nine months ended September 30, 2009 was \$4,214,000 compared to \$3,616,000 for the same period last year. The increase in investment income in 2009 was primarily due to a recovery in the value of a company owned life insurance investment.

Capital gains:

Realized capital losses were significantly less at \$151,000 for the first nine months of 2009 compared to capital losses \$1,026,000 for the same period last year. Net realized losses for the current period were primarily comprised of \$286,000 in other-than-temporary impairments and \$129,000 in net realized gains from the sale of investments. Likewise, realized losses for the same period last year were generated primarily from the recognition of \$1,722,000 in other-than-temporary impairments which were partially offset by realized capital gain on equity investments of \$418,000.

Other income:

Other income decreased \$386,000 in the first nine months of 2009 compared to the same period last year. Other income is primarily composed of insurance related fees tied to the non-standard auto line of business as well as billing fees generated from our property lines of business.

Policyholder benefits and settlement expenses:

Year-to-date policyholder benefits and settlement expenses for 2009 were \$28,237,000 compared to \$37,167,000 for the same period last year; a decrease of 24%. Through the third quarter of 2009, the P&C segment was impacted by ten non-hurricane catastrophes which totaled \$2,033,000. In contrast, the P&C segment was impacted by nineteen non-hurricane catastrophes through third quarter of 2008 totaling \$4,916,000. These amounts primarily consisted of tornado and windstorm related losses. The non-hurricane catastrophe losses added 5.3 percentage points to the 2009 loss ratio and 13.2 percentage points to the 2008 loss ratio.

The P&C segment's year-to-date incurred losses and loss adjustment expenses from Hurricane Gustav totaled \$10.1 million through the end of third quarter 2008. In addition, Hurricane Ike generated incurred losses and incurred adjustment expenses totaling \$3.5 million as of September 30, 2008. The net losses and loss adjustment expenses retained by the Company related to these two hurricanes added 19.7 percentage points to the 2008 loss ratio. While the Company maintains reinsurance to mitigate the effects of catastrophic events such as Hurricanes Gustav and Ike, the Company incurs 100% of losses from each event up to a retention of \$3.5 million per event under its catastrophe reinsurance agreement. The 2009 hurricane season has been quiet with no storms affecting the P&C segment. However, the P&C segment has been impacted by year-to-date incurred loss and loss adjustment expense development resulting from Hurricane Katrina (which struck the Louisiana coast in August 2005) totaling \$498,000. These claims are not reinsured due to exceeding the upper limit on the coverage for the 2005 catastrophe contract.

Policy acquisition costs:

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For the nine-month period ended September 30, 2009, policy acquisition cost was 22% of premium revenue compared to 22.1% for the same period last year.

General expenses:

General expenses for the nine months ended September 30, 2009 totaled \$6,816,000 compared to \$6,578,000 for the same period last year. General expenses as a percent of earned premium were virtually unchanged at 15.16% and 15.56% for the year-to-date periods ended September 30, 2009 and 2008 respectively.

Taxes, licenses, and fees:

Taxes, licenses and fees were \$1,356,000 for the nine-month period ended September 30, 2009 compared to \$1,298,000 for the same period last year. As a percent of earned premium, taxes, licenses and fees were virtually unchanged at 3.02% and 3.07% for the year-to-date periods ended September 30, 2009 and 2008, respectively.

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Interest expense:

Interest expense totaled \$842,000 compared to \$860,000 for the nine-months ended September 30, 2008. The decrease in interest expense was primarily due to the repayment of a line of credit during the first half of 2008.

Income taxes:

For the nine-month period ended September 30, 2009, income tax expense totaled \$217,000 compared to a benefit of \$3,249,000 for the same period last year. Income tax expense in the current year results in an effective tax rate of 8.89% and is primarily the result of income generated from tax free investments and an increase in income in the life insurance subsidiary which has a lower statutory effective tax rate due to the small life insurance company deduction. Significant losses sustained in the property and casualty subsidiaries generated significant tax benefits for the year to date in 2008.

Investments:

Invested assets at September 30, 2009 increased \$10,472,000 compared to December 31, 2008. Much improved market conditions contributed to a recovery of approximately \$4,968,000 in market value of fixed maturity available-for-sale securities. Approximately \$1,093,000 of the increase in invested assets is attributable to a recovery in the value of equity investments. The value of the Company's investment in company owned life insurance increased in value by \$658,000.

In addition to increases in market values of available-for-sale securities, the Company used positive cash flow primarily from operations to increase investment purchases by \$4,029,000.

The Company considers any fixed income investment with a Standard & Poor's rating of BB+ or lower to be below investment grade (Commonly referred to as "Junk Bonds"). At September 30, 2009 the Company has no material exposure to sub-prime mortgage loans and approximately 2% of the Company's investment portfolio was invested in fixed income investments rated below investment grade. The Company currently has no bonds in the investment portfolio in default. The Company monitors its level of investments in debt and equity securities held in issuers of below investment grade debt securities. Management believes the level of such investments is not material to the Company's financial condition.

Liquidity and capital resources:

At September 30, 2009, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$40,425,000, up \$5,777,000 compared to December 31, 2008. Recoveries in market values of fixed maturities and equity securities totaling \$4,533,000 (net of tax) were the primary factors contributing to the improved equity position. Additional factors contributing to the change in equity were year-to-date net income of \$2,224,000, a gain on the interest rate swap of \$130,000 and dividends paid of \$1,110,000.

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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 \$1,825,000 in cash and short-term investments at September 30, 2009. Net cash provided by operating activities totaled \$3,936,000 for the nine-months ended September 30, 2009 primarily due to year-to-date net income of \$2,224,000 and reinsurance recoveries of \$2,048,000. 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.

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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. However, the Company maintains a catastrophe reinsurance program to limit the effect of such catastrophic events on the Company's financial condition. The Company deductible under the terms of the reinsurance contract totals \$3.5 million however; the Company maintains cash and short-term investments in sufficient amounts to cover the deductible payment in the event of a catastrophic event.

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 incurred material losses in its investment portfolio in the first nine months of 2008 due 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, 2008.

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, 2009. 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 nine month period ended September 30, 2009, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

Please refer to Note 8 to the 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 2008 on Form 10-K.

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

None

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits

a. Exhibits

11. Computation of Earnings Per Share Filed Herewith, See Note 3 to Consolidated Financial Statements.

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

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

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

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

b. Reports on Form 8-K during the quarter ended September 30, 2009

| Date of Report | Date Filed | Description |
|-----------------|-----------------|---|
| August 14, 2009 | August 18, 2009 | Press release, dated August 14, 2009, issued by The National Security Group, Inc. |
| July 17, 2009 | July 22, 2009 | Press release, dated July 22, 2009, 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: November 13, 2009