

NATIONAL SECURITY GROUP INC

Form 10-K

March 21, 2014

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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FORM 10-K

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(Mark One)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 or 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal Period Ended December 31, 2013

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

None

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

Common Stock, par value \$1.00 per share

The NASDAQ Global Market (EXCHANGE)

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☐ No ☒

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

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

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

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

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

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

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of the last business day of the registrant's most recently completed second fiscal quarter, based upon the bid price of these shares on NASDAQ on such date, was \$10,908,436

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

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Class	Outstanding March 21, 2014
Common Stock \$1.00 par value	2,494,480 shares

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DOCUMENTS INCORPORATED BY REFERENCE

Definitive proxy statement for the 2013 Annual Meeting of Stockholders to be held May 16, 2014 is incorporated by 1.reference into Part III of this report. The proxy statement will be filed no later than 120 days from December 31, 2013.

2.Current Report on Form 8-K for event occurring on March 7, 2014 is incorporated into Part IV of this report.

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PART I

Item 1. Business

Summary Description of The National Security Group, Inc.

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

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

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

The property and casualty subsidiaries of the Company, National Security Fire and Casualty (NSFC), and Omega One Insurance Company (Omega), primarily write personal lines dwelling coverage including dwelling fire and windstorm, homeowners and mobile homeowners lines of insurance in ten states. Property and casualty insurance is the most significant industry segment, accounting for 87% of total premium revenues.

The Company's life insurance subsidiary, National Security Insurance Company (NSIC), offers a basic line of life and health and accident insurance products in seven states.

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

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

Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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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 price 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 and loss of capital.

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

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

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

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## Industry Segment and Geographical Area Information

## Property and Casualty Insurance Segment

The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992. This segment will be referred to throughout this report as NSFC, property-casualty segment or P&C segment. NSFC is licensed to write property and casualty insurance in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia, and operates on a surplus lines basis in the state of Louisiana. Omega is licensed to write insurance in Alabama and Louisiana.

The following table indicates allocation percentages of direct written premium by state for the two years ended December 31, 2013 and 2012:

State	Percent of Direct Written Premium				
	2013		2012		
Alabama	\$ 16,811,000	30.20	% \$ 15,858,000	29.62	%
Arkansas	2,730,000	4.90	% 2,711,000	5.06	%
Georgia	5,819,000	10.46	% 5,196,000	9.70	%
Louisiana	7,643,000	13.73	% 7,184,000	13.42	%
Mississippi	10,199,000	18.32	% 9,382,000	17.52	%
South Carolina	6,178,000	11.10	% 6,141,000	11.47	%
Florida	(14,000	) (0.02	)% 86,000	0.16	%
Missouri	—	—	% 6,000	0.01	%
Oklahoma	3,070,000	5.52	% 2,237,000	4.18	%
Tennessee	3,217,000	5.78	% 3,062,000	5.72	%
Texas	6,000	0.01	% 1,681,000	3.14	%
	\$55,659,000	100.00	% \$53,544,000	100.00	%

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

The premiums or payments to be made by the insured for direct products of the property and casualty subsidiaries are based upon expected costs of providing benefits, writing and administering the policies. In determining the premium to be charged, the property and casualty subsidiaries utilize data from past claims experience, modeled catastrophe losses and anticipated claims estimates along with catastrophe reinsurance cost, commissions, taxes and general expenses.

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





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The following table sets forth the premiums earned and pretax income during the periods reported for the property and casualty insurance segment (dollars in thousands):

	Year Ended December 31,	
	2013	2012
Net premiums earned:		
Fire, allied lines and homeowners	\$45,417	\$43,962
Automobile	—	474
Other	358	770
Total net earned premium	\$45,775	\$45,206
Income before taxes	\$6,266	\$2,552

#### Property and Casualty Loss Reserves

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

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

The following Loss Reserve Re-estimates table illustrates the change over time of the net reserves established for property-liability insurance claims and claims expense at the end of the last 10 calendar years. The first section shows the reserves as originally reported at the end of the stated year. The second section, reading down, shows retroactive re-estimates of the original recorded reserve as of the end of each successive year. These re-estimates are the result of the Company's expanded awareness of additional facts and circumstances that pertain to the unsettled claims. The third section, reading down, shows the cumulative amounts paid as of the end of successive years with respect to that year's reserve liability. The last section compares the latest re-estimated reserve to the reserve originally established and indicates whether the original reserve was adequate to cover the estimated costs of unsettled claims. The Loss Reserve Re-estimates table is cumulative, and therefore, ending balances should not be added since the amount at the end of each calendar year includes activity for both the current and prior years.

While the information in the table provides a historical perspective on the adequacy of unpaid losses and loss adjustment expenses established in previous years, it should not be assumed to be predictive of redundancies or deficiencies on current year unpaid losses in future periods. Company management believes that the reserves established at the end of 2013 are adequate. However, due to inherent uncertainties in the loss reserve estimation

process, management cannot guarantee that current year reserve balances will prove to be adequate. Due to the relatively short tail nature of the property and casualty subsidiaries' claim liabilities, the Company does not discount loss reserves for the time value of money. Dollar amounts are in thousands.

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		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Gross unpaid losses per												
Consolidated Balance Sheet		\$11,343	\$13,094	\$19,511	\$12,498	\$11,973	\$14,436	\$12,646	\$13,184	\$14,386	\$11,214	\$8,000
Ceded reserves		(1,232 )	(2,611 )	(8,560 )	(1,783 )	(555 )	(2,421 )	(549 )	(1,329 )	(2,381 )	(1,229 )	(7,000 )
Net unpaid losses		\$10,111	\$10,483	\$10,951	\$10,715	\$11,418	\$12,015	\$12,097	\$11,855	\$12,005	\$9,985	\$7,000
Cumulative net payments:	1 year later	\$5,567	\$5,584	\$7,384	\$6,438	\$4,797	\$5,636	\$5,349	\$5,738	\$4,035	\$4,827	
	2 years later	6,765	7,006	9,063	8,103	6,496	6,350	6,305	7,239	5,346		
	3 years later	7,038	7,521	10,198	9,652	6,767	6,725	6,764	7,841			
	4 years later	7,274	7,811	11,439	10,094	6,976	6,980	7,244				
	5 years later	7,351	8,018	11,763	10,360	7,202	7,295					
	6 years later	7,390	8,006	11,900	10,662	7,213						
	7 years later	7,398	8,024	12,012	10,810							
	8 years later	7,400	8,056	12,141								
	9 years later	7,419	8,050									
	10 years later	7,419										
Net Liability re-estimated:	1 year later	9,186	9,042	11,844	11,817	9,046	9,438	8,621	11,443	9,606	9,354	
	2 years later	8,607	9,118	11,827	11,061	8,739	7,916	8,869	11,064	8,439		
	3 years	8,098	8,669	12,161	11,121	7,739	8,179	9,033	9,725			

later							
4							
years	7,863	8,404	12,337	10,792	7,792	8,514	8,418
later							
5							
years	7,629	8,274	12,178	11,089	8,010	7,855	
later							
6							
years	7,570	8,135	12,372	11,413	7,636		
later							
7							
years	7,484	8,184	12,699	11,175			
later							
8							
years	7,500	8,093	12,451				
later							
9							
years	7,430	8,070					
later							
10							
years	7,419						
later							

## Net cumulative

redundancy            \$2,692    \$2,413    \$(1,500 ) \$(460 ) \$3,782    \$4,160    \$3,679    \$2,130    \$3,566    \$631  
(deficiency)

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

	For The Years Ended December 31, 2013		2012	
Change in Loss and LAE Reserves	Adjusted Loss and LAE Reserves	% Change in Equity	Adjusted Loss and LAE Reserves	% Change in Equity
*Loss and LAE reserves are in thousands				
(10.0)%	\$7,861	2.61%	\$10,093	3.71%
(7.5)%	8,079	1.96%	10,373	2.78%
(5.0)%	8,297	1.31%	10,653	1.86%
(2.5)%	8,516	0.65%	10,934	0.93%
Reported	8,734	—%	11,214	—%
2.5%	8,952	(0.65)%	11,494	(0.93)%
5.0%	9,171	(1.31)%	11,775	(1.86)%
7.5%	9,389	(1.96)%	12,055	(2.78)%
10.0%	9,607	(2.61)%	12,335	(3.71)%

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

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## Life Insurance Segment

National Security Insurance Company (NSIC), a wholly owned subsidiary organized in 1947, conducts the Company's life insurance business. This segment will be referred to throughout this report as NSIC, Life Company, or Life segment. NSIC is licensed to write insurance in seven states: Alabama, Florida, Georgia, Mississippi, South Carolina, Tennessee and Texas.

The following table indicates NSIC's percentage of direct premiums collected by state for the two years ended December 31, 2013 and 2012:

State	Percentage of Total Direct Premiums					
	2013		2012			
Alabama	\$3,923,000	58.75	% \$3,959,000	58.17		
Georgia	1,361,000	20.38	% 1,408,000	20.69		
Mississippi	699,000	10.47	% 678,000	9.96		
South Carolina	446,000	6.68	% 476,000	6.99		
Texas	176,000	2.64	% 169,000	2.48		
Florida	71,000	1.07	% 116,000	1.71		
Tennessee	1,000	0.01	% —	—		
	\$6,677,000	100.00	% \$6,806,000	100.00		

NSIC has two primary methods of distribution of insurance products: independent agents and home service (career) agents. The independent agent distribution method accounts for 62.3% of total premium revenue in the life insurance segment. Approximately 200 agents of the Company's independent agents produced new business during 2013. The home service distribution method of life insurance products accounts for 31.5% of total premium revenue in the life insurance segment. Home service life products consist of products marketed directly at the home or other premises of the insured by an employee agent. The Company employed seven career agents and one regional manager as of December 31, 2013. The remaining 6.2% of premium revenue consists of the following: a book of business acquired from a state guaranty association in 2000 (2.4%), premium generated through direct sales of school accident insurance (3.6%), and other miscellaneous business serviced directly through the home office (0.2%).

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

The following table displays a schedule of 2013 life segment premium produced by product and distribution method (dollars in thousands):

Line of Business	Home Service Agent	Independent Agent	Other
Industrial	\$67	\$—	\$39
Ordinary	1,775	2,777	26
Group Life	—	14	59
A&H Group	—	—	252
A&H Other	263	1,366	39

Total Premium by Distribution Method	\$2,105	\$4,157	\$415
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The following table sets forth certain information with respect to the development of the Life Company's business (dollars in thousands):

	Year ended December 31, 2013	2012
Life insurance in force at end of period:		
Ordinary-whole life	\$ 169,400	\$ 170,800
Term life	21,700	21,400
Industrial life	18,800	19,500
	\$ 209,900	\$ 211,700
Life insurance issued:		
Ordinary-whole life	\$ 26,000	\$ 24,800
	\$ 26,000	\$ 24,800
Net premiums earned:		
Life insurance	\$ 4,652	\$ 4,745
Accident and health insurance	1,939	1,864
	\$ 6,591	\$ 6,609

**Life Insurance Segment Reserves**

We engage Wakely Actuarial Services of Palm Harbor, Florida as consulting actuary to calculate our reserves for traditional life insurance products. The methodology used requires that the present value of future benefits to be paid under life insurance policies less the present value of future net premiums be calculated. The calculation uses assumptions including estimates of any adverse deviation, investment yields and changes in investment yields, mortality, maintenance expenses and any non-forfeiture options or termination benefits. The assumptions determine the level and sufficiency of reserves which are calculated and reviewed by our consulting actuary at the end of each quarter. The independent consulting actuary also reviews our estimates for other insurance products including claims reserves under accident and health contracts. Management believes that the reserve amounts reflected in the accompanying consolidated financial statements are adequate.

**Investments**

A significant percentage of the total income for the Company is tied to the performance of its investments. Assets that will eventually be used to pay reserve liabilities and other policyholder obligations along with Company capital are invested to generate investment income while held by the Company. Our investment income is comprised primarily of interest and dividend income on debt and equity securities and realized capital gains and losses generated by debt and equity securities. At December 31, 2013, investments comprise 74.7% of total assets, and investment income (including realized gains) comprises almost 13.4% of total revenues evidencing the significant impact investments can have on financial results. Because the Company's insurance subsidiaries are regulated as to the types of investments they may make and the amount of funds they may maintain in any one type of investment, the Company has developed a conservative value oriented investment philosophy, in order to meet regulatory requirements. The Company's investment goals are to conserve capital resources and assets, obtain the necessary investment income threshold to meet reserves, and provide a reasonable return. Current yield from invested assets and capital appreciation of investments create this return.

**Marketing and Distribution**

As mentioned earlier in this report, NSIC products are marketed through a field force of agents who are employees of the Life Company and through a network of independent agents. The Company's use of independent agents is expected to be more cost effective in the long term and has become the fastest growing method of distribution over the past decade. In an effort to boost productivity and better educate agents on the products and services of NSIC, the Life Company marketing team travels extensively throughout our service areas holding training sessions for agents. We

also offer our best agents the opportunity to periodically attend retreats to network with the home office staff that help serve them and our policyholders. In addition, the retreat provides agents with additional knowledge of the products we offer, and serves as a forum for feedback on how we can better serve our agency force and policyholders.



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

Agents receive compensation for their sales efforts. In the case of life insurance agents, compensation is paid in the form of sales commissions plus a servicing commission. Commissions paid by NSIC in 2013 averaged approximately 11.8% of premiums. Commissions paid by NSFC in 2013 averaged approximately 15% of premiums. During 2013, one independent agent, accounted for more than 10% of total net earned premium of the property-casualty insurance subsidiaries. The net earned premium from this general agent totaled \$6,057,000 or 13.2% of total P&C segment net earned premium. NSFC also offers a “profit sharing bonus plan” to independent agents in order to promote better field underwriting and encourage retention of profitable business. This plan not only rewards our agents but also enhances profitability by giving the agent a vested interest in our success and also aids in maintaining price stability for all our customers as agents have a financial incentive to use good field underwriting practices when completing an application for insurance.

At December 31, 2013, NSIC employed seven career agents and one regional manager. NSIC also had approximately 200 independent agents actively producing new business.

At December 31, 2013, NSFC had contracts with approximately 1,400 independent agencies in eleven states.

## Competition

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

NSFC and Omega's primary insurance products are dwelling fire and homeowners, including mobile homeowners. Dwelling fire and homeowners, collectively referred to as the dwelling property line of business, is the largest line of business in property and casualty operations, composing 94% of total property and casualty premium revenue. We focus on providing niche insurance products within the markets we serve. We are in the top twenty-five dwelling property insurance carriers in our two largest states, Alabama and Mississippi. However, due to the large concentration of business among the top five carriers, our total market share in the dwelling fire line of business is approximately 2% in Alabama and 1% in Mississippi. In the homeowners line of business, our market share in both Alabama and Mississippi is less than 1%. The homeowners markets are even more concentrated with the top three homeowners carriers in both Alabama and Mississippi controlling over 50% of the market share.

We have actively sought competitive advantages over the last decade in the area of technological advancement. We have replaced our primary policy administration systems in both our property and casualty and life insurance subsidiaries. We replaced our legacy policy administration system in our life subsidiary in 2002. In late 2006 and throughout 2007, we began the process in transitioning to a new policy administration system in our property and casualty subsidiary. In 2010, we converted to our current property and casualty claims administration system.

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

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

### Regulation

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

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

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

Our insurance subsidiaries are subject to risk based capital requirements adopted by the National Association of Insurance Commissioners (NAIC). These requirements direct our insurance companies to calculate and report information according to a risk based formula which attempts to measure statutory capital and surplus needs based on the risk in our product mix and investment portfolio. The formula is designed to allow state insurance regulators to identify companies that are potentially inadequately capitalized. Under the formula, the Company calculates Risk Based Capital (RBC) by taking into account certain risks inherent in an insurer's assets, including investments and an insurer's liabilities. Risk based capital rules provide for different levels of action depending on the ratio of a company's total adjusted capital to its "authorized control level" RBC. Based on calculations made by each of our insurance subsidiaries at December 31, 2013, each subsidiary exceeds any levels that would require regulatory actions.

### A.M. Best Rating

A.M. Best Company is a leading provider of insurance company financial strength ratings and insurance company issuer credit ratings. Best's financial strength ratings and issuer credit ratings provide an independent opinion based on comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance

and business profile. All of our insurance companies have been assigned ratings by A.M. Best Co (Best). On November 20, 2013, Best affirmed the financial strength rating (FSR) of B++ (Good) and the issuer credit rating (ICR) of "bbb" of NSFC. Best maintained the negative outlook on both of NSFC's ratings. In addition, Best affirmed the FSR of B+(Good) and ICR of "bbb-" of Omega and NSIC. The outlook for all of these ratings is stable. Best also affirmed the ICR of "bb" of the parent holding company, NSEC, with a negative outlook. For the latest ratings, you can access [www.ambest.com](http://www.ambest.com).

#### Demotech Rating

The property and casualty subsidiaries have been assigned ratings by Demotech, Inc. On November 22, 2013, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

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Employees

The Company itself has no management or operational employees. Instead, all human resource activities are within the subsidiary National Security Insurance Company. NSIC employed 101 staff members as of December 31, 2013, none of which were represented by a labor union. The Company and its property and casualty subsidiary have a Management Service Agreement (“Agreement”) with National Security Insurance Company whereby the Company and the property and casualty subsidiaries reimburse NSIC for salaries and expenses of employees provided under the Agreement. Involved are employees in the areas of Underwriting, Customer Service, Policy Services, Accounting, Marketing, Administration, Document Management, Data Processing, Programming, Personnel, Claims, and Management. The Company, through NSIC, is represented by 8 employee agents in Alabama. The Company's property and casualty subsidiaries had approximately 1,400 independent (non-employee) agents producing business at December 31, 2013. We consider our employee relations to be good.

Additional information with respect to The National Security Group's Business

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

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

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

Item 1A. Risk Factors

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

Underwriting and product pricing

The insurance subsidiaries maintain underwriting departments that seek to evaluate the risks associated with the issuance of an insurance policy. NSIC accepts standard risks and, to an extent, substandard risks. In the case of the property and casualty subsidiaries, the underwriting staff attempts to assess, in light of the type of insurance sought by an applicant, the risks associated with a prospective insured or insurance situation. The underwriting assessment may involve various components in the risk evaluation process including, but not limited to, potential liability or fire hazards, age of dwelling, loss history, credit history of insured, employment status, location of fire department, home value, home heat source, and general maintenance of the property. In general, the property and casualty subsidiaries specialize in writing nonstandard risks.

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

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

### Approval of rates

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

### Maintenance of profit margins and potential for margin compression

Our maximum long term average pretax profit margin on most of our insurance products is approximately five to six percent. In most states, we have limited ability to increase our margins beyond this level for higher risk, and we can incur significant delays in our ability to pass along higher cost that we may incur. Examples of this risk include:

Our catastrophe reinsurance cost is negotiated annually and effective January 1 of each year. The reinsurance market in which we operate is unregulated, and our reinsurance cost is based on negotiated rates that adjust annually. Due to increased frequency of storms over the past decade and cycles of limited reinsurance market capacity, we often experience rate increases in which we have limited ability to negotiate and often cannot include these increases in our rates until the new reinsurance agreement is negotiated. Due to increased cat loads in more storm prone areas, significant year over year increases in cat cost can often temporarily eliminate our profit margins in some areas and significantly compress our overall profit margins priced into our insurance coverages.

We have a geographic concentration in the Southeastern U.S. which is exposed to significant hurricane risk. We believe that we are often not adequately compensated for certain heavily exposed risk through a combination of limits on allowable margin and regulatory delays in obtaining rate increases. We often have to manage these exposures using alternatives to pricing, such as limits on new business production, to help us manage exposure concentrations and protect our capital position.

Due to increasing catastrophe reinsurance cost, we have incurred increases in our reinsurance retentions/deductibles over the past decade years. Again, due to limits to profit margins, we are often not adequately compensated for the increased risk associated with these higher reinsurance retentions due to overall limits on margins in some of the states in which we operate.

### Reinsurance, risk of loss from catastrophic event and geographic concentration

Both insurance subsidiaries customarily reinsure with other insurers certain portions of the insurance risk. The primary purpose of such reinsurance arrangements is to enable the Company to limit its risk on individual policies, and in the case of property insurance, limit its risk in the event of a catastrophe in various geographic areas. A reinsurance arrangement does not discharge the issuing company from primary liability to the insured, and the issuing company is required to discharge its liability to the insured even if the reinsurer is unable to meet its obligations under the reinsurance arrangements. Reinsurance, however, does make the reinsurer liable to the issuing company to the extent of any reinsurance in force at the time of the loss. Reinsurance arrangements also decrease premiums retained by the issuing company since that company pays the reinsuring company a portion of total premiums based upon the amount of liability reinsured. NSIC generally reinsures all risks in excess of \$50,000 with respect to any one insured. NSFC and Omega generally reinsure with third-parties any liability in excess of \$225,000 on any single policy. In addition, the property and casualty subsidiaries have catastrophe excess reinsurance, which provided protection in part with respect to aggregate property losses arising out of a single catastrophe, such as a hurricane.

During 2013, the property and casualty segment maintained a catastrophe contract, which covered losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeded the \$4 million company retention stated in the contract, reinsurers would reimburse the company 100% of gross losses up to the upper limits of the reinsurance agreement, which was \$72.5 million in 2013 and 2012. Any losses above the \$72.5 million upper limit are the responsibility of our Company. The contract in place during 2013 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed. This reinsurance structure is expected to remain unchanged in 2014.

The property and casualty subsidiaries utilize our actual in force policy data modeled utilizing two different industry accepted catastrophe models to structure catastrophe reinsurance and determine upper limits of catastrophe



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reinsurance agreements. Based on modeling results utilized in 2013 and 2012, the Company was reinsured at approximately a 250 year event level. While this estimate is subject to some uncertainty and model risk, the models indicate that we maintain catastrophe reinsurance upper limits to cover an event that has less than a 0.5% probability of occurring in a given year.

Our inability to procure reinsurance, primarily catastrophe reinsurance, could adversely impact our ability to maintain our level of premium revenue. The increased frequency of catastrophic events also increases our cost of reinsurance pressuring the profit margins of our insurance products. It is generally cost prohibitive to maintain deductibles below levels currently in place. Our current \$4.0 million catastrophe deductible will adversely impact underwriting results in years in which we incur losses from a major hurricane or tornado outbreak.

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

Catastrophe modeling results play a major role in our decision making process regarding the upper limits of our catastrophe reinsurance protection. While the level of sophistication has increased significantly in recent years in the design of computer generated catastrophe modeling, there are risks inherent in the modeling process, and the process continues to evolve. We believe the chance of a catastrophe event exceeding the upper limits of our reinsurance protection is remote; however, with the unpredictability of natural disasters, we are unable to eliminate all risk of exceeding the upper limits of our reinsurance protection. Hurricane Katrina exceeded the upper limits of our coverage in 2005. We have since increased the upper limits of our coverage, but should a future event exceed the upper limits of our reinsurance coverage by a material amount, our financial condition could be adversely impacted.

### Climate change

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

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

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

Reserve liabilities

NSIC maintains life insurance reserves for future policy benefits to meet future obligations under outstanding policies. These reserves are calculated to be sufficient to meet policy and contract obligations as they arise. Liabilities for future policy benefits are calculated using assumptions for interest, mortality, morbidity, expense and withdrawals determined at the time the policies were issued. As of December 31, 2013, the total reserves of NSIC (consisting of reserves for accident and health insurance) were approximately \$33.3 million. We believe, based on current available information, reserves for future policy benefits are adequate. However, we are currently in a period of persistent low interest rates, and should this period of low rates be sustained over the long term, it can impair our ability to make sufficient returns

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to cover future policy liabilities. Also, should actual mortality, morbidity, expense or withdrawal assumption differ materially from assumptions, our operating results could be negatively impacted.

The property and casualty subsidiaries are also required to maintain loss reserves (claim liabilities) for all lines of insurance. Such reserves are intended to cover the probable ultimate cost of settling all claims, including those incurred but not yet reported. The reserves of the property and casualty subsidiaries reflect estimates of the liability with respect to incurred claims and are determined by evaluating reported claims on an ongoing basis and by estimating liabilities for incurred but not reported claims. Such reserves include adjustment expenses to cover the cost of investigating losses and defending lawsuits. The establishment of accurate reserves is complicated by the fact that claims in some lines of insurance are settled many years after the policies have been issued, thus raising the possibility that inflation may have a significant effect on the amount of ultimate loss payment, especially when compared to initial loss estimates. The subsidiaries, however, attempt to restrict their writing to risks that settle within one to four years of issuance of the policy. As of December 31, 2013, the property and casualty subsidiaries had reserves for unpaid claims of approximately \$8.7 million, before subtracting unpaid claims due from reinsurers of \$782,000, leaving net unpaid claims of \$8.0 million. The reserves are not discounted for the time value of money. No changes were made in the assumptions used in estimating the reserves during the years ending December 31, 2013 or 2012. The Company believes, based on current available information, such reserves are adequate to provide for settlement of claims.

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

## Financial Ratings

The insurance subsidiaries are rated by the independent insurance rating agencies A.M. Best and Demotech. A downgrade in our ratings from either of these rating agencies could adversely impact our ability to maintain existing business or generate new business. See page 12 of this Form 10-K for additional information on our current financial ratings.

## Regulation

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

Many states in which the insurance subsidiaries operate, including Alabama, have laws requiring that insurers become members of guaranty associations. These associations guarantee that benefits due policyholders of insurance companies will continue to be provided even if the insurance company which wrote the business is financially unable to fulfill its obligations. To provide these benefits, the associations assess the insurance companies licensed in a state

that write the line of insurance for which coverage is guaranteed. The amount of an insurer's assessment is generally based on the relationship between that company's premium volume in the state and the premium volume of all companies writing the particular line of insurance in the state. The Company has paid no material amounts to guaranty associations over the past two years. These payments, when made, are principally related to association costs incurred due to the insolvency of various insurance companies. Future assessments depend on the number and magnitude of insurance company insolvencies, and such assessments are therefore difficult to predict.

Most states have enacted legislation or adopted administrative rules and regulations covering such matters as the acquisition of control of insurance companies, transactions between insurance companies and the persons controlling them. The National Association of Insurance Commissioners has recommended model legislation on these subjects, and all states where the Company's subsidiaries transact business have adopted, with some modifications, that model

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legislation. Among the matters regulated by such statutes are the payments of dividends. These regulations have a direct impact on the Company since its cash flow is substantially derived from dividends from its subsidiaries, and adverse operating results in the insurance subsidiaries or the development of significant additional obligations in the holding company could adversely impact liquidity at the holding company level. Statutory limitations of dividend payments by subsidiaries are disclosed in Note 12 of the accompanying Consolidated Financial Statements.

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

### Competition

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

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

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

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

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

#### Inflation

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

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### Investment Risk and Liquidity

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

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

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

### Litigation

We are routinely involved in litigation related to our insurance products. Litigation can involve claims for damages in excess of stated policy limits and include damages for bad faith. Defense of these claims can often be expensive adding to our loss adjustment expenses, and adverse jury verdicts could materially impact our results of operations and financial position.

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

The Company is an insurance holding company with no significant operations and limited outside sources of income. The primary asset of the Company is its stock in the insurance subsidiaries. The Company relies on dividends from the insurance subsidiaries in order to pay operating expenses, to service debt obligations and to provide liquidity for the payment of dividends to shareholders. The ability of the insurance subsidiaries to pay dividends is subject to regulatory restrictions discussed in detail in Note 12 of the Consolidated Financial Statements included herein. Should the insurance subsidiaries become subject to restrictions imposed by insurance regulations regarding the payment of dividends, the ability of the Company to pay expenses, meet debt service requirements and pay cash dividends to shareholders could be adversely impacted. Additionally, should business conditions deteriorate, we could be forced to further limit or suspend dividend payments in order to protect our capital position.

### Low common stock trading volume and liquidity limitations

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

### Debt covenants

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

### Technology

Our insurance subsidiaries are dependent on computer technology and internet based platforms in the delivery of insurance products. Our ability to innovate and manage technological change is a key to remaining competitive in the

insurance industry. A breakdown in major systems or failure to maintain up to date technology could adversely impact our ability to write new business and service existing policyholders, which would adversely impact our results of operations and financial condition. The occurrence of computer viruses, information security breaches, disasters, or unanticipated events could affect the data processing systems of the Company or its service providers which could damage the Company's business and adversely affect our financial condition and results of operations.



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### Access to capital

We rely on debt and equity capital to operate. Due to a recent litigation settlement, our debt levels are higher than our historical norm. Adverse operating results, general market and economic conditions could impair our ability to raise new capital needed to support our operations.

### Key Personnel

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

### Accounting Standards

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

### Item 1B. Unresolved Staff Comments

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

### Item 2. Properties

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

The Company and its subsidiaries own certain real estate investment properties. Following the sale of 2,739 acres of timber property during 2013, the Company owns approximately 211 acres of real estate in Coffee County in Alabama. There was no timber revenue during 2013 compared to \$87,000 during 2012. There were no gains on timber sales during 2013 compared to \$71,000 in 2012. The Company had realized gains from the sale of timber property of \$3,308,000 during 2013.

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

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

### Item 3. Legal Proceedings

As disclosed in Note 16 to these consolidated financial statements regarding contingencies, the Company was involved in litigation related to its divestiture of Mobile Attic, Inc. In June 2012, the matter was settled. Under the terms of the settlement agreement, the Company will pay a total of \$13 million to the plaintiff. Further information regarding events leading to settlement and settlement details found within the Company's discussion of Liquidity and

Capital Resources as well as in Note 16 to the consolidated financial statements.

The Company and its subsidiaries are named parties to litigation related to the conduct of their insurance operations. Further information regarding details of pending suits can be found in Note 16 to the consolidated financial statements.

#### Item 4. Mine Safety Disclosures

This section is not applicable.

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## Part II

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

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

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

	Stock Closing Prices			
	2013 High	Low	2012 High	Low
First Quarter	\$8.58	\$7.76	\$9.91	\$7.67
Second Quarter	\$8.22	\$6.84	\$9.36	\$8.01
Third Quarter	\$7.62	\$6.13	\$9.36	\$8.00
Fourth Quarter	\$10.23	\$6.04	\$8.58	\$7.58

## Shareholders

The number of shareholders of the Company's common stock was approximately 1,200, and the Company had 2,494,480 shares of common stock outstanding on March 21, 2014.

## Dividends

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

	Dividends Per Share	
	2013	2012
First Quarter	\$0.025	\$0.10
Second Quarter	\$0.025	\$0.10
Third Quarter	\$0.025	\$0.10
Fourth Quarter	\$0.025	\$0.025

Discussion regarding dividend restrictions may be found on page 40 of the Managements' Discussion and Analysis as well as in Note 12 of the Consolidated Financial Statements.

The payment of shareholder dividends is subject to the discretion of our Board of Directors and is dependent upon many factors including our operating results, financial condition, capital requirements and general economic conditions. Total shareholder dividends paid in 2013 totaled \$248,000.

Future dividends are dependent on future earnings, the Company's financial condition and other factors evaluated periodically by management and the Board of Directors. The Company is an insurance holding company and depends upon the dividends from the insurance subsidiaries to pay operating expenses and to provide liquidity for the payment of shareholder dividends. The payment of shareholder dividends is subject to the profitability of the insurance subsidiaries and the ability of the insurance subsidiaries to pay dividends to the holding company. Dividends from the insurance subsidiaries are subject to approval of the regulator in the state of domicile, the Alabama Department of Insurance.

Securities authorized for issuance under equity compensation plans

The Company currently only has one equity compensation plan which was approved by security holders at the 2009 Annual Shareholders Meeting.

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The following table sets forth securities authorized for issuance under the Company's equity compensations plans:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	—	—	172,120
Equity compensation plans not approved by security holders	—	—	—
Total	—	—	172,120

## Item 6. Selected Financial Data

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

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

Selected Financial Data:	2013	2012	2011	2010	2009
Net premiums earned	\$52,366	\$51,815	\$56,243	\$61,263	\$59,594
Net investment income	3,746	4,191	4,261	5,089	5,289
Net realized investment gains	4,439	2,790	669	1,879	357
Other income	609	720	919	1,161	764
Total revenues	\$61,160	\$59,516	\$62,092	\$69,392	\$66,004
Net (loss) income	\$5,658	\$(6,671)	\$(4,956)	\$3,265	\$4,224
Net (loss) income per share	\$2.28	\$(2.70)	\$(2.01)	\$1.32	\$1.71
Total shareholders' equity	\$33,472	\$30,227	\$38,015	\$43,710	\$41,168
Book value per share	\$13.42	\$12.25	\$15.41	\$17.72	\$16.69
Dividends per share	\$0.10	\$0.325	\$0.550	\$0.600	\$0.600
Net change in unrealized capital gains (net of tax)	\$(2,801)	\$(101)	\$1,258	\$847	\$3,520
Total assets	\$133,980	\$135,716	\$132,951	\$136,867	\$131,396

Quarterly Information:	Premiums	Investment & Other Income	Realized Investment Gains (Losses)	Claims and Benefit Payments	Net Income (Loss)	Net Income (Loss) Per Share
2013						
First Quarter	\$12,934	\$1,256	\$27	\$9,551	\$(409)	\$(0.17)
Second Quarter	13,038	873	1,030	8,260	965	0.39
Third Quarter	13,191	1,209	3,297	7,112	3,339	1.35
Fourth Quarter	13,203	1,017	85	6,223	1,763	0.71
	\$52,366	\$4,355	\$4,439	\$31,146	\$5,658	\$2.28
2012						
First Quarter	\$13,496	\$1,332	\$206	\$7,845	\$531	\$0.21
Second Quarter	12,533	1,259	865	7,976	(7,306)	(2.96)
Third Quarter	12,904	1,398	1,703	11,564	(627)	(0.25)
Fourth Quarter	12,882	922	16	6,720	731	0.30

\$51,815      \$4,911      \$2,790      \$34,105      \$(6,671      ) \$(2.70      )

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

Overview

The following discussion highlights significant factors influencing the consolidated financial position and results of operations of The National Security Group, Inc. (referred to in this document as we, our, us, the Company or NSEC) and its subsidiaries. We are a “smaller reporting company” under Securities and Exchange Commission (SEC) regulations and therefore qualify for the scaled disclosure of smaller reporting companies. In general, the same information is required to be disclosed in the management discussion and analysis by smaller reporting companies except that the discussion need only cover the latest two year period and disclosures relating to contractual obligations are not required. In accordance with the scaled disclosure requirements, this discussion covers the two year period ended December 31, 2013.

The National Security Group, Inc. is made up of two segments: the Life segment and the P&C segment. The Company's life, accident and health insurance business is conducted through National Security Insurance Company (NSIC), a wholly owned subsidiary of the Company organized in 1947. The Company's property and casualty insurance business is conducted through National Security Fire & Casualty Company (NSFC), a wholly owned subsidiary of the Company organized in 1959, and Omega One Insurance Company (Omega), a wholly owned subsidiary of National Security Fire & Casualty Company organized in 1992.

This discussion and analysis of the consolidated results of operations and financial condition of the Company should be read in conjunction with the Selected Financial Data and Consolidated Financial Statements and related notes included in this Form 10-K. Please refer to our note regarding forward-looking statements on pages 4-5 of this report.

Information in this discussion is presented in whole dollars rounded to the nearest thousand. Tabular amounts are presented in thousands.

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 ten states with 50.4% of total premium revenue generated in the states of Alabama and Mississippi. Property and casualty insurance is the most significant segment, accounting for 89.0% of gross insurance premium revenue in 2013. Revenue generated from the life segment accounted for 11.0% of gross insurance premium revenue in 2013.

National Security Insurance Company (NSIC) is a life, accident and health insurance company founded in 1947. The premium revenue produced in NSIC from the traditional life products and accident and health products accounted for 7.8% and 3.2%, respectively, of total gross 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, Tennessee and Texas.

The property and casualty segment consists of the consolidated operations of two subsidiaries, National Security Fire and Casualty Company and its wholly owned subsidiary, Omega One Insurance Company. There is no material differentiation between the products underwritten by NSFC and Omega as both underwrite primarily dwelling personal lines coverage. The Property and Casualty segment has premium in-force in the states of Alabama, Arkansas, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, and Tennessee. We ceased writing business in the state of Texas in late 2012 and had no business in force in the state at December 31, 2013.

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 in which the rates will apply.

All of our insurance companies have been assigned ratings by A.M. Best Co (Best). On November 20, 2013, Best affirmed the financial strength rating (FSR) of B++ (Good) and the issuer credit rating (ICR) of "bbb" of NSFC. Best maintained the negative outlook on both of NSFC's ratings. In addition, Best affirmed the FSR of B+(Good) and ICR of "bbb-" of Omega and NSIC. The outlook for all of these ratings is stable. Best also affirmed the ICR of "bb" of the parent holding company, NSEC, with a negative outlook.



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The property and casualty subsidiaries have been assigned ratings by Demotech, Inc. On November 22, 2013, Demotech affirmed a Financial Stability Rating of A (Exceptional) for both NSFC and Omega.

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). Due to the small amount of earned 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.

The property and casualty segment can be impacted by severe storm activity resulting in incurred losses and loss adjustment expenses primarily from tornado, wind and hail related damage. These storm systems or other natural disasters are classified as catastrophes (referred to as "cat events" or "catastrophe events" throughout the remainder of this document) by Property Claim Service (PCS) when these events cause \$25 million or more in industry wide direct insured losses and affect a significant number of policyholders and insurers.

## Summary of Consolidated Results of Operations

Financial Results for the years ended December 31, 2013 and 2012 were as follows:

(dollars in thousands)	Twelve months ended December 31,	
	2013	2012
REVENUES		
Net premiums earned	\$52,366	\$51,815
Net investment income	3,746	4,191
Net realized investment gains	4,439	2,790
Other income	609	720
Total Revenues	61,160	59,516
EXPENSES		
Policyholder benefits and settlement expenses	31,146	34,105
Amortization of deferred policy acquisition costs	3,613	3,711
Commissions	7,103	7,556
General and administrative expenses	8,443	8,754
Litigation settlement and defense costs	—	13,328
Taxes, licenses and fees	1,846	1,846
Interest expense	1,686	1,280
Total Expenses	53,837	70,580
Income (Loss) Before Income Taxes	7,323	(11,064 )
INCOME TAX EXPENSE (BENEFIT)		
Current	92	527
Deferred	1,573	(4,920 )
	1,665	(4,393 )
Net Income (Loss)	\$5,658	\$(6,671 )
INCOME (LOSS) PER COMMON SHARE	\$2.28	\$(2.70 )
DIVIDENDS DECLARED PER SHARE	\$0.10	\$0.325
Reconciliation of Net Income (Loss) to non-GAAP Measurement		
Net income (loss)	\$5,658	\$(6,671 )

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Income tax expense (benefit)	1,665	(4,393	)
Realized investment (gains) losses, net	(4,439	) (2,790	)
Litigation	—	13,328	
Operating Income (Loss)	\$2,884	\$(526	)

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For the year ended December 31, 2013, the Company had net income totaling \$5,658,000, \$2.28 per share, compared to a net loss of \$6,671,000, \$2.70 loss per share, for the year ended December 31, 2012. On a pretax basis, for the year ended December 31, 2013, we had income of \$7,323,000 compared to a loss of \$11,064,000 for the year in 2012. Our pretax income for the year ended December 31, 2013, consisted of income from operations of \$2,884,000 and realized investment gains of \$4,439,000. The pretax loss for the year ended December 31, 2012, consisted of a loss from operations of \$526,000, realized investment gains of \$2,790,000 and expenses associated with a non-insurance related litigation settlement (Mobile Attic Litigation) of \$13,328,000.

For the year ended December 31, 2012, pretax income was adversely impacted by litigation related settlement expenses of \$13,328,000. This settlement was associated with previously disclosed litigation stemming from the sale of a holding company investment, Mobile Attic Inc., and was not associated with either of our insurance segments. Since this action was settled in 2012, our 2013 results were not impacted by this litigation.

The significant improvement in income from operations in 2013 compared to the prior year was primarily associated with improved underwriting results in the property and casualty segment. Favorable weather patterns during 2013, particularly in the second half of the year, contributed to a \$1,918,000 decrease in non-catastrophe related wind and hail claims. In addition, fire related losses were down \$725,000 compared to 2012. Our 2012 results were adversely impacted by losses from Hurricane Isaac. Losses from Hurricane Isaac increased our incurred losses in 2012 by \$3,390,000.

Realized capital gains were \$4,439,000 in 2013 compared to \$2,790,000 for the same period last year. The \$1,649,000 increase in year over year realized capital gains was primarily due to the September 2013 sale of 2,739 acres of investment real estate consisting of timber property in Alabama. Capital gains in 2012 were primarily associated with the sale of debt and equity investments held by the insurance subsidiaries.

Shareholders' equity as of December 31, 2013 was \$33,472,000 up \$3,245,000 compared to \$30,227,000 as of December 31, 2012. Book value per share increased \$1.17 per share for the period ended December 31, 2013 to \$13.42 per share compared to \$12.25 per share at December 31, 2012. The primary reason for the increase in book value per share was the significant turnaround in net income due to both improved operating results in the insurance subsidiaries and the increase in equity due to the realized capital gain on the sale of timber property mentioned previously.

#### Results of Operations for Years Ended December 31, 2013 and 2012

The Company ended 2013 with net premiums earned totaling \$52,366,000 compared to \$51,815,000 for the same period last year. Premium revenue is generated from our two operating segments: P&C segment and life segment. The P&C segment accounts for approximately 87% of total premium revenue while our life segment contributes the remaining 13%. The P&C segment operates in personal lines insurance products primarily generating premium revenue from dwelling fire and homeowners coverages. Our life segment produces premium revenue primarily from whole life, accident and critical illness insurance policies.

The following tables provide a summary of premium revenue by segment and line of business for the year ended December 31, 2013 and 2012:

(dollars in thousands)	Year ended December 31,		Percent increase (decrease)
	2013	2012	
Life, accident and health operations premiums earned:			
Traditional life insurance	\$4,718	\$4,818	(2.1 )%

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Accident and health insurance	1,939	1,864	4.0	%
Gross life, accident and health	6,657	6,682	(0.4	)%
Reinsurance premium ceded	(66	) (73	) (9.6	)%
Net life, accident and health premiums earned	\$ 6,591	\$ 6,609	(0.3	)%

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(dollars in thousands)	Year ended December 31,		Percent	
	2013	2012	increase (decrease)	
Property and Casualty operations premiums earned:				
Dwelling fire & extended coverage	\$ 29,302	\$ 27,206	8.0	%
Homeowners (Including mobile homeowners)	22,830	23,287	(2.0)	)%
Ocean marine	524	1,090	(51.9)	)%
Private passenger auto liability	—	319	(100.0)	)%
Other liability	1,593	1,412	12.8	%
Commercial auto liability	—	6	(100.0)	)%
Auto physical damage	—	149	(100.0)	)%
Gross property and casualty	54,249	53,469	1.5	%
Reinsurance premium ceded	(8,474)	) (8,263	) 2.6	%
Net property and casualty earned	\$ 45,775	\$ 45,206	1.3	%
Gross premiums earned	\$ 60,906	\$ 60,151	1.3	%
Reinsurance premium ceded	(8,540)	) (8,336	) 2.4	%
Net premiums earned	\$ 52,366	\$ 51,815	1.1	%

Consolidated net earned premium revenue was \$52,366,000 for the year ended December 31, 2013 compared to \$51,815,000 for the same period last year; an increase of \$551,000 or 1.1%. The P&C segment was the primary source of the increase in net earned premium ending December 31, 2013, at \$45,775,000 compared to \$45,206,000 for the same period last year; an increase of \$569,000. With the termination of all automobile lines of business in 2012 and the discontinuation of our marine program in June 2013, we have streamlined our property and casualty operations to focus on the home insurance market. With a combination of rate adjustments and modest organic growth, we increased P&C segment net earned premium by 1.3% in 2013 compared to 2012.

While gross premium earned from our dwelling fire program increased 8.0% in 2013 compared to the same period last year, this was partially offset by a 2.0% decline from our homeowners programs as well as the reduction in premium from the discontinued automobile and ocean marine programs.

P&C segment gross earned premium was also impacted by a 2.4% increase in catastrophe reinsurance cost in 2013 compared to the same period last year. While our reinsurance structure remained unchanged, we did incur a slight increase in our reinsurance rate leading to the increase in reinsurance cost in 2013.

The life segment ended December 2013 with year-to-date net earned premium revenue (net of reinsurance ceded) of \$6,591,000 compared to \$6,609,000 for the same period last year; a decrease of \$18,000 or 0.3%. A \$100,000 decrease in net earned premium from our traditional life insurance products was the primary reason for the overall decline in 2013 life segment premium revenue. However, this decrease was mostly offset by growth in accident and health lines.

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Major categories of investment income are summarized as follows:

(dollars in thousands)	Year ended December 31,	
	2013	2012
Fixed maturities	\$3,351	\$3,452
Equity securities	137	196
Mortgage loans on real estate	22	26
Investment real estate	8	64
Policy loans	104	95
Company owned life insurance change in surrender value	(73	) 271
Other, principally short-term investments	437	337
	3,986	4,441
Less: Investment expenses	240	250
Net investment income	\$3,746	\$4,191

For the year ended December 31, 2013, net investment income was \$3,746,000 compared to \$4,191,000 for the same period last year; a decrease of \$445,000 or 10.6%. The primary reason for the 2013 decline in year to date investment income was a decrease in value of company owned life insurance (COLI). The decrease in value of COLI was primarily driven by the rise in interest rates, particularly mortgage interest rates, as most of the cash value is invested in mortgage related investments.

Major categories of realized investment gains and losses are summarized as follows:

(dollars in thousands)	Year ended December 31,	
	2013	2012
Fixed maturities	\$(95 )	\$539
Equity securities	1,219	2,263
Trading securities	—	2
Other, principally real estate	3,315	73
Other-than-temporary impairments	—	(87 )
Net realized investment gains	\$4,439	\$2,790

Net realized investment gains totaled \$4,439,000 in 2013 compared to \$2,790,000 in 2012; an increase of \$1,649,000. The \$1,649,000 increase in realized investment gains in 2013 compared to 2012 was primarily related to net realized capital gains from the sale of 2,739 acres of investment real estate consisting of timber property in Alabama. The timber property sale contributed \$3.3 million to pretax realized capital gains. The timber property, carried at historical cost of \$1.3 million, was sold for \$4.6 million.

Policyholder benefits and settlement expenses (claims) were \$31,146,000 (59.5% of net premiums earned) for the year ended December 31, 2013, compared to \$34,105,000 (65.8% of net premium earned) for the same period last year; a decrease of 8.7%. The primary reason for the decrease in claims in 2013 compared to 2012 was a reduction in reported non-catastrophe wind and hail claims as well as a decline in reported fire losses; both in the P&C segment.

Amortization of deferred policy acquisition costs (DAC) and commissions totaled \$10,716,000 compared to \$11,267,000 for the same period last year; a decrease of \$551,000. A change in terms of agent contingent commission contracts in the P&C segment coupled with a decrease in first year commissions in the life segment were the primary reasons for the decrease in DAC and commission expenses in 2013 compared to 2012.

General and administrative expenses decreased \$311,000, ending 2013 at \$8,443,000 compared to \$8,754,000 for the same period last year. General expenses were 16.1% of earned premium revenue in 2013 compared to 16.9% of

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earned premium revenue in 2012. The decline in general expenses in 2013 compared to 2012 was primarily the result of a reduction in costs associated with actuarial fees and continued company wide cost reduction measures. Management continues to focus on this area as we seek ways to maximize efficiency and reduce costs by streamlining processes and cross-training employees across both insurance segments of the Company.

The company had no litigation settlement costs for the year ended December 31, 2013 compared to \$13,328,000 for the same period last year. This line item reflects cost associated with Mobile Attic litigation which was settled in 2012.

Interest expense for the year ended December 31, 2013 was up \$406,000 from the prior year at \$1,686,000 compared to \$1,280,000 in 2012. An increase in debt related to the litigation settlement (discussed above) in the holding company was the primary reason for the increase in interest expense in 2013 compared to 2012.

The Company had an income tax expense of \$1,665,000 in 2013 compared to an income tax benefit totaling \$4,393,000 in 2012. Income tax expense in 2013 was composed of current taxes totaling \$92,000 and deferred taxes totaling \$1,573,000. The income tax benefit in 2012 was composed of current tax expense of \$527,000 and a deferred tax benefit totaling \$4,920,000. The utilization of net operating loss carryforwards associated with prior year operating losses limited current tax expense on a consolidated basis.

The Company ended 2013 with net income of \$5,658,000 compared to a net loss of \$6,671,000 for the same period last year. The increase in net earned premiums and decline in claims in 2013 both contributed to underwriting profits and therefore, were the primary reasons for the net income in the current year. The litigation settlement and \$3,400,000 in pretax Hurricane Isaac losses mentioned above were the primary reasons for the net loss in 2012.

Industry Segment Data

Premium revenues for The National Security Group's two operating segments (Life segment, Property and Casualty segment) are summarized as follows (amounts in thousands):

(dollars in thousands)	2013	%	2012	%	
Life, accident and health insurance	\$6,591	12.6	% \$6,609	12.8	%
Property and casualty insurance	45,775	87.4	% 45,206	87.2	%
	\$52,366	100.0	% \$51,815	100.0	%

The property and casualty segment composed 87.4% of total premium revenue in 2013 compared to 87.2% in 2012. The P&C segment is primarily composed of dwelling fire and homeowners lines of business. The life segment composed 12.6% of premium revenue in 2013 compared to 12.8% in 2012 with revenue produced primarily from life, accident and supplemental health insurance products.

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



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## Life and Accident and Health Insurance Operations:

Our life segment is the smaller of our insurance segments contributing 12.6% of total insurance premium revenue in 2013 and 12.8% in 2012. Premium revenues and operating income for the life segment for the year ended December 31, 2013 and 2012 are summarized below (amounts in thousands):

(dollars in thousands)	2013	2012
<b>REVENUE</b>		
Net premiums earned	\$6,591	\$6,609
Net investment income	2,032	1,993
Net realized investment gains	111	1,635
Other income	5	2
<b>Total Revenues</b>	<b>8,739</b>	<b>10,239</b>
<b>BENEFITS AND EXPENSES</b>		
Policyholder benefits paid or provided	4,927	5,294
Amortization of deferred policy acquisition costs	1,037	938
Commissions	425	468
General and administrative expenses	2,034	1,973
Insurance taxes, licenses and fees	232	218
Interest expense	77	53
<b>Total Expenses</b>	<b>8,732</b>	<b>8,944</b>
<b>INCOME BEFORE INCOME TAXES</b>	<b>\$7</b>	<b>\$1,295</b>

## Year Ended December 31, 2013 Compared to Year Ended December 31, 2012:

NSIC premium accounted for 12.6% of total consolidated net premium revenue for 2013. Net premium revenue in NSIC was \$6,591,000 at December 31, 2013 compared to \$6,609,000 for the same period last year; a decrease of 0.3%. The \$18,000 decrease in net premium revenue was primarily due to a 2% reduction in net premium revenue from the traditional life insurance line of business in 2013 compared to 2012. While net premium revenue from our accident and health products increased 4% in 2013 compared to 2012, and partially offset the decline, total NSIC net premium revenue was down 0.3%.

Net investment income was virtually unchanged at \$2,032,000 for the year ended December 31, 2013 compared to \$1,993,000 for the same period last year. Investment income in NSIC is generated from securities held in our investment portfolio as well as mortgage and policy loan interest. Life segment invested assets were up in 2013 compared to 2012 leading to the slight increase in net investment income.

NSIC ended 2013 with net realized investment gains totaling \$111,000 compared to \$1,635,000 for the same period last year. The primary reason for the \$1,524,000 decrease in net realized investment gains was a decline in selling activity in 2013 compared to 2012. Realized investment gains in both 2013 and 2012 were primarily generated from the sale of equity securities. In an effort to lessen statutory capital volatility and reduce capital charges for equity investment holdings, we have reduced our equity investments over the past two years with the level of reductions in equity holdings in 2012 exceeding 2013. During the prior year, net realized capital gains were impacted by recognized other-than-temporary impairment losses on one security totaling \$87,000; however, we had recoveries from previously recognized other-than-temporary impairments totaling \$364,000.

Claims were \$4,927,000 through December 31, 2013 compared to \$5,294,000 through December 31, 2012; a decrease of \$367,000. The primary reason for the reduction in claims in the current year compared to the prior year was a decrease in claims in both the ordinary and individual accident and health lines of business.

Deferred policy acquisition cost amortization and commission expenses increased \$56,000 for the year ended December 31, 2013 at \$1,462,000 compared to \$1,406,000 for the same period last year; an increase of 4%. The slight increase in deferred acquisition cost was primarily due less cost being capitalized as a component of deferred acquisition cost due to a reduction in new product sales.

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General and administrative expenses were \$2,034,000 in 2013 compared to \$1,973,000 in 2012. As a percent of earned premium, general and administrative expenses were comparable ending December 31, 2013 and 2012 at 30.9% and 29.9%, respectively. Historically, general and administrative expenses in our life segment have run higher than industry averages due to the small size of the subsidiary.

For the year ended December 31, 2013 and 2012, insurance taxes, licenses and fees were \$232,000 and \$218,000, respectively. As a percent of earned premium, insurance taxes, licenses and fees were comparable at 3.5% in 2013 and 3.3% in 2012.

For the year ended December 31, 2013, the life segment had year-to-date pretax income of \$7,000 compared to pretax income of \$1,295,000 for the same period last year. The primary reason for the decline was the \$1,524,000 decrease in realized capital gains.

**Property & Casualty Operations:**

Property and casualty operations constitute our largest segment composing 87.4% and 87.2% of our total consolidated premium revenue in 2013 and 2012, respectively. Premium revenues and operating income for the P&C segment for the year ended December 31, 2013 and 2012 are summarized below:

(dollars in thousands)	2013	2012
<b>REVENUE</b>		
Net premiums earned	\$45,775	\$45,206
Net investment income	1,637	2,107
Net realized investment gains	1,020	1,083
Other income	604	718
Total Revenues	49,036	49,114
<b>BENEFITS AND EXPENSES</b>		
Policyholder benefits paid or provided	26,219	28,811
Amortization of deferred policy acquisition costs	2,576	2,773
Commissions	6,678	7,088
General and administrative expenses	5,683	6,262
Insurance taxes, licenses and fees	1,614	1,628
Total Expenses	42,770	46,562
<b>INCOME BEFORE INCOME TAXES</b>	<b>\$6,266</b>	<b>\$2,552</b>

**Year Ended December 31, 2013 Compared to Year Ended December 31, 2012:**

Property and casualty segment premium revenue for 2013 was \$45,775,000 compared to \$45,206,000 for the same period last year; an increase of 1.3%. The primary reason for the increase in 2013 compared to 2012 was an 8.0% increase in gross premium revenue in our dwelling fire program. However, this increase was partially offset by revenue reductions associated with the elimination of our ocean marine program in 2013 and auto program during 2012.

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

Line of Business	2013		2012		2013		
	Premium Earned	% of NPE	Premium Earned	% of NPE	Increase (Decrease) over 2012		
Dwelling Fire/Allied Lines	\$30,895	67.5	% \$28,618	63.4	%	8.0	%
Homeowners	22,830	49.9	% 23,287	51.5	%	(2.0	)%
Ocean Marine	524	1.1	% 1,090	2.4	%	(51.9	)%
Private Passenger Automobile	—	—	% 468	1.0	%	(100.0	)%
Commercial Automobile	—	—	% 6	—	%	(100.0	)%
Catastrophe Excess Reinsurance	(7,170	) (15.7	)% (6,824	) (15.1	)%	5.1	%
Catastrophe Reinstatement Premium Protection	(1,304	) (2.8	)% (1,439	) (3.2	)%	(9.4	)%
Net Premium Earned	\$45,775	100.0	% \$45,206	100.0	%	1.3	%

P&C segment net premium revenue was up 1.3% for the year ended December 31, 2013, at \$45,775,000 compared to \$45,206,000 through December 31, 2012. The primary reason for the increase was 8.0% growth in gross premium earned in the dwelling fire program in the current year compared to the same period last year. The 2013 increase in dwelling fire gross earned premium was partially offset by a 2.0% decrease in gross earned premium from our homeowners programs as well as the reduction in premium from the discontinued automobile and ocean marine programs.

P&C segment net earned premium was also impacted by a 2.6% increase in ceded premium associated with increased catastrophe reinsurance cost in 2013 compared to the same period last year. The Company maintains catastrophe reinsurance coverage to mitigate loss exposure from catastrophic events. Our catastrophe retention remained unchanged at \$4 million and we maintain catastrophe reinsurance covering the cost of a single catastrophe event up to \$72.5 million after exceeding the retention. The 2.6% increase included coverage related to our reinsurance premium protection (RPP) which was added in 2012. The decision to add and maintain the RPP coverage was made by management in an effort to reduce earnings volatility and strengthen our capital position in the P&C segment. In the event of a major catastrophe, the RPP coverage limits the pretax impact on earnings of a modeled 100 year cat event by approximately \$4.5 million. A 100 year event is defined as an event that has approximately a 1% probability of occurring in a given year.

Under the catastrophe reinsurance program for 2013, the Company retains the first \$4,000,000 in losses from each event. Reinsurance coverage is maintained in four layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	100% of \$6,000,000 in excess of \$4,000,000
Second Layer	100% 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

Additional details regarding the structure of the current year agreement can be found in Note 10 to the consolidated financial statements.

Net investment income totaled \$1,637,000 in 2013 compared to \$2,107,000 in 2012; a decrease of \$470,000. The primary reason for the 2013 decline in year to date investment income was a decrease in value of company owned life insurance. The change in COLI value accounted for 73.2% of the total decrease in P&C segment net investment income in 2013 compared to 2012.

The P&C segment ended 2013 with realized capital gains totaling \$1,020,000 compared to \$1,083,000 for the same period last year. The \$63,000 or 5.8% decrease in realized capital gains was primarily associated with a decline in selling activity during the current year compared to the prior year. The realization of capital gains in the investment portfolio is influenced by both market conditions and liquidity requirements and therefore can vary significantly from

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year to year. Other activities, such as tax planning strategies, may also lead to significant variation in realized capital gains from year to year. The P&C segment was not impacted by the write-down of other-than-temporary impairments in 2013 or 2012.

Other income was \$604,000 in 2013 compared to \$718,000 for the same period last year; a \$114,000 or 15.9% decrease. Other income consists primarily of fees related to the issuance of our property and automobile insurance policies as well as miscellaneous income. As a percent of net earned premium, other income was 1.3% in 2013 compared to 1.6% in 2012. Due to the termination of our automobile programs in 2012, billing, payment and policy fees declined, which triggered the overall reduction in other income for the current year.

Claims were \$26,219,000 in 2013 compared to \$28,811,000 for the same period last year; a decrease of \$2,592,000 or 9.0%. The primary reason for the decrease was a reduction in reported losses and loss adjustment expenses (LAE) from non-catastrophe wind and hail claims as well as a decline in losses and LAE reported from fire related claims in 2013 compared to 2012.

The table below provides a recap of P&C segment gross reported losses and LAE by catastrophe event and non-catastrophe wind and hail losses and LAE for the year ended December 31, 2013 and 2012 (dollars in thousands):

For the year ended December 31, 2013			For the year ended December 31, 2012		
	Reported Losses & LAE	Claim Count		Reported Losses & LAE	Claim Count
Cat event			Cat event		
Cat 14	\$336,000	85	Cat 65	\$190,000	50
Cat 15	178,000	56	Cat 67	498,000	161
Cat 17	48,000	22	Cat 69	3,000	1
Cat 22	21,000	6	Cat 71	10,000	1
Cat 91	350,000	85	Cat 72	17,000	8
Cat 92	186,000	63	Cat 73	16,000	2
Cat 93	3,054,000	915	Cat 83	116,000	41
Cat 94	69,000	20	Cat 87	3,390,000	1,147
Cat 95	43,000	10	Cat 88	55,000	13
Cat 99	80,000	19			
	\$4,365,000	1,281		\$4,295,000	1,424
Non-cat wind & hail	\$6,031,000	2,252	Non-cat wind & hail	\$7,949,000	2,800

Non-catastrophe wind and hail claims reported in 2013 totaled \$6,031,000 compared to non-catastrophe wind and hail claims reported in 2012 totaling \$7,949,000; a decline of \$1,918,000 or 24.1%. During 2013, the P&C segment had 2,252 non-cat wind and hail claims reported (an average of \$2,700 per claim) compared to 2,800 claims reported during 2012 (an average of \$2,800 per claim). Non-cat wind and hail claims reported during 2013 accounted for 23% of total incurred losses and LAE in the current year. Non-cat wind and hail claims reported during 2012 accounted for 27.6% of total incurred losses and LAE in the prior year.

During 2013, the P&C segment had reported losses and LAE from ten cat events totaling \$4,365,000 from 1,281 claims compared to reported losses and LAE from nine cat events totaling \$4,295,000 from 1,424 claims in 2012. While the reported losses and LAE from cat events were comparable in 2013 compared to 2012, the pattern of losses was significantly different. During 2013, the majority of the cat events were the result of an active spring storm season. In contrast, Hurricane Isaac (cat 87), occurring in August of 2012, was the primary contributing factor to the 2012 cat events.

The largest cat event during 2013 was cat 93 which occurred in March 2013. This cat event, consisting primarily of straight line wind and isolated tornadoes, lead to reported losses and LAE totaling \$3,054,000 from 915 claims. In comparison, Hurricane Isaac in 2012 lead to reported losses and LAE during the prior year totaling \$3,390,000 from 1,147 policyholder claims. The P&C segment maintains catastrophe reinsurance to reduce risk associated with losses

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from cat events. The reinsurance is structured with a \$4,000,000 retention/deductible from a single cat event. Any claim activity exceeding the deductible is 100% reinsured up to \$72,500,000 in ultimate incurred losses and LAE. No single cat event in 2013 or 2012 exceeded our \$4,000,000 retention and therefore, no losses were recovered under our catastrophe reinsurance program.

We routinely evaluate our claims frequency and severity statistics in order to better understand the nature of our risks and aid in the loss reserve liability estimation process. Claims frequency is a measure of the number of claims incurred during a measurement period regardless of amount. Claims severity is a measure of the average dollar amount of claims during a measurement period. The P&C companies incurred 1,281 claims from ten cat events in 2013 compared to 1,424 claims from nine cat events in 2012. The average cost per claim related to the 2013 cat events was \$3,400 compared to \$3,000 per claim in 2012. The largest cat events were cat 93 in 2013 and cat 87 (Hurricane Isaac) in 2012 with an average per claim of \$3,300 and \$3,000 per claim, respectively. Historically, spring time cat events primarily consisting of more costly tornado related damage, lead to higher average payments per claim. In contrast, claims in the second half of the year tend to be associated with tropical storm and hurricane related activity. These losses tend to be more widespread leading to more claims per event but with most of the claims resulting from less severe damage, usually from straight line winds, so average claim settlement tend to be slightly lower.

Fire losses reported in 2013 were down \$725,000 or 5.7% compared to fire losses reported during 2012. The P&C segment had 518 fire losses reported in 2013 totaling \$12,002,000 compared to 525 claims reported in 2012 totaling \$12,727,000. The average cost per claim was \$23,000 for fire losses reported in 2013 compared to \$24,000 for fire losses reported in 2012.

Deferred policy acquisition costs totaled \$2,576,000 in 2013 compared to \$2,773,000 in 2012. Deferred policy acquisition costs were comparable at 5.6% of premium revenue for 2013; down 0.5 percentage points compared to 6.1% of premium revenue for the same period last year. Deferred policy acquisition costs consist of amortization of previously capitalized distribution costs, primarily commissions.

Commission expense for 2013 was \$6,678,000 (14.6% of premium revenue) compared to \$7,088,000 (15.7% of premium revenue) for the same period last year. The primary reason for the \$410,000 or 5.8% decrease in commission expense during 2013 compared to 2012 was a decline in contingent commissions payments to our general agents.

General and administrative expenses totaled \$5,683,000 in 2013 compared to \$6,262,000 in 2012; a 9.2% decrease. The primary reason for the \$579,000 decline in general and administrative expenses was a reduction in costs associated with actuarial fees and continued company wide cost reduction measures.

Insurance taxes, licenses and fees were \$1,614,000 through December 31, 2013 compared to \$1,628,000 for the same period last year. Insurance taxes, licenses and fees were down slightly at 3.5% of premium revenue in 2013 compared to 3.6% in 2012.

The P&C segment ended 2013 with pretax net income of \$6,266,000 compared to pretax income of \$2,552,000 for the same period last year. The \$3,714,000 increase in pretax income primarily consisted of a \$2,592,000 decline in claims coupled with a \$569,000 increase in net premiums earned. In addition, the P&C segment had decreases in commissions and general expenses totaling \$410,000 and \$579,000, respectively compared to the same period last year.

### Property & Casualty Combined Ratio:

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

The loss and loss expense ratio, which measures losses and loss adjustment expenses incurred as a percentage of premium revenue.



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

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

	2013	2012	
Loss and LAE Ratio	57	% 64	%
Underwriting Expense Ratio	36	% 39	%
Combined Ratio	93	% 103	%

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

During 2013, the P&C segment experienced a decrease of 10 percentage points in the combined ratio compared to 2012. The primary reason for the decrease was a \$2,592,000 decline in incurred losses coupled with a \$569,000 increase in net earned premium in 2013 compared to 2012. Reported non-catastrophe wind and hail related claims added 13.2 percentage points to the current year loss ratio and 17.6 percentage points to the prior year loss ratio. Cat events increased the loss ratio by 9.5 percentage points in both 2013 and 2012. While cat events are unpredictable and beyond the control of management, measures have been taken to improve underwriting results in the P&C segment. Management also continues to evaluate rate adequacy, exposure concentrations and risk management strategies in order to improve underwriting profitability and reduce earnings volatility.

## Non-insurance Operations:

(dollars in thousands)

	2013	2012
REVENUE		
Net investment income	\$77	\$91
Net realized investment gains	3,308	72
Total Revenues	3,385	163

## BENEFITS AND EXPENSES

General and administrative expenses	726	519
Litigation settlement and defense costs	—	13,328
Interest expense	1,609	1,227
Total Expenses	2,335	15,074

INCOME (LOSS) BEFORE INCOME TAXES	\$1,050	\$(14,911 )
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The non-insurance operations of the Company consist of our parent company, The National Security Group, Inc. (NSG). The National Security Group has no material sources of revenue and relies on dividends and management service fees from our insurance subsidiaries to pay expenses. Dividends from subsidiaries are subject to insurance department approval and are subject to statutory restrictions. Subsidiary dividends are eliminated upon consolidation of the subsidiaries in the audited financial statements included herein. In July of 2012, NSG's wholly owned subsidiary National Security Fire and Casualty Company issued an extraordinary dividend of investment real estate, consisting of timber property, to the holding company which allowed NSG to secure a \$4,000,000 bank line of credit for the primary purpose of paying final legal fees and making an initial settlement payment associated with the Mobile Attic litigation which was settled in June of 2013. In August of 2013, NSG sold substantially all of its timber property

holdings and paid down the line of credit. Realized gains of \$3,308,000 on the transaction account for the \$3,236,000 increase over the prior year.

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General and administrative expenses totaled \$726,000 in 2013 compared to \$519,000 for the same period last year; a 39.9% increase. The expenses of NSG are primarily associated with the public listing of our stock, taxes and fees, and directors' fees. The most significant item impacting the increase in general expenses were increases in interest costs related to deferred compensation plans and director fees.

Litigation settlement and defense costs incurred by NSG during 2012 totaled \$13,328,000 and was directly related to the settlement of the previously disclosed Mobile Attic litigation matter. There were no additional costs related to this settlement in 2013. However, interest on a promissory note executed to finance the settlement accounted for most of the \$382,000 increase in interest expense for the year. Total interest expense associated with short-term and long-term borrowings of NSG was \$1,609,000 for the period ended December 31, 2013 and \$1,227,000 for the same period last year.

**Investments:**

The life insurance and property/casualty subsidiaries primarily invest in highly liquid investment grade debt and equity securities. The types of assets in which the Company can invest are influenced by various state insurance laws which prescribe qualified investment assets. While working within the parameters of these regulatory requirements and further considering liquidity and capital needs, the Company considers investment quality, investment return, asset/liability matching and composition of the investment portfolio when making investment decisions.

At December 31, 2013, the Company's holdings in debt securities amounted to 80.2% of total investments and 59.9% of total assets. The Company utilizes the ratings of various Nationally Recognized Statistical Rating Organizations when classifying fixed maturity investments by quality rating. The most significant shift in quality ratings occurring in 2011 was the downgrade of US Government debt by S&P from their highest rating of AAA to AA+. Moody's and Fitch continued to carry US Government debt at their highest rating throughout 2012. Due to the split ratings of the major rating agencies, US Government and agency debt is shown in the table below in the category of AAA/AA+.

The following is a breakdown of the Company's fixed maturity investments by quality rating:

S&P or Equivalent Ratings	% of Total Bond Portfolio	
	2013	2012
AAA/AA+*	34.65%	31.35%
AA	3.01%	3.32%
AA-	9.75%	11.90%
A+	4.22%	4.89%
A	6.79%	6.85%
A-	7.86%	8.30%
BBB+	7.94%	8.11%
BBB	10.98%	8.18%
BBB-	11.73%	12.82%
Below Investment Grade	3.07%	4.28%

\*Due to the downgrade of United States Government bonds, AAA and AA+ are presented consolidated for comparability. Most of the securities within this combined category are United States Government and Agency bonds, which are now rated AA+.

There has been no material shift in credit quality except for a moderate increase in securities rated AA+ or better. This increase is primarily due to an increase in investment allocation to government agency securities during 2013.



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The amortized cost and aggregate fair values of investments in securities at December 31, 2013 and December 31, 2012 are as follows (dollars in thousands):

December 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	\$35,831	\$1,698	\$713	\$36,816
Trust preferred securities	538	33	—	571
Mortgage backed securities	7,622	75	557	7,140
Private label mortgage backed securities	2,152	38	4	2,186
Obligations of states and political subdivisions	16,412	524	195	16,741
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	16,519	169	708	15,980
Total fixed maturities	79,074	2,537	2,177	79,434
Equity securities	2,420	2,365	411	4,374
Total	\$81,494	\$4,902	\$2,588	\$83,808
Held-to-maturity securities:				
Mortgage backed securities	\$706	\$34	\$—	\$740
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	106	7	—	113
Total	\$812	\$41	\$—	\$853
December 31, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities:				
Corporate debt securities	\$31,387	\$2,430	\$80	\$33,737
Trust preferred securities	537	50	—	587
Mortgage backed securities	8,595	175	85	8,685
Private label mortgage backed securities	7,679	294	9	7,964
Obligations of states and political subdivisions	16,160	1,359	3	17,516
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	7,320	487	2	7,805
Total fixed maturities	71,678	4,795	179	76,294
Equity securities	3,191	2,398	544 457	5,132
Total	\$74,869	\$7,193	\$636	\$81,426
Held-to-maturity securities:				
Mortgage backed securities	\$1,194	\$91	\$—	\$1,285
Obligations of states and political subdivisions	145	2	—	147
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	163	14	—	177
Total	\$1,502	\$107	\$—	\$1,609

As shown in the tables above, the Company experienced an overall increase in fixed income securities in 2013 compared to the portfolio composition at December 31, 2012. Most of the increase within the fixed income portfolio was due to increase in investment in corporate debt securities and US Treasury and agency securities. These increases were partially offset by decreases in non-agency mortgage backed securities.

A number of factors influence portfolio allocation within each of the insurance subsidiaries. Within the property and casualty subsidiaries, due to the relatively short term nature of segment liabilities, fixed income investments tend to be of shorter duration, typically inside of seven years. Also due to higher levels of potential volatility of policy liabilities (severe weather related losses), a greater emphasis is placed upon overall liquidity of investments. In contrast, within the life insurance subsidiary, policy liabilities tend to be more stable and of significantly longer duration. In order to match the longer duration of liabilities, investments in the life insurance portfolio tend to have longer maturities and higher average book yields. Also, less emphasis is placed upon short term liquidity.

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A downside of investing in longer duration securities in the life segment is that the portfolio is exposed to more significant price volatility as market interest rates change. This exposure to sudden interest rate changes can lead to declines in market value of fixed income securities in a rising interest rate environment. In the second quarter of 2013 we experienced some of the adverse impact of rising interest rates when the US Treasury yield curve on securities with maturities of five years and longer shifted 60+ basis points within a ninety day period. This market interest rate shift led to declines in market value of our intermediate and long duration fixed income investments. As shown in the table above, unrealized losses increased from \$636,000 as of December 31, 2012 to \$2,588,000 as of December 31, 2013. Unrealized losses in the fixed income portfolio are interest rate driven as opposed to credit quality driven and management believes no ultimate loss will be realized.

At December 31, 2013, 3.07% of total investments in the fixed income portfolio were classified as 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. Management has evaluated each security in a significant unrealized loss position. For the year ended December 31, 2013, the Company realized no other-than-temporary impairments.

The amortized cost and aggregate fair value of debt securities at December 31, 2013, by contractual maturity, are as follows (dollars in thousands). 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.

	Amortized Cost	Fair Value
Available-for-sale securities:		
Due in one year or less	\$1,239	\$1,258
Due after one year through five years	14,704	15,821
Due after five years through ten years	27,526	27,671
Due after ten years	35,605	34,684
Total	\$79,074	\$79,434
Held-to-maturity securities:		
Due in one year or less	\$—	\$—
Due after one year through five years	249	263
Due after five years through ten years	180	193
Due after ten years	383	397
Total	\$812	\$853

As discussed earlier, the majority of our longer duration securities are investments made to match longer duration liabilities in the life segment and are investments in mortgage backed securities, primarily government agency. Due to the amortizing nature and the ability to prepay mortgage backed securities, actual maturities tend to be significantly shorter than contractual maturities.

## Investment portfolio income

Investment returns with respect to the investment portfolio for the years ended December 31, 2013 and 2012 follows:

	Year Ended December 31,		
	2013	2012	
Net investment income	\$3,746	\$4,191	
Average current yield on investments	3.7	% 4.2	%



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Total return on investments	3.9	%	6.8	%
Net realized gains on investments (before taxes)	\$4,439		\$2,790	
Change in accumulated net unrealized gains (before income taxes)	\$(4,243	)	\$(153	)

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Average current yield on investments declined due to the maturity of investments at higher book yields reinvested at current historically low interest rates. With the recent increase in market interest rates, the erosion of average current yield on investments is expected to stabilize. However, in this persistent low interest rate environment, generation of investment income will remain challenging.

The total return on investments declined in 2013 compared to 2012 primarily due to increases in market interest rates which drove down the market value of our longer duration fixed income securities. Partially offsetting this decline was an increase in value of our equity investments. However, due to increased underwriting leverage and reduced capital positions in our property and casualty subsidiaries, we have reduced our allocation to equity investments in order to reduce volatility in our statutory capital and reduce capital charges in our statutory risk based capital.

Repurchase agreements

The Company's subsidiaries maintain repurchase agreements for cash held on deposit under which the policy requires 102% (100% minimum) of the fair value of the securities purchased to be maintained as collateral. The repurchase investments are limited to government securities that are highly liquid and therefore, the investment is reflected on the balance sheet as a cash equivalent. Due to a combination of the 102% collateral requirement and short term interest rates hovering near zero, we realize virtually no interest income from repurchase agreements/short term investments. However, repurchase agreements utilizing government agency securities do provide deposit protection for short term cash held in excess of FDIC deposit limits. The Company does not have any reverse repurchase agreements.

Liquidity and capital resources:

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

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

Virtually all invested assets of the Company are held in the insurance subsidiaries. As of December 31, 2013, the contractual maturity schedule for all bonds and notes held by the Company, stated at amortized cost, was as follows (dollars in thousands):

Maturity	Available- for-Sale	Held-to-Maturity	Total	Percentage of Total	
Maturity in less than 1 year	\$1,239	\$—	\$1,239	1.55	%
Maturity in 1-5 years	14,704	249	14,953	18.72	%
Maturity in 5-10 years	27,526	180	27,706	34.68	%
Maturity after 10 years	35,605	383	35,988	45.05	%
	\$79,074	\$812	\$79,886	100.00	%

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

to minimize the impact of interest rate risk. However, due to other factors, both regulatory and those associated with good investment management practices associated with asset/liability matching, we do have exposure to changes in market values of securities due to changes in interest rates. Currently, a 100 basis point immediate increase in interest rates would generate approximately a \$4,700,000 decline in the market value of fixed income investment. Alternatively, a 100 basis point decrease in interest rates will generate approximately \$4,700,000 in increases in market value of fixed income investments.

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At December 31, 2013, the Company had aggregate equity capital, unrealized investment gains (net of income taxes) and retained earnings of \$33,472,000, up \$3,245,000 compared to \$30,227,000 at December 31, 2012. Components of the change in equity were a net income of \$5,658,000, reduction in accumulated unrealized gains on investments of \$2,801,000, a net unrealized gain of \$412,000 related to interest rate swaps, common stock issued of \$28,000, additional paid in capital of \$196,000 and cash dividends paid totaling \$248,000.

As discussed above, changing interest rates can have a significant impact on the market value of fixed income securities. Fixed income securities classified as available-for-sale increase the liquidity resources of the Company as they can be sold at any time to pay claims or meet other Company obligations. However, these securities are required to be carried at market value with net of tax accumulated unrealized gains and losses directly impacting shareholder's equity.

While the increase in interest rates causes near term declines in the value of fixed income securities, we are able to reap the benefit of reinvesting at higher rates as current fixed income investments are called, amortized (mortgage backed securities) or reach contractual maturity. Over the next twelve months, based on cash flow projection modeling that considers such factors as anticipated principal payments on mortgage backed securities, likelihood of call provisions being enacted and regular contractual maturities, we expect approximately 5.6% of our current fixed income portfolio to be reinvested or otherwise available to meet Company obligations.

The Company, primarily through its insurance subsidiaries, had \$4,987,000 in cash and cash equivalents at December 31, 2013, compared to \$6,779,000 at December 31, 2012. Improved performance in our insurance operations coupled with the decline in litigation related expenses, for the period ended December 31, 2013 contributed to the \$2,659,000 in cash provided by operations compared to cash used the same period last year totaling \$13,706,000. Negative cash flows from operations in the prior year were related to the settlement of Mobile Attic litigation and losses from Hurricane Isaac.

Net cash used in investing activities totaled \$357,000 for the period ended December 31, 2013, compared \$4,111,000 provided by investing activities for the same period last year. At December 31, 2012, the Company had \$6,779,000 in cash which was subsequently reduced by the purchase of available-for-sale securities, primarily fixed income investments. These purchases were partially offset by \$4,847,000 in proceeds from the sale of investment real estate, of which the proceeds were used to pay expenses associated with the sale and to repay debt obligations.

Net cash used in financing activities totaled \$4,094,000 for the period ended December 31, 2013 compared to net cash provided of \$12,981,000 for the same period last year. During 2013, the Company paid the first installment on the note that financed the settlement obligation related to the Mobile Attic litigation. The installment due November 15, 2013 was \$1,167,000. As of December 31, 2013, a total of \$9,333,000 remained outstanding on the settlement obligation with the next installment due in November of 2014 (\$1,166,000) included in short-term notes payable. The Company maintains a \$1,000,000 operating line of credit which matures in September 2017 as well as a \$700,000 line of credit which matures in February of 2014. The Company had \$1,000,000 available on lines of credit at December 31, 2013. Also, the \$700,000 short-term operating line of credit was renewed for a two year term in February of 2014.

The Company had a total of \$20,889,000 of long-term debt outstanding as of December 31, 2013, compared to \$25,339,000 at December 31, 2012, which includes \$12,372,000 in trust preferred securities issued by the Company in addition to the installment note and operating line of credit. The company had \$700,000 drawn on the operating line of credit included in short-term notes payable at December 31, 2013.

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The following table reflects the anticipated cash flows associated with our short- and long-term contractual obligations and commitments as of December 31, 2013 (dollars in thousands):

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	Years 1 through 3	Years 4 through 5	More than 5 years
Notes payable	\$1,866	\$1,866	\$—	\$—	\$—
Debt obligations <sup>1</sup>	\$20,889	\$—	\$3,851	\$2,334	\$14,704
Interest on debt obligations <sup>1</sup>	\$16,314	\$1,449	\$3,986	\$2,368	\$8,511
Property and casualty claim reserves <sup>2</sup>	\$8,734	\$5,327	\$2,794	\$437	\$176
Future life insurance obligations <sup>3</sup>	\$81,356	\$4,892	\$13,349	\$7,764	\$55,351

<sup>1</sup> Long-term debt, consisting of two separate issues of trust preferred securities, a line of credit and the long-term portion of an installment note is assumed to be settled at contractual maturity. Interest on long-term debt is calculated using the interest rates in effect at December 31, 2013 for each issue. Interest on long-term debt is accrued and settled quarterly on the trust preferred securities, monthly on the line of credit and annually on the installment note. Therefore, the timing and amount of interest payments may vary from the calculated value included in the table above. These calculations do not take into account any potential prepayments. For additional information regarding long-term debt and interest on long-term debt, please see Note 8, Notes Payable and Long-term Debt, in the notes to consolidated financial statements.

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

<sup>3</sup> Future life insurance obligations consist primarily of estimated future contingent benefit payments and surrender benefits on policies in force at December 31, 2013. These estimated payments are computed using assumptions for future mortality, morbidity and persistency. In contrast to this table, the majority of NSIC's obligations is recorded on the balance sheet at the current account values and do not incorporate an expectation of future market growth, interest crediting or future deposits. Therefore, the estimated future life insurance obligations presented in this table significantly exceed the liabilities recorded in the Company's consolidated balance sheet. Due to the significance of the assumptions used, the actual amount and timing of such payments may differ significantly from the estimated amounts. Management believes that current assets, future premiums and investment income will be sufficient to fund all future life insurance obligations.

Contractual obligations reflected in the table above include the issuance of \$9,279,000 in subordinated debentures completed on December 15, 2005. The subordinated debentures mature December 15, 2035. It is anticipated that principal payments will not be made before maturity. Also included in long-term debt is the issuance of \$3,093,000 in subordinated debentures on June 21, 2007. This issue matures June 15, 2037 and may be prepaid at any time. Also included in long-term debt held by the Company is a line of credit in the amount of \$500,000 obtained in September 2012. The line of credit is secured by real estate and had \$350,000 drawn at December 31, 2013. In July 2012, the Company executed an installment note in the amount of \$13,000,000 to finance the settlement obligation related to the Mobile Attic litigation. As of December 31, 2013, a total of \$9,333,000 was outstanding with \$1,166,000 included in short-term notes payable.

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

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

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 payment of dividends, management fees, reimbursements 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 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 is the primary source of dividends to the holding company. Due to a combination of growth opportunities and continued risk of capital exposure to weather related events, management is maintaining a

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conservative stance with regard to paying of dividends to the holding company. Strengthening capital levels in the insurance subsidiaries remains a priority.

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, the amount that The National Security Group's insurance subsidiaries can transfer in the form of dividends to the parent company during 2014 is limited to \$1,463,000 in the life insurance subsidiary and \$2,632,000 in the property/casualty insurance subsidiary. Dividends are limited to the greater of net income (operating income for life subsidiary) or 10% of statutory capital, and regulators consider dividends paid within the preceding twelve months when calculating the available dividend capacity. Therefore, all of the above referenced dividend capacity will not be available for consideration of payment until dividends paid in the preceding twelve months have been considered on a rolling basis. The Company also has to continuously evaluate other factors such as subsidiary operating performance, subsidiary capital requirements and potential impact by rating agencies in making decisions on how much capital can be released for payment of dividends to NSG. These factors are considered along with the goal of growing year over year statutory surplus in the subsidiaries, and these considerations along with recent adverse impacts on regulatory surplus, will likely lead to dividend payments to NSG substantially below the above referenced regulatory maximums.

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.

As discussed previously, improved underwriting results in the P&C segment resulted in much improved operating results following losses from CAT 46 in 2011 and Hurricane Isaac in 2012. While improved operations have allowed the P&C companies to work towards restoring capital levels, it is still necessary to remain cautious and protect subsidiary capital. The Company has implemented various changes 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. The final in-force policies in this program expired in mid-2012.

We have incurred substantial losses from catastrophe events over the past eight years. These events have driven up catastrophe reinsurance cost and forced our catastrophe reinsurance deductible up from \$2 million in 2005 to the current \$4 million. 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 expense structure. So, since we were limited in our ability to increase margins for this additional retained risk the Company continues to place additional reinsurance cover in the form of reinsurance premium protection (RPP). The RPP cover serves to reduce our risk from a major catastrophe and strengthen our capital position. The additional RPP cover reduces 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 \$1,304,000 to our cat reinsurance cost in 2013.

In 2013, we discontinued our marine insurance program in order to increase underwriting capacity in our core dwelling fire line of business.

In June 2012, we reached a settlement in the longstanding Mobile Attic litigation. Under the terms of the settlement agreement, the Company agreed to pay \$13 million to the plaintiff. In order to manage the liquidity constraints, the settlement is 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 cumulative catastrophe losses exceeding \$3.5 million, thus allowing capital management flexibility in the P&C subsidiaries. Under the terms of the agreement, the



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annual debt service on the note cannot be less than the dividends paid to our shareholders in the last twelve months. The Company made an initial payment of \$2,500,000 in September 2012 and the first installment payment of \$1,167,000 in November of 2013. The remaining principal will be repaid in eight annual installments. Accrued and unpaid interest shall be payable with each installment of principal based on the prime rate published in the Wall Street Journal plus 1%.

Cash to fund the remaining balance of the litigation settlement will come from two primary sources. First, 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 from the litigation. This NOL carryforward generated approximately \$5 million in tax benefits a part of which have been used to offset the tax on realized gains from the sale of real estate by the holding company as well as to reduce the tax liability of the insurance subsidiaries for 2013. At December 31, 2013, approximately \$2.5 million of this NOL carryforward remains. Second, dividends and management fees paid by the insurance subsidiaries will provide an additional source of proceeds to pay this obligation. Although not a preferred source of flexibility, the Company can also defer interest payments on the trust preferred securities to provide additional operating cash flow. In the event that the Company elects to defer interest payments, shareholder dividends will be suspended until interest payments are current.

Except as discussed above, 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.

We have taken and will continue to take corrective action as necessary to improve our profitability and capital position. Over the past decade we have experienced a significant reduction in equity capital due to the adverse effects of six major hurricanes, the financial market meltdown in 2008, continued historically low interest rates, an unprecedented tornado outbreak in April of 2011 and the Mobile Attic litigation. While we are beginning to see improvement and have put some major obstacles behind us, we are in a position where we believe it necessary to continue 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 maintain and improve our capital position, we will continue to monitor our dividend policy on a quarterly basis and should we encounter another significant adverse capital event we could take action which could include the suspension of shareholder dividends. Due to various factors discussed herein, we must remain flexible in our dividend policy until we achieve more consistent profitability and capital growth.

### Off-Balance Sheet Arrangements

The Company has no material off balance sheet arrangements.

### Statutory Risk-Based Capital of Insurance Subsidiaries

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

The levels and ratios are as follows:

Ratio of Total Adjusted Capital to

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

The ratios of Total Adjusted Capital to Authorized Control Level RBC for The National Security Group's life/health and property/casualty insurance subsidiaries are all in excess of 4.3 to 1 at December 31, 2013.

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National Security Insurance Company (life insurer) has regulatory adjusted capital of \$12.4 million and \$11.1 million at December 31, 2013 and 2012, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 16.8 and 15.7 at December 31, 2013 and 2012, respectively. Accordingly, National Security Insurance Company exceeds the minimum RBC requirements.

National Security Fire & Casualty Company (property/casualty insurer) has regulatory adjusted capital of \$26.3 million and \$24.1 million at December 31, 2013 and 2012, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 4.3 and 3.7 at December 31, 2013 and 2012, respectively. Accordingly, National Security Fire & Casualty Company exceeds the minimum RBC requirements.

Omega One Insurance Company (property/casualty insurer), which began writing business in late 1995, has regulatory adjusted capital of \$9.0 million and \$8.0 million at December 31, 2013 and 2012, respectively, and a ratio of regulatory total adjusted capital to authorized control level RBC of 37.7 and 23.6 at December 31, 2013 and 2012, respectively. Accordingly, Omega One Insurance Company exceeds the minimum RBC requirements.

### Application of Critical Accounting Policies

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

Reinsurance

Deferred Policy Acquisition Costs

Income Taxes

Fair Values of Financial Instruments

Claim Liabilities

Recognition of Revenue

Contingencies

### Reinsurance

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

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

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

NSFC and Omega generally reinsure with third parties any liability in excess of \$225,000 on any single policy. During 2013, the property and casualty segment maintained a catastrophe contract, which covered losses related to a catastrophic event with multiple policyholders affected. In the event a catastrophe exceeded the \$4 million company retention stated in the contract, reinsurers would reimburse the company 100% of gross losses up to the upper limits of the reinsurance agreement, which was \$72.5 million in 2013 and 2012. Any losses above the \$72.5 million upper limit are the responsibility of our Company. The contract in place during 2013 also allowed one reinstatement for coverage under the contract for a second catastrophic event if needed.

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The property and casualty subsidiaries utilize our actual in force policy data modeled utilizing two different industry accepted catastrophe models to structure catastrophe reinsurance and determine upper limits of catastrophe reinsurance agreements. Based on modeling results utilized in 2013 and 2012, the Company was reinsured at approximately a 250 year event level. While this estimate is subject to some uncertainty and model risk, the models indicate that we maintain catastrophe reinsurance upper limits to cover an event that has less than a 0.5% probability of occurring in a given year.

At December 31, 2013, the estimated reinsurance recoverable recorded was \$1,501,000 compared to \$1,541,000 for the same period last year. The Company does not anticipate any issues with collection of the recorded amount. In 2013, catastrophe reinsurance premiums ceded totaled \$7,040,000 compared to \$6,646,000 ceded in 2012. Catastrophe reinsurance premiums are based on a premium calculation applying the agreed upon rate to the earned premium of the covered lines of business. The increase in ceded premium in 2013 is attributable to a 2.4% increase in the rate applied. In addition to catastrophe reinsurance, the Company placed reinstatement premium protection (RPP) reinsurance during 2013 and 2012 totaling \$1,367,000 and \$1,346,000, respectively.

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

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

### Deferred Policy Acquisition Costs

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

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

At December 31, 2013 and 2012, the Company recorded \$8,776,000 and \$9,097,000, respectively, as an asset for DAC in the financial statements. We do not foresee any issues related to recoverability of these capitalized costs. For more information regarding deferred policy acquisition costs, see Note 1 to our consolidated financial statements.

### Income Taxes

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

portion of the deferred tax asset will not be realized. The effect of a change in tax rates is recognized in the period the new rate is enacted.

At December 31, 2013, there is no evidence to suggest to management that any deferred tax asset is unrealizable. For more information regarding deferred income taxes, see Note 7 to our consolidated financial statements.

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

#### Fair Values of Financial Instruments

Investments are recorded at fair value based upon quoted prices when available. Quoted prices are available for most investment debt and equity securities included in the financial statements. Further discussion of fair value methodology

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is discussed in Note 5 to the consolidated financial statements. Periodically, the carrying values of an individual investment may become temporarily impaired because of time value, volatility, credit quality and existing market conditions. Management evaluates investments to determine whether the impairment is other-than-temporary. Evaluation criteria include credit quality of security, severity of decrease between cost and market value, length of time of the impairment and likelihood that the impairment will reverse in the near future. This evaluation requires significant assumptions, estimates and judgments by management. If the impairment is determined to be other-than-temporary, the investment is written down to the current fair value and a realized loss is recorded on the income statement. We have very limited exposure to less liquid and difficult to value investments such as collateralized debt obligations.

### Claim Liabilities

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

At December 31, 2013 and 2012, the recorded liability for loss and loss adjustment expense was \$8,734,000 and \$11,214,000, respectively, a \$2,480,000 decrease. The decline was primarily associated with the discontinuation of our non-standard auto programs and our ocean marine program coupled with a reduction in claim frequency during the fourth quarter of 2013 in our dwelling fire and homeowners insurance programs. We believe the estimate of unpaid losses and loss adjustment expenses to be sufficient based on currently available information and a review of our historical reserving practices. For more information regarding loss and loss adjustment expense, see Note 9 to our consolidated financial statements.

### Recognition of Revenue

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

### Contingencies

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

### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

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

The Company's primary objectives in managing its investment portfolio are to maximize investment income and total investment returns while minimizing overall credit risk. Investment strategies are developed based on many factors including changes in interest rates, overall market conditions, underwriting results, regulatory requirements and tax

position. Investment decisions are made by management and reviewed by the Board of Directors. Market risk represents the potential for loss due to adverse changes in fair value of securities. The three potential risks related to the Company's fixed maturity portfolio are interest rate risk, prepayment risk and default risk. The primary risk related to the Company's equity portfolio is equity price risk.

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

The Company is exposed to equity price risk on its equity securities. The Company holds common stock with a fair value of \$4.4 million. Our portfolio has historically been highly correlated to the S&P 500 with regard to market risk.



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Based on an evaluation of the historical risk measure of our portfolio relative to the S&P 500, if the market value of the S&P 500 Index decreased 10% from its December 31, 2013 value, the fair value of the Company's common stock would decrease by approximately \$440,000.

Certain fixed interest rate market risk sensitive instruments may not give rise to incremental income or loss during the period illustrated but may be subject to changes in fair values. Notes 1 and 5 in the consolidated financial statements present additional disclosures concerning fair values of Financial Assets and Financial Liabilities and are incorporated by reference herein.

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

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

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

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders

The National Security Group, Inc.

Elba, Alabama

We have audited the accompanying consolidated balance sheets of The National Security Group, Inc. as of December 31, 2013 and 2012, and the related consolidated statements of income (loss), comprehensive income (loss), shareholders' equity and cash flows for the years then ended. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The National Security Group, Inc. as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the financial statement schedules listed in the accompanying index appearing under Item 8, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ Warren Averett, LLC

Birmingham, Alabama

March 21, 2014

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## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED BALANCE SHEETS (In thousands)

	December 31, 2013	December 31, 2012
<b>ASSETS</b>		
Investments		
Fixed maturities held-to-maturity, at amortized cost (estimated fair value: 2013 - \$853; 2012 - \$1,609)	\$812	\$1,502
Fixed maturities available-for-sale, at estimated fair value (cost: 2013 - \$79,074; 2012 - \$71,678)	79,434	76,294
Equity securities available-for-sale, at estimated fair value (cost: 2013 - \$2,420; 2012 - \$3,191)	4,374	5,132
Trading securities	19	40
Mortgage loans on real estate, at cost	333	383
Investment real estate, at book value	4,218	5,757
Policy loans	1,443	1,317
Company owned life insurance	5,858	5,931
Other invested assets	3,559	3,777
Total Investments	100,050	100,133
Cash	4,987	6,779
Accrued investment income	817	788
Policy receivables and agents' balances, net	10,276	9,006
Reinsurance recoverable	1,501	1,541
Deferred policy acquisition costs	8,776	9,097
Property and equipment, net	2,077	2,392
Accrued income tax recoverable	6	—
Deferred income tax asset	4,654	4,997
Other assets	836	983
Total Assets	\$133,980	\$135,716
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Property and casualty benefit and loss reserves	\$8,734	\$11,214
Accident and health benefit and loss reserves	2,651	2,341
Life and annuity benefit and loss reserves	30,696	30,041
Unearned premiums	27,301	25,777
Policy and contract claims	842	995
Other policyholder funds	1,447	1,417
Short-term notes payable and current portion of long-term debt	1,866	1,292
Long-term debt	20,889	25,339
Accrued income taxes	—	296
Other liabilities	6,082	6,777
Total Liabilities	100,508	105,489
Contingencies		
Shareholders' equity		
Common stock	2,495	2,467
Additional paid-in capital	5,147	4,951
Accumulated other comprehensive income	936	3,325

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Retained earnings	24,894	19,484
Total Shareholders' Equity	33,472	30,227
Total Liabilities and Shareholders' Equity	\$133,980	\$135,716

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

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## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(In thousands, except per share amounts)

	Year ended December 31, 2013	2012	
REVENUES			
Net premiums earned	\$52,366	\$51,815	
Net investment income	3,746	4,191	
Net realized investment gains	4,439	2,790	
Other income	609	720	
Total Revenues	61,160	59,516	
EXPENSES			
Policyholder benefits and settlement expenses	31,146	34,105	
Amortization of deferred policy acquisition costs	3,613	3,711	
Commissions	7,103	7,556	
General and administrative expenses	8,443	8,754	
Litigation settlement and defense costs	—	13,328	
Taxes, licenses and fees	1,846	1,846	
Interest expense	1,686	1,280	
Total Expenses	53,837	70,580	
Income (Loss) Before Income Taxes	7,323	(11,064)	)
INCOME TAX EXPENSE (BENEFIT)			
Current	92	527	
Deferred	1,573	(4,920)	)
	1,665	(4,393)	)
Net Income (Loss)	\$5,658	\$(6,671)	)
INCOME (LOSS) PER COMMON SHARE	\$2.28	\$(2.70)	)
DIVIDENDS DECLARED PER SHARE	\$0.10	\$0.325	

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

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THE NATIONAL SECURITY GROUP, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

	Year ended December 31,		
	2013	2012	
Net income (loss)	\$5,658	\$(6,671	)
Other comprehensive loss, net of tax			
Changes in:			
Unrealized losses on securities, net of reclassification adjustment of \$2,930 and \$1,842 for 2013 and 2012, respectively	(2,801	) (101	)
Unrealized gain (loss) on interest rate swap	412	(214	)
Other comprehensive loss, net of tax	(2,389	) (315	)
Comprehensive income (loss)	\$3,269	\$(6,986	)

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

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## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	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
Net loss for 2012	(6,671 )	(6,671 )			
Other comprehensive loss (net of tax)	(315 )		(315 )		
Cash dividends	(802 )	(802 )			
Balance at December 31, 2012	30,227	19,484	3,325	2,467	4,951
Net income for 2013	5,658	5,658			
Other comprehensive loss (net of tax)	(2,389 )		(2,389 )		
Common stock issued	28			28	
Additional paid-in capital	196				196
Cash dividends	(248 )	(248 )			
Balance at December 31, 2013	\$33,472	\$24,894	\$936	\$2,495	\$5,147

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



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## THE NATIONAL SECURITY GROUP, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (In thousands)

	Year Ended December	
	31,	
	2013	2012
Cash Flows from Operating Activities		
Net income (loss)	\$5,658	\$(6,671 )
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation expense and amortization/accretion, net	703	657
Decrease (Increase) in cash surrender value of company owned life insurance	73	(271 )
Net realized gains on investments	(4,439 )	(2,790 )
Deferred income taxes	1,573	(4,920 )
Amortization of deferred policy acquisition costs	3,613	3,711
Changes in assets and liabilities:		
Change in accrued investment income	(29 )	(82 )
Change in reinsurance recoverable	40	1,237
Policy acquisition costs deferred	(3,292 )	(3,250 )
Change in accrued income taxes/recoverable	(302 )	1,965
Change in net policy liabilities and claims	(1,422 )	(1,838 )
Change in other assets/liabilities, net	250	(1,462 )
Other, net	233	8
Net cash provided by (used in) operating activities	2,659	(13,706 )
Cash Flows from Investing Activities		
Purchase of:		
Available-for-sale securities	(21,036 )	(29,166 )
Trading securities and short-term investments	—	(40 )
Real estate held for investment	—	(32 )
Property and equipment	(75 )	(303 )
Proceeds from sale or maturities of:		
Held-to-maturity securities	689	1,826
Available-for-sale securities	15,281	31,676
Trading securities and short-term investments	—	83
Real estate held for investment	4,847	87
Property and equipment	11	9
Other invested assets, net	(74 )	(29 )
Net cash (used in) provided by investing activities	(357 )	4,111
Cash Flows from Financing Activities		
Change in other policyholder funds	30	9
Change in long-term debt	(4,450 )	14,134
Change in short-term notes payable	574	(360 )
Dividends paid	(248 )	(802 )
Net cash (used in) provided by financing activities	(4,094 )	12,981
Net change in cash and cash equivalents	(1,792 )	3,386
Cash and cash equivalents, beginning of year	6,779	3,393
Cash and cash equivalents, end of year	\$4,987	\$6,779

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



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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements include the accounts of The National Security Group, Inc. (the Company) and its wholly-owned subsidiaries: National Security Insurance Company (NSIC), National Security Fire and Casualty Company (NSFC) and NATSCO, Inc. (NATSCO). NSFC includes a wholly-owned subsidiary, Omega One Insurance Company (Omega). The accompanying consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (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, 2013, which includes information and disclosures not presented herein.

Description of Business

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

NSFC is licensed in Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, Oklahoma, South Carolina, Tennessee and West Virginia. In addition, NSFC operates on a surplus lines basis in Louisiana. NSFC operates in various property and casualty lines, the most significant of which are: dwelling fire and extended coverage, homeowners and mobile homeowners.

Omega is licensed in the states of Alabama and Louisiana. Omega currently has no insurance policies in-force.

The Company is incorporated under the laws of the State of Delaware. Its common stock is traded on the NASDAQ Global Market under the ticker symbol NSEC. Pursuant to the regulations of the United States Securities and Exchange Commission (SEC), the Company is considered a "Smaller Reporting Company" as defined by SEC Rule 12b-2 of the Exchange Act. The Company has elected to comply with the scaled disclosure requirements of Regulation S-K and only two years of financial statements are included 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Among the more significant estimates included in these consolidated financial statements are reserves for future life insurance policy benefits, liabilities for losses and loss adjustment expenses, reinsurance recoverable associated with 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 these estimates.

Concentration of Risk

The Company's property and casualty subsidiaries, composing 89% of gross consolidated premium revenue, produced business during 2013 in ten states. However, 62% of property and casualty segment revenue is generated in the states of Alabama, Mississippi and Louisiana, subjecting the Company to significant geographic concentration.

Consequently, adverse weather conditions or changes in the legal, regulatory or economic environment could adversely impact the Company.

The Company's life, accident and health insurance subsidiary, composing approximately 11% of gross consolidated revenues, is licensed in seven states. However, over 79% of life segment revenue is generated in the states of Alabama and Georgia. Consequently, changes in the legal, regulatory or economic environment in these states could adversely impact the Company.

For the year ended December 31, 2013, one agency individually produced greater than 5% of the Company's direct written premium.

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Investments

The Company's securities are classified as follows:

**Securities Held-to-Maturity.** Bonds, notes and redeemable preferred stock for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using methods which approximate level yields over the period to maturity.

**Securities Available-for-Sale.** Bonds, notes, common stock and non-redeemable preferred stock, not classified as either held-to-maturity or trading, are reported at fair value and adjusted for other-than-temporary declines in fair value.

**Trading Securities.** Mutual funds (primarily) are reported at fair value.

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

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

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

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

- the Company has the intent to sell the security

- it is more likely-than-not that the Company will be required to sell the security before recovery of its amortized cost basis

- the Company does not expect to recover the entire amortized cost basis of the security.

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

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

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

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Investment real estate is reported at cost, less allowances for depreciation computed on the straight-line basis. Investment real estate consists primarily of undeveloped commercial real estate. The Company sold substantially all timber land investments in 2013 with the gain reflected in realized capital gains in the statement of income. Real estate is carried at cost.

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

The Company owns life insurance (COLI) contracts on certain management and supervisory employees each having a face amount of approximately \$2,000,000. The Company's original investment in company owned life insurance was \$5,000,000. The primary purpose of the program is to offset future employee benefit expenses through earnings on the cash value of the policies. The Company is the owner and principal beneficiary of these policies. The life insurance contracts are carried at their current cash surrender value. Cash surrender value at December 31, 2013 and December 31, 2012 was \$5,858,000 and \$5,931,000, respectively. Changes in cash surrender values are included in investment income in the current period. The change in surrender value included in earnings for the periods ended December 31, 2013 and 2012 was a decline of \$73,000 and an increase of \$271,000, respectively. Death proceeds from the contracts are recorded when the proceeds become payable under the terms of the policy. There were no proceeds received from the COLI during 2013 or 2012.

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

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

Fair Values of Financial Instruments

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

Investments

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

Equity security fair values are based on quoted market prices.

Multiple observable inputs are not available for some of our investments, primarily private placements and limited partnerships. Management values these investments either using non-binding broker quotes or pricing models that utilize market based assumptions that have limited observable inputs. These investments compose less than 1% of total assets.

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

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

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

Policy Receivables

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



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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Accounts Receivable

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

Property and Equipment

Property and equipment is carried at cost less accumulated depreciation and includes expenditures that substantially increase the useful lives of existing property and equipment. Significant costs incurred for internally developed software are capitalized and amortized over estimated useful lives of 3 years. Maintenance, repairs, and minor renovations are charged to expense as incurred. Upon sale or retirement of property and equipment, the costs and related accumulated depreciation are eliminated from the respective account and the resulting gain or loss is included in the results of operations. The Company provides for depreciation of property and equipment using the straight-line method designed to amortize costs over estimated useful lives. Estimated useful lives range up to 40 years for buildings and from 3-10 years for electronic data processing equipment and furniture and fixtures. Property and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

Statement of Cash Flows

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

Premium Revenue

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

Deferred Policy Acquisition Costs

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

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

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

Policy Liabilities

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

Years of Issue

1947 - 1968

1969 - 1978

1979 - 2003

2004 - 2012

2013

Interest Rate

4%

6% graded to 5%

7% graded to 6%

5.25%

4.25%

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

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Claim Liabilities

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

Earnings Per Share

Earnings per share of common stock is based on the weighted average number of shares outstanding during each year. The adjusted weighted average shares outstanding were 2,480,884 in 2013 and 2,466,600 in 2012.

Reinsurance

The Company's insurance operations re-insure certain risks in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. See Note 10 for additional information regarding the Company's reinsurance practices.

Income Taxes

The Company files a consolidated federal income tax return. Tax related interest and penalties are reported as components of income tax expense.

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

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

Contingencies

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

Reclassifications

Certain 2012 amounts have been reclassified from the prior year consolidated financial statements to conform to the 2013 presentation.

Advertising

The Company expenses advertising costs as incurred.

#### Concentration of Credit Risk

The Company maintains cash balances which are generally held in non-interest bearing demand deposit accounts. Through December 31, 2012, these balances were insured by the FDIC with no balance limits. On January 1, 2013, \$250,000 per entity account balance limits were reinstated. At December 31, 2013, the net amount exceeding FDIC insured limits was \$2,778,000 at one financial institution. The Company has not experienced any losses in such accounts. Management of the Company reviews financial information of the financial institution on a quarterly basis and believes the Company is not exposed to any significant credit risk on cash and cash equivalents.

Policy receivables are reported at unpaid balances. Policy receivables are generally offset by associated unearned premium liabilities and are not subject to significant credit risk. Receivables from agents, less provision for credit

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

losses, are composed of balances due from independent agents. At December 31, 2013, the single largest balance due from one agent totaled \$546,000.

Reinsurance contracts do not relieve the Company of its obligations to policyholders. A failure of a reinsurer to meet their obligation could result in losses to the insurance subsidiaries. Allowances for losses are established if amounts are believed to be uncollectible. At December 31, 2013 and 2012, no amounts were deemed uncollectible. The Company, at least annually, evaluates the financial condition of all reinsurers and evaluates any potential concentrations of credit risk. At December 31, 2013, management does not believe the Company is exposed to any significant credit risk related to its reinsurance program.

Accounting Changes Not Yet Adopted

**Investments-Equity Method and Joint Ventures-Accounting for Investments in Qualified Affordable Housing Projects**  
In January 2014, the FASB issued guidance which permits qualified reporting entities to use a new accounting method, the proportional amortization method, for investments in qualified affordable housing projects. Under the new method the initial cost of an investment is amortized in proportion to the tax benefits received, and investment performance is recognized as a component of income tax expense (benefit) rather than as a component of investment income. This guidance is effective for fiscal years beginning after December 15, 2014. The Company anticipates that adoption of the standard will not have a material impact on its Consolidated Financial Statements. The Company plans to adopt the guidance beginning January 1, 2015.

**Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists**

In July 2013, the FASB issued guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss ("NOL") carryforward, a similar tax loss, or a tax credit carryforward exists. This guidance applies to all entities with unrecognized tax benefits that also have tax loss or tax credit carryforwards in the same tax jurisdiction as of the reporting date. This guidance is effective for fiscal years beginning after December 15, 2013. The Company will adopt this standard on January 1, 2014. The Company anticipates that adoption of the standard will not have a material impact on its Consolidated Financial Statements.

Recently Adopted Accounting Standards

**Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income**

In February 2013, the FASB issued an accounting standards update that requires additional disclosures for reclassification adjustments from accumulated other comprehensive income (AOCI). These additional disclosures include changes in AOCI balances by component and significant items reclassified out of AOCI. These disclosures must be presented either on the face of the affected financial statement or in the notes to the financial statements. The disclosures were effective beginning in the first quarter of 2013 and were to be provided on a prospective basis. These disclosures are presented in Note 14 to the consolidated financial statements.

**Intangibles-Goodwill and Other**

In July 2012, the FASB issued guidance related to impairment of indefinite-lived intangible assets other than goodwill. The new guidance allows an entity to first make a qualitative assessment of whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount before applying the quantitative impairment test. An entity is required to perform the quantitative test only if it determines that it is more

likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. The Company adopted this guidance January 1, 2013. This guidance did not have a material effect on results of operations or financial position.

#### NOTE 2 – VARIABLE INTEREST ENTITIES

The Company holds a passive interest in a limited partnership that is considered to be a Variable Interest Entity (VIE) under the provisions of FIN 46(R). The Company is not the primary beneficiary of the entity and is not required to consolidate under FIN 46(R). The entity is a private placement investment fund formed for the purpose of investing in private equity investments. The Company owns less than 1% of the limited partnership. The carrying value of the

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

investment totals \$325,000 and is included as a component of Other Invested Assets in the accompanying consolidated balance sheets.

In December 2005, the Company formed National Security Capital Trust I, a statutory trust created under the Delaware Statutory Trust Act, for the sole purpose of issuing, in private placement transactions, \$9,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$9,279,000 of variable rate subordinated debentures issued by the Company. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$9,005,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the trust. The Subordinated Debentures, disclosed in Note 8, are reported in the accompanying Consolidated Balance Sheets as a component of long-term debt. The Company's equity investments in the Trust total \$279,000 and are included in Other Assets in the accompanying consolidated balance sheets.

In June 2007, the Company formed National Security Capital Trust II for the sole purpose of issuing, in private placement transactions, \$3,000,000 of trust preferred securities (TPS) and using the proceeds thereof, together with the equity proceeds received from the Company in the initial formation of the Trust, to purchase \$3,093,000 unsecured junior subordinated deferrable interest debentures. The Company owns all voting securities of the Trust and the subordinated debentures are the sole assets of the Trust. The Trust will meet the obligations of the TPS with the interest and principal paid on the subordinated debentures. The Company received net proceeds from the TPS transactions, after commissions and other costs of issuance, of \$2,995,000. The Company also holds all the voting securities issued by the Trust and such trusts are considered to be VIE's. The Trust is not consolidated because the Company is not the primary beneficiary of the Trust. The Subordinated Debentures, disclosed in Note 8, are reported in the accompanying consolidated balance sheets as a component of long-term debt. The Company's equity investments in the Trust total \$93,000 and are included in Other Assets in the accompanying consolidated balance sheets.

## NOTE 3 – STATUTORY ACCOUNTING PRACTICES

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

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

	2013	2012
NSIC - including realized capital gains of \$111 and \$1,722, respectively	\$1,427	\$1,425
NSFC - including realized capital gains of \$939 and \$842, respectively; excluding prior year intercompany gain on real estate of \$2,417 (\$1,595, net of tax)	\$2,389	\$874

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Omega - including realized capital gains of \$81 and \$241, respectively	\$ 890	\$ 1,157
Statutory risk-based adjusted capital:		
NSIC - including AVR of \$806 and \$748, respectively	\$ 12,383	\$ 11,092
NSFC - including investment in Omega of \$5,473 and \$4,459, respectively	\$ 26,317	\$ 24,089
Omega	\$ 8,975	\$ 7,961

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



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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 4 – INVESTMENTS

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2013 are as follows:

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$35,831	\$1,698	\$713	\$36,816
Trust preferred securities	538	33	—	571
Mortgage backed securities	7,622	75	557	7,140
Private label mortgage backed securities	2,152	38	4	2,186
Obligations of states and political subdivisions	16,412	524	195	16,741
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	16,519	169	708	15,980
Total fixed maturities	79,074	2,537	2,177	79,434
Equity securities	2,420	2,365	411	4,374
Total	\$81,494	\$4,902	\$2,588	\$83,808

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2013 are as follows:

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$706	\$34	\$—	\$740
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	106	7	—	113
Total	\$812	\$41	\$—	\$853

The amortized cost and aggregate fair values of investments in available-for-sale securities as of December 31, 2012 are as follows:

Available-for-sale securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Corporate debt securities	\$31,387	\$2,430	\$80	\$33,737
Trust preferred securities	537	50	—	587
Mortgage backed securities	8,595	175	85	8,685
Private label mortgage backed securities	7,679	294	9	7,964
Obligations of states and political subdivisions	16,160	1,359	3	17,516
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	7,320	487	2	7,805
Total fixed maturities	71,678	4,795	179	76,294
Equity securities	3,191	2,398	457	5,132
Total	\$74,869	\$7,193	\$636	\$81,426



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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The amortized cost and aggregate fair values of investments in held-to-maturity securities as of December 31, 2012 are as follows:

Held-to-maturity securities:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Mortgage backed securities	\$1,194	\$91	\$—	\$1,285
Obligations of states and political subdivisions	145	2	—	147
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	163	14	—	177
Total	\$1,502	\$107	\$—	\$1,609

The amortized cost and aggregate fair value of debt securities at December 31, 2013, 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	\$1,239	\$1,258
Due after one year through five years	14,704	15,821
Due after five years through ten years	27,526	27,671
Due after ten years	35,605	34,684
Total	\$79,074	\$79,434
Held-to-maturity securities:		
Due in one year or less	\$—	\$—
Due after one year through five years	249	263
Due after five years through ten years	180	193
Due after ten years	383	397
Total	\$812	\$853

A summary of securities available-for-sale with unrealized losses as of December 31, 2013, 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:

	Less than 12 months		12 months or longer		Total		
December 31, 2013	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Total Securities in a Loss Position
Fixed maturities							
Corporate debt securities	\$10,589	\$600	\$1,548	\$113	\$12,137	\$713	26
Mortgage backed securities	3,215	427	1,796	130	5,011	557	18
Private label mortgage backed securities	472	4	—	—	472	4	3
	3,545	165	325	30	3,870	195	11

Obligations of state and political subdivisions							
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	11,534	600	390	108	11,924	708	21
Equity securities	—	—	875	411	875	411	1
	\$29,355	\$1,796	\$4,934	\$792	\$34,289	\$2,588	80

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A summary of securities available-for-sale with unrealized losses as of December 31, 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:

December 31, 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	\$2,226	\$31	\$963	\$49	\$3,189	\$80	7
Mortgage backed securities	2,904	77	165	8	3,069	85	8
Private label mortgage backed securities	206	8	65	1	271	9	2
Obligations of state and political subdivisions	356	3	—	—	356	3	1
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	495	2	—	—	495	2	1
Equity securities	—	—	829	457	829	457	1
	\$6,187	\$121	\$2,022	\$515	\$8,209	\$636	20

There were no securities held-to-maturity with unrealized losses as of December 31, 2013 and December 31, 2012.

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 3.07% 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 year ended December 31, 2013, the Company realized no additional other-than-temporary impairments. The single largest accumulated loss not realized as an impairment was in the equity portfolio and totaled \$411,000. The second largest loss position was in the bond portfolio and totaled \$137,000. The third largest loss position was in the bond portfolio and totaled \$108,000.

For the year ended December 31, 2012, the Company realized \$87,000 in other-than-temporary impairments. The single largest accumulated loss not realized as an impairment was in the equity portfolio and totaled \$457,000. The

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

second largest loss position was in the bond portfolio and totaled \$39,000. The third largest loss position was in the bond portfolio and totaled \$27,000.

Major categories of investment income are summarized as follows (dollars in thousands):

	Year ended December 31,	
	2013	2012
Fixed maturities	\$3,351	\$3,452
Equity securities	137	196
Mortgage loans on real estate	22	26
Investment real estate	8	64
Policy loans	104	95
Company owned life insurance change in surrender value	(73	) 271
Other, principally short-term investments	437	337
	3,986	4,441
Less: Investment expenses	240	250
Net investment income	\$3,746	\$4,191

Major categories of investment gains and losses are summarized as follows (dollars in thousands):

	Year ended December 31,	
	2013	2012
Fixed maturities	\$(95 )	\$539
Equity securities	1,219	2,263
Trading securities	—	2
Other, principally real estate	3,315	73
Other-than-temporary impairments	—	(87 )
Net realized investment gains	\$4,439	\$2,790

Other, principally real estate gain above reflects the third quarter sale of investment real estate with a carrying value of \$1,300,000.

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

	December 31, 2013	December 31, 2012
Net change in unrealized appreciation on available-for-sale securities before deferred tax	\$(4,243)	\$(153)
Deferred income tax	1,442	52
Net change in unrealized appreciation on available-for-sale securities	\$(2,801)	\$(101)

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THE NATIONAL SECURITY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5 – 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 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.

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2013 are summarized in the following table by the type of inputs applicable to the fair value measurements (unaudited) (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	\$36,816	\$—	\$36,816	\$—
Trust preferred securities	571	—	571	—
Mortgage backed securities	7,140	—	7,140	—
Private label mortgage backed securities	2,186	—	2,186	—
Obligations of states and political subdivisions	16,741	—	16,741	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	15,980	15,980	—	—
Trading securities	19	19	—	—
Equity securities available-for-sale	4,374	3,499	—	875
Total Financial Assets	\$83,827	\$19,498	\$63,454	\$875
Financial Liabilities				
Interest rate swap	\$897	\$—	\$—	\$897
Total Financial Liabilities	\$897	\$—	\$—	\$897

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 Maturities" and below under "Equity Securities."

**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 brokers and are classified within Level 3.

As of December 31, 2013, Level 3 fair value measurements of assets include \$875,000 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.

As of December 31, 2013, Level 3 fair value measurements of liabilities include \$897,000 net fair value of various interest rate swap agreements whose value is based on analysis provided by a third party broker who utilizes financial

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

modeling tools and assumptions on interest and other factors. The Company does not develop the unobservable inputs used in measuring fair value. Additional information regarding the interest rate swap agreements is provided in Note 8.

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, 2013 (in thousands):

For the year ended December 31, 2013	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$829	\$(1,521)
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	46	624
Purchases:	—	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$875	\$(897)
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, 2013:	\$—	\$—

For the year ended December 31, 2013, 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, 2012 are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

Description	Fair Value Measurements at Reporting Date Using			
	Total	Level 1	Level 2	Level 3
Financial Assets				
Fixed maturities available-for-sale				
Corporate debt securities	\$33,737	\$—	\$33,737	\$—
Trust preferred securities	587	—	587	—
Mortgage backed securities	8,685	—	8,685	—
Private label mortgage backed securities	7,964	—	7,964	—
Obligations of states and political subdivisions	17,516	—	17,516	—
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	7,805	7,805	—	—
Trading securities	40	40	—	—
Equity securities available-for-sale	5,132	4,303	—	829
Total Financial Assets	\$81,466	\$12,148	\$68,489	\$829
Financial Liabilities				
Interest rate swap	\$1,521	\$—	\$—	\$1,521
Total Financial Liabilities	\$1,521	\$—	\$—	\$1,521



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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2012 (in thousands):

For the year ended December 31, 2012	Equity Securities Available-for-Sale	Interest Rate Swap
Beginning balance	\$642	\$(1,196 )
Total gains or losses (realized and unrealized):		
Included in earnings	—	—
Included in other comprehensive income	44	(325 )
Purchases:	143	—
Sales:	—	—
Issuances:	—	—
Settlements:	—	—
Transfers in/(out) of Level 3	—	—
Ending balance	\$829	\$(1,521 )
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, 2012:	\$—	\$—

For the year ended December 31, 2012, 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 swap agreements 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 8 for additional information about the interest rate swap agreements.

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

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

Company owned life insurance — the carrying amount is a reasonable estimate of fair value.

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

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

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

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The carrying amount and estimate fair value of the Company's financial instruments as of December 31, 2013 and December 31, 2012 are as follows (in thousands):

	December 31, 2013		December 31, 2012	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
Assets and related instruments				
Mortgage loans	\$333	\$333	\$383	\$383
Policy loans	1,443	1,443	1,317	1,317
Company owned life insurance	5,858	5,858	5,931	5,931
Other invested assets	3,559	3,559	3,777	3,777
Liabilities and related instruments				
Other policyholder funds	1,447	1,447	1,417	1,417
Short-term notes payable and current portion of long-term debt	1,866	1,866	1,292	1,292
Long-term debt	20,889	20,889	25,339	25,339

## NOTE 6 – PROPERTY AND EQUIPMENT

Major categories of property and equipment are summarized as follows (dollars in thousands):

	December 31, 2013	December 31, 2012
Building and improvements	\$3,185	\$3,185
Electronic data processing equipment	1,822	1,814
Furniture and fixtures	874	912
	5,881	5,911
Less accumulated depreciation	3,804	3,519
	\$2,077	\$2,392

Depreciation expense for the year ended December 31, 2013 was \$386,000 (\$433,000 for the year ended December 31, 2012).

## NOTE 7 – INCOME TAXES

The Company recognizes tax-related interest and penalties as a component of tax expense. 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 2009. Tax returns have been filed through the year 2012.

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 positions of \$4,654,000 at



December 31, 2013 and \$4,997,000 at December 31, 2012.

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	Year ended December 31,		
	2013	2012	
General expenses	\$1,326	\$1,211	
Unearned premiums	1,855	1,751	
Claims liabilities	700	243	
Litigation settlement	3,173	3,570	
AMT credit	335	246	
NOL carryforward	849	2,711	
Other-than-temporary impairments on securities owned	—	164	
Unrealized loss on interest rate swaps	305	518	
Deferred tax assets	8,543	10,414	
Trading securities	—	(1	)
Depreciation	(119	) (94	)
Deferred policy acquisition costs	(2,984	) (3,093	)
Unrealized gains on securities available-for-sale	(786	) (2,229	)
Deferred tax liabilities	(3,889	) (5,417	)
Net deferred tax asset	\$4,654	\$4,997	

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

	Year ended December 31,		
	2013	2012	
Deferred policy acquisition costs	\$(109	) \$(157	)
Other-than-temporary impairments	164	94	
Trading securities	(1	) 1	
Unearned premiums	(104	) (37	)
General expenses	(115	) (60	)
Depreciation	25	(50	)
Claim liabilities	(457	) 28	
Litigation settlement	397	(3,145	)
AMT credit	(89	) (246	)
NOL carryforward	1,862	(1,348	)
Deferred income tax expense (benefit)	\$1,573	\$(4,920	)

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	Year ended December 31,			
	2013		2012	
Federal income tax rate applied to pre-tax income/loss	34.0	%	(34.0	)%
Dividends received deduction and tax-exempt interest	(1.7	)%	(1.4	)%
Small life deduction	(4.0	)%	(3.2	)%
Life reserve tax adjustment	(6.7	)%	—	%
Other, net	1.1	%	(1.1	)%
Effective federal income tax rate	22.7	%	(39.7	)%

Under pre-1984 life insurance company tax laws, a portion of NSIC's gain from operations was not subject to current income taxation, but was accumulated for tax purposes in a memorandum account designated "policyholders' surplus". The aggregate balance in this account, \$2,520,000 at December 31, 2013, would be taxed at current rates only if distributed to shareholders or if the account exceeded a prescribed minimum. The Deficit Reduction Act of 1984 eliminated additions to policyholders' surplus for 1984 and thereafter. Deferred taxes have not been provided on amounts designated as policyholders' surplus. The deferred income tax liability not recognized is approximately \$857,000 at December 31, 2013.

At December 31, 2013, the Company has approximately \$2,499,000 of net operating loss carryforwards available (\$849,000 tax benefit) to be applied to future periods. These carryforwards expire in 2031 and 2032.

## NOTE 8 – NOTES PAYABLE AND LONG-TERM DEBT

Short-term debt and current portion of long-term debt consisted of the following as of December 31, 2013 and December 31, 2012 (dollars in thousands):

	2013	2012
Line of credit with variable interest rate equal to the Wall Street Journal (WSJ) prime rate, subject to a 5.0% floor; maturity February 2014. Interest payments due quarterly. Unsecured.	\$ 700	\$ 125
Current portion of installment note payable due November 2014 with variable interest rate equal to the WSJ prime rate plus 1%; Unsecured	1,166	1,167
	\$ 1,866	\$ 1,292

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Long-term debt consisted of the following as of December 31, 2013 and December 31, 2012 (dollars in thousands):

	2013	2012
Line of credit with variable interest rate equal to the WSJ prime rate, subject to a 4.5% floor; maturity September 2017. Interest payments due monthly. Secured.	\$350	\$3,634
Long term portion of installment note with variable interest rate equal to the WSJ prime rate plus 1% and adjustable each November; maturity November 2021. Interest payable annually with principal payable in equal annual installments. Next principal installment on long term portion due November 2015. Unsecured.	8,167	9,333
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
	\$20,889	\$25,339

Annual maturities of all outstanding debt for the next five years and beyond are as follows:

2014	2015	2016	2017	2018	Thereafter
\$1,866	\$1,167	\$1,167	\$1,517	\$1,167	\$15,871

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 TPS 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 receives 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.

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The swaps entered into in 2009 and 2010 have fair values of \$278,000 (liability) and \$619,000 (liability), respectively, for a total liability of \$897,000 at December 31, 2013 (\$1,521,000 at December 31, 2012). The swap liability is reported as a component of other liabilities on the condensed consolidated balance sheets. A net valuation gain of \$412,000 (net of tax) is included in accumulated other comprehensive income related to the swap agreements for the current period. A net valuation loss of \$214,000 (net of tax) was included in accumulated other comprehensive income related to the swap at December 31, 2012.

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. At December 31, 2013, the Company has securities on deposit with fair market values of \$1,422,000 (all of which is posted as collateral). At December 31, 2012, the Company had securities on deposit with fair market values of \$1,557,000, all of which is posted as collateral. See Note 5 for additional information about the interest rate swaps.

In January 2013, 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 December 31, 2013, there was \$700,000 drawn on this line (\$125,000 at December 31, 2012).

In July 2012, the Company executed a promissory note in the amount of \$13,000,000 payable to the Bagley Family Revocable Trust with an interest rate of WSJ prime plus 1% (4.25% at December 31, 2013 and 2012). The purpose of this promissory note is to finance the settlement obligation related to the Mobile Attic litigation. As of December 31, 2013 a total of \$9,333,000 (\$10,500,000 at December 31, 2012) was outstanding with principal payments due in equal annual installments of \$1,167,000 payable each November beginning in 2013. Installment payments due within 12 months of the balance sheet date are classified as current portion of long term debt. The promissory note allows for the Company to defer payments in years in which its P&C subsidiaries incur substantial catastrophe losses thus allowing capital management flexibility in the P&C subsidiaries. Under the terms of the promissory note, annual debt service payments on the note must equal or exceed any payment of dividends to shareholders in the preceding twelve months.

In September 2012, the Company obtained a secured line of credit in the amount of \$4,000,000 with an interest rate equal to the WSJ prime but subject to a floor of 4.5% (4.5% at December 31, 2012). In August of 2013, the Company sold substantially all timber property securing the credit line and paid the \$4,000,000 principal balance outstanding. The line remains available but, due to the sale of substantially all collateral securing the line of credit, as of December 31, 2013, the line was reduced to \$1,000,000 and there was \$350,000 drawn on this line (\$3,634,000 at December 31, 2012).

NOTE 9 – POLICY AND CLAIM RESERVES

The Company regularly updates its reserve estimates as new information becomes available and events occur that may impact the resolution of unsettled claims. Changes in prior years' reserve estimates are reflected in the results of operations in the year such changes are determined.



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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table is a reconciliation of beginning and ending property and casualty reserve balances for claims and claim adjustment expense (dollars in thousands):

	Year ended December 31,	
	2013	2012
Summary of claims and claim adjustment expense reserves		
Balance, beginning of year	\$ 11,214	\$ 14,386
Less reinsurance recoverable on unpaid losses	1,229	2,381
Net balances at beginning of year	9,985	12,005
Net losses:		
Provision for claims and claim adjustment expenses for claims arising in current year	27,091	30,569
Estimated claims and claim adjustment expenses for claims arising in prior years	(152)	(1,476)
Total increases	26,939	29,093
Claims and claim adjustment expense payments for claims arising in:		
Current year	23,823	26,272
Prior years	5,149	4,841
Total payments	28,972	31,113
Net balance at end of year	7,952	9,985
Plus reinsurance recoverable on unpaid losses	782	1,229
Claims and claim adjustment expense reserves at end of year	\$ 8,734	\$ 11,214

The 2013 decrease in property and casualty benefit loss reserves was primarily due to a reduced frequency of weather related losses in the property and casualty subsidiaries in the second half of 2013 compared to prior year.

The Company has a geographic exposure to catastrophe losses in certain areas of the country. Catastrophes can be caused by various events including hurricanes, windstorms, earthquakes, hail, severe winter weather, explosions and fires, and the incidence and severity of catastrophes are inherently unpredictable. The extent of losses from a catastrophe is a function of both the total amount of insured exposure in the area affected by the event and the severity of the event. Most catastrophe losses are restricted to small geographic areas; however, hurricanes and earthquakes may produce significant damage in large, heavily populated areas. The Company generally seeks to reduce its exposure to catastrophes through individual risk selection and the purchase of catastrophe reinsurance. At December 31, 2013, the Company's estimate of unpaid losses and adjustment expenses for claims incurred in prior years related to catastrophes that exceeded our retention totaled \$476,000 before reinsurance (\$958,000 in 2012). Because the Company has exhausted its catastrophe coverage limits available for Hurricane Katrina any additional development will not be covered by reinsurance. The Company maintains case reserves of \$174,000 for losses in excess of catastrophe reinsurance (\$390,000 in 2012).

## NOTE 10 – REINSURANCE

The Company's insurance operations utilize reinsurance in order to limit losses, minimize exposure to large risks, provide additional capacity for future growth and effect business-sharing arrangements. Life reinsurance is accomplished through yearly renewable term coverage. Property and casualty reinsurance is placed on both a quota-share and excess of loss basis. Reinsurance ceded arrangements do not discharge the insurance subsidiaries as the primary insurer, except for cases involving a novation. Failure of re-insurers to honor their obligations could result in losses to the insurance subsidiaries. The insurance subsidiaries evaluate the financial conditions of their reinsurance



companies and monitor concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the companies to minimize their exposure to significant losses from reinsurance insolvencies.

In the normal course of business, NSFC seeks to reduce the loss that may arise from catastrophes or other individually significant large loss events that cause unfavorable underwriting results by re-insuring certain levels of risk in various

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

areas of exposure with reinsurance companies. 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 catastrophe event. Catastrophe reinsurance coverage is maintained in four layers as follows:

Layer	Reinsurers' Limits of Liability
First Layer	100% of \$6,000,000 in excess of \$4,000,000
Second Layer	100% 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

Each reinsurance layer covers events occurring from January 1-December 31 of the contract year. All significant reinsurance companies under the program carry A.M. Best ratings of A- (Excellent) or higher, or equivalent ratings.

The Company's catastrophe reinsurance contract allows for one reinstatement. The Company maintains reinstatement premium protection (RPP) to cover reinstatement premiums incurred. The RPP further reduces risk from a major catastrophe and serves to strengthen the Company's capital position by reducing the modeled 100 year event net cost.

Amounts recoverable from re-insurers are estimated in a manner consistent with the claim liability associated with the underlying insurance policies. 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 reinsurance companies 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.

At December 31, 2013, the largest reinsurance recoverable of a single reinsurer was \$214,000 (\$295,000 at December 31, 2012). Amounts reported as ceded incurred losses in both 2013 and 2012 were related to the development of losses from prior year catastrophes.

The effect of reinsurance on premiums written and earned in the property and casualty segment is as follows (dollars in thousands):

	Year ended December 31, 2013		Year ended December 31, 2012	
	Written	Earned	Written	Earned
Direct	\$55,659	\$54,249	\$53,544	\$53,469
Assumed	—	—	—	—
Ceded	(8,462	) (8,474	) (8,263	) (8,263
Net	\$47,197	\$45,775	\$45,281	\$45,206

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The effect of reinsurance on premiums written and earned in the life segment is as follows (dollars in thousands):

	Year ended December 31, 2013		Year ended December 31, 2012	
	Written	Earned	Written	Earned
Direct	\$6,677	\$6,657	\$6,806	\$6,682
Assumed	—	—	—	—
Ceded	(66	) (66	(73	) (73
Net	\$6,611	\$6,591	\$6,733	\$6,609

## NOTE 11 – EMPLOYEE BENEFIT PLANS

The Company and its subsidiaries have an established retirement savings plan (401K Plan). All full-time employees are eligible to participate, and all employer contributions are fully vested for employees who have completed 1,000 hours of service in the year of contribution. Company matching contributions for the years ended December 31, 2013 and 2012 amounted to \$198,000 and \$202,000, respectively. The Company contributes dollar-for-dollar matching contributions up to 5% of compensation subject to government limitations.

In January 2006, the Company established a non-qualified plan under which directors are allowed to defer all or a portion of directors' fees into various investment options.

The supplemental executive retirement plan (SERP) became effective March 1, 2008 and covers named executive officers with the Company contributing 15% of executive compensation to the plan. Contributions to the plan are fully vested upon the earlier of death, disability, change in control, or ten years of participation in the plan. Costs for amounts credited of the non-qualified deferred compensation plans for the period ended December 31, 2013 and 2012 amounted to approximately \$259,000 and \$158,000, respectively.

The Company and its subsidiaries established an Employee Stock Ownership Plan (ESOP) in January 2010, to enable its eligible employees to acquire a proprietary interest in the Company's common stock and to provide retirement and other benefits to such employees. Costs for amounts contributed to the ESOP for the period ended December 31, 2013 and 2012 amounted to \$125,000 and \$100,000, respectively. All contributions were made in cash for purchase of Company shares in the open market. The Company has not allocated shares directly to the plan and the plan has no debt.

## NOTE 12 – REGULATORY REQUIREMENTS AND DIVIDEND RESTRICTIONS

The Company is dependent on dividends from its insurance subsidiaries to fund operations and payment of shareholder dividends. Dividend payments from the insurance subsidiaries are subject to regulatory review/approval and statutory limitations. The statutory limitations are outlined as follows:

The amount of dividends paid from NSIC to the Company in any year may not exceed, without prior approval of regulatory authorities, the greater of 10% of statutory surplus as of the end of the preceding year, or the statutory net gain from operations for the preceding year. At December 31, 2013, NSIC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to \$1,463,000.

NSFC is similarly restricted in the amount of dividends payable to the Company; dividends may not exceed the greater of 10% of statutory surplus as of the end of the preceding year, or net income for the preceding year. At December 31, 2013, NSFC's retained earnings unrestricted for the payment of dividends in the next twelve months amounted to \$2,632,000.

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.

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

At December 31, 2013, securities with market values of \$3,503,000 (\$3,785,000 at December 31, 2012) were deposited with various states pursuant to statutory requirements.

## NOTE 13 – SHAREHOLDERS' EQUITY

During the year ended December 31, 2013, and year ended December 31, 2012, changes in shareholders' equity consisted of a net income of \$5,658,000 and net loss of \$6,671,000, respectively; dividends paid of \$248,000 in 2013 and \$802,000 in 2012; changes in accumulated other comprehensive loss, net of applicable taxes, of \$2,389,000 in 2013 and \$315,000 in 2012. Other comprehensive loss consists of accumulated unrealized gains and losses on securities and unrealized gains and losses on interest rate swaps.

## Preferred Stock

Preferred Stock may be issued in one or more series as shall from time to time be determined and authorized by the Board of Directors. The directors may make specific provisions regarding (a) the voting rights, if any (b) whether such dividends are to be cumulative or noncumulative (c) the redemption provisions, if any (d) participating rights, if any (e) any sinking fund or other retirement provisions (f) dividend rates (g) the number of shares of such series and (h) liquidation preference.

## Common Stock

The holders of the Class A Common Stock will have one-twentieth of one vote per share, and the holders of the common stock will have one vote per share. There is currently no Class A Common Stock issued or outstanding.

In the event of any liquidation, dissolution or distribution of the assets of the Company remaining after the payments to the holders of the Preferred Stock of the full preferential amounts to which they may be entitled as provided in the resolution or resolutions creating any series thereof, the remaining assets of the Company shall be divided and distributed among the holders of both classes of common stock, except as may otherwise be provided in any such resolution or resolutions.

The table below provides information regarding the Company's preferred and common stock as of December 31, 2013 and December 31, 2012:

	December 31, 2013			December 31, 2012		
	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	2,494,480	2,494,480	3,000,000	2,466,600	2,466,600

The Company has a share based compensation plan in place for directors by which shares are issued for board service. The share based compensation plan is in accordance with the 2009 Equity Incentive Plan (the Plan) previously approved by shareholders. Under the Plan, 200,000 shares are authorized for issuance. On June 28, 2013, 27,880 shares of common stock were issued to directors as compensation under the Plan. Compensation costs for shares issued under the Plan are calculated at market value on the date of award. Compensation costs for shares issued on June 28, 2013, totaled \$224,000.



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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 14 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The balance of and changes in each component of accumulated other comprehensive income (loss) (“AOCI”) for the period ended December 31, 2013, net of income taxes, are as follows (dollars in thousands):

	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Total
Beginning balance	\$(1,003	) \$4,328	\$3,325
Other comprehensive income before reclassifications	412	(1,291	) (879
Amounts reclassified from accumulated other comprehensive— income		(1,510	) (1,510
Net current period other comprehensive income	412	(2,801	) (2,389
Ending balance	\$(591	) \$1,527	\$936

The following table presents the amounts reclassified out of AOCI for the period ended December 31, 2013 (dollars in thousands):

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized Gains and Losses on Available-for-Sale Securities	\$4,439	Net realized investment gains
	4,439	Total before tax
	(1,509	) Tax (expense) or benefit
	\$2,930	Net of Tax

## NOTE 15 – SEGMENTS

The Company’s property and casualty insurance operations comprise one business segment. The property and casualty insurance segment primarily underwrites home insurance coverage with primary lines of business consisting of: dwelling fire and extended coverage, homeowners (including mobile homeowners) and other liability. The Company has ceased writing ocean marine, private passenger auto liability, commercial auto liability and auto physical damage coverages over the past two years with no policies remaining in-force at December 31, 2013 in the lines of business.

Management organizes the business utilizing a niche strategy focusing on lower valued dwellings. Our chief decision makers (Chief Executive Officer, Chief Financial Officer and President) 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.



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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

Total assets by industry segment for the years ended December 31, 2013 and 2012 are summarized below (dollars in thousands):

	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
December 31, 2013	\$ 133,980	\$71,003	\$53,831	\$9,146
December 31, 2012	\$ 135,716	\$71,447	\$53,760	\$10,509

Premium revenues and operating income by business segment for the years ended December 31, 2013 and 2012 are summarized below (dollars in thousands):

Year ended December 31, 2013	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
<b>REVENUE</b>				
Net premiums earned	\$52,366	\$45,775	\$6,591	\$—
Net investment income	3,746	1,637	2,032	77
Net realized investment gains	4,439	1,020	111	3,308
Other income	609	604	5	—
	61,160	49,036	8,739	3,385
<b>BENEFITS AND EXPENSES</b>				
Policyholder benefits paid	31,146	26,219	4,927	—
Amortization of deferred policy acquisition costs	3,613	2,576	1,037	—
Commissions	7,103	6,678	425	—
General and administrative expenses	8,443	5,683	2,034	726
Taxes, licenses and fees	1,846	1,614	232	—
Interest expense	1,686	—	77	1,609
	53,837	42,770	8,732	2,335
Income Before Income Taxes	\$7,323	\$6,266	\$7	\$1,050

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Year ended December 31, 2012	Total	P&C Insurance Operations	Life Insurance Operations	Non-Insurance Operations
<b>REVENUE</b>				
Net premiums earned	\$51,815	\$45,206	\$6,609	\$—
Net investment income	4,191	2,107	1,993	91
Net realized investment gains	2,790	1,083	1,635	72
Other income	720	718	2	—
	59,516	49,114	10,239	163
<b>BENEFITS AND EXPENSES</b>				
Policyholder benefits paid	34,105	28,811	5,294	—
Amortization of deferred policy acquisition costs	3,711	2,773	938	—
Commissions	7,556	7,088	468	—
General and administrative expenses	8,754	6,262	1,973	519
Litigation settlement and defense costs	13,328	—	—	13,328
Taxes, licenses and fees	1,846	1,628	218	—
Interest expense	1,280	—	53	1,227
	70,580	46,562	8,944	15,074
Income (Loss) Before Income Taxes	\$(11,064 )	\$2,552	\$1,295	\$(14,911 )

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 years ended December 31, 2013 and 2012, respectively:

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

	Year ended December 31,	
	2013	2012
Life, accident and health operations premiums written:		
Traditional life insurance	\$4,756	\$4,936
Accident and health insurance	1,921	1,870
Gross life, accident and health	6,677	6,806
Reinsurance premium ceded	(66	) (73
Net life, accident and health premiums written	\$6,611	\$6,733
Property and Casualty operations premiums written:		
Dwelling fire & extended coverage	\$30,527	\$28,161
Homeowners (Including mobile homeowners)	23,367	22,867
Ocean marine	75	981
Other liability	1,690	1,471
Private passenger auto liability	—	37
Commercial auto liability	—	6
Auto physical damage	—	21
Gross property and casualty	55,659	53,544
Reinsurance premium ceded	(8,462	) (8,263
Net property and casualty written	\$47,197	\$45,281
Gross premiums written	\$62,336	\$60,350
Reinsurance premium ceded	(8,528	) (8,336
Net premiums written	\$53,808	\$52,014

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 years ended December 31, 2013 and 2012, respectively:

	Year ended December 31,	
	2013	2012
Life, accident and health operations premiums earned:		
Traditional life insurance	\$4,718	\$4,818
Accident and health insurance	1,939	1,864
Gross life, accident and health	6,657	6,682
Reinsurance premium ceded	(66)	) (73
Net life, accident and health premiums earned	\$6,591	\$6,609
Property and Casualty operations premiums earned:		
Dwelling fire & extended coverage	\$29,302	\$27,206
Homeowners (Including mobile homeowners)	22,830	23,287
Ocean marine	524	1,090
Other liability	1,593	1,412
Private passenger auto liability	—	319
Commercial auto liability	—	6
Auto physical damage	—	149
Gross property and casualty	54,249	53,469
Reinsurance premium ceded	(8,474)	) (8,263
Net property and casualty earned	\$45,775	\$45,206
Gross premiums earned	\$60,906	\$60,151
Reinsurance premium ceded	(8,540)	) (8,336
Net premiums earned	\$52,366	\$51,815

## NOTE 16 – CONTINGENCIES

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 the Company's subsidiaries, and other miscellaneous causes of action.

The Company's property & casualty subsidiaries are defending a limited number of matters filed in the aftermath of Hurricanes Katrina in Mississippi and Louisiana as well as Gustav and Ike in Texas. These actions include individual lawsuits with allegations of underpayment of hurricane-related claims.

The various suits seek a variety of remedies, including actual and/or punitive damages in unspecified amounts and/or declaratory relief. The Company has reserves set up on litigated claims and the reserves are included in benefit and loss reserves.

In June 2012, the Company reached a settlement agreement related to its disposition of Mobile Attic, Inc. The settlement is reflected in expenses presented in the 2012 statement of income. Also see Note 8.

NOTE 17 – SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during 2013 was \$1,742,000 (\$1,163,000 in 2012 ). Cash paid for income taxes during 2013 was \$395,000. Cash received from income tax refunds during 2012 was \$1,437,000.

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## THE NATIONAL SECURITY GROUP, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

During the twelve months ended December 31, 2013, non-cash changes in equity included \$28,000 in common stock issued to Directors in lieu of cash compensation along with a corresponding \$196,000 increase in additional paid in capital.

## NOTE 18 – SUBSEQUENT EVENTS

Management has evaluated subsequent events and their potential effects on these consolidated financial statements.

## Schedule I. Summary of Investments Other Than Investments in Related Parties

## THE NATIONAL SECURITY GROUP, INC.

(dollars in thousands)

	December 31, 2013			December 31, 2012		
	Cost	Fair Value	Amount per the Balance Sheet	Cost	Fair Value	Amount per the Balance Sheet
Securities Held-to-Maturity:						
United States government	\$ 106	\$ 113	\$ 106	\$ 163	\$ 177	\$ 163
States, municipalities and political subdivisions	—	—	—	145	147	145
Mortgage backed securities	706	740	706	1,194	1,285	1,194
Private label mortgage backed securities	—	—	—	—	—	—
Industrial and Miscellaneous	—	—	—	—	—	—
Total Securities Held-to-Maturity	812	853	812	1,502	1,609	1,502
Securities Available-for-Sale:						
Equity Securities:						
Banks and insurance companies	1,364	1,409	1,409	1,363	1,231	1,231
Industrial and all other	1,056	2,965	2,965	1,828	3,901	3,901
Total equity securities	2,420	4,374	4,374	3,191	5,132	5,132
Debt Securities:						
United States government	16,519	15,980	15,980	7,320	7,805	7,805
States, municipalities and political subdivisions	16,412	16,741	16,741	16,160	17,516	17,516
Mortgage backed securities	7,622	7,140	7,140	8,595	8,685	8,685
Private label mortgage backed securities	2,152	2,186	2,186	7,679	7,964	7,964
Trust preferred securities	538	571	571	537	587	587
Industrial and Miscellaneous	35,831	36,816	36,816	31,387	33,737	33,737
Total Debt Securities	79,074	79,434	79,434	71,678	76,294	76,294
Total Available-for-Sale	81,494	83,808	83,808	74,869	81,426	81,426
Total Securities	82,306	84,661	84,620	76,371	83,035	82,928
Trading securities	19	19	19	40	40	40
Mortgage loans on real estate	333	333	333	383	383	383
Investment real estate	4,218	4,218	4,218	5,757	5,757	5,757

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Policy loans	1,443	1,443	1,443	1,317	1,317	1,317
Company owned life insurance	5,000	5,858	5,858	5,000	5,931	5,931
Other invested assets	3,559	3,559	3,559	3,777	3,777	3,777
Total investments	\$96,878	\$100,091	\$100,050	\$92,645	\$100,240	\$100,133

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THE NATIONAL SECURITY GROUP, INC.

## FINANCIAL STATEMENT SCHEDULES

## Schedule II. Condensed Financial Information of Registrant

THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)

## BALANCE SHEETS

(dollars in thousands)

	December 31, 2013	2012
Assets		
Fixed maturities available-for-sale, at estimated fair value	\$ 1,422	\$ 1,557
Investment real estate, at book value	356	1,457
Cash	948	58
Investment in subsidiaries (equity method) eliminated upon consolidation	49,565	49,407
Deferred income tax asset	5,866	6,706
Other assets	689	723
Total Assets	\$58,846	\$59,908
Liabilities and Shareholders' Equity		
Liabilities		
Accrued general expenses	\$ 1,722	\$ 1,529
Interest rate swaps	897	1,521
Notes payable	22,755	26,631
Total Liabilities	25,374	29,681
Total Shareholders' Equity	33,472	30,227
Total Liabilities and Shareholders' Equity	\$58,846	\$59,908



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THE NATIONAL SECURITY GROUP, INC.

## FINANCIAL STATEMENT SCHEDULES

THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)

## STATEMENTS OF INCOME (LOSS)

(Dollars in thousands)

	Years Ended December 31,	
	2013	2012
Income		
Dividends (eliminated upon consolidation)	\$ 1,250	\$ 1,800
Property transfer from subsidiary	—	1,473
Net realized investment gains (losses)	3,308	72
Holding company management service fees	929	906
Other income	76	91
	5,563	4,342
Expenses		
State taxes	41	42
Litigation settlement and defense costs	—	13,328
Interest	1,609	1,229
Other expenses	684	477
	2,334	15,076
Income (loss) before income taxes and equity in undistributed earnings of subsidiaries	3,229	(10,734 )
Income tax expense (benefit)	672	(4,697 )
Income (loss) before equity in undistributed earnings of subsidiaries	2,557	(6,037 )
Equity in undistributed earnings of subsidiaries	3,101	(634 )
Net income (loss)	\$ 5,658	\$ (6,671 )

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THE NATIONAL SECURITY GROUP, INC.

## FINANCIAL STATEMENT SCHEDULES

THE NATIONAL SECURITY GROUP, INC. (PARENT COMPANY)

## STATEMENTS OF CASH FLOWS

(dollars in thousands)

	Years Ended December 31,	
	2013	2012
Cash Flows from Operating Activities:		
Net income (loss)	\$5,658	\$(6,671)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Equity in undistributed earnings of subsidiaries	(3,101)	) 634
Net realized investment gains	(3,308)	) (72)
Deferred income tax expense (benefit)	672	(4,697)
Property transfer from subsidiary	—	(1,473)
Other, net	246	(1,142)
Net cash provided by (used in) operating activities	167	(13,421)
Cash Flows from Investing Activities:		
Net sales (purchases) of investments	4,847	(567)
Net cash provided by (used in) investing activities	4,847	(567)
Cash Flows from Financing Activities:		
Net (repayments) proceeds from debt	(3,876)	) 13,774
Cash dividends	(248)	) (802)
Net cash (used in) provided by financing activities	(4,124)	) 12,972
Net increase (decrease) in cash and cash equivalents	890	(1,016)
Cash, at beginning of year	58	1,074
Cash, at end of year	\$948	\$58

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THE NATIONAL SECURITY GROUP, INC.

FINANCIAL STATEMENT SCHEDULES

Notes to Condensed Financial Information of Registrant

Note 1 - Basis of Presentation

Pursuant to the rules and regulations of the Securities and Exchange Commission, the Condensed Financial Information of the Registrant does not include all of the information and notes normally included with financial statements prepared in accordance with generally accepted accounting principles. It is, therefore, suggested that this Condensed Financial Information be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Registrant's Annual Report as referenced in Form 10-K, Part II, Item 8, page 40.

Note 2 - Cash Dividends and Asset Transfers from Insurance Subsidiaries

In 2013, cash dividends of \$1.3 million were paid to the Registrant by its subsidiaries (\$1.8 million in 2012). Also in 2012, timber property with a carrying value of \$1.5 million was transferred to the Registrant from an insurance subsidiary.

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## THE NATIONAL SECURITY GROUP, INC.

## FINANCIAL STATEMENT SCHEDULES

## Schedule III. Supplementary Insurance Information

## THE NATIONAL SECURITY GROUP, INC.

(dollars in thousands)

				Deferred Acquisition Costs	Future Policy Benefits	Unearned Premiums
At December 31, 2013:						
Life and accident and health insurance				\$5,607	\$34,189	\$ 14
Property and casualty insurance				3,169	—	27,287
Total				\$8,776	\$34,189	\$ 27,301
At December 31, 2012:						
Life and accident and health insurance				\$5,960	\$33,377	\$ 16
Property and casualty insurance				3,137	—	25,761
Total				\$9,097	\$33,377	\$ 25,777
	Premium Revenue	Net Investment Income	Other Income	Benefits, Claims, Losses and Settlement Expenses	Commissions, Amortization of Policy Acquisition Costs	General Expenses, Taxes, Licenses and Fees
For the year ended December 31, 2013:						
Life and accident and health insurance	\$6,591	\$2,032	\$5	\$4,927	\$1,462	\$ 2,266
Property and casualty insurance	45,775	1,637	604	26,219	9,254	7,297
Other	—	77	—	—	—	726
Total	\$52,366	\$3,746	\$609	\$31,146	\$10,716	\$ 10,289
For the year ended December 31, 2012:						
Life and accident and health insurance	\$6,609	\$1,993	\$2	\$5,294	\$1,406	\$ 2,191
Property and casualty insurance	45,206	2,107	718	28,811	9,861	7,890
Other	—	91	—	—	—	13,847
Total	\$51,815	\$4,191	\$720	\$34,105	\$11,267	\$ 23,928

Note: Investment income and other operating expenses are reported separately by segment and not allocated.

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THE NATIONAL SECURITY GROUP, INC.

## FINANCIAL STATEMENT SCHEDULES

## Schedule IV. Reinsurance

THE NATIONAL SECURITY GROUP, INC.

(dollars in thousands)

	Gross Amount	Ceded to Other Companies	Assumed from Other Companies	Net Amount	Percentage of Amount Assumed to Net	
For the year ended December 31, 2013						
Life insurance in force	\$209,909	\$9,126	\$—	\$200,783	—	%
Premiums:						
Life insurance and accident and health insurance	\$6,657	\$66	\$—	\$6,591	—	%
Property and casualty insurance	54,249	8,474	—	45,775	—	%
Total premiums	\$60,906	\$8,540	\$—	\$52,366	—	%
For the year ended December 31, 2012						
Life insurance in force	\$211,778	\$11,200	\$—	\$200,578	—	%
Premiums:						
Life insurance and accident and health insurance	\$6,682	\$73	\$—	\$6,609	—	%
Property and casualty insurance	53,469	8,263	—	45,206	—	%
Total premiums	\$60,151	\$8,336	\$—	\$51,815	—	%

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THE NATIONAL SECURITY GROUP, INC.

FINANCIAL STATEMENT SCHEDULES

Schedule V. Valuation and Qualifying Accounts

The National Security Group, Inc

Years ended December 31, 2013 and 2012

(dollars in thousands)

	2013	2012	
Balance, January 1 Allowance for Doubtful Accounts	\$6	\$29	
Additions	4	—	
Deletions	—	(23	)
Balance, December 31 Allowance for Doubtful Accounts	\$10	\$6	

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

Company management, including the Chief Executive Officer and Chief Financial Officer, have conducted an evaluation of the effectiveness of disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be filed in this annual report has been made known to them in a timely fashion. There have been no significant changes in internal controls, or in factors that could significantly affect internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation.

Management's Report on Internal Control over Financial Reporting

Management of The National Security Group, Inc. is responsible for establishing and maintaining effective internal control over financial reporting. The Company's internal control system was designed to provide reasonable assurance to management and board of directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP).

The Company's internal control over financial reporting includes those policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2013.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

Item 9B. Other Information

None

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Executive Officers

JACK E. BRUNSON (57) has served as a director since 1999 and as President of NSFC since 1997. He also serves on the Boards of Directors of NSFC and Omega. He joined the Company in 1982. Mr. Brunson is a Chartered Property and Casualty Underwriter.



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W. L. BRUNSON, JR. (55) has served as a director since 1999 and as President and Chief Executive Officer of the Company since 2000. He also holds the position of President of NSIC. He joined the Company in 1983. Mr. Brunson is also a director of NSFC, NATSCO, NSIC, and Omega. Mr. Brunson is a member of the Alabama State Bar.

BRIAN R. MCLEOD (45) currently serves as Vice President of Finance & Operations, CFO and Treasurer of the Company. From 1992-2002 he served as Controller. He joined the Company in 1992. Mr. McLeod is a Director of NSIC, NSFC, Omega and NATSCO. Mr. McLeod is also a member of the Board of Directors for Trinity Bank, a community bank in Dothan, Alabama. Mr. McLeod is a Certified Public Accountant.

The information contained in The National Security Group's definitive proxy statement for the 2014 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 4, 2014 with respect to directors and executive officers of the Company as well as Corporate Governance, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2014 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 4, 2014 with respect to Audit Committee and Audit Committee financial expert, is incorporated herein by reference in response to this item.

The information contained in The National Security Group's definitive proxy statement for the 2014 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 4, 2014 with respect to information on the beneficial ownership reporting for directors and executive officers, is incorporated herein by reference in response to this item.

Item 11. Executive Compensation

The information contained in The National Security Group's definitive proxy statement for the 2014 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 4, 2014, with respect to executive compensation and transactions, is incorporated herein by reference in response to this item.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information contained in The National Security Group's definitive proxy statement for the 2014 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 4, 2014, with respect to security ownership of certain beneficial owners and management is incorporated herein by reference in response to this item.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information contained in The National Security Group's definitive proxy statement for the 2014 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 4, 2014, with respect to certain relationships and related transactions, is incorporated herein by reference in response to this item.

Item 14. Principal Accounting Fees and Services

The information contained in The National Security Group's definitive proxy statement for the 2014 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 4, 2014, with respect to principal accountant fees and services, is incorporated herein by reference in response to this item.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this report:

1. Consolidated financial statements, notes thereto and related information of The National Security Group, Inc. (the “Company”) are included in Item 8 of Part II of this report:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets - December 31, 2013 and 2012

Consolidated Statements of Income (Loss) - Years ended December 31, 2013 and 2012

Consolidated Statements of Shareholders' Equity - Years ended December 31, 2013 and 2012

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Consolidated Statements of Cash Flows - Years ended December 31, 2013 and 2012

Consolidated Notes to the Financial Statements

2. Additional financial statement schedules and report of independent registered accounting firm are furnished herewith pursuant to the requirements of Form 10-K:

The National Security Group, Inc.

Schedule I	Summary of Investments Other Than Investments in Related Parties
Schedule II	Condensed Financial Information of the Registrant
Schedule III	Supplementary Insurance Information
Schedule IV	Reinsurance
Schedule V	Valuation and Qualifying Accounts

3. Exhibits filed as part of this Form 10-K:

- 11. Computation of Earnings Per Share Filed Herewith, See Note 1 to Consolidated Financial Statements.
- 14. Code of Ethics, See Additional Information in Part I, Item 1 of This Report
- 21.1 Subsidiaries of the Registrant
- 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) During the last fiscal quarter of the period covered by this Report, the Company filed the following Current Reports on Form 8-K:

Date of Report	Date Filed	Description
October 18, 2013	October 22, 2013	Press release announcing quarterly dividend.
November 14, 2013	November 14, 2013	Press release announcing financial results for the period ended September 30, 2013.

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

THE NATIONAL SECURITY GROUP, INC.

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

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

Date: March 21, 2014

POWER OF ATTORNEY

Know all by these present, that the undersigned hereby constitutes and appoints Brian R. McLeod, with full power of substitution and/or revocation, the undersigned's true and lawful attorney-in-fact: to execute for and on behalf of the undersigned, in the undersigned's capacity as a director of National Security Group, inc. (the "Company"), any and all forms (including, without limitation Form 10-K) required or desired to be executed by or on behalf of the Company pursuant to section 13 or 15(D) of the Securities Exchange Act of 1934, as amended, after said form has been approved by the Company's audit committee; to do and perform any and all acts for and on behalf of the undersigned which may be necessary or desirable to complete and execute any such Form and timely file such Form with the appropriate governmental authority (including, without limitation, the United States Securities and Exchange Commission) and any stock exchange or similar authority; and Take any other action of any type whatsoever in connection with the foregoing which, in the opinion of such attorney-in-fact, may be of benefit to, in the best interest of, or legally required by, the undersigned, it being understood that the documents executed by any such attorney-in-fact on behalf of the undersigned pursuant to this Power of Attorney shall be in such form and shall contain such terms and conditions as such attorney-in-fact may approve in such attorney-in-fact's discretion.

The undersigned hereby grants to each such attorney-in-fact full power and authority to do and perform any and every act and thing whatsoever requisite, necessary, or proper to be done in the exercise of any of the rights and powers herein granted, as fully to all intents and purposes as the undersigned might or could do if personally present, with full power of substitution or revocation, hereby ratifying and confirming all that such attorney-in-fact, or such attorney-in-fact's substitute or substitutes, shall lawfully do or cause to be done by virtue of this Power of Attorney and the rights and powers herein granted. The undersigned acknowledges that the foregoing attorneys-in-fact, and each of them, in serving in such capacity at the request of the undersigned, are not assuming, nor is the Company assuming, any of the undersigned's responsibilities to comply with section 13 or 15(D) of the Securities Exchange Act of 1934, as amended.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in their capacity as a Director of The National Security Group, Inc. on March 21, 2014:

SIGNATURE

/s/ Winfield Baird  
/s/ Fleming Brooks  
/s/ Jack E. Brunson  
/s/ William L. Brunson, Jr.  
/s/ Fred D. Clark, Jr.

/s/ Frank B. O'Neil  
/s/ Mickey L. Murdock  
/s/ Donald Pittman  
/s/ Paul C. Wesch  
/s/ Walter P. Wilkerson

