

NATIONAL SECURITY GROUP INC  
Form 10-K  
March 31, 2011

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

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FORM 10-K

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

63-1020300

(State or Other Jurisdiction of  
Incorporation or Organization)

(IRS Employer  
Identification No.)

661 East Davis Street  
Elba, Alabama

36323

(Address of principal executive offices)

(Zip-Code)

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

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

None

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

Common Stock, par value \$1.00 per share

Global Market (EXCHANGE)

The NASDAQ

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of the last business day of the registrant's most recently completed second fiscal quarter, based upon the bid price of these shares on NASDAQ on such date, was \$18,515,280

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

Class	Outstanding March 26, 2011
Common Stock, \$1.00 par value	2,466,600 shares



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DOCUMENTS INCORPORATED BY REFERENCE

1. Definitive proxy statement for the 2011 Annual Meeting of Stockholders to be held May 20, 2011 is incorporated by reference into Part III of this report. The proxy statement will be filed no later than 120 days from December 31, 2010.
2. Current Report on form 8-K for event occurring on March 31, 2011 is incorporated into Part IV of this report.

## PART I

### Item 1. Business

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

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

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

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

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

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

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

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

### Cautionary Statement Regarding Forward-Looking Statements

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

- § The insurance industry is highly competitive and the Company encounters significant competition in all lines of business from other insurance companies. Many of the competing companies have more abundant financial resources than the Company.
- § Insurance is a highly regulated industry. It is possible that legislation may be enacted which would have an adverse effect on the Company’s business.
- § The Company is subject to regulation by state governments for each of the states in which it conducts business. The Company cannot predict the subject of any future regulatory initiative(s) or its (their) impact on the Company’s business.
- § The Company is rated by various insurance rating agencies. If a rating is downgraded from its current level by one of these agencies, sales of the Company’s products and stock could be adversely impacted.
- § The Company’s financial results are adversely affected by increases in policy claims received by the Company. While a manageable risk, this fluctuation is often unpredictable.
- § The Company’s investments are subject to a variety of risks. Investments are subject to defaults and changes in market value. Market value can be affected by changes in interest rates, market performance and the economy.
- § The Company mitigates risk associated with life policies through implementing effective underwriting and reinsurance strategies. These factors mitigate, not eliminate, risk related to mortality and morbidity exposure. The Company has established reserves for claims and future policy benefits based on amounts determined by independent actuaries. There is no assurance that these estimated reserves will prove to be sufficient or that the Company will not incur claims exceeding reserves, which could result in operating losses.
- § The Company mitigates risk associated with property and casualty policies through implementing effective underwriting and reinsurance strategies. The Company obtains reinsurance which increases underwriting capacity and limits the risk associated with policy claims. The Company is subject to credit risk with regard to reinsurers as reinsurance does not alleviate the Company’s liability to its insured’s for the ceded risks. The Company utilizes a third-party to develop a reinsurance treaty with reinsurers who are reliable and financially stable. However, there is no guarantee that booked reinsurance recoverable will actually be recovered. A reinsurer’s insolvency or inability to make payments due could have a material adverse impact on the financial condition of the Company.

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

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

## Industry Segment and Geographical Area Information

### Property and Casualty Insurance Segment

The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992. This segment will be referred to throughout this report as NSFC, property-casualty segment or P&C segment. NSFC is licensed to write insurance in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia, and operates on a surplus lines basis in the states of Louisiana, Missouri, and Texas. Omega is licensed to write insurance in Alabama and Louisiana. The following table indicates allocation percentages of direct written premium by state for the two years ended December 31, 2010 and 2009:

State	Percent of Direct Written Premium	
	2010	2009
Alabama	27.59%	32.53%
Arkansas	6.82%	7.61%
Georgia	6.94%	6.34%
Louisiana	19.39%	14.24%
Mississippi	15.93%	16.43%
South		
Carolina	9.62%	9.59%
Florida	0.15%	0.18%
Missouri	0.83%	0.93%
Oklahoma	4.05%	3.98%
Tennessee	5.92%	5.94%
Texas	2.76%	2.23%
	100.00%	100.00%

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

The premiums or payments to be made by the insured for direct products of the property and casualty subsidiaries are based upon expected costs of providing benefits, writing and administering the policies. In determining the premium

to be charged, the property and casualty subsidiaries utilize data from past claims experience and anticipated claims estimates along with commissions and general expenses.

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

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

	Year Ended December 31	
	(Amounts In Thousands)	
	2010	2009
Net premiums earned:		
Fire, Allied lines and Homeowners	\$ 48,271	\$ 49,311
Automobile	4,984	2,205
Other	981	879
	\$ 54,236	\$ 52,395
Income (Loss) before taxes	\$ 7,331	\$ 6,617

#### Property and Casualty Loss Reserves

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

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

The following Loss Reserve Re-estimates table illustrates the change over time of the net reserves established for property-liability insurance claims and claims expense at the end of the last 10 calendar years. The first section shows the reserves as originally reported at the end of the stated year. The second section, reading down, shows retroactive re-estimates of the original recorded reserve as of the end of each successive year. These re-estimates are the result of the Company's expanded awareness of additional facts and circumstances that pertain to the unsettled claims. The third section, reading down, shows the cumulative amounts paid as of the end of successive years with respect to that year's reserve liability. The last section compares the latest re-estimated reserve to the reserve originally established and

indicates whether the original reserve was adequate to cover the estimated costs of unsettled claims. The Loss Reserve Re-estimates table is cumulative and, therefore, ending balances should not be added since the amount at the end of each calendar year includes activity for both the current and prior years.

While the information in the table provides a historical perspective on the adequacy of unpaid losses and loss adjustment expenses established in previous years, it should not be assumed to be predictive of redundancies or deficiencies on current year unpaid losses in future periods. Company management believes that the reserves established at the end of 2010 are adequate. However, due to inherent uncertainties in the loss reserve estimation process, management cannot guarantee that current year reserve balances will prove to be adequate. Due to the relatively short tail nature of the property and casualty subsidiaries' claim liabilities, the Company does not discount loss reserves for the time value of money. Dollar amounts are in thousands.

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Gross unpaid losses per											
Consolidated Balance Sheet	\$15,409	\$11,489	\$11,513	\$11,343	\$13,094	\$19,511	\$12,498	\$11,973	\$14,436	\$12,646	\$12,646
Ceded reserves	(3,092)	(2,396)	(1,555)	(1,232)	(2,611)	(8,560)	(1,783)	(555)	(2,421)	(549)	(549)
Net unpaid losses	\$12,317	\$9,093	\$9,958	\$10,111	\$10,483	\$10,951	\$10,715	\$11,418	\$12,015	\$12,097	\$12,097
Cumulative net payments:											
1 year later	\$3,907	\$3,362	\$4,342	\$5,567	\$5,584	\$7,384	\$6,438	4,797	5,636	5,349	
2 years later	5,643	4,416	5,520	6,765	7,006	9,063	8,103	6,496	6,350		
3 years later	6,359	5,076	5,865	7,038	7,521	10,198	9,652	6,767			
4 years later	6,737	5,221	5,945	7,274	7,811	11,439	10,094				
5 years later	6,837	5,106	6,136	7,351	8,018	11,763					
6 years later	6,731	5,164	6,167	7,390	8,006						
7 years later	6,773	5,180	6,183	7,398							
8 years later	6,789	5,193	6,192								
9 years later	6,822	5,195									
	6,822										

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10 years later										
1 year re-estimated: later	8,847	6,805	7,334	9,186	9,042	11,844	11,817	9,046	9438	8621
2 years later	7,863	6,017	7,165	8,607	9,118	11,827	11,061	8,739	7916	
3 years later	7,460	5,856	6,906	8,098	8,669	12,161	11,121	7,739		
4 years later	7,236	5,699	6,509	7,863	8,404	12,337	10,792			
5 years later	7,240	5,436	6,499	7,629	8,274	12,178				
6 years later	6,995	5,413	6,313	7,570	8,135					
7 years later	6,961	5,297	6,314	7,484						
8 years later	6,897	5,308	6,278							
9 years later	6,928	5,260								
10 years later	6,878									
Net cumulative redundancy (deficiency)	\$5,439	\$3,833	\$3,680	\$2,627	\$2,348	\$(1,227)	\$(77)	\$3,679	\$4,099	3,476

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

	For the Years Ended December 31,				
	2010		2009		
Change in Loss and LAE Reserves	Adjusted Loss and LAE Reserves	% Change in Equity	Adjusted Loss and LAE Reserves	% Change in Equity	
10.0	% \$11,866	3.07	% \$11,381	3.07	%

\*Loss and LAE reserves are in thousands

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7.5	%	12,195	2.30	%	11,698	2.30	%
5.0	%	12,525	1.54	%	12,014	1.54	%
2.5	%	12,854	0.77	%	12,330	0.77	%
Reported		13,184	-		12,646	-	
2.5	%	13,514	0.77	%	12,962	0.77	%
5.0	%	13,843	1.54	%	13,278	1.54	%
7.5	%	14,173	2.30	%	13,594	2.30	%
10.0	%	14,502	3.07	%	13,911	3.07	%

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

## Life Insurance Segment

National Security Insurance Company (NSIC), a wholly owned subsidiary organized in 1947, conducts the Company's life insurance business. This segment will be referred to throughout this report as NSIC, Life Company, or Life segment. NSIC is licensed to write insurance in six states: Alabama, Florida, Georgia, Mississippi, South Carolina, and Texas. The following table indicates NSIC's percentage of direct premiums collected by state for the two years ended December 31, 2010 and 2009:

State	Percentage of Total Direct Premiums	
	2010	2009
Alabama	57.41%	57.02%
Georgia	20.94%	21.54%
Mississippi	9.99%	10.20%
South Carolina	7.62%	7.09%
Texas	2.60%	1.59%
Florida	1.44%	2.56%
	100.00%	100.00%

NSIC has two primary methods of distribution of insurance products, home service (career) agents and independent agents. The home service distribution method of life insurance products accounts for 32.3% of total premium revenue in the life insurance segment. Home service life products consist of products marketed directly at the home or other premises of the insured by an employee agent. The home service distribution method has been the Company's primary method of distribution since the founding of NSIC in 1947. However, over the past ten years, the Company has placed its primary emphasis for future growth on alternative methods of distribution. The Company employed nine career agents and one regional manager as of December 31, 2010. The independent agent distribution method accounts for 64.9% of total premium revenue in the life insurance segment. Since NSIC began marketing life, accident and health products through independent agents in 1999, this distribution channel has become the Company's fastest growing and primary method of distribution. Approximately 270 agents of the Company's independent agents produced new business during 2010. The remaining 2.8% of premium revenue consists of the following: a book of business acquired from a state guaranty association in 2000 (1%), premium generated through direct sales of school accident insurance (.1%), and other miscellaneous business serviced directly through the home office (1.7%).

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



The following table displays a schedule of 2010 life segment premium produced by product and distribution method (dollars in thousands):

Line of Business	Home		
	Service Agent	Independent Agent	Other
Industrial	\$ 92	\$ -	\$ 68
Ordinary	1,870	3,022	(74 )
Group Life	-	13	67
A&H Group	-	-	87
A&H Other	309	1,527	46
Total Premium by Distribution Method	\$ 2,271	\$ 4,562	\$ 194

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

	Year Ended December 31	
	(Amounts In Thousands)	
	2010	2009
Life insurance in force at end of period:		
Ordinary-whole life	\$ 173,200	\$ 168,400
Term life	23,700	25,000
Industrial life	20,900	21,600
Other	-	-
	\$ 217,800	\$ 215,000
Life insurance issued:		
Ordinary-whole life	\$ 47,000	\$ 39,000
Term life	-	-
Industrial life	-	-
Other	-	-
	\$ 47,000	\$ 39,000
Net premiums earned:		
Life insurance	\$ 5,058	\$ 5,282
Accident and health insurance	1,969	1,917
	\$ 7,027	\$ 7,199

#### Life Insurance Segment Reserves

We engage Wakely Actuarial Services of Clearwater, Florida as consulting actuary to calculate our reserves for traditional life insurance products. The methodology used requires that the present value of future benefits to be paid under life insurance policies less the present value of future net premiums be calculated. The calculation uses

assumptions including estimates of any adverse deviation, investment yields and changes in investment yields, mortality, maintenance expenses and any non-forfeiture options or termination benefits. The assumptions determine the level and sufficiency of reserves and reserves are calculated and reviewed by our consulting actuary at the end of each quarter. The independent consulting actuary also reviews our estimates for other insurance products including claims reserves under accident and health contracts. Management believes that the reserve amounts reflected in the accompanying consolidated financial statements are adequate.

#### Investments

A significant percentage of the total income for the Company is tied to the performance of its investments. Assets that will eventually be used to pay reserve liabilities and other policyholder obligations along with Company capital are invested to generate investment income while held by the Company. Our investment income is comprised primarily of interest and dividend income on debt and equity securities and realized capital gains and losses generated by debt and equity securities. At December 31, 2010, investments comprise 80% of total assets and investment income (including realized gains) comprises 10% of total revenues evidencing the significant impact investments can have on financial results. Because the Company's insurance subsidiaries are regulated as to the types of investments they may make and the amount of funds they may maintain in any one type of investment, the Company has developed a conservative value oriented investment philosophy, in order to meet regulatory requirements. The Company's investment goals are to conserve capital resources and assets, obtain the necessary investment income threshold to meet reserves, and provide a reasonable return. Current yield from invested assets and capital appreciation of investments create this return.

## Marketing and Distribution

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

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

Agents receive compensation for their sales efforts. In the case of life insurance agents, compensation is paid in the form of sales commissions plus a servicing commission. Commissions paid by NSIC in 2010 averaged approximately 8% of premiums. Commissions paid by NSFC in 2010 averaged approximately 14% of premiums. During 2010, one independent agent, First Premium Insurance Group (FPIG), accounted for more than 10% of total net earned premium of the property-casualty insurance subsidiaries. The net earned premium from FPIG in 2010 totaled \$6,986,000 or 12.9% of total P&C segment net earned premium. NSFC also offers a "profit sharing bonus plan" to independent agents in order to promote better field underwriting and encourage retention of profitable business. This plan not only rewards our agents but also enhances profitability by giving the agent a vested interest in our success and also aids in maintaining price stability for all our customers as agents have a financial incentive to use good field underwriting practices when completing an application for insurance.

At December 31, 2010, NSIC employed nine career agents and one regional manager. NSIC also had approximately 270 independent agents actively producing new business.

At December 31, 2010, NSFC had contracts with approximately 1,500 independent agencies in eleven states.

## Competition

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

procedures in order to garner further competitive advantages.

NSFC and Omega's primary insurance products are dwelling fire, homeowners, including mobile homeowners, and private passenger auto coverage. Dwelling fire and homeowners, collectively referred to as the dwelling property line of business, is the largest segment of property and casualty operations composing 89% of total property and casualty premium revenue. We focus on providing niche insurance products within the markets we serve. We are in the top twenty dwelling property insurance carriers in our two largest states, Alabama and Mississippi. However, due to the large concentration of business among the top five carriers our total market share in the dwelling fire line of business is approximately 3% in Alabama and 2% in Mississippi. In the homeowners line of business our market share in both Alabama and Mississippi is less than 1%. The homeowners markets are even more concentrated with the top three homeowners carriers in both Alabama and Mississippi controlling over 50% of the market share.

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

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

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

## Regulation

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

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

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

Our insurance subsidiaries are subject to risk based capital requirements adopted by the National Association of Insurance Commissioners (NAIC). These requirements direct our insurance companies to calculate and report information according to a risk based formula which attempts to measure statutory capital and surplus needs based on the risk in our product mix and investment portfolio. The formula is designed to allow state insurance regulators to identify companies that are potentially inadequately capitalized. Under the formula, the Company calculates Risk Based Capital (RBC) by taking into account certain risks inherent in an insurer's assets, including investments and an insurer's liabilities. Risk based capital rules provide for different levels of action depending on the ratio of a company's total adjusted capital to its "authorized control level" RBC. Based on calculations made by each of our insurance subsidiaries at December 31, 2010, each subsidiary exceeds any levels that would require regulatory actions.

#### A.M. Best Rating

A.M. Best Company is a leading provider of insurance company financial strength ratings and insurance company issuer credit ratings. Best's financial strength ratings and issuer credit ratings provide an independent opinion based on comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The Company currently has an issuer credit rating of "bb" with a negative outlook. The property and casualty companies currently carry an A.M. Best group financial strength rating of B++ (Good) with a negative outlook. This rating of B++ has remained the same for the past twelve years. The property and casualty group maintains an issuer credit rating of "bbb" with a negative outlook. The standalone financial strength rating for property and casualty subsidiary Omega One is currently B+ (Good) and Omega's issuer credit rating is "bbb-". National Security Insurance Company maintains a company specific financial strength rating of B (Fair) with a stable outlook and an issuer credit rating of "bb" with a stable outlook. A.M. Best maintained a negative outlook on the property and casualty and group ratings citing uncertainty related to the Company's exposure to pending legal actions regarding the sale of its investment in Mobile Attic, Inc. in 2007. See Note 16 to the Consolidated Financial Statements and the Management Discussion and Analysis included herein for additional information on this matter. For the latest ratings, access [www.ambest.com](http://www.ambest.com).

#### Employees

The Company itself has no management or operational employees. Instead, all human resource activities are within subsidiary National Security Insurance Company. NSIC employed 147 staff members as of December 31, 2010. The Company and its property and casualty subsidiary have a Management Service Agreement ("Agreement") with The National Security Insurance Company whereby the Company and the property and casualty subsidiaries reimburse NSIC for salaries and expenses of employees provided under the Agreement. Involved are employees in the areas of Underwriting, Customer Service, Policy Services, Accounting, Marketing, Administration, Document Management, Data Processing, Programming, Personnel, Claims, and Management. The Company, through NSIC, is represented by 9 employee agents in Alabama. The Company's property and casualty subsidiaries had approximately 1,500 independent (non-employee) agents producing business at December 31, 2010. We consider our employee relations to be good.

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

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



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

Any of the materials we file with the SEC may also be read and copied at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the SEC's Public Reference Room may be obtained by calling the SEC at 1.800.SEC.0330. Our periodic reports filed with the SEC, which include Forms 3, 4 and 5, Form 10-K, Form 10-Q, Form 8-K and any amendments thereto may also be accessed free of charge from the SEC's website at [www.sec.gov](http://www.sec.gov).

#### Item 1A. Risk Factors

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

#### Underwriting and product pricing

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

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

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

Approval of rates

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

## Reinsurance

Both insurance subsidiaries customarily reinsure with other insurers certain portions of the insurance risk. The primary purpose of such reinsurance arrangements is to enable the Company to limit its risk on individual policies, and in the case of property insurance, limit its risk in the event of a catastrophe in various geographic areas. A reinsurance arrangement does not discharge the issuing company from primary liability to the insured, and the issuing company is required to discharge its liability to the insured even if the reinsurer is unable to meet its obligations under the reinsurance arrangements. Reinsurance, however, does make the reinsurer liable to the issuing company to the extent of any reinsurance in force at the time of the loss. Reinsurance arrangements also decrease premiums retained by the issuing company since that company pays the reinsuring company a portion of total premiums based upon the amount of liability reinsured. NSIC generally reinsures all risks in excess of \$50,000 with respect to any one insured. NSFC and Omega generally reinsure with third-parties any liability in excess of \$225,000 on any single policy. In addition, the property and casualty subsidiaries have catastrophe excess reinsurance, which provided protection in part with respect to aggregate property losses arising out of a single catastrophe, such as a hurricane. In 2010, the property and casualty subsidiaries had catastrophe protection up to a \$72.5 million aggregate loss. Under the property and casualty subsidiaries reinsurance arrangement in force during 2010, the Company retained the first \$3.5 million of insured losses from any single catastrophic event. The next \$17.5 million in insured losses from any single event was 95% reinsured with the Company's net retention being 5%. The third layer of reinsurance protection provided coverage for 100% of insured losses exceeding \$17.5 million and up to \$42.5 million. The fourth layer of reinsurance protection provided coverage for 100% of insured losses in excess of \$42.5 million up to \$72.5 million. The amount of catastrophe reinsurance protection purchased by the Company was based on computer modeling of actual Company exposure. The Company generally seeks catastrophe protection for scenarios based on the computer modeling that mitigates losses up to a near term 1 in 100 year event, further described as an amount at which the probability of not exceeding is not less than 99%. NSFC and Omega had a provision for one reinstatement (coverage for two catastrophic events) during 2010.

Our inability to procure reinsurance, primarily catastrophe reinsurance, could adversely impact our ability to maintain our level of premium revenue. The increased frequency of catastrophic events also increases our cost of reinsurance pressuring the profit margins of our insurance products. It is generally cost prohibitive to maintain deductibles below levels currently in place. Our current \$3.5 million catastrophe deductible will materially adversely impact underwriting results earnings in years in which we incur losses from a major hurricane.

## Risk of loss from catastrophic events and geographic concentration

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

## Climate change

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

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

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

#### Reserve liabilities

NSIC maintains life insurance reserves for future policy benefits to meet future obligations under outstanding policies. These reserves are calculated to be sufficient to meet policy and contract obligations as they arise. Liabilities for future policy benefits are calculated using assumptions for interest, mortality, morbidity, expense and withdrawals determined at the time the policies were issued. As of December 31, 2010, the total reserves of NSIC (including the reserves for accident and health insurance) were approximately \$30.8 million. We believe, based on current available information, reserves for future policy benefits are adequate.

The property and casualty subsidiaries are also required to maintain loss reserves (claim liabilities) for all lines of insurance. Such reserves are intended to cover the probable ultimate cost of settling all claims, including those incurred but not yet reported. The reserves of the property and casualty subsidiaries reflect estimates of the liability with respect to incurred claims and are determined by evaluating reported claims on an ongoing basis and by estimating liabilities for incurred but not reported claims. Such reserves include adjustment expenses to cover the cost of investigating losses and defending lawsuits. The establishment of accurate reserves is complicated by the fact that claims in some lines of insurance are settled many years after the policies have been issued, thus raising the possibility that inflation may have a significant effect on the amount of ultimate loss payment, especially when compared to initial loss estimates. The subsidiaries, however, attempt to restrict their writing to risks that settle within one to four years of issuance of the policy. As of December 31, 2010, the property and casualty subsidiaries had reserves for unpaid claims of approximately \$13.2 million before subtracting unpaid claims, due from reinsurers of \$1,329,000 leaving net unpaid claims of \$11.9 million. The reserves are not discounted for the time value of money. No changes were made in the assumptions used in estimating the reserves during the years ending December 31, 2010 or 2009. The Company believes, based on current available information, such reserves are adequate to provide for settlement of claims.

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

#### Financial Ratings

The insurance subsidiaries are rated by AM Best Company, an insurance company-rating agency. NSFC is rated B++ (Good), Omega is rated B+ (Good) and NSIC is rated B (Fair) by AM Best Company. A downgrade in our AM Best ratings could adversely impact our ability to maintain existing business or generate new business. See page 12 of this Form 10-K for additional information on our current A.M. Best rating.



## Regulation

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

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

Most states have enacted legislation or adopted administrative rules and regulations covering such matters as the acquisition of control of insurance companies, transactions between insurance companies and the persons controlling them. The National Association of Insurance Commissioners has recommended model legislation on these subjects and all states where the Company's subsidiaries transact business have adopted, with some modifications, that model legislation. Among the matters regulated by such statutes are the payments of dividends. These regulations have a direct impact on the Company since its cash flow is substantially derived from dividends from its subsidiaries and adverse operating results in the insurance subsidiaries or the development of significant additional obligations in the holding company could adversely impact liquidity at the holding company level. Statutory limitations of dividend payments by subsidiaries are disclosed in Note 13 of the accompanying Consolidated Financial Statements.

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

## Competition

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

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

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

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

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

#### Inflation

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

#### Investment Risk and Liquidity

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

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

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

## Litigation

As described in Item 3 of this report, the Company is a party to litigation involving the sale of its stock in Mobile Attic, Inc. The claim against the Company asserts that the financial statements of Mobile Attic, Inc. were not accurate at the time of the sale. The accounting functions were performed by management of Mobile Attic, Inc., and the financial records of Mobile Attic, Inc. have been in the possession and control of the purchaser of the stock since the transaction occurred in April 2007. Access to the financial records is important to the defense of this case, and the financial records are only available to the Company through discovery in the litigation. Accordingly, the Company will have difficulty in predicting whether and the extent to which it has liability in this litigation. The litigation involves claims of a significant amount against the Company. If the Company is found to be liable for the amount claimed, the liability to pay the claim could have an adverse effect on the Company's liquidity and capital resources.

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

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

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

We are a small public company with a large percentage of common stock outstanding owned by founding family members, employees, officers and directors. Consequently, our average daily trading volume is very low with no shares traded on some days and only a few hundred shares trading in a typical day. This low trading volume can lead to significant volatility in our share price and limit a shareholders ability to dispose of large quantities of stock in a short period of time.

#### Debt covenants

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

#### Technology

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

#### Key Personnel

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

#### Accounting Standards

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



### Item 1B. Unresolved Staff Comments

As a smaller reporting company, the Company is not required to furnish the information required in Item 1B.

### Item 2. Properties

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

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

We also own approximately 100 acres of undeveloped commercial real estate in Greenville, Alabama. We sell undeveloped lots from this development and the development has no depreciable improvements.

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

### Item 3. Legal Proceedings

In April 2007, the Company sold substantially all of its 50% interest in a subsidiary, Mobile Attic, Inc., to Bagley Family Revocable Trust (the "Purchaser"). The Company, Peter L. Cash and Russell L. Cash (collectively the "Sellers") sold to Purchaser 61% of the outstanding stock of Mobile Attic under the terms of a Stock Purchase Agreement dated April 5, 2007, executed by Sellers, Mobile Attic and Purchaser's assignor, James W. Bagley (the "Stock Purchase Agreement"). Under the terms of the Stock Purchase Agreement, the Sellers made certain warranties to Purchaser regarding the financial condition of Mobile Attic and agreed to jointly and severally indemnify Purchaser for any damages resulting from a breach of any of the warranties.

On January 9, 2009, Purchaser filed a complaint against Peter L. Cash and others in the U.S. District Court for the Middle District of Alabama, Southern Division, in which Purchaser asserted, among other claims, a claim for damages resulting from a breach of certain of the warranties regarding the financial statements of Mobile Attic and other financial information provided by Mobile Attic. Purchaser then notified the Company of its claim for breach of warranty under the Stock Purchase Agreement and requested indemnity from the Company. On July 9, 2009, the Company filed a complaint in intervention requesting the Court to find that the Company is not liable for indemnity under the Stock Purchase Agreement, or in the alternative, to award damages to the Company for any loss suffered as a result of the fraudulent actions of Peter Cash and as a result of the negligence of Mobile Attic and its auditors in the preparation of Mobile Attic's financial statements. [Mobile Attic, Inc., MA Manufacturing Company, Inc. and Bagley Family Revocable Trust, plaintiffs, v. Peter L. Cash, Cash Brothers Leasing, Inc., Bridgeville Trailers, Inc., and

Barfield, Murphy, Shank & Smith, P.C, defendants, v. The National Security Group, Inc., intervenor plaintiff, v. Peter L. Cash, Barfield, Murphy, Shank & Smith, P.C. and Bagley Family Revocable Trust, intervenor defendants, U.S. District Court, Middle District of Alabama, Eastern Division, Civil Action No. 09-cv-00024.]

On August 13, 2009, the Court granted the Company's motion to intervene. The parties have conducted initial discovery in this action, and at the request of the Court, each party filed an amended complaint on or before August 23, 2010. The Purchaser has asserted counterclaims against the Company for losses incurred as a result of failure to disclose material facts or alleged innocent, negligent or reckless false representations made to induce Purchaser to enter into the Stock Purchase Agreement, breach of the Stock Purchase Agreement and indemnification of Purchaser's losses and damages as a result of the breach of representations and warranties in the Stock Purchase Agreement. Among the specific allegations in the Purchaser's amended counterclaims against the Company, the Purchaser contends that the balance sheet and depreciation schedule of Mobile Attic included an overstatement of portable storage containers of more than \$3,000,000 and that the balance sheet of Mobile Attic included a note receivable from an affiliate of Mobile Attic and Peter Cash in the amount of approximately \$1.8 million that was not generated in the ordinary course of business and that was not collectible.

Under the terms of the Stock Purchase Agreement, the Purchaser paid the Company \$2,700,000 for 45% of the total outstanding stock of Mobile Attic and paid the other Sellers \$960,000 for an additional 16% of the total outstanding stock in Mobile Attic, thus obtaining a controlling interest of 61% of the outstanding stock. The Stock Purchase Agreement also required the Purchaser as a condition to the transaction to cause the Company to be released from its guaranty of a bank loan to Mobile Attic having an outstanding principal balance of approximately \$9,400,000. The bank loan was secured by portable storage containers of Mobile Attic.

The Purchaser has asserted that the Company is jointly and severally liable with the other Sellers (whom the Company believes have limited resources) for all losses suffered by Purchaser as a result of Sellers' misrepresentations. Purchaser claims that the misrepresentations caused Purchaser to purchase the stock of Mobile Attic, Inc. with the result that Sellers should be liable for all of Purchaser's losses resulting from the transaction, which include the value paid for the stock of Mobile Attic, Inc., the losses suffered on the assumption of the bank loan, the operating losses funded by Purchaser after the transaction, and attorneys' fees incurred by Purchaser to enforce its claim for indemnity.

The Company has denied the allegations supporting Purchaser's claims. The financial records of Mobile Attic have been in the possession of Purchaser since Purchaser acquired the stock of Mobile Attic in early 2007 and are only available to the Company through discovery in the litigation. The Company is actively conducting discovery in defense of Purchaser's claims and has requested Purchaser to provide the financial information supporting the allegations made in its complaint. Discovery has not been completed at this time. The Company believes that the Purchaser's claim for damages is unreasonable and excessive even if the Purchaser is able to prove the alleged misrepresentations in Mobile Attic's financial statements.

Please refer to Note 16 to the Consolidated Financial Statements included herein for additional information regarding contingencies related to legal proceedings.

## PART II

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

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

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

	Stock Closing Prices	
	High	Low
2010		
First Quarter	\$ 14.00	\$ 11.10
Second Quarter	13.63	11.49
Third Quarter	13.35	10.00
Fourth Quarter	12.67	10.00

2009		
First Quarter	\$ 7.14	\$ 5.87
Second Quarter	10.85	6.76
Third Quarter	9.08	7.50
Fourth Quarter	11.10	7.61

### Shareholders

The number of shareholders of the Company's common stock was approximately 1,300, and the Company had 2,466,600 shares of common stock outstanding on March 26, 2011.

### Dividends

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

Dividends Per Share	
2010	
First Quarter	\$ 0.15
Second Quarter	\$ 0.15
Third Quarter	\$ 0.15
Fourth Quarter	\$ 0.15
2009	
First Quarter	\$ 0.15
Second Quarter	\$ 0.15
Third Quarter	\$ 0.15
Fourth Quarter	\$ 0.15

Discussion regarding dividend restrictions may be found on page 37 of the Managements' Discussion and Analysis as well as in Note 13 of the consolidated financial statements.

The payment of shareholder dividends is subject to the discretion of our Board of Directors and is dependent upon many factors including our operating results, financial condition, capital requirements and general economic conditions. Total shareholder dividends paid in 2010 totaled \$1,480,000. Dividends from the insurance subsidiaries are subject to approval of the regulator in the state of domicile, the Alabama Department of Insurance.

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

### Item 6. Selected Financial Data

Under smaller reporting company rules we are not required to disclose information required under Item 6. However, in order to provide information to our investors, we have elected to provide certain selected financial data.

Five-Year Financial Information:  
(Amounts in thousands, except per share)

Operating results	2010	2009	2008	2007	2006
Net premiums earned	\$ 61,263	\$ 59,594	\$ 56,264	\$ 62,250	\$ 58,874
Net investment income	5,089	5,289	4,368	4,749	4,463
Net realized investment (losses) gains	1,879	357	(1,049 )	1,493	2,565
Other income	1,161	764	1,107	1,071	1,211
Total revenues	\$ 69,392	\$ 66,004	\$ 60,690	\$ 69,563	\$ 67,113
Net income (loss)	\$ 3,265	\$ 4,224	\$ (5,204 )	\$ 6,040	\$ 4,250
Net income (loss) per share	\$ 1.32	\$ 1.71	\$ (2.11 )	\$ 2.45	\$ 1.72

Other Selected Financial Data	2010	2009	2008	2007	2006
Total shareholders' equity	\$ 43,710	\$ 41,168	\$ 34,648	\$ 48,447	\$ 45,379
Book value per share	\$ 17.72	\$ 16.69	\$ 14.04	\$ 19.64	\$ 18.39
Dividends per share	\$ 0.600	\$ 0.600	\$ 0.900	\$ 0.900	\$ 0.885
Net change in unrealized capital gains (net of tax)	\$ 847	\$ 3,520	\$ (6,147 )	\$ (664 )	\$ (244 )
Total assets	\$ 136,867	\$ 131,396	\$ 124,890	\$ 135,585	\$ 134,911

## Quarterly Information:

	Premiums	Investment & Other Income	Realized Investment Gains (Losses)	Claims and Benefit Payments	Net Income (Loss)	Net Income (Loss) Per Share
2010						
1st QTR	\$ 15,038	\$ 1,625	\$ 669	\$ 8,473	\$ 1,894	\$ 0.77
2nd QTR	15,903	1,451	689	11,061	814	0.33
3rd QTR	15,248	1,434	75	10,096	223	0.09
4th QTR	15,074	1,740	446	9,401	334	0.13
	\$ 61,263	\$ 6,250	\$ 1,879	\$ 39,031	\$ 3,265	\$ 1.32
2009						
1st QTR	\$ 15,220	\$ 1,378	\$ 1	\$ 7,792	\$ 1,481	\$ 0.60
2nd QTR	15,373	1,566	(231 )	11,314	92	0.04
3rd QTR	14,357	1,584	79	9,131	651	0.26
4th QTR	14,644	1,525	508	7,602	2,000	0.81
	\$ 59,594	\$ 6,053	\$ 357	\$ 35,839	\$ 4,224	\$ 1.71

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

## Overview

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSG) and its subsidiaries. We are a "smaller reporting company" under Securities and Exchange Commission (SEC) regulations and therefore qualify for the scaled disclosure of smaller reporting companies. In general the same information is required to be disclosed in the management discussion and analysis by smaller reporting companies except that the discussion need only cover the latest two year period and disclosures relating to contractual obligations are not required. In accordance with the scaled disclosure requirements, this discussion covers the two year period ended December 31, 2010.

The National Security Group, Inc. is made up of two segments: the Life segment and the P&C segment. The Company's life, accident and health insurance business is conducted through National Security Insurance Company

(NSIC), a wholly owned subsidiary of the Company organized in 1947. The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992.

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

## Summary of Consolidated Results of Operations

Condensed revenue and income information follows:

	Year	
	Ended December 31,	
	2010	2009
Premium		
Earned	\$ 61,263,000	\$ 59,594,000
Investment		
Income	5,089,000	5,289,000
Realized		
Investment		
Gains	1,879,000	357,000
Other Income	1,161,000	764,000
Total		
Revenues	69,392,000	66,004,000
Net Income	\$ 3,265,000	\$ 4,224,000
Net Income		
Per Share	\$ 1.32	\$ 1.71

For the year ended December 31, 2010 total revenues were \$69,392,000 compared to \$66,004,000 for the same period last year; an increase of 5.1%. Earned premium increases in the P&C segment as well as the increase in net realized investment gains were the primary contributing factors to the increase in total revenue for 2010 over 2009.

The Company ended 2010 with net income totaling \$3,265,000 compared to \$4,224,000 in 2009. The Company ended 2010 with net income per share of \$1.32 compared to \$1.71 in 2009. An 8.9% increase in policyholder benefits was the primary factor contributing to the decrease in net income. For the year 2010, policyholder benefits were 63.7% of earned premium compared to 60.1% in 2009, an increase of 3.6 percentage points. Increased accident and health claims in the Life Segment contributed approximately one percentage point to the increase while increased homeowners and auto claims in the P&C segment account for most of the remaining increase.

## Results of Operations for Years Ended December 31, 2010 and 2009

The Company ended 2010 with premiums earned totaling \$61,263,000 compared to \$59,594,000 for the same period last year. Premium revenue is generated from our two operating segments: P&C segment and Life segment. The P&C segment accounts for approximately 89% of total premium revenue while our Life segment contributes the remaining 11%. The P&C segment operates in personal lines insurance products primarily generating premium revenue from dwelling fire, allied lines and homeowners policies. Our Life segment produces premium revenue primarily from whole life, accident and critical illness insurance policies.

Net investment income totaled \$5,089,000 in 2010 compared to \$5,289,000 in 2009; a decrease of \$200,000. We currently hold \$5,000,000 in company owned life insurance (COLI). The change in value related to this investment

led to investment income totaling \$323,000 in 2010 compared to \$740,000 for the same period last year. The reduction in COLI income was the primary reason for the overall decrease in investment income. Invested assets were up 7.8% at December 31, 2010 compared to December 31, 2009. The increase in invested assets, primarily in fixed income investments, led to higher interest income from the portfolio and partially offset the decrease in income from COLI.

Net realized investment gains totaled \$1,879,000 in 2010 compared to \$357,000 in 2009. The primary reason for the increase was favorable market conditions coupled with an increase in sales of securities in the P&C portfolio. The most significant contributions were from the sale of four bonds and three common stocks totaling \$395,000 and \$759,000, respectively. The realized gains from these seven securities accounted for approximately 76% of the increase in 2010 compared to 2009.

Other income was \$1,161,000 as of December 31, 2010 compared to \$764,000 for the same period last year; a \$397,000 increase. Other income consists primarily of billing, payment and policy fees related to the issuance of our property and automobile insurance policies in the P&C segment as well as miscellaneous income. The primary reason for the \$397,000 increase was an increase in fee income related to a rise in policy issuance in the automobile program in the P&C segment during 2010.

Policyholder benefits paid or provided increased 8.9%, ending 2010 at \$39,031,000 compared to \$35,839,000 for the same period last year. Policyholder benefits as a percentage of net premiums earned totaled 63.71% for the year in 2010 compared to 60.14% in 2009. The primary reason for the \$3,192,000 increase was higher claims activity in the P&C segment associated with an increase in fire related losses primarily homeowners lines of business coupled with increase claims in the auto line of business. Fire losses incurred in the homeowners programs totaled \$9,113,000 in 2010 compared to \$7,097,000 in 2009; an increase of 2,016,000 or 28.4%. The increase in fire losses incurred in 2010 compared to fire losses incurred in 2009 in the above mentioned lines of business accounted for 63.2% of the overall increase in policyholder benefits costs. In addition, the personal lines automobile program ended 2010 with incurred losses and incurred loss adjustment expenses of \$4,661,000 compared to \$1,596,000 for the same period last year; an increase of \$3,065,000. The auto program also experienced significant revenue growth during the year, partially contributing to the increased frequency of claims. However, the loss and adjustment expense ratio increased over 30 percentage points in 2010 compared to 2009. To stem losses in the auto program, we implemented significant rate increases in late 2010 which had an immediate impact of decreasing new business production and is expected to ultimately decrease the loss ratio on the program.

The previously mentioned increases in policyholder benefit expense were partially offset by a decline in wind losses related to storm activity in the P&C segment. Although both 2010 and 2009 were impacted by ten non-hurricane catastrophic weather related events, losses from these storms totaled \$1,704,000 in 2010 compared to \$2,328,000 in 2009; a decrease of \$624,000.

General and administrative expenses increased \$276,000 in 2010 compared to the same period last year. The primary factor contributing to the increase in general expenses was an increase in litigation related defense costs associated with the Company's sale of an investment in Mobile Attic in 2007.

Taxes, licenses and fees were \$2,081,000 in 2010, up 27.6% compared to \$1,631,000 for the same period last year. Taxes, licenses and fees were 3.4% of premiums earned for the year 2010 compared to 2.74% in 2009. An increase in premium revenue in the auto program was a primary factor contributing to the increase in tax expense.

Interest expense increased \$30,000 in 2010 compared to 2009. The increase in interest expense was primarily associated with the interest on a revolving line of credit maintained in our holding company.

The Company incurred income tax expense totaling \$1,372,000 compared to \$1,252,000 in 2009. Income tax expense as a percent of income before taxes was 29.59% in 2010 compared to 22.86% in 2009. The most significant factor contributing to the increase in the effective tax rate was a decline in income from company owned life insurance.

Due to the increase in policyholder benefit expenses as well as an increase in taxes, licenses and fees, the Company ended 2010 with net income of \$3,265,000, down 22.7% from \$4,224,000 for the same period last year.

#### Stockholder Equity and Book Value per Share

Stockholders equity for the year ended December 31, 2010 was \$43,710,000 compared to \$41,168,000 at December 31, 2009, an increase of \$2,542,000 or 6.2%. The change in stockholders equity is composed of dividends paid to shareholders of \$1,480,000 and net income of \$3,265,000 as well as accumulated other comprehensive income,

primarily increases in accumulated unrealized capital gains, totaling \$847,000 and unrealized losses on interest rate swap totaling \$90,000. Year-end book value per share, defined as stockholders equity divided by common shares outstanding of 2,466,600, was \$17.72 at December 31, 2010 compared to \$16.69 at December 31, 2009.

## Industry Segment Data

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

Premium revenues:	2010	%	2009	%
Life, accident and health insurance	\$ 7,027	11.47 %	\$ 7,199	12.08 %
Property and casualty insurance	54,236	88.53 %	52,395	87.92 %
	\$ 61,263	100.00 %	\$ 59,594	100.00 %

The property and casualty segment composed 88.53% of total premium revenue in 2010 compared to 87.92% in 2009. The property and casualty segment is primarily composed of dwelling fire, allied lines and homeowners lines of business. The life segment composed 11.47% of premium revenue in 2010 compared to 12.08% in 2009 with revenue produced primarily from life insurance products.

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

## Life and Accident and Health Insurance Operations:

Our life segment is the smaller of our insurance segments contributing 11.5% of total insurance premium revenue in 2010 and 12.1% in 2009. Premium revenues and operating income for the life segment for the years ended December 31, 2010 and 2009 are summarized below (amounts in thousands):

	2010	2009
<b>REVENUE</b>		
Net premiums earned	\$ 7,027	\$ 7,199
Net investment income	2,116	2,114
Net realized investment gains	420	234
Other income	3	3
	9,566	9,550
<b>BENEFITS AND EXPENSES</b>		
Policyholder benefits paid or provided	5,286	4,931
	590	276

Amortization of deferred policy acquisition costs		
Commissions	552	546
General and administrative expenses	2,166	2,543
Insurance taxes, licenses and fees	387	244
Interest expense	65	49
	9,046	8,589
Income Before Income Taxes	520	961
INCOME TAX EXPENSE		
Current	190	105
Deferred	458	392
	648	497
NET INCOME	\$ (128 )	\$ 464

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009:

NSIC premium accounted for 11.5% of total consolidated premium revenue for 2010. As mentioned above, NSIC operates using two primary methods of distribution: home service employee agents and independent agents. While the company has used the traditional home service distribution method since its founding in 1947, the independent agent distribution method has become the largest source of renewal business and new business production over the past decade. For 2010, the home service and independent agent distribution methods accounted for 32.3% and 64.9%, respectively of NSIC premium revenue.

NSIC ended 2010 with premium revenue of \$7,027,000 compared to \$7,199,000 for the same period last year; a decrease of 2.4%. The \$172,000 decrease in premium revenue was primarily due to the decline in ordinary business related to the home service distribution method. Premium revenue declined 5.6% in 2010 compared to the same period last year. Partially offsetting this decline was an 8.7% increase in A&H premium revenue produced by the independent agent distribution method.

Net investment income totaled \$2,116,000 as of December 31, 2010 compared to \$2,114,000 for the same period last year. Investment income in NSIC is generated from securities held in our investment portfolio as well as mortgage and policy loan interest. Investment income remained virtually unchanged increasing \$2,000 in 2010 compared to 2009.

NSIC ended 2010 with net realized investment gains totaling \$420,000 compared to \$234,000 in 2009. The primary reason for the improved results in the current year was the lack of other-than-temporary impairment losses compared to the \$293,000 in other-than-temporary impairment losses recognized during 2009.

Policyholder benefit expenses increased \$355,000 ending 2010 at \$5,286,000 compared to \$4,931,000 for the same period last year. The primary reason for the increase was an increase in claims incurred related to supplemental accident and health claim benefits in 2010 compared to 2009.

General and administrative expenses decreased \$377,000 while deferred policy acquisition costs (DAC) increased \$314,000 in 2010 compared to 2009. One reason for the decline in general and administrative expenses was the absence of a bonus accrual in 2010 compared to 2009, which accounted for approximately 25% of the decrease. In addition, software expenses in the Life segment decreased \$142,000 compared to the same period last year and accounted for another 38% of the overall decrease in general and administrative expenses compared to the same period last year.

Life segment incurred income tax expenses totaled \$648,000 compared to \$497,000 in 2009. Income tax expense increased due to the impact of the small life deduction on capital gains.

NSIC ended 2010 with a year to date net loss of \$128,000 compared to net income of \$464,000 for the same period last year. The decrease in premium revenue coupled with the increase in policyholder benefit expense, deferred policy acquisition costs and tax expense were the primary reasons for the net loss in 2010 compared to the net income in 2009.



## Property &amp; Casualty Operations:

Property and casualty operations constitute our largest segment composing 88.5% and 87.9% of our total premium revenue in 2010 and 2009, respectively. Premium revenues and operating income for the P&C segment for the years ended December 31, 2010 and 2009 are summarized below:

	2010	2009
<b>REVENUE</b>		
Net premiums earned	\$ 54,236	\$ 52,395
Net investment income	2,900	3,125
Net realized investment gains	1,352	120
Other income	1,158	761
	59,646	56,401
<b>BENEFITS AND EXPENSES</b>		
Policyholder benefits paid or provided	33,745	30,908
Amortization of deferred policy acquisition costs	3,354	3,397
Commissions	7,319	7,317
General and administrative expenses	6,203	6,775
Insurance taxes, licenses and fees	1,694	1,387
	52,315	49,784
<b>Income Before Income Taxes</b>	<b>7,331</b>	<b>6,617</b>
<b>INCOME TAX EXPENSE</b>		
Current	1,294	1,369
Deferred	529	97
	1,823	1,466
<b>NET INCOME</b>	<b>\$ 5,508</b>	<b>\$ 5,151</b>

## Year Ended December 31, 2010 Compared to Year Ended December 31, 2009:

Property and casualty segment premium revenue for 2010 was \$54,236,000 compared to \$52,395,000 for the same period last year; an increase of 3.5%. The primary reasons for the increase in premium revenue in 2010 compared to 2009 were the growth of the automobile line of business in addition to moderate rate increases related to our property programs in our largest states.

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

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Line of Business	Net Premium			Net Premium	
	2010	% of NPE		2009	% of NPE
Dwelling Fire/Allied					
Lines	\$ 24,217,000	44.7 %	\$ 25,524,000	48.7 %	
Homeowners	24,054,000	44.3 %	23,787,000	45.4 %	
Ocean Marine	981,000	1.8 %	879,000	1.7 %	
Private Passenger					
Automobile	4,483,000	8.3 %	1,586,000	3.0 %	
Commercial					
Automobile	501,000	0.9 %	619,000	1.2 %	
	\$ 54,236,000	100.0 %	\$ 52,395,000	100.0 %	

In our fire/allied lines and homeowners lines of business, we have slowed our rate of growth through a combination of rate increases, stricter underwriting standards and fewer appointments of new agents. These efforts have been undertaken in an effort to improve underwriting profitability, particularly in our homeowners line of business. The full effect of these efforts was not realized in 2010 as only our dwelling fire/allied lines program produced an underwriting profit. However, we expect the changes implemented, while continuing to slow top line revenue growth should lead to improved underwriting results in future periods.

Also, during 2010, we experienced rapid growth in our personal lines auto program. This program is composed primarily of non-standard auto policies with the largest concentration of business in the state of Louisiana. Due to early unfavorable underwriting results, we implemented significant rate increases in Louisiana in the second half of 2010. The rate adjustments will slow the production of new business in Louisiana going forward but is expected to help reduce underwriting losses.

Net investment income totaled \$2,900,000 in 2010 compared to \$3,125,000 in 2009; a decrease of \$225,000. The decrease in investment income in the P&C segment was primarily attributable to decline in investment income associated with the investment of the cash value of company owned life insurance (COLI). Investment income from COLI totaled \$323,000 in 2010 compared to \$740,000 in 2009.

The P&C segment ended 2010 with realized capital gains totaling \$1,352,000 compared to \$120,000 for the same period last year. The most significant contributions were from the sale of four bonds and three common stocks totaling \$395,000 and \$759,000, respectively. The realized gains from these seven securities accounted for approximately 94% of the increase in 2010 compared to 2009. The P&C segment was not impacted by the write-down of other-than-temporary impairments in 2010; however, other-than-temporary impairment losses totaled \$151,000 in 2009. For information regarding management's method of determining investment impairment, please see Note 4.

Other income was \$1,158,000 in 2010 compared to \$761,000 for the same period last year; a \$397,000 increase. Other income consists primarily of fees related to the issuance of our property and automobile insurance policies as well as miscellaneous income. The primary reason for the \$397,000 increase was policy fee income related to the automobile program. The fees associated with the automobile business totaled \$340,000 in 2010 compared to \$145,000 in 2009; an increase of \$195,000. The increase in policy fees associated with the automobile line of business accounted for 49.1% of the total increase in other income in 2010 compared to 2009.

Policyholder benefit expenses were \$33,745,000 in 2010, up \$2,837,000 from \$30,908,000 for the same period last year. The primary reasons for the increase were fire losses in the homeowners lines of business as well as the surge in claims frequency related to the growth of the automobile program. Fire losses incurred in 2010 in the homeowners line of business totaled \$9,113,000, a 28.4% increase from fire losses incurred during 2009 which totaled \$7,097,000.

The personal lines automobile program ended 2010 with incurred losses and incurred loss adjustment expenses of \$4,661,000 compared to \$1,596,000 for the same period last year; an increase of \$3,065,000. The auto program also experienced significant revenue growth during the year partially contributing to the increased frequency of claims. However, the loss and adjustment expense ratio increase over 30 percentage points in 2010 compared to 2009. In order to stem losses in the auto program, we implemented significant rate increases in late 2010 which had an immediate impact of decreasing new business production and is expected to decrease the loss ratio on the program.

Partially offsetting the previously mentioned increases in policyholder benefit expense was a decline in wind losses related to storm activity in the P&C segment. Although both 2010 and 2009 were impacted by ten non-hurricane catastrophic weather related events, losses from these storms totaled \$1,704,000 in 2010 compared to \$2,328,000 in 2009; a decrease of \$624,000.

We routinely evaluate our claims frequency and severity statistics in order to better understand the nature of our risks and aid in the loss reserve liability evaluation process. Claims frequency is a measure of the number of claims incurred during a measurement period regardless of amount. Claims severity is a measure of the average dollar amount of claims during a measurement period. During 2010, tornado and storm related frequency was below levels we experienced throughout 2009. Although the P&C segment experienced losses from ten weather related events classified as catastrophes during 2010 and 2009, incurred losses from the current year storms totaled \$1,704,000 compared to \$2,328,000 in the prior year; a 26.8% decrease. The average severity per claim related to the ten non-hurricane catastrophes affecting the P&C companies during 2010 and 2009 totaled approximately \$,3500 and \$2,500, respectively per claim.

The P&C segment continued to be involved in litigation pertaining to claims from Hurricane Katrina which impacted our coverage areas in Louisiana and Mississippi in August 2005. During 2008, the cumulative claims associated with Hurricane Katrina breached the \$37,500,000 million upper limit of the reinsurance agreement in effect during 2005. As of December 31, 2010, cumulative claims incurred related to Hurricane Katrina exceeded the reinsurance upper limit by \$1,467,000. Although the reinsurance for this catastrophe has been exhausted and the ultimate outcome of the remaining open claims is unknown, the company believes it maintains adequate reserves for the 53 open claims based on information available at the present time.

During 2010, the P&C segment experienced adverse development related to claims from Hurricane Ike which impacted our coverage areas in September 2008. Cumulative incurred losses related to Hurricane Ike totaled \$5,866,000 as of December 31, 2010 compared to \$4,843,000 for the same period last year; an increase of \$1,023,000. The company has met its catastrophe reinsurance deductible with regard to Ike and is still well within the upper limits of reinsurance coverage for this hurricane covering 95% of the amounts incurred and therefore expects a minimal additional net development with regard to this hurricane.

There was no significant change in deferred policy acquisition costs which totaled \$3,354,000 in 2010 (6.18% of premium revenue) compared to \$3,397,000 in 2009 (6.48% of premium revenue). Deferred policy acquisition cost consists of amortization of previously capitalized distribution costs; primarily commissions.

Commission expense for 2010 totaled 13.49% of premium revenue compared to 13.97% of premium revenue in 2009. Commission expenses totaled \$7,319,000 in 2010 compared to \$7,317,000 in 2009; a .03% increase. During 2009, a new profit sharing bonus calculation was implemented which reduced commission expense and led to the comparable and virtually unchanged results between 2010 and the prior year.

General and administrative expenses totaled \$6,203,000, or 11.4% of premium revenue in 2010 compared to \$6,775,000, or 12.9% of premium revenue, in 2009. The primary reason for the decline in general and administrative expenses was the absence of a bonus accrual in 2010 compared to \$364,000 accrued in 2009.

Insurance taxes, licenses and fees were \$1,694,000 in 2010 compared to \$1,387,000 for the same period last year. Insurance taxes, licenses and fees were 3.1% of premium revenue in 2010 compared to 2.6% in 2009. An increase in the mix of business in states with higher premium taxes was the primary factor leading to the increase in taxes, licenses and fees.

The P&C segment ended 2010 with income tax expense of \$1,823,000 compared to \$1,466,000 in 2009. The effective tax rate for 2010 was 25% compared to 22% in 2009 primarily due to less income from tax free bonds and tax free income from COLI in 2010 compared to 2009.

The combined ratio was 96% in 2010 compared to 95% in 2009. The increase in fire losses in the dwelling fire and homeowners lines of business combined with the increase in incurred losses in the automobile program adversely impacted the combined ratio in 2010.

#### Property & Casualty Combined Ratio:

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

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

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

	2010	2009
Loss and LAE Ratio	62.0%	59.0%
Underwriting Expense Ratio	34.0%	36.0%
Combined Ratio	96.0%	95.0%

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

During 2010, the P&C segment experienced an increase of one percentage point in the combined ratio. The primary reasons for the increase were a \$2,384,000 increase in fire related losses primarily in the homeowners line of business as well as the \$3,065,000 increase in losses incurred related to the automobile program. However, the negative impact of these claim expenses was partially offset by the \$624,000 decrease in tornado and storm related losses incurred in the dwelling fire program in 2010 compared to 2009.

#### Non-insurance Operations:

	2010	2009
<b>REVENUE</b>		
Net premiums earned	\$ -	\$ -
Net investment income	73	50
Net realized investment gains	107	3
Other income	-	-
	180	53
<b>BENEFITS AND EXPENSES</b>		
Policyholder benefits paid or provided	-	-
Amortization of deferred policy acquisition costs	-	-
Commissions	-	-
General and administrative expenses	2,303	1,078
Insurance taxes, licenses and fees	-	-

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Interest expense	1,091	1,077
	3,394	2,155
Loss Before Income		
Taxes	(3,214)	(2,102)
INCOME TAX		
BENEFIT		
Current	(818 )	(338 )
Deferred	(281 )	(373 )
	(1,099)	(711 )
NET LOSS	\$ (2,115)	\$ (1,391)

The non-insurance operations of the Company consist of our parent company, The National Security Group, Inc. The National Security Group has no material sources of revenue and relies almost entirely on dividends from subsidiaries to pay expenses. Dividends from subsidiaries are subject to insurance department approval and are subject to statutory restrictions. Dividends are eliminated upon consolidation of the subsidiaries in the audited financials included herein. The expenses of the group consist of expenses associated with the public listing of our stock, taxes and fees, and directors' fees. The single most significant recurring expense of the group is interest expense associated with \$12,372,000 in debt. This debt is composed of two trust preferred securities offerings, the first being \$9,279,000 issued in the December 2005 and the second being \$3,093,000 issued in June 2007. The primary use for these proceeds was to add capital to the property and casualty subsidiaries following the hurricanes of 2004 and 2005. Total interest expense for the Group associated with these borrowings in 2010 was \$1,091,000 compared to \$1,077,000 in 2009. Defense cost related to matters disclosed in note 16 of the consolidated financial statements, was the most significant factor impacting the increase in general expenses.

## Investments:

The life insurance and property/casualty subsidiaries primarily invest in highly liquid investment grade debt and equity securities. At December 31, 2010, the company's holdings in debt securities amounted to 76.1% of total investments and 60.9% of total assets. The following is a breakdown of the bond portfolio quality according to the nationally recognized rating organization equivalents of Standard and Poor's:

Bond Portfolio Ratings	
S&P or Equivalent Ratings	% of Total Bond Portfolio
AAA	44.77%
AA+	10.94%
AA	4.21%
AA-	7.30%
A+	3.49%
A	7.02%
A-	4.77%
BBB+	3.62%
BBB	4.21%
BBB-	5.81%
Below Investment Grade	3.86%

A summary of debt and equity securities available-for-sale with unrealized losses as of December 31, 2010 along with related fair value, aggregated by length of time that the investments have been in a continuous unrealized loss position follows:

	(Dollars in thousands)						December 31, 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 debt securities	\$4,504	\$112	\$250	\$7	\$4,754	\$119	11	
Mortgage backed securities	1,909	104	-	-	1,909	104	8	

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Private label mortgage backed securities	2,463	46	3,591	361	6,054	407	12
Obligations of state and political subdivisions	8,216	612	1,304	127	9,520	739	34
U.S. Treasury securities and obligations of U.S. government corporations and agencies	4,020	172	-	-	4,020	172	9
Equity securities	264	10	903	435	1,167	445	3
	\$21,376	\$1,056	\$6,048	\$930	\$27,424	\$1,986	77

## Other than temporary impairments and credit quality

At December 31, 2010, 3.98% of total investments in the fixed income portfolio were classified as below investment grade. Management has evaluated each security in a significant unrealized loss position. No OTTI were recorded for the year ended December 31, 2010. For the year ended December 31, 2009, \$443,000 in OTTI was recorded by the Company. Of the securities in loss positions, management believes based on current information, that no ultimate loss will be realized on the securities. Most unrealized losses in the fixed income portfolio are interest rate and market driven as opposed to credit quality driven. The Company has no material direct exposure to sub-prime mortgage loans. With respect to equity securities in a loss position, management evaluated financial information on each company and reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the remaining securities in an accumulated loss position in the portfolio were temporary impairments.

The amortized cost and aggregate fair value of debt securities at December 31, 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	Fair
Available-for-sale securities:	Cost	Value
Due in one year or less	\$ 1,020	\$ 1,027
Due after one year through five years	10,790	11,727
Due after five years through ten years	28,122	29,353
Due after ten years	37,187	36,361
	Total \$ 77,119	\$ 78,468
Held-to-maturity securities:		
Due in one year or less	\$ 500	\$ 504
Due after one year through five years	300	308
Due after five years through ten years	1,738	1,827
Due after ten years	2,421	2,505
	Total \$ 4,959	\$ 5,144



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The amortized cost and aggregate fair values of investments in securities at December 31, 2010 and December 31, 2009 are as follows:

(Dollars in thousands)				
December 31, 2010				
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
Available-for-sale securities:				
Corporate debt securities	\$ 22,405	\$ 1,666	\$ 119	\$ 23,952
Mortgage backed securities	7,053	326	104	7,275
Private label mortgage backed securities	13,313	200	407	13,106
Obligations of states and political subdivisions	18,902	252	739	18,415
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	15,446	446	172	15,720
Total fixed maturities	77,119	2,890	1,541	78,468
Equity securities	5,478	4,014	445	9,047
Total	\$ 82,597	\$ 6,904	\$ 1,986	\$ 87,515
Held-to-maturity securities:				
Mortgage backed securities	\$ 2,669	\$ 126	\$ 1	\$ 2,794
Private label mortgage backed securities	118	4	-	122
Obligations of states and political subdivisions	1,837	48	12	1,873
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	335	20	-	355
Total	\$ 4,959	\$ 198	\$ 13	\$ 5,144

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

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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

## Mortgage backed security investments

The insurance subsidiaries' fixed maturity securities include residential mortgage-backed securities (RMBS) of \$23.2 million and \$21.2 million at amortized value at December 31, 2010 and 2009 respectively. We own no commercial mortgage backed securities. We also have no material direct exposure in sub-prime mortgage loans in our private label RMBS portfolio.

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

As for the composition of the RMBS portfolio, agency mortgage backed securities compose 42% and 52% of the RMBS portfolio at December 31, 2010 and 2009, respectively. The remainder of the RMBS portfolio is composed of private label mortgage backed securities. These securities consist primarily of conventional 15 and 30 year loans with an average borrower FICO score of 740. We own no mortgage backed securities with direct exposure to subprime loans and less than 1% of the RMBS portfolio is composed of loans subject to rate resets. Three securities in the private label mortgage backed security portfolio are rated below investment grade and compose less than 2% of total invested assets.

## Investment portfolio income

Investment returns with respect to the investment portfolio for the years ended December 31, 2010 and 2009 follows:

	Year Ended December	
	31,	
	2010	2009
Net investment income	\$ 5,089	\$ 5,289
Average current yield on investments	4.8 %	5.5 %
Total return on investments	7.8 %	11.5 %
Net realized gains on investments (before taxes)	\$ 1,879	\$ 357
Change in accumulated net unrealized gains (before income taxes)	\$ 1,261	\$ 5,339

The decrease in current yield on investments is primarily due to a decrease in average yields on new investments in corporate bonds in 2010 compared to 2009 coupled with a higher allocation of tax free investments. Tax free investments typically yield less than comparable taxable securities but result in lowering the overall effective tax rate of the company.

The total return on investments consists of return of current interest and dividend payments (current yield components) plus realized and unrealized appreciation or depreciation in asset market values. Due to a second consecutive year of improving market values on fixed income investments coupled with a capital gain return of 12.6% on the equity portfolio, we had a 7.8% total return on investments. The total return consisted of a 4.8% return from current interest and dividend payments and a 3.0% total return from increases in market values of securities. The total return in 2010 was down compared to the 11.5% total return experienced in 2009 primarily due to an overall more stable market in 2010. The results for 2009 were significantly impacted by improvements in the corporate and mortgage backed security market from the meltdown experienced in 2008.

## Repurchase Agreements

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

## Liquidity and Capital Resources

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

The liquidity requirements for the Company are primarily met by funds generated from operations of the life insurance and property/casualty insurance subsidiaries. Premium and investment income as well as maturities and sales of invested assets provide the primary sources of cash for both the life and property/casualty businesses, while applications of cash are applied by both businesses to the payment of policy benefits, the cost of acquiring new business (principally commissions), operating expenses, purchases of new investments, and in the case of life insurance, policy loans.

As of December 31, 2010, the maturity schedule for all bonds and notes held by the Company, stated at amortized cost, was as follows:

(Amounts in thousands)

Maturity	Available-for-sale	Held-to-Maturity	Total	Percentage of Total
Maturity in less than 1 year	\$ 1,020	\$ 500	\$ 1,520	1.9 %
Maturity in 1-5 years	10,790	300	11,090	13.5 %
Maturity in 5-10 years	28,122	1,738	29,860	36.4 %
Maturity after 10 years	37,187	2,421	39,608	48.2 %
	\$ 77,119	\$ 4,959	\$ 82,078	100.0 %

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

The National Security Group's consolidated statement of cash flows indicates that cash flow provided from operating activities was \$2,793,000 in 2010 compared to \$8,723,000 in 2009. Cash flows from operating activities were negatively impacted by declines in underwriting performance for both the P&C and Life subsidiaries. Specifically, losses from the homeowners and auto lines of business were the most significant factors contributing to the decline in

underwriting performance. During 2009, net cash provided by operating activities was positively impacted by recoveries of reinsurance receivables arising from losses stemming from Hurricanes Gustav and Ike which occurred during 2008. An improvement in underwriting results in our property and casualty insurance operations in 2009, largely related to no hurricane activity, was the primary source of operating cash flow in 2009. In a typical year, cash flow from operating activities and cash flow from investing activities tend to have an inverse relationship. In 2010, a decline in underwriting profits decreased cash from operations resulting in a reduction in the cash available to invest, \$4,931,000 in 2010 compared to \$5,587,000 in 2009. In 2009, improved underwriting results in the property and casualty subsidiaries increased cash from operations. This increased cash from operations was then used to increase investments leading to a net increase in cash used in investing activities.

The consolidated statement of cash flows also reflects a decrease in cash used in financing activities of \$(976,000) and \$(1,477,000), respectively. Cash flows from financing activities in 2010 reflect cash provided of \$500,000 from a short-term line of credit and shareholder dividends paid of \$1,480,000.

The following table reflects the anticipated cash flows associated with our short- and long-term contractual obligations as of December 31, 2010:

Contractual Obligations and Commitments					
Contractual Obligations	Total	Payments due by period			
		(\$ in thousands)			
		Less than 1 year	1-3 years	4-5 years	More than 5 years
Notes payable <sup>1</sup>	\$500	\$500	\$-	\$-	\$-
Debt obligations <sup>1</sup>	\$12,372	\$-	\$-	\$-	\$12,372
Interest on debt obligations <sup>1</sup>	\$16,913	\$1,077	\$3,109	\$2,010	\$10,717
Property and casualty claim reserves <sup>2</sup>	\$13,184	\$8,040	\$4,218	\$659	\$267
Future life insurance obligations <sup>3</sup>	\$88,436	\$4,490	\$8,007	\$7,261	\$68,678

<sup>1</sup> Long-term debt, consisting of two separate issues of trust preferred securities, is assumed to be settled at contractual maturity. Interest on long-term debt is calculated using the interest rates in effect at December 31, 2010 for each issue. Interest on long-term debt is accrued and settled quarterly. Therefore, the timing and amount of interest payments may vary from the calculated value included in the table above. These calculations do not take into account any potential prepayments. For additional information regarding long-term debt and interest on long-term debt, please see Note 9, Notes Payable and Long-term Debt, in the notes to consolidated financial statements.

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

<sup>3</sup> Future life insurance obligations consist primarily of estimated future contingent benefit payments and surrender benefits on policies in force at December 31, 2010. These estimated payments are computed using assumptions for future mortality, morbidity and persistency. In contrast to this table, the majority of NSIC's obligations is recorded on the balance sheet at the current account values and do not incorporate an expectation of future market growth, interest crediting or future deposits. Therefore, the estimated future life insurance obligations presented in this table significantly exceed the liabilities recorded in the Company's consolidated balance sheet. Due to the significance of the assumptions used, the actual amount and timing of such payments may differ significantly from the estimated amounts. Management believes that current assets, future premiums and investment income will be sufficient to fund all future life insurance obligations.

Included in long-term debt held by the Company is the issuance of \$9,279,000 in subordinated debentures completed on December 15, 2005. The proceeds from the debentures were used to make a \$6,000,000 capital infusion in the P&C subsidiary National Security Fire and Casualty with the remainder to be held for general corporate purposes. The subordinated debentures mature December 15, 2035. It is anticipated that principal payments will not be made until the expiration of the fixed rate period on the debt in 2015. Also included in long-term debt is the issuance of \$3,093,000 in subordinated debentures completed June 21, 2007. The proceeds from the debentures were used to fund general corporate expenses thereby reducing the amount of dividends to the Group paid by the P&C subsidiary National Security Fire & Casualty in 2007 and 2008 thereby continuing to restore capital in the P&C subsidiary National Security Fire and Casualty to pre-hurricane levels. The second issue matures June 15, 2037 and may be redeemed following the fifth anniversary of issuance.

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

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

As disclosed in Note 16 to the consolidated financial statements regarding contingencies, the Company is involved in litigation related to the sale of Mobile Attic, Inc. As is customarily discussed in the Management Discussion and Analysis, the Company's liquidity requirements are primarily met by funds provided from operations of the insurance subsidiaries. The Company maintains minimal liquidity in order to maximize liquidity within the insurance subsidiaries in order to support ongoing insurance operations. The Company has no separate source of revenue other than dividends and fees from the insurance subsidiaries. Also, dividends from the insurance subsidiaries are subject to regulatory restrictions and, therefore, are limited depending on capital levels and earnings of the subsidiaries. In the event of a substantial adverse judgment related to the litigation against the Company, we could face limitations in our ability to fund shareholder dividends and service interest payments on outstanding debt.

The uncertainty related to the pending litigation could also temporarily impair our ability to raise new debt or equity capital until this matter is resolved. The Company is vigorously defending the allegations raised in this litigation and is unable to determine a potential liability at this time which limits our ability to predict the ultimate impact on our liquidity and capital resources.

The Company filed a claim for coverage under a liability policy having aggregate limits of \$5,000,000, but the insurer has denied coverage and no provision for any recovery has been made in the accompanying condensed consolidated financial statements.

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. 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.

Except as discussed above and in Note 16 to the consolidated financial statements, the Company is aware of no known trends, events, or uncertainties reasonably likely to have a material effect on its liquidity, capital resources, or operations. Additionally, the Company has not been made aware of any recommendations of regulatory authorities, which if implemented, would have such an effect.

As disclosed in Note 13 to the consolidated financial statements, in 2010, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company is limited to \$1,002,000 in the life insurance subsidiary and \$5,394,000 in the property/casualty insurance subsidiary.

An operating line of credit was obtained by the holding company in December of 2009 to allow flexibility with respect to cash management at the holding company level. The outstanding balance at December 31, 2010 was \$500,000.

Off-Balance Sheet Arrangements

The Company has no material off balance sheet arrangements.

### Statutory Risk-Based Capital of Insurance Subsidiaries

The NAIC has adopted Risk-Based Capital (RBC) requirements for life/health and property/casualty insurance companies to evaluate the adequacy of statutory capital and surplus in relation to investment and insurance risks such as asset quality, mortality and morbidity, asset and liability matching, benefit and loss reserve adequacy, and other business factors. State insurance regulators will use the RBC formula as an early warning tool to identify, for the purpose of initiating regulatory action, insurance companies that potentially are inadequately capitalized. In addition, the formula defines minimum capital standards that will supplement the current system of low fixed minimum capital and surplus requirements on a state-by-state basis. Regulatory compliance is determined by a ratio of the company's regulatory total adjusted capital, as defined by the NAIC, to its authorized control level RBC, as defined by the NAIC. Companies below specific trigger points or ratios are classified within levels, each of which requires corrective action.

The levels and ratios are as follows:

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

The ratios of Total Adjusted Capital to Authorized Control Level RBC for The National Security Group's life/health and property/casualty insurance subsidiaries are all in excess of 4.0 to 1 at December 31, 2010.

National Security Insurance Company (life insurer) has regulatory adjusted capital of \$11.0 million and \$9.6 million at December 31, 2010 and 2009, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 12.4 and 12.2 at December 31, 2010 and 2009, respectively. Accordingly, National Security Insurance Company exceeds the minimum RBC requirements.

National Security Fire & Casualty Company (property/casualty insurer) has regulatory adjusted capital of \$30.5 million and \$28.7 million at December 31, 2010 and 2009, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 5.1 and 4.6 at December 31, 2010 and 2009, respectively. Accordingly, National Security Fire & Casualty Company exceeds the minimum RBC requirements.

Omega One Insurance Company (property/casualty insurer), which began writing business in late 1995, has regulatory adjusted capital of \$9.0 million and \$9.6 million at December 31, 2010 and 2009, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 12.8 and 23.0 at December 31, 2010 and 2009, respectively. Accordingly, Omega One Insurance Company exceeds the minimum RBC requirements.

### Application of Critical Accounting Policies

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

results of operations.

§ Reinsurance

§ Deferred Policy Acquisition Costs

§ Income Taxes

§ Fair Values of Financial Instruments

§ Claim Liabilities

§ Recognition of Revenue

§ Contingencies

§ Recently Issued Accounting Standards

## Reinsurance

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

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

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

NSFC and Omega generally reinsure with third parties any liability in excess of \$225,000 on any single policy. In addition, the property and casualty segment holds a catastrophe contract which covers losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeds the \$3.5 million retention stated in the contract, reinsurers will reimburse the company 95% (5% co-pay) of gross losses and loss adjustment expenses paid up to \$ 17.5 million (layer one and layer two of the contract). If losses exceed \$ 17.5 million, the contract allows for 100% reimbursement of losses and loss adjustment expenses up to \$72.5 million. Any losses above the \$72.5 million upper limit are the responsibility of our company. The contract in place during 2010 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed. The contract provided protection up to at least a 100 year "near term" event as depicted in catastrophe modeling results. The "near term" catastrophe modeling results reflect a predicted increase in storm activity given the current weather pattern and various factors projected to impact our weather patterns in the near term.

At December 31, 2010, the estimated reinsurance recoverable recorded was \$1,699,000 compared to \$784,000 for the same period last year. The Company does not anticipate any issues with collection of the recorded amount. In 2010, catastrophe reinsurance premiums totaled \$5,876,000 ceded compared to \$6,193,000 in 2009. Catastrophe reinsurance premiums are based on a premium calculation applying the agreed upon rate to the earned premium of the covered lines of business. The reduction in ceded premium in 2010 is attributable to a 3.2% decline in the premium base and a 1.9% decline in the rate applied.

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

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

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



### Deferred Policy Acquisition Costs

Deferred policy acquisition costs (DAC) are those costs incurred in connection with acquiring new business or renewing existing business. DAC is primarily comprised of commissions, premium taxes, and underwriting costs associated with issuing new policies. In accordance with generally accepted accounting principles, these costs are not expensed in their entirety at policy inception, rather they are recorded as an asset and amortized over the lives of the policies.

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

At December 31, 2010 and 2009, the Company recorded \$10,189,000 and \$10,210,000, respectively, as an asset for DAC in the financial statements. We do not foresee any issues related to recoverability of these capitalized costs. For more information regarding deferred policy acquisition costs, please see Note 1 to our financial statements.

### Income Taxes

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

At December 31, 2010, there is no evidence to suggest to management that any deferred tax asset is unrealizable. For more information regarding deferred income taxes, please see Note 8 to our financial statements.

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

### Fair Values of Financial Instruments

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



### Claim Liabilities

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

At December 31, 2010 and 2009, the recorded liability for loss and loss and adjustment expense was \$13,184,000 and \$12,646,000, respectively, a \$538,000 increase. Claim activity from fire related losses in the dwelling fire and homeowners lines of business during 2010 combined with increased automobile claims were the primary factors contributing to the increase. We believe the estimate of unpaid losses and loss adjustment expenses to be sufficient based on currently available information and a review of our historical reserving practices. For more information regarding loss and loss adjustment expense, see Note 10 to our financial statements.

### Recognition of Revenue

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

### Contingencies

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

### Recently Issued Accounting Standards

#### Fair Value Measurements

Effective for 2010, 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 related to purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements which are effective for 2011; adoption of this accounting standard had no effect on our results of operations or financial position.

#### Subsequent Events

In February 2010 the FASB issued amended guidance on disclosure of subsequent events that was effective immediately. The guidance eliminates the requirement for an SEC filer to disclose the date through which it has evaluated subsequent events. Adoption of this accounting standard had no effect on our results of operations or financial position.

#### Consolidation of Variable Interest Entities

Effective for 2010, 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. Adoption of this accounting standard had no effect on our results of operations or financial position.

#### Transfers and Servicing-Accounting for Transfers of Financial Assets

Effective for 2010, 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 do not expect the adoption of this guidance to have any impact on our results of operations or financial position.

#### Accounting Changes Not Yet Adopted

##### Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses

During 2010 the FASB issued new guidance, effective for 2011, that requires entities to disclose detailed information regarding the credit quality of financing receivables, including credit risk exposures and the allowance for credit losses. We do not expect the adoption of this guidance to have any impact on our results of operations or financial position.

#### Business Combinations

Effective prospectively for business combinations for which the acquisition date is on or after January 1, 2011, the FASB issued guidance related to pro forma disclosure information for business combinations. The guidance clarifies that the required pro forma revenue and earnings disclosures should be prepared as if the business combination had occurred at the beginning of the prior annual reporting period. The guidance also expands supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments included in the reported pro forma revenue and earnings. We do not expect the adoption of this guidance to have any impact on our results of operations or financial position.

#### Intangibles-Goodwill and Other

Effective for 2011, the FASB revised guidance related to goodwill impairment testing. The revised guidance clarifies that when evaluating goodwill associated with a reporting unit that has a zero or negative carrying value, an initial determination should be made as to whether it is more likely than not that the goodwill is impaired. When impairment is more likely than not, the goodwill is required to be tested for impairment. We do not expect the adoption of this guidance to have any impact on our results of operations or financial position.

#### Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

Effective for fiscal years beginning after December 15, 2011, the FASB revised guidance regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The guidance permits deferral of qualifying costs associated only with successful contract acquisitions. The portion of internal selling agent and underwriter salary and benefit costs allocated to unsuccessful contracts, as well as advertising costs, are excluded. The guidance should be applied prospectively, but may be applied retrospectively for all prior periods. We do not expect the adoption of this guidance to have a material effect on our results of operations or financial position.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Under smaller reporting company rules we are not required to disclose information required under Item 7A. However, in order to provide information to our investors, we have elected to provide information related to market risk.

The Company's primary objectives in managing its investment portfolio are to maximize investment income and total investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including changes in interest rates, overall market conditions, underwriting results, regulatory requirements and tax position. Investment decisions are made by management and reviewed by the Board of Directors. Market risk represents the potential for loss due to adverse changes in fair value of securities. The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk and default risk. The primary risk related to the Company's equity portfolio is equity price risk.

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

The Company is exposed to equity price risk on its equity securities. The Company holds common stock with a fair value of \$9 million. Our portfolio has historically been highly correlated to the S&P 500 with regard to market risk. Based on an evaluation of the historical risk measure of our portfolio relative to the S&P 500, if the market value of the S & P 500 Index decreased 10% from its December 31, 2010 value, the fair value of the Company's common stock would decrease by approximately \$900,000.

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

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

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

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



Item 8. Financial Statements and Supplementary Data

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

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of The National Security Group, Inc. as of December 31, 2010 and 2009, and the related consolidated statements of operations, shareholders' equity and cash flows for the years then ended. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The National Security Group, Inc. as of December 31, 2010 and 2009, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the financial statement schedules listed in the accompanying index appearing under Item 8, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

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

Birmingham, Alabama  
March 31, 2011



## The National Security Group, Inc.

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)		
December 31,		
ASSETS	2010	2009
<b>Investments</b>		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2010 - \$5,144;		
2009 - 6,080)	\$ 4,959	\$ 5,942
Fixed maturities available-for-sale, at estimated fair value (cost: 2010 - \$77,119;		
2009- 69,796)	78,468	70,269
Equity securities available-for-sale, at estimated fair value (cost: 2010 - \$5,478		
2009 - 5,851	9,047	9,035
Trading securities	705	374
Receivable for securities	-	96
Mortgage loans on real estate, net	935	1,041
Investment real estate, at book value	5,010	4,815
Policy loans	1,123	1,018
Company owned life insurance	5,520	5,197
Other invested assets	3,915	3,933
<b>Total Investments</b>	<b>109,682</b>	<b>101,720</b>
Cash	1,572	4,686
Accrued investment income	823	802
Policy receivables and agents' balances, net	9,531	9,700
Reinsurance recoverable	1,699	784
Deferred policy acquisition costs	10,189	10,210
Property and equipment, net	2,437	2,537
Other assets	934	957
<b>Total Assets</b>	<b>\$ 136,867</b>	<b>\$ 131,396</b>

See accompanying notes to consolidated financial statements which are an integral part of the financial statements.



## The National Security Group, Inc.

## CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

December 31,

LIABILITIES AND SHAREHOLDERS' EQUITY	2010	2009
Property and casualty benefit and loss reserves	\$ 13,184	\$ 12,646
Accident and health benefit and loss reserves	1,881	1,612
Life and annuity benefit and loss reserves	28,897	28,579
Unearned premiums	26,433	27,381
Policy and contract claims	611	535
Other policyholder funds	1,351	1,347
Short-term notes payable	500	-
Long-term debt	12,372	12,372
Accrued income taxes	127	111
Deferred income tax liability	1,043	61
Other liabilities	6,758	5,584
<b>Total Liabilities</b>	<b>93,157</b>	<b>90,228</b>
Contingencies	-	-
<b>Shareholders' Equity</b>		
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 shares authorized, 2,466,600 shares issued and outstanding	2,467	2,467
Additional paid-in capital	4,951	4,951
Accumulated other comprehensive income	3,022	2,265
Retained earnings	33,270	31,485
<b>Total Shareholders' Equity</b>	<b>43,710</b>	<b>41,168</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 136,867</b>	<b>\$ 131,396</b>

See accompanying notes to consolidated financial statements which are an integral part of the financial statements.

## The National Security Group, Inc.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in thousands  
except per share amounts)  
Year Ended December 31,

	2010	2009
<b>REVENUES</b>		
Net premiums earned	\$ 61,263	\$ 59,594
Net investment income	5,089	5,289
Net realized investment gains	1,879	357
Other income	1,161	764
	69,392	66,004
<b>BENEFITS AND EXPENSES</b>		
Policyholder benefits paid or provided	39,031	35,839
Amortization of deferred policy acquisition costs	3,944	3,673
Commissions	7,871	7,863
General and administrative expenses	10,672	10,396
Taxes, licenses and fees	2,081	1,631
Interest expense	1,156	1,126
	64,755	60,528
Income Before Income Tax Expense	4,637	5,476
<b>INCOME TAX EXPENSE</b>		
Current	666	1,136
Deferred	706	116
	1,372	1,252
Net Income	\$ 3,265	\$ 4,224
Net Earnings Per Common Share	\$ 1.32	\$ 1.71

See accompanying notes to consolidated financial statements which are an integral part of the financial statements.

## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(Dollars in thousands)

		Comprehensive	Retained	Accumulated	Common	Paid-in
	Total	Income (Loss)	Earnings	Other	Stock	Capital
				Comprehensive		
				Income (Loss)		
Balance at December 31, 2008	\$34,648	\$ -	\$ 28,741	\$(1,511)	\$2,467	\$ 4,951
Comprehensive income:						
Net income for 2009	4,224	4,224	4,224	-	-	-
Other comprehensive income, net of tax						
Unrealized gain on securities, net of reclassification adjustment of \$282	3,337	3,337	-	3,337	-	-
Unrealized gains relating to OTTI for which a portion has been recognized in earnings	183	183		183		
Unrealized gain on interest rate swap	256	256	-	256	-	-
Comprehensive income		8,000				
Cash dividends (\$0.60 per share)	(1,480)		(1,480)	-	-	-
Balance at December 31, 2009	41,168		31,485	2,265	2,467	4,951
Comprehensive income:						
Net income for 2010	3,265	3,265	3,265	-	-	-
Other comprehensive income, net of tax						
Unrealized gain on securities, net of reclassification adjustment of \$1,240	834	834		834		
Unrealized gains relating to OTTI for						

which a portion has  
been recognized in  
earnings

	13	13	-	13	-	-
Unrealized loss on interest rate swap	(90)	(90)	-	(90)	-	-
Comprehensive income		4,022				
Cash dividends (\$0.60 per share)	(1,480)		(1,480)	-	-	-
Balance at December 31, 2010	\$43,710		\$ 33,270	\$3,022	\$2,467	\$ 4,951

See accompanying notes to consolidated financial statements which are an integral part of the financial statements.



## Proceeds from sale or maturities of:

Held-to-maturity securities	1,059	4,926
Available-for-sale securities	33,475	22,830
Trading securities and short-term investments	21	20
Real estate held for investment	3	19
Other invested assets	18	732
Other	(84 )	( 589 )
Net cash used in investing activities	( 4,931 )	( 5,587 )
Cash flows from financing activities:		
Proceeds from short-term debt	500	-
Change in other policyholder funds	4	3
Dividends paid	( 1,480 )	( 1,480 )
Net cash used in financing activities	( 976 )	( 1,477 )
Net (decrease) increase in cash	( 3,114 )	1,659
Cash at beginning of year	4,686	3,027
Cash at end of year	\$ 1,572	\$ 4,686

See accompanying notes to consolidated financial statements which are an integral part of the financial statements.

## NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

### Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary - Omega One Insurance Company (Omega). The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). All significant intercompany transactions and accounts have been eliminated.

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

### Description of Business

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

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

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

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

### Use of Estimates

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

### Concentration of Risk

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

The Company's life, accident and health insurance segment, composing nearly 14% of consolidated revenues, is licensed in six states. However, over 75% of segment revenue is generated in the states of Alabama and Georgia. Consequently, changes in the legal, regulatory or economic environment could adversely impact the Company.

For the year ended December 31, 2010, one agency individually produced greater than 5% of the Company's direct written premium.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Investments

The Company's securities are classified as follows:

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

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

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

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

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

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

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

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

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

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Mortgage loans and policy loans are stated at the unpaid principal balance of such loans, net of any related allowance for uncollectible amounts.

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

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

The Company owns 21 life insurance contracts on certain management and supervisory employees each having a face amount of approximately \$2,000,000. The Company's original investment in company owned life insurance was \$5,000,000. The primary purpose of the program is to offset future employee benefit expenses through earnings on the cash value of the policies. The Company is the owner and principal beneficiary of these policies. The life insurance contracts are carried at their current cash surrender value. Cash surrender value at December 31, 2010 and 2009 was \$5,520,000 and \$5,197,000, respectively. Changes in cash surrender values are included in income in the current period. The change in surrender value included in earnings for the periods ended December 31, 2010 and 2009 was \$323,000 and \$740,000, respectively. Death proceeds from the contracts are recorded when the proceeds become payable under the terms of the policy. There were no proceeds received from the COLI during 2010 or 2009.

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

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

Fair Values of Financial Instruments

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

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

Equity security fair values are based on quoted market prices.

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

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

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

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

Policy Receivables

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

Accounts Receivable

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

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Property and Equipment

Property and equipment is carried at cost less accumulated depreciation and includes expenditures that substantially increase the useful lives of existing property and equipment. Significant costs incurred for internally developed software

are capitalized and amortized over estimated useful lives of 3 years. Maintenance, repairs, and minor renovations are charged to expense as incurred. Upon sale or retirement of property and equipment, the costs and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations. The Company provides for depreciation of property and equipment using the straight-line method designed to amortize costs over estimated useful lives. Estimated useful lives range up to 40 years for buildings and from 3-8 years for electronic data processing equipment and furniture and fixtures. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Statement of Cash Flows

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

Premium Revenue

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

Deferred Policy Acquisition Costs

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

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

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

Policy Liabilities

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

Years of Issue	Interest Rate
1947 - 1968	4%
1969 - 1978	6% graded to 5%
1979 - 2003	7% graded to 6%
2004 - 2010	5.25%

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

#### Claim Liabilities

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

## NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

## Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,466,600 in both 2010 and 2009.

## Reinsurance

In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. In 2010, NSFC maintained a catastrophe reinsurance agreement to cover losses from catastrophic events, primarily hurricanes.

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:

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

All significant reinsurers under the program carry A.M. Best ratings of A- (Excellent) or higher.

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

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

## Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Deferred income taxes arise from the recognition of temporary differences between financial statement carrying amounts and the tax bases of the Company's assets and liabilities and operating loss carry-forwards. Deferred tax assets and liabilities are measured

using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A valuation allowance is provided when it is more likely than not that some portion of the deferred tax asset will not be realized. The effect of a change in tax rates is recognized in the period the new rate is enacted.

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

#### Contingencies

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

#### Reclassifications

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

#### Advertising

The Company expenses advertising costs as incurred. Advertising costs charged to expense were \$113,000 for the year ended December 31, 2010 (\$109,000 for the year ended December 31, 2009). Advertising cost consists primarily of agent convention expense and print media.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Concentration of Credit Risk

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

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit losses, are composed of balances due from independent agents. At December 31, 2010 the single largest balance due from one agent totaled \$479,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At December 31, 2010 and 2009, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At December 31, 2010, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Recently Issued Accounting Standards

Fair Value Measurements

Effective for 2010, 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 related to purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements which are effective for 2011; adoption of this accounting standard had no effect on our results of operations or financial position.

Subsequent Events

In February 2010 the FASB issued amended guidance on disclosure of subsequent events that was effective immediately. The guidance eliminates the requirement for an SEC filer to disclose the date through which it has evaluated subsequent events. Adoption of this accounting standard had no effect on our results of operations or financial position.

Consolidation of Variable Interest Entities

Effective for 2010, 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. Adoption of this accounting standard had no effect on our results of operations or financial position.

Transfers and Servicing-Accounting for Transfers of Financial Assets

Effective for 2010, 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. Adoption of this accounting standard had no effect on our results of operations or financial position.

Accounting Changes Not Yet Adopted

Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses

During 2010 the FASB issued new guidance, effective for 2011, that requires entities to disclose detailed information regarding the credit quality of financing receivables, including credit risk exposures and the allowance for credit losses. do not expect the adoption of this guidance to have any impact on our results of operations or financial position.

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES – CONTINUED

Business Combinations

Effective prospectively for business combinations for which the acquisition date is on or after January 1, 2011, the FASB issued guidance related to pro forma disclosure information for business combinations. The guidance clarifies that the required pro forma revenue and earnings disclosures should be prepared as if the business combination had occurred at the beginning of the prior annual reporting period. The guidance also expands supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments included in the reported pro forma revenue and earnings. We do not expect the adoption of this guidance to have any impact on our results of operations or financial position.

Intangibles-Goodwill and Other

Effective for 2011, the FASB revised guidance related to goodwill impairment testing. The revised guidance clarifies that when evaluating goodwill associated with a reporting unit that has a zero or negative carrying value, an initial determination should be made as to whether it is more likely than not that the goodwill is impaired. When impairment is more likely than not, the goodwill is required to be tested for impairment. We do not expect the adoption of this guidance to have any impact on our results of operations or financial position.

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

Effective for fiscal years beginning after December 15, 2011, the FASB revised guidance regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The guidance permits deferral of qualifying costs associated only with successful contract acquisitions. The portion of internal selling agent and underwriter salary and benefit costs allocated to unsuccessful contracts, as well as advertising costs, are excluded. The guidance should be applied prospectively, but may be applied retrospectively for all prior periods. We do not expect the adoption of this guidance to have a material effect on our results of operations or financial position.

NOTE 2 – VARIABLE INTEREST ENTITIES

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

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, \$9,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$9,279,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 9, are reported in the accompanying Consolidated Balance Sheets as a component of long-term debt. The Company's equity investments in the Trust total \$279,000 and are included in Other Assets in the accompanying consolidated balance sheets.

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, \$3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$3,093,000 unsecured junior subordinated deferrable interest debentures. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$2,995,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the Trust. The Subordinated Debentures, disclosed in Note 9, are reported in the accompanying Consolidated Balance Sheets as a component of long-term debt. The Company's equity investments in the Trust total \$93,000 and are included in Other Assets in the accompanying consolidated balance sheets.

## NOTE 3 – STATUTORY ACCOUNTING PRACTICES

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

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

	2010	2009
NSIC - including realized capital gains of \$333 and \$234, respectively	\$ 819	\$ 1,314
NSFC - including realized capital gains of \$1,294 and \$198, respectively	\$ 5,394	\$ 4,179
Omega - including realized capital gains (losses) of \$58 and \$(78), respectively	\$ (582 )	\$ 246
Statutory risk-based adjusted capital:		
NSIC - including AVR of \$954 and \$517, respectively	\$ 10,973	\$ 9,642
NSFC - including investment in Omega of \$5,467	\$ 30,521	\$ 28,742
Omega	\$ 8,965	\$ 9,568

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

## NOTE 4 – INVESTMENT SECURITIES

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

(Dollars in thousands)				
December 31, 2010				
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
Available-for-sale securities:				
Corporate debt securities	\$ 22,405	\$ 1,666	\$ 119	\$ 23,952
Mortgage backed securities	7,053	326	104	7,275
Private label mortgage backed securities	13,313	200	407	13,106
Obligations of states and political subdivisions	18,902	252	739	18,415
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	15,446	446	172	15,720
Total fixed maturities	77,119	2,890	1,541	78,468
Equity securities	5,478	4,014	445	9,047
Total	\$ 82,597	\$ 6,904	\$ 1,986	\$ 87,515
Held-to-maturity securities:				
Mortgage backed securities	\$ 2,669	\$ 126	\$ 1	\$ 2,794
Private label mortgage backed securities	118	4	-	122
Obligations of states and political subdivisions	1,837	48	12	1,873
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	335	20	-	355
Total	\$ 4,959	\$ 198	\$ 13	\$ 5,144
December 31, 2009				
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
Available-for-sale securities:				
Corporate debt securities	\$ 26,786	\$ 1,557	\$ 519	\$ 27,824
Mortgage backed securities	8,203	282	165	8,320

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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

## NOTE 4 – INVESTMENT SECURITIES – CONTINUED

The amortized cost and aggregate fair value of debt securities at December 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	Fair
Available-for-sale securities:	Cost	Value
Due in one year or less	\$ 1,020	\$ 1,027
Due after one year through five years	10,790	11,727
Due after five years through ten years	28,122	29,353
Due after ten years	37,187	36,361
Total \$	77,119	\$ 78,468
Held-to-maturity securities:		
Due in one year or less	\$ 500	\$ 504
Due after one year through five years	300	308
Due after five years through ten years	1,738	1,827
Due after ten years	2,421	2,505
Total \$	4,959	\$ 5,144

A summary of securities available-for-sale with unrealized losses as of December 31, 2010 and 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)						December 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 debt securities	\$ 4,504	\$ 112	\$ 250	\$ 7	\$ 4,754	\$ 119	11	
Mortgage backed securities	1,909	104	-	-	1,909	104	8	

Private label mortgage backed securities	2,463	46	3,591	361	6,054	407	12
Obligations of state and political subdivisions	8,216	612	1,304	127	9,520	739	34
U.S. Treasury securities and obligations of U.S. government corporations and agencies	4,020	172	-	-	4,020	172	9
Equity securities	264	10	903	435	1,167	445	3
	\$ 21,376	\$ 1,056	\$ 6,048	\$ 930	\$ 27,424	\$ 1,986	77

## NOTE 4 – INVESTMENT SECURITIES – CONTINUED

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

For 2010, gross gains of \$2,016,000 (\$1,102,000 for 2009) and gross losses of \$247,000 (\$319,000 for 2009) were realized on sales of available-for-sale-securities.

A summary of securities held-to-maturity with unrealized losses as of December 31, 2010 and 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:

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(Dollars in thousands)							December 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 debt securities	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	-	
Mortgage backed securities	331	1	-	-	331	1	1	
Private label mortgage backed securities	-	-	-	-	-	-	-	
Obligations of state and political subdivisions	161	12	-	-	161	12	1	
U.S. Treasury securities and obligations of U.S. government corporations and agencies	-	-	-	-	-	-	-	
	\$ 492	\$ 13	\$ -	\$ -	\$ 492	\$ 13	2	

(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	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	-	
	-	-	333	25	333	25	2	

Mortgage backed securities							
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

## NOTE 4 – INVESTMENT SECURITIES – CONTINUED

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

Management has evaluated each security in a significant unrealized loss position. For the year ended December 31, 2010, the Company realized no other than temporary impairments. The single largest accumulated loss was in the equity portfolio and totaled \$360,000. The second largest loss position was in the bond portfolio and totaled \$185,000. The third largest loss position was in the equity portfolio and totaled \$83,000. 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 4% of the fixed income investment portfolio is rated below investment grade. For the year ended December 31, 2009, the Company realized \$443,000 in other than temporary impairments. The single largest accumulated loss was in the equity portfolio and totaled \$337,000. The second largest loss position was in the bond portfolio and totaled \$332,000. The third largest loss position was in the equity portfolio and totaled \$163,000. Most unrealized losses in the fixed income portfolio are interest rate driven as opposed to credit quality driven and management believes no ultimate loss will be realized. The Company has no material exposure to sub-prime mortgage loans and less than 2% of the fixed income investment portfolio is rated below investment grade. In evaluating whether or not the equity loss positions were other-than-temporary impairments, management evaluated financial information on each company and reviewed analyst reports from at least two independent sources. Based on a review of the available financial information, the prospect for future earnings of each company and consideration of the Company's intent and ability to hold the securities until market values recovered, it was determined that the remaining securities in an accumulated loss position in the portfolio were temporary impairments.

## NOTE 5 – NET INVESTMENT INCOME

Major categories of investment income are summarized as follows:

	(Dollars in thousands)	
	Year ended December 31,	
	2010	2009
Fixed maturities	\$ 4,242	\$ 4,075
Equity securities	226	199
Mortgage loans on real estate	54	62
Investment real estate	65	82
Policy loans	79	73
Company owned life insurance	323	740
	288	346

Other, principally short-term investments	5,277	5,577
Less: Investment expenses	188	288
Net investment income	\$ 5,089	\$ 5,289

An analysis of investment gains (losses) follows:	Year ended December 31,	
	2010	2009

Net realized investment gains (losses):