

NATIONAL SECURITY GROUP INC  
Form 10-Q  
August 07, 2012  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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(Mark One)

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

For Quarterly Period Ended June 30, 2012

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-18649

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

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

63-1020300  
(IRS Employer  
Identification No.)

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

36323  
(Zip-Code)

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

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

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

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

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

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

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THE NATIONAL SECURITY GROUP, INC.

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Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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

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

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

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

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

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

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



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## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## THE NATIONAL SECURITY GROUP, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

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

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

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

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(In thousands, except per share amounts)

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

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





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## THE NATIONAL SECURITY GROUP, INC.

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

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

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

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## THE NATIONAL SECURITY GROUP, INC.

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

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

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

## THE NATIONAL SECURITY GROUP, INC.

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

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

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

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

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

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

Use of Estimates

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

Recently Adopted Accounting Standards

Presentation of Comprehensive Income

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

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts

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

#### Amendments to Fair Value Measurement and Disclosure Requirements

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

#### Accounting Changes Not Yet Adopted

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

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

#### NOTE 2 – REINSURANCE

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

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

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

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

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

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

#### NOTE 3 – CALCULATION OF EARNINGS PER SHARE

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

#### NOTE 4 – CHANGES IN SHAREHOLDERS' EQUITY

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

#### NOTE 5 – INVESTMENTS

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

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

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

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

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

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

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

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

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

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

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

A summary of securities available-for-sale with unrealized losses as of June 30, 2012, along with the related fair value, aggregated by the length of time that investments have been in a continuous unrealized loss position, is as follows:

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

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

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

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

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



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

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

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

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

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

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

#### NOTE 6 – INCOME TAXES

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

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

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

## NOTE 7 –NOTES PAYABLE AND LONG-TERM DEBT

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

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

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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

The Company has entered into various swap agreements related to the trust preferred securities. On March 19, 2009, the Company entered into a forward swap effective September 17, 2012, with a notional amount of \$3,000,000 and designated the swap as a hedge against changes in cash flows attributable to changes in the benchmark interest rate (LIBOR) associated with the subordinated debentures issued June 21, 2007. Commencing September 17, 2012, under the terms of the forward swap, the Company will receive interest at the three-month LIBOR rate plus 3.4% and pay interest at the fixed rate of 7.02%. This forward swap will effectively fix the interest rate on \$3,000,000 in debt until September of 2019.

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

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

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

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

9 for additional information about the interest rate swaps.

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

NOTE 8 – CONTINGENCIES

Litigation

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

The Company's property & casualty subsidiaries are defending a limited number of matters filed in the aftermath of Hurricanes Katrina and Rita in Mississippi, Louisiana and Alabama. These actions include individual lawsuits with allegations of underpayment of hurricane-related claims, including allegations that the flood exclusion found in the Company's subsidiaries' policies, and in certain actions other insurance companies' policies, is either ambiguous, unenforceable as unconscionable or contrary to public policy, or inapplicable to the damage sustained.

The various suits seek a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief. All of these matters are in various stages of development and the Company's subsidiaries intend to vigorously defend them. The outcome of these disputes is currently uncertain.

In April 2007, the Company sold substantially all of its 50% interest in Mobile Attic, Inc., to Bagley Family Revocable Trust (the "Purchaser"). The Company, Peter L. Cash and Russell L. Cash (collectively the "Sellers") sold to Purchaser 61% of the outstanding stock of Mobile Attic under the terms of a Stock Purchase Agreement dated April 5, 2007, executed by Sellers, Mobile Attic and Purchaser's assignor, James W. Bagley (the "Stock Purchase Agreement").

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

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

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

#### NOTE 9 – FAIR VALUE OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

| For the quarter ended June 30, 2012   | Equity Securities<br>Available-for-Sale | Interest Rate Swap |
|---|---|--------------------|
| Beginning balance   | \$642                                   | \$(1,196)          |
| Total gains or losses (realized and unrealized):  |   |                    |
| Included in earnings  | —                                       | —                  |
| Included in other comprehensive income  | 3                                       | (241)              |
| Purchases:  | 143                                     | —                  |
| Sales:  | —                                       | —                  |
| Issuances:  | —                                       | —                  |
| Settlements   | —                                       | —                  |
| Transfers in/(out) of Level 3   | —                                       | —                  |
| Ending balance  | \$788                                   | \$(1,437)          |
| The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held as of June 30, 2012: | \$—                                     | \$—                |

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## Liabilities and related instruments

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

## NOTE 10 – SEGMENTS

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

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

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

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



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THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

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

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

## NOTE 11 – PREFERRED AND COMMON STOCK

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

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

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REVIEW REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

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

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

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

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

/s/ Warren Averett, LLC

Birmingham, Alabama  
August 7, 2012



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Item 2.

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

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

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

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

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

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

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

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

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

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

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

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

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

## CONSOLIDATED RESULTS OF OPERATIONS

### Summary:

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

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

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

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

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

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

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

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

## Premium Revenue:

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

|  | Three-Months Ended |               | Percent  |            |
|--|--------------------|---------------|----------|------------|
|  | 2012               | 2011          | increase | (decrease) |
| Life, accident and health segment:       |                    |               |          |            |
| Traditional life insurance               | \$ 1,270,000       | \$ 1,302,000  | (2.5     | )%         |
| Accident and health insurance            | 449,000            | 475,000       | (5.5     | )%         |
| Total life, accident and health          | 1,719,000          | 1,777,000     | (3.3     | )%         |
| Property and Casualty segment:           |                    |               |          |            |
| Dwelling fire & extended coverage        | 6,665,000          | 6,666,000     | —        | %          |
| Homeowners (Including mobile homeowners) | 5,790,000          | 6,227,000     | (7.0     | )%         |
| Ocean marine                             | 275,000            | 300,000       | (8.3     | )%         |
| Other liability                          | 343,000            | 321,000       | 6.9      | %          |
| Private passenger auto liability         | 93,000             | 685,000       | (86.4    | )%         |
| Commercial auto liability                | —                  | 92,000        | (100.0   | )%         |
| Auto physical damage                     | 44,000             | 274,000       | (83.9    | )%         |
| Reinsurance premium ceded                | (2,396,000         | ) (3,021,000  | ) (20.7  | )%         |
| Total property and casualty              | 10,814,000         | 11,544,000    | (6.3     | )%         |
| Total earned premium revenue             | \$ 12,533,000      | \$ 13,321,000 | (5.9     | )%         |

Consolidated premium revenue was \$12,533,000 for the three-months ended June 30, 2012 compared to \$13,321,000 for the same period last year; a decrease of \$788,000 or 5.9%. The decline in revenue was primarily concentrated in the P&C segment. The primary reason for the decline in P&C segment premium revenue was the termination of the private passenger non-standard and commercial automobile programs. Due to unprofitable underwriting results for multiple years, the decision was made by management to discontinue the automobile program in late 2011. The termination of these programs led to a \$914,000 decline in automobile earned premium for the quarter-ended June 30, 2012 compared to the same period last year. In addition, premium revenue was down in the homeowners program. For

the quarter-ended June 30, 2012, premium revenue from the homeowners program was \$5,790,000 compared to \$6,227,000 for the same period last year; a decline of \$437,000 or 7.0%. The implementation of more stringent underwriting standards and an ongoing comprehensive review of property risks within this program was the primary reasons for the decline in homeowners premium revenue in the current quarter compared to the same period last year.

Partially offsetting the decline in premium revenue was a reduction in ceded premium in the current year compared to the prior year. For the three-months ended June 30, 2012 reinsurance premium ceded was down 20.7% compared to the quarter-ended June 30, 2011. The primary reason for the \$625,000 decline was a reduction in the amount of reinstatement premium incurred during the current year compared to the prior year. In 2011 we incurred \$1.5 million in catastrophe reinstatement premium triggered by the tornado and wind losses of catastrophe 46 while we incurred no major spring storm season catastrophes in 2012. However, partially offsetting the decline in ceded premium in 2012, due to a lack of reinstatement premium, was an increase in our base

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catastrophe reinsurance costs. Our base cost for catastrophe reinsurance increased \$843,000 for the quarter in 2012 compared to last year. A 19% increase in catastrophe reinsurance premium coupled with the addition of reinstatement premium protection were the primary reasons for the increase in ceded premium during 2012 compared to 2011. We are currently implementing rate increases to adjust for our increased cost of catastrophe reinsurance. However, because rates in the reinsurance market are unregulated and our rates generally have to be approved by the state insurance departments of each respective state in which we operate, we incur significant lag time in our ability to recover cost related to increased reinsurance costs and our 2012 increase is temporarily compressing our profit margins.

Investment income:

Investment income decreased \$105,000 to \$1,066,000 for the three-months ended June 30, 2012 from \$1,171,000 for the same period last year. A decrease in average invested assets in the second quarter of 2012 compared to the second quarter of 2011 was the primary factor contributing to the decline in investment income. As a result of the severe storm activity in 2011, investment holdings in the P&C subsidiaries were sold to increase liquidity necessary to pay storm claims during the second quarter of that year. The reduction in invested assets caused by last year's spring storm activity led to reduced investment income in the current year. Furthermore, the continued low investment rate environment has pushed down overall book yields as maturing investments are generally reinvested at current historically low interest rates.

Realized investment gains and losses:

For the quarter-ended June 30, 2012, realized investment gains totaled \$865,000 compared to \$261,000 for the same period last year; an increase of \$604,000. The increase in realized capital gains was primarily associated with an increase in trading activity during the second quarter of 2012 compared to the second quarter of 2011. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements of the insurance subsidiaries and therefore can vary significantly from quarter to quarter. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from quarter to quarter.

Other income:

Other income was \$193,000 for the three-months ended June 30, 2012 compared to \$256,000 for the quarter-ended June 30, 2011; a decrease of 24.6%. Other income is primarily composed of billing, payment and policy fees associated with residential property and automobile policies issued in the P&C segment. Due to the discontinuation of the automobile program, billing, payment and policy fees decreased \$63,000. This decrease was the primary reason for the overall reduction in other income for the current quarter compared to the same period last year.

Policyholder benefits paid:

The P&C segment is sometimes affected by storm systems classified as "catastrophes" by Property Claims Service (PCS) [referred to as cat events throughout the remainder of this discussion]. PCS generally deems a cat event to be a single storm system or other natural disaster which causes in excess of \$25 million in industry losses. During the second quarter of 2012, the P&C segment was not materially impacted by any cat events. In contrast, during the second quarter of 2011, the P&C segment was impacted by ten cat events with incurred losses and LAE totaling \$12,632,000 before reinsurance and \$6,518,000 net of reinsurance.

Policyholder benefits paid (claims) as a percent of net premiums earned was 63.6% for the three-months ended June 30, 2012 compared to 117.7% for the three-months ended June 30, 2011. Policyholder benefits for the three-months ended June 30, 2012 were \$7,976,000 compared to \$15,682,000 for the same period last year; a decrease

of 49.1%. The \$7,706,000 decrease in claims was primarily associated with declines in year to date losses and LAE incurred in the P&C segment. Year-to-date incurred losses and LAE in the P&C segment decreased \$7,623,000 for the three-months ended June 30, 2012 compared to the same period in 2011 and accounted for 98.9% of the total decrease. As mentioned previously, the decline was primarily due to the increase in claim activity during 2011 from the multitude of tornado, wind and hail events, including catastrophe 46, during the second quarter of the prior year.

Another factor contributing to the decrease in incurred losses and incurred LAE for the three-months ended June 30, 2012 compared to the quarter-ended June 30, 2011 was a decrease in fire losses in the P&C segment. Fire losses incurred during the quarter were down \$273,000 for the three-month period ended June 30, 2012 compared to the same period last year. The severity per claim for the quarter in 2012 and 2011 were \$29,000 and \$26,000, respectively, while the frequency decreased by 20 claims in the second quarter of 2012 compared to the second quarter of 2011. Because fire losses cost significantly more, on average, on a per claim basis, a slight change in the frequency of fire losses can significantly influence quarterly underwriting results.



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Policy acquisition cost:

For the three-months ended June 30, 2012, policy acquisition costs were \$2,933,000 compared to \$3,071,000 for the same period last year. The decrease was primarily associated with the 1.5% reduction in written premium for the three-month period in the current year compared to the same period last year. Policy acquisition costs were 23.4% of premium revenue for the second quarter of 2012 compared to 23.1% for the same period last year.

General expenses:

General expenses were down for the three-months ended June 30, 2012 at \$1,835,000 compared to \$2,418,000 for the same period last year; a decrease of \$583,000. As a percent of earned premium, general expenses were 14.6% and 18.2%, respectively for the three-months ended June 30, 2012 and 2011. The Company has implemented significant cost reduction measures over the past nine months and continues to work on streamlining processes and reducing overhead in order to reduce general expenses.

Litigation settlement and defense costs:

On June 18, 2012, NSG settled longstanding litigation related to the Company's sale of an investment in Mobile Attic, Inc. The final settlement totaled \$13,000,000 and the impact of the settlement and remaining legal fees are reflected in these financial statements. Additional information related to the settlement can be found in the liquidity and capital resources section of the Management Discussion and Analysis and in Note 8 to the financial statements.

Taxes, licenses and fees:

Taxes, licenses and fees for the three-months ended June 30, 2012 and 2011 were \$438,000 and \$622,000, respectively. Taxes, licenses and fees as a percentage of earned premiums were 3.5% for the quarter-ended June 30, 2012 and 4.7% for the same period last year. The primary reason for the \$184,000 decrease was the \$819,000 decline in P&C gross written premium for the second quarter of 2012 compared to the second quarter of 2011.

Interest expense:

Interest expense was virtually unchanged at \$288,000 for the quarter-ended June 30, 2012 compared to \$285,000 for the same period last year.

Income taxes:

For the quarter-ended June 30, 2012, income tax benefit was \$4,177,000 compared to an income tax benefit of \$2,606,000 for the same period last year. The effective tax rate for the three-months ended June 30, 2012 was 36.4% compared to 34.5% for the three-months ended June 30, 2011. Income tax expense/(benefit) was composed of current taxes totaling \$145,000 for the quarter-ended June 30, 2012 compared to income tax benefit of \$(2,515,000) for the same period last year. Deferred tax benefit totaled \$4,322,000 for the three-months ended June 30, 2012 compared to income tax benefit of \$91,000 for the three-months ended June 30, 2011.

Net (loss) income:

The Company ended the first three months of 2012 with a year to date net loss of \$7,306,000 compared to a net loss of \$4,945,000 for the same period last year. The primary reason for the net loss for the three-months ended June 30, 2012

was an additional \$12,670,000 in net litigation settlement related expenses incurred in June. The primary reason for the net loss for the three-months ended June 30, 2011 was an increase in claims incurred in the P&C segment related to significant storm activity, including catastrophe 46, during April 2011.

Six-months ended June 30, 2012 compared to six-months ended June 30, 2011:

Premium Revenue:

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

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|  | Six months ended June 30, |              | Percent  |            |
|--|---------------------------|--------------|----------|------------|
|  | 2012                      | 2011         | increase | (decrease) |
| Life, accident and health operations:    |                           |              |          |            |
| Traditional life insurance               | \$2,558,000               | \$2,688,000  | (4.8     | )%         |
| Accident and health insurance            | 913,000                   | 958,000      | (4.7     | )%         |
| Total life, accident and health          | 3,471,000                 | 3,646,000    | (4.8     | )%         |
| Property and Casualty operations:        |                           |              |          |            |
| Dwelling fire & extended coverage        | 13,212,000                | 13,165,000   | 0.4      | %          |
| Homeowners (Including mobile homeowners) | 11,694,000                | 12,471,000   | (6.2     | )%         |
| Ocean marine                             | 543,000                   | 619,000      | (12.3    | )%         |
| Other liability                          | 683,000                   | 631,000      | 8.2      | %          |
| Private passenger auto liability         | 328,000                   | 1,441,000    | (77.2    | )%         |
| Commercial auto liability                | 6,000                     | 211,000      | (97.2    | )%         |
| Auto physical damage                     | 151,000                   | 571,000      | (73.6    | )%         |
| Reinsurance premium ceded                | (4,059,000                | ) (4,564,000 | ) (11.1  | )%         |
| Total property and casualty              | 22,558,000                | 24,545,000   | (8.1     | )%         |
| Total earned premium revenue             | \$26,029,000              | \$28,191,000 | (7.7     | )%         |

Consolidated premium revenue was \$26,029,000 for the six-months ended June 30, 2012 compared to \$28,191,000 for the same period last year; a decrease of \$2,162,000 or 7.7%. The decrease was primarily driven by declines in earned premium in the P&C segment. Year-to-date P&C segment earned premium was down 8.1% due to the discontinuation of the non-standard private passenger and commercial automobile programs in late 2011 along with the implementation of more stringent underwriting standards during the prior year which led to a decline in homeowners earned premium. A reduction in catastrophe reinstatement premium in the current year partially offset the P&C earned premium decreases.

The P&C segment ended June 2012 with year-to-date net earned premiums of \$22,558,000 compared to \$24,545,000 for the same period last year. As mentioned above, the primary reason for the decrease in earned premium was related to the discontinuation of the automobile programs. In late 2011, management decided to terminate the automobile programs due to continued unprofitable underwriting results. Year-to-date automobile earned premium was \$485,000 through June 30, 2012 compared to \$2,223,000 for the same period last year; a decrease of 78.2%. Because this program is now in runoff, it will not be a significant contributor to total P&C segment premium revenue in 2012. Furthermore, earned premium from the homeowners programs also declined in 2012 compared to 2011. Year-to-date homeowners earned premium totaled \$11,694,000 in 2012 compared to \$12,471,000 in 2011; a decrease of 6.2%. As we continue to implement strategies to improve underwriting margins and reduce coastal exposure, we expect the P&C segment to continue to incur marginal declines in premium revenue in the near term.

Partially offsetting the decline in P&C premium revenue was a reduction in ceded premium in the current year compared to the prior year. For the six-months ended June 30, 2012, reinsurance premium ceded was down 11.1% compared to the six-months ended June 30, 2011. The primary reason for the \$505,000 decline was a reduction in the amount of reinstatement premium incurred during the current year compared to the prior year. Due to the impact of catastrophe 46, the P&C segment incurred nearly \$1.5 million in catastrophe reinstatement premium in the first six months of 2011. In contrast, due to a lack of major spring storm activity, we incurred no reinstatement premium charges related to 2012 spring storm events. Without the impact of reinstatement premium, reinsurance premium ceded is up \$878,000 for the first six months of 2012 compared to last year. A 19% increase in catastrophe reinsurance premium coupled with the addition of reinstatement premium protection were the primary reasons for the

increase in ceded premium during 2012 compared to 2011. In addition to the increase in base reinsurance cost, the additional catastrophe reinsurance coverage will increase ceded reinsurance cost by approximately \$1.3 million in 2012. However, in the event of a major catastrophe, the pretax impact on earnings of a 100 year cat event has been reduced by over \$5 million.

The life segment ended June 2012 with year- to-date premium revenue of \$3,471,000; a decrease of 4.8% compared to \$3,646,000 through June 2011. The life segment earned premium was down primarily due to more stringent underwriting standards in the current year compared to the prior year.

Investment income:

Investment income decreased \$27,000 to \$2,201,000 through June 30, 2012 compared to \$2,228,000 through June 30, 2011. The decrease in investment income was primarily due to lower yields on reinvested cash flows from sales and maturities in the fixed

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income portfolio. Also, P&C segment investment holdings were sold during the second quarter of 2011 to increase liquidity necessary to pay storm claims in the P&C subsidiaries and therefore reduced invested assets, leading to a reduction in investment income.

Realized investment gains and losses:

For the six-months ended June 30, 2012 and 2011, realized investment gains were comparable at \$1,071,000 and \$1,031,000, respectively. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements of the insurance subsidiaries and therefore can vary significantly from year to year.

Other income:

Other income was \$390,000 through June 30, 2012 compared to \$511,000 through June 30, 2011; a decrease of 23.7%. Other income is primarily composed of billing, payment and policy fees associated with residential property and automobile policies issued in the P&C segment. Due to the termination of our automobile programs, billing, payment and policy fees declined and was the primary reason for the overall reduction in other income for the current year.

Policyholder benefits:

Claims were \$15,821,000 for the six-months ended June 30, 2012 compared to \$25,004,000 for the same period last year; a decrease of \$9,183,000 or 36.7%. The primary reason for the current year decline was the reduction in claim activity from tornado, wind and hail storms in the P&C segment in 2012 compared to 2011. During the prior year, claim activity in the P&C segment was significantly higher due to a greater frequency of severe wind, hail and tornado damage incurred from April storms including catastrophe 46. The losses incurred from cat 46 exceeded our catastrophe reinsurance retention of \$3,500,000 and triggered coverage under our catastrophe reinsurance program. The P&C segment incurred losses and loss adjustment expenses before reinsurance totaling \$9,936,000 (\$3,822,000 net of reinsurance) from catastrophe 46. The net incurred losses and LAE from catastrophe 46 claims increased the overall loss ratio 13.6 percentage points in 2012 compared to 2011. The non-reinsured April 2011 cat events totaled \$1,760,000 and added 6.2 percentage points to the 2011 loss ratio.

During the first half of 2012, the P&C segment was impacted by seven cat events totaling \$644,000. The P&C subsidiaries incurred 201 claims from these cat events which added 2.5 percentage points to the loss ratio. The average severity per claim related to the 2012 cat events was \$3,200 per claim. In contrast, the P&C subsidiaries were impacted by 16 cat events during the first half of the prior year and incurred 2,474 claims. The average severity per claim was \$5,300 before reinsurance and \$2,600 net of reinsurance. The net impact of 2011 cat events added 24.5 percentage points to the prior year loss ratio.

Fire losses incurred in the P&C segments were down \$569,000 through June 2012 compared to the same period last year. The P&C subsidiaries incurred fire losses totaling \$6,512,000 in 2012 compared to \$7,081,000 in 2011. The fire losses incurred during 2012 resulted in 253 claims compared to fire losses incurred during 2011 from 298 claims. These losses had an average severity per claim of \$26,000 and \$24,000 for 2012 and 2011, respectively.

Life segment claims were down 5.8% ending June 2012 at \$2,645,000 compared to \$2,807,000 for the same period last year. Declines in claims incurred in both the ordinary and industrial lines of business were the primary reasons for the \$162,000 decrease in year to date claims in the life segment for 2012 compared to 2011.

Policy acquisition cost:

For the six-months ended June 30, 2012, policy acquisition costs were \$5,705,000 compared to \$5,995,000 for the same period last year; a decrease of \$290,000. The decrease was primarily attributable to the decline in premium revenue which reduced commission costs in 2012 compared to the same period last year.

General Expenses:

General expenses were down \$266,000 through June 30, 2012 at \$4,323,000 compared to \$4,589,000 through June 30, 2011. The reduction in general expenses was primarily associated with a reduction in costs associated with the discontinued auto programs, along with continued company wide cost reduction measures.

Litigation Settlement:

On June 18, 2012, the Company settled longstanding litigation related to the Company's sale of Mobile Attic, Inc. The final

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settlement and legal costs incurred resulted in expenses of \$13,259,000 in the first six months of 2012 compared to costs associated with the matter of \$789,000 in the first six months of 2011. Additional information and discussion related to the settlement can be found in the liquidity and capital resources section of Management Discussion and Analysis and in Note 8 to the condensed consolidated financial statements.

Taxes, licenses and fees:

Taxes, licenses and fees were down \$172,000 for the six-months ending June 30, 2012 at \$930,000 compared to \$1,102,000 for the same period last year. Taxes, licenses and fees as a percentage of earned premiums were 3.6% through June 2012 compared to 3.9% through June 2011.

Interest expense:

Interest expense was comparable at \$580,000 for the six-months ended June 30, 2012 compared to \$570,000 for the same period last year.

Income taxes:

For the period ended June 30, 2012, income tax benefit totaled \$4,152,000 compared to income tax benefit of \$2,138,000 for the same period last year. The effective tax rate through June 30, 2012 was 38.0% compared to 35.1% through June 30, 2011. Income tax expense/(benefit) was composed of current taxes totaling \$173,000 for the six-months ended June 30, 2012 compared to income tax benefit of \$(2,165,000) for the six-months ended June 30, 2011. Deferred tax (benefit)/expense totaled \$(4,325,000) for 2012 and \$27,000 for 2011. The litigation settlement in 2012 was the primary reason for the income tax benefit in 2012 while the significant number of losses incurred from spring storms was the primary contributor to the 2011 tax benefit.

Net (loss) income:

For the six-months ended June 30, 2012, the Company had a net loss of \$6,775,000 compared to a net loss of \$3,950,000 for the same period last year. The primary contributing factor to the current year net loss was the litigation settlement expenses incurred during June 2012. The prior year net loss was primarily attributable to P&C segment claims incurred from tornado, wind and hail related weather events, including catastrophe 46, during April 2011.

Liquidity and capital resources:

At June 30, 2012, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$30,663,000 down \$7,352,000 compared to \$38,015,000 at December 31, 2011. Components of the change in equity were a net loss of \$6,775,000, net unrealized gains on investments of \$76,000, a net unrealized loss of \$159,000 related to interest rate swaps and cash dividends paid totaling \$494,000.

The Company has \$12,372,000 in debt outstanding consisting of long-term debt from the proceeds of two separate trust preferred securities issuances, the latest of which totaled \$3,000,000 and was completed in June 2007. The Company has an operating line of credit to allow flexibility with respect to cash management at the holding company level. The outstanding balance on the line, at June 30, 2012, was \$625,000. We had \$75,000 available at June 30, 2012, under the operating credit line.

The Company, primarily through its insurance subsidiaries, had \$6,345,000 in cash and cash equivalents at June 30, 2012, compared to \$965,000 at June 30, 2011. Cash used in operations for the six-month period ended June 30, 2012

totaled \$17,000 compared to cash used in the same period last year totaling \$7,609,000.

Net cash provided by investing activities totaled \$3,268,000 for the six-months ending June 30, 2012 compared to cash provided of \$8,039,000 for the same period last year. A \$3,490,000 increase in costs related to the acquisition of investments combined with a \$1,157,000 decrease in cash flows from the sale and maturity of investments were the primary reasons for the \$4,771,000 decline in cash provided by investing activities in 2012 compared to 2011. During the prior year, investment sales were necessary to increase liquidity in order to pay storm claims in the P&C segment during the second quarter as a result of losses from catastrophe 46.

The Company's liquidity requirements are primarily met by funds provided from operations of the insurance subsidiaries. The Company receives funds from its subsidiaries through payments for federal income taxes and reimbursement of expenses incurred at the corporate level for the subsidiaries. These funds are used to pay stockholder dividends, interest on debt, corporate



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administrative expenses, federal income taxes, and for funding investments in the 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.

Our P&C segment, which composes the largest segment of our insurance operations, incurred substantial operating losses in 2011. These operating losses contributed to a decline of over 16% in capital levels in the segment. These reduced capital levels, while adequate to operate our existing business, have substantially reduced our ability to pay dividends upstream to the holding company in the near term. Dividends paid from the insurance subsidiaries are subject to regulatory restrictions and prior approval of the Alabama Department of Insurance. As disclosed in Note 12 to the Consolidated Financial Statements filed in the 2011 Form 10-K, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company during 2012 is limited to \$1,039,000 in the life insurance subsidiary and \$2,546,000 in the property/casualty insurance subsidiary.

Regulators consider dividends paid within the preceding twelve months when calculating the available dividend. As of June 30, 2012, the total amount available to dividend up to the holding company was \$985,000 (\$339,000 in the life insurance subsidiary and \$646,000 in the property/casualty insurance subsidiary). The payment of any subsidiary dividend requires prior notice to the regulatory authorities who may disallow the dividend if, in their judgment, payment of the dividend would have an adverse effect on the surplus of the subsidiary.

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, which is held by the insurance subsidiaries, consists of readily marketable securities, which can be sold for cash.

Due to the erosion in capital levels in the P&C subsidiaries in 2011, stemming from a very active spring storm season and underwriting losses in our automobile line of business, we have made changes in order to reduce capital/surplus strain in the P&C subsidiaries and help protect capital levels from substantial further erosion resulting from a major catastrophic event. These changes include a combination of reduction in underwriting leverage and an increase in catastrophe reinsurance protection a summary of each change follows:

In late 2011, we discontinued both our private passenger and commercial automobile programs. These two programs accounted for approximately 6% of net written premium in 2011, down from nearly 10% in 2010 but had produced significant underwriting losses over the last five years. Due to a combination of reduced capital levels and a view that it would take some time to achieve underwriting profitability, we made the decision to discontinue the program in order to reduce surplus strain and underwriting leverage in the P&C subsidiaries.

¶ We have incurred substantial losses from catastrophe events over the past seven years. These events have driven up catastrophe reinsurance cost and forced our catastrophe reinsurance deductible up from \$2 million in 2005 to \$4 million in our 2012 renewal. As our cat retention has increased, we have attempted to achieve higher margins in our insurance rate structure in order to compensate for the additional risk of the higher catastrophe reinsurance retention but with limited success due to regulatory constraints primarily because this additional retention was not a "hard dollar" cost in our rate structure. So, since we were limited in our ability to increase margins for this additional retained risk and due to the capital erosion incurred in 2011, in the second quarter of 2012 we placed additional reinsurance cover in the form of reinsurance premium protection (RPP). The RPP cover will serve to reduce our risk from a major catastrophe and strengthen our capital position. The effect of adding this additional RPP cover is to reduce our modeled 100 year event net cost (net of reinsurance recoveries) from approximately \$9 million (pretax) to

an estimated \$4.5 million (pretax). A 100 year event is defined as an event that has approximately a 1% probability of occurring in a given year. This additional cover added \$1.3 million to our cat reinsurance cost and will compress margins in 2012 as we go through the process of updating rates to reflect this higher cost but will help protect capital from major events going forward.

As disclosed in Note 8 to these Condensed Consolidated Financial Statements regarding contingencies, the Company has been involved in litigation related to its divestiture of Mobile Attic, Inc. The Company's insurance subsidiaries were not involved in this litigation and the Company has funded all costs associated with defending this action. The defense cost has placed a strain on our liquidity in the holding company leading up to the date of the jury trial which was set for June of 2012. As was disclosed in our previous filings, the Company believed that the damages claimed in the litigation were excessive in amount and that a substantial portion of the claimed damages was unrelated to the Company's involvement in the Mobile Attic transaction. The Company believed that the damages should be limited to a diminished value of the purchaser's original investment in Mobile Attic resulting from the claimed breach of warranty in the stock purchase agreement. The Company had filed motions for summary judgment

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requesting a court ruling as to how damages should be measured as a matter of law. As was disclosed in our first quarter Form 10-Q, on April 24, 2012, the Court heard oral arguments on the motion for summary judgment and took the matter under advisement.

Several events unfolded in June of 2012, leading up to trial that caused the Company to reexamine positions with regard to the litigation. First, shortly before trial, Mobile Attic's former auditors and our co-defendant in the matter reached an out of court settlement with plaintiff and therefore would not be defending their actions which were expected to help support the defense of claims. Second, one of the remaining co-defendants with whom the Company was jointly liable for claims under the stock purchase agreement was the former president of Mobile Attic who was sentenced to Federal Prison for bank fraud in 2010 and is currently serving a five year sentence in a West Virginia Federal Penitentiary. Third, the Court had not made a definitive ruling prior to commencement of the trial on how damages would be calculated. Fourth, with the lack of clarity on potential damages, it appeared that damage amounts were potentially going to be left in the hands of a jury in a matter that involved very complex legal and accounting issues with the potential to include damages for other actions involving our co-defendants in which we had no involvement. Fifth, while we believe it is possible that a jury would have returned a verdict for less than the amount for which we settled, we believe it would have been difficult to negotiate post trial settlement terms that would allow us to support our insurance operations and maintain our rating agency ratings. Finally, with no guidance on damages, in the event of an excess verdict we would have faced significant liquidity constraints in supporting a potentially long, expensive and arduous appeal process.

Immediately before the trial, settlement discussions with the plaintiff approached the amount of the financial benefit that NSG had received from the purchaser in the Mobile Attic transaction. After careful consideration of the aforementioned factors, management made a decision to reach a settlement agreement just as the trial was about to commence. Under the terms of the settlement agreement, the Company will pay a total of \$13 million to the plaintiff. In order to manage the liquidity constraints, the settlement will be in the form of an interest-bearing note with amounts to be paid over nine years with the ability to defer payments in years in which the Company's P&C subsidiaries incur substantial catastrophe losses thus allowing capital management flexibility in the P&C subsidiaries. Under the expected terms of the agreement, the annual debt service on the note cannot be less than the dividends paid to our shareholders in the last twelve months. The last details of the agreement are expected to be finalized in August of 2012.

It is expected that cash to fund the litigation settlement will come from three primary sources. First, the Company owns 3,000 acres of timber property with a carrying value of approximately \$1.4 million and an estimated fair market value of \$6 million. We will initially use this property as collateral to obtain an operating line of credit through a regional bank to aide in restoring short-term liquidity and allow flexibility in managing holding company liquidity. Ultimately the Company will seek to sell the property or use the proceeds from timber sales on the property to retire the debt. Second, the holding Company has significant deferred tax assets associated with a net operating loss (NOL) carryforward generated by a combination of this settlement and defense costs incurred over the last two years. This NOL carryforward will generate tax benefits that will offset a portion of future tax liabilities of the P&C insurance subsidiaries in our consolidated tax returns. It is expected that this NOL carry-forward will generate approximately \$5 million in tax benefits over the term of the settlement. Finally, dividends and management fees paid by the insurance subsidiaries will provide an additional source of proceeds to pay this obligation.

The Company is seeking recovery of a portion of amounts to be paid under this settlement from its insurance carrier but to date no recovery had been obtained and no allowance has been made for any recovery.

In order to improve holding company liquidity, we are in the process of obtaining an operating line of credit secured by certain real estate investments. The Company has received a commitment to place the line of credit with a regional bank and terms are expected to be finalized in August of 2012.

Except as discussed above and in Note 8 to these Condensed Consolidated Financial Statements, the Company is unaware of any 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.

The Company maintains an operating line of credit, with a \$700,000 limit, to allow flexibility with respect to cash management at the holding company level. The outstanding balance at June 30, 2012 was \$625,000.

We have taken and continue to take corrective action to improve our profitability and capital position. However, due to the adverse effects of five major hurricanes in the last eight years, the financial market meltdown in 2008, continued historically low interest rates, an unprecedented tornado outbreak in April of 2011 and the recently settled litigation, we have experienced significant reduction in equity capital. While we are beginning to see improvement and have put some major obstacles behind us, we are in a position where we have to preserve capital in the near term in order to put our Company in the best position to be successful moving forward. In order to improve our capital position we will revisit our dividend policy in the near term. It is likely that we

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will reduce quarterly dividends by at least 50% with a range of actions up to and including the suspension of dividends beginning in the fourth quarter of 2012 as we rebuild our capital position in our P&C subsidiaries. Due to various factors discussed herein, we must remain flexible in our dividend policy until we achieve more consistent profitability and capital growth.

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

Under smaller reporting company rules, we are not required to disclose information required under Item 3. 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. The Company has not incurred material losses in its investment portfolio in the quarter ended June 30, 2012 related to interest rate changes, defaults on certain securities and changes in value of equity investments. Changes are discussed in detail under Item 2 of this Form 10-Q. For further information regarding market risk, reference is made to the Company's Form 10-K for the year ended December 31, 2011.

### Item 4. Controls and Procedures

Our management carried out an evaluation, with the participation of our chief executive officer and chief financial officer, of the effectiveness of our disclosure controls and procedures as of June 30, 2012. Based upon that evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission.

There has not been any change in our internal control over financial reporting in connection with the evaluation required by Rule 13A-15(d) under the Exchange Act that occurred during the six-month period ended June 30, 2012, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## Part II. OTHER INFORMATION

### Item 1. Legal Proceedings

Please refer to Note 8 to the condensed consolidated financial statements included herein, and the 2011 Annual Report filed on Form 10-K.

### Item 1A. Risk Factors

There has been no material change in risk factors previously disclosed under Item 1A. of the Company's annual report for 2011 on Form 10-K.

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

None

### Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

None

Item 5. Other Information

None

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Item 6. Exhibits

a. Exhibits

- 10.1 Settlement Agreement between Bagley Family Revocable Trust, Mobile Attic, Inc. and The National Security Group, Inc. dated August 3, 2012.
- 10.2 Promissory Note between Bagley Family Revocable Trust and The National Security Group, Inc. dated August 3, 2012.
- 31.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification Pursuant to 18 U. S. C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

b. Reports on Form 8-K during the quarter ended June 30, 2012

| Date of Report | Date Filed     | Description  |
|----------------|----------------|--|
| April 13, 2012 | April 17, 2012 | Press release, dated April 17, 2012, issued by The National Security Group, Inc. |
| May 14, 2012   | May 14, 2012   | Press release, dated May 14, 2012, issued by The National Security Group, Inc.   |
| May 18, 2012   | May 22, 2012   | Item 5.07 - announcement of annual meeting voting results                        |
| June 20, 2012  | June 22, 2012  | Item 8.01 - announcement of litigation settlement                                |

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SIGNATURE

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

The National Security Group, Inc.

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

/s/ Brian R. McLeod  
Brian R. McLeod  
Vice President and Chief Financial Officer

Dated: August 7, 2012