

ORIGINAL

**STATE OF ALABAMA  
DEPARTMENT OF INSURANCE  
MONTGOMERY, ALABAMA**

**REPORT OF EXAMINATION OF**

**NATIONAL SECURITY INSURANCE COMPANY**

**ELBA, ALABAMA**

**AS OF DECEMBER 31, 2009**

**PARTICIPATION:  
SOUTHEASTERN ZONE, NAIC  
ALABAMA**

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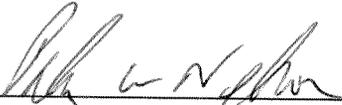
**EXAMINER'S AFFIDAVIT**

**STATE OF ALABAMA  
COUNTY OF COFFEE**

Palmer W. Nelson, CFE, being duly sworn, states as follows:

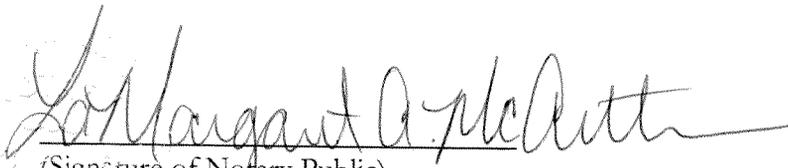
1. I have the authority to represent Alabama in the examination of National Security Insurance Company.
2. Alabama is accredited under the National Association of Insurance Commissioners Financial Regulation Standards and Accreditation.
3. I have reviewed the examination workpapers and examination report, and the examination of National Security Insurance Company was performed in a manner consistent with the standards and procedures required by the State of Alabama.

The affiant says nothing further.

  
\_\_\_\_\_  
Examiner-in-charge

Subscribed and sworn before me by PALMER W. NELSON on this  
20<sup>TH</sup>  
day of MAY, 2011.

(SEAL)

  
\_\_\_\_\_  
(Signature of Notary Public)

LaMargaret Ann McArthur  
NOTARY PUBLIC  
AL State at Large

My commission expires \_\_\_\_\_  
My Commission Expires 01/28/2014



**ROBERT BENTLEY**  
GOVERNOR

**JIM L. RIDLING**  
COMMISSIONER

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DEPUTY COMMISSIONER  
**CHARLES M. ANGELL** (acting)

CHIEF OF STAFF  
**RAGAN INGRAM**

CHIEF EXAMINER  
**RICHARD L. FORD**

STATE FIRE MARSHAL  
**EDWARD S. PAULK**

GENERAL COUNSEL  
**REYN NORMAN**

Elba, Alabama

May 20, 2011

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Chairman, Examination Oversight (E) Task Force  
Ohio Department of Insurance  
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Third Floor, Suite 300  
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Alabama Department of Insurance  
201 Monroe Street, Suite 1700  
Montgomery, AL 36104

Dear Director and Commissioners:

Pursuant to your authorizations and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners (NAIC), an examination has been made of the affairs and financial condition of

National Security Insurance Company  
Elba, Alabama

at its home office located at 661 Davis Street, Elba, Alabama 36323 as of December 31, 2009. The report of examination is submitted herewith. Where the description "Company" appears herein without qualification, it will be understood to indicate National Security Insurance Company.

EQUAL OPPORTUNITY EMPLOYER

## SCOPE OF EXAMINATION

The Company was last examined for the four year period ended December 31, 2004, by the examiners representing the Southeastern Zone, NAIC. The current examination covers the intervening period from the date of the last examination through December 31, 2009, and was conducted by examiners from Alabama, representing the Southeastern Zone, NAIC. Where deemed appropriate, transactions, activities and similar items subsequent to 2009 were reviewed.

The examination was conducted in accordance with applicable statutory requirements of the *Code of Alabama, 1975*, as amended, the Alabama Insurance Department regulations, bulletins and directives and in accordance with the procedures and guidelines promulgated by the NAIC, as deemed appropriate, and in accordance with generally accepted examination standards and practices.

The examination was conducted in accordance with the NAIC *Financial Condition Examiners Handbook*. The examination was planned and performed to evaluate the financial condition of the Company as of December 31, 2009, and to identify the Company's prospective risks by obtaining information about the Company including corporate governance, by identifying and assessing inherent risks within the Company and by evaluating system controls and procedures used to mitigate those risks. The examination also included assessing the principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation and management's compliance with statutory accounting principles and NAIC *Annual Statement Instructions*.

The Company's annual statements for each year under examination were compared with or reconciled to the corresponding general ledger account balances.

An examination of the Company's information technology systems (IT) was conducted concurrently with the financial examination. The IT examination included a review of management and organizational controls, logical and physical security controls, changes in applications controls, system and program development controls, contingency planning controls, service provider controls, operations controls, processing controls, e-commerce controls, and network and internet controls.

A market conduct examination was performed concurrently with the financial examination. The examination included reviews of the Company's territory and plan of operation, management and operations, claims, complaint handling, marketing and sales, policyholder services, producer licensing, underwriting and rating, and privacy standards. See "MARKET CONDUCT ACTIVITIES" on page 10 for further discussion of the market conduct examination.

Warren, Averett, Kimbrough & Marino, LLC was the Company's certified public accountants (CPAs) for the final year of the period under examination. The Company was audited by Barfield, Murphy, Shank & Smith for the years under examination prior to 2009. The examiners reviewed the CPAs' workpapers, copies of which were incorporated into the examination as deemed appropriate.

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attested to having valid title to all assets and to the nonexistence of unrecorded liabilities as of December 31, 2009.

## **ORGANIZATION AND HISTORY**

The Company was incorporated on February 5, 1947, as a mutual aid company in Coffee County, Alabama. It commenced business with paid up capital of \$25,000 divided into 250 shares of \$100 par value common stock and \$7,500 paid in surplus.

In 1955, the authorized capital stock was increased to 500,000 common shares, with a one dollar par value, and the Company was converted to a legal reserve life insurance company. The Company merged with two Birmingham, Alabama based insurance companies, Alabama Life and Casualty Company in 1959, and Mercantile Life Insurance Company in 1961. The Company survived the mergers, and its subsequent capital stock was 1,200,000 common shares, with a par value of one dollar per share.

In 1987, Mutual Savings Life Insurance Company of Decatur, Alabama, acquired 22.2% of the Company's common stock in an attempt to take control of the Company. Acquisition of control by Mutual Savings was disapproved by the Alabama Department of Insurance on March 2, 1988, pursuant to a Form A hearing. Mutual Savings appealed the Department's ruling, but during the litigation that followed, control of Mutual Savings changed hands. A settlement agreement was reached with the new owners of Mutual Savings, and in accordance with said agreement, the Company purchased the 226,243 shares of its stock held by Mutual Savings.

In 1988, the authorized capital stock of the Company was increased to 10,000,000 common shares, with a par value of one dollar per share. Also, 10,000,000 shares of preferred stock, with a par value of one dollar per share were authorized; however, no preferred stock had been issued at year end 2009.

As a result of a proposed plan of exchange/reorganization, approved by the stockholders on April 19, 1990, the Company became a wholly owned subsidiary of The National Security Group, Inc. Also, pursuant to the reorganization, the Company's subsidiary, National Security Fire & Casualty Company, was contributed to The National Security Group, Inc.

The Company's capital structure at December 31, 2009, consisted of common capital stock of \$1,500,000, gross paid in and contributed surplus of \$401,752, and unassigned funds of \$7,224,044. The Company's reported capital and surplus \$9,125,796 in its 2009 Annual Statement.

## **MANAGEMENT AND CONTROL**

### **Stockholders**

The Company is a stock corporation with ultimate control vested in its stockholders. At December 31, 2009, 100% of the Company's issued and outstanding common stock was owned by National Security Group, Inc., a Delaware corporation.

### Board of Directors

Members elected to the Board of Directors by the sole shareholder and serving at December 31, 2009, were as follows.

<u>Director</u>	<u>Residence</u>	<u>Principal Occupation</u>
William Lister Brunson, Jr.	Elba, Alabama	President, National Security Insurance Company/CEO, The National Security Group
Mickey Lane Murdock	Elba, Alabama	Retired
Brian Richard Mcleod	Elba, Alabama	Chief Financial Officer of National Security Insurance Company, National Security Fire & Casualty Company, and Omega One Insurance Company

### Committees

No committees of the board were appointed during the examination period.

### Officers

Officers of the Company elected by the Board of Directors and serving at December 31, 2009 were as follows.

<u>Officer</u>	<u>Title</u>
William Lister Brunson, Jr.	President
Brian Richard Mcleod	Treasurer
Tonya Mathews Jones	Secretary
Mickey Lane Murdock	Senior Vice President
Patricia Henderson	Vice President

### Management and Service Agreements

The following agreements between the Company and its affiliates were in effect during the examination period.

#### Personnel Agreement

Effective January 1, 1982, the Company accepted all employees of its affiliate, National Security Fire & Casualty Company (NSF&CC) as employees of the Company. NSF&CC in turn, agreed to reimburse the Company for all expenses involved in the employment of personnel who operated NSF&CC. The stated purpose of the agreement was to bring NSF&CC employees under the benefit plans that the Company had established.

### Agreement for the Allocation of General and Administrative Expenses

Effective January 1, 1982, the agreement provides for allocation of salaries, fringe benefits, employment taxes, and other common expenses between the Company and NSF&CC on the basis of the ratio of gross written premiums. The agreement also provides that NSF&CC will pay rent for office space based on a formula tied to the Company's cost in the building and the number of NSF&CC employees.

The agreement was amended June 1, 1994, to include NSF&CC's wholly owned subsidiary, Omega One Insurance Company (Omega), which was organized in 1992. Omega never had any employees of its own, but was operated by NSF&CC personnel.

### Agreement for Claims Adjustment Services

Effective July, 1981, the Company agreed to provide and train claims adjustors for NSF&CC, to adjust claims for NSF&CC and to be reimbursed by NSF&CC at industry rates on a monthly basis.

### Tax Allocation Agreement

The tax allocation agreement has been in effect since January 1, 1994. It provides that state and federal income taxes will be allocated among the parties on the basis of the actual tax liability. The parties to the agreement are:

- The National Security Group, Inc.
- National Security Insurance Company
- National Security Fire & Casualty Company
- Omega One Insurance Company
- NATSCO, Inc.

The tax allocation agreement was amended on January 21, 2002, to clarify the arrangement regarding tax related settlements between the parties. Each affiliate's tax liability or benefit each year will be calculated on an individual company basis. The National Security Group (NSG) will make all federal income tax deposits. In the event that an individual company has a tax benefit that can be used to offset the taxable income of another affiliated company in the consolidated tax return, any tax savings generated by the tax benefit will be remitted by the company utilizing the tax benefit to the affiliate that generated the tax benefit at the applicable federal tax rate utilized by the entity receiving the benefit.

### Agreement for Service Fee in Connection With the Future First Life Insurance Administration System

The agreement was effective during the examination period to October 1, 2007, when the parties entered into a mutual agreement to terminate the agreement.

In an agreement dated October 1, 2003, NSG agreed to provide the Company all rights and privileges to use the Future First Life Administration System for administering any and all life and health insurance contracts in force with the Company. In consideration for these services,

the Company agreed to pay NSG a monthly service fee of \$15,000, which was reimbursement of all direct cost incurred by NSG, including debt service. The initial term of the agreement was one year, commencing November 1, 2003 and ending October 31, 2004. The agreement was renewable for successive one year periods until either party elected to terminate the agreement. The agreement could have been terminated by either party at any time by mutual consent or by either party at the end of any term by giving the other notice at least 30 days prior to the expiration of any one year term.

The agreement for the allocation of general and administrative expenses between the Company, NSF&CC and Omega and the adjustors training agreement between the Company and NSF&CC and the tax allocation agreement between NSG and the Company, NSF&CC, and Omega do not provide for timely settlement of amounts owed, with a specified due date. SSAP No. 96, which is an amendment to SSAP No. 25 that became effective December 31, 2007, states:

Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted, except to the extent this is specifically addressed by other statements of statutory accounting principles (SSAPs). If the due date is not addressed by the written agreement, any uncollected receivable is nonadmitted.

The three agreements with affiliates were approved by the Department, but these approvals were prior to the implementation of SSAP No. 96.

### **Conflicts of Interest**

The conflict of interest statements filed by the officers and directors of the Company were reviewed for the period covered by this examination. There were no disclosures that indicated that any officers or directors had a conflict of interest.

### **CORPORATE RECORDS**

The Company's Articles of Incorporation, By-Laws, and amendments thereto were inspected and found to provide for the operation of the Company in accordance with Alabama statutes and regulations and with accepted corporate practices.

Minutes of the meetings of the stockholder and board of directors meetings from December 31, 2004, through the most recent meetings held at the conclusion of the examination were reviewed. The minutes appeared to be complete and to adequately document the actions of the respective governing bodies.

### **HOLDING COMPANY AND AFFILIATE MATTERS**

The Company was subject to the Alabama Insurance Holding Company Regulatory Act, as defined in ALA. CODE § 27-29-1 (1975). The Company's sole owner, National Security Group,

Inc., was registered with the Alabama Department of Insurance as registrant of an Insurance Holding Company System.

Appropriate filings required under the Holding Company Act were made from time to time by the registrant. A review of the Company's filings during the period under examination indicated that all required filings were made.

**Dividends to Stockholder**

The Company paid stockholder dividends in the following amounts during the period under examination.

<u>Year</u>	<u>Dividends Paid</u>
2009	\$200,000
2008	\$0
2007	\$0
2006	\$500,000
2005	\$700,000

**Dividends to Policyholders**

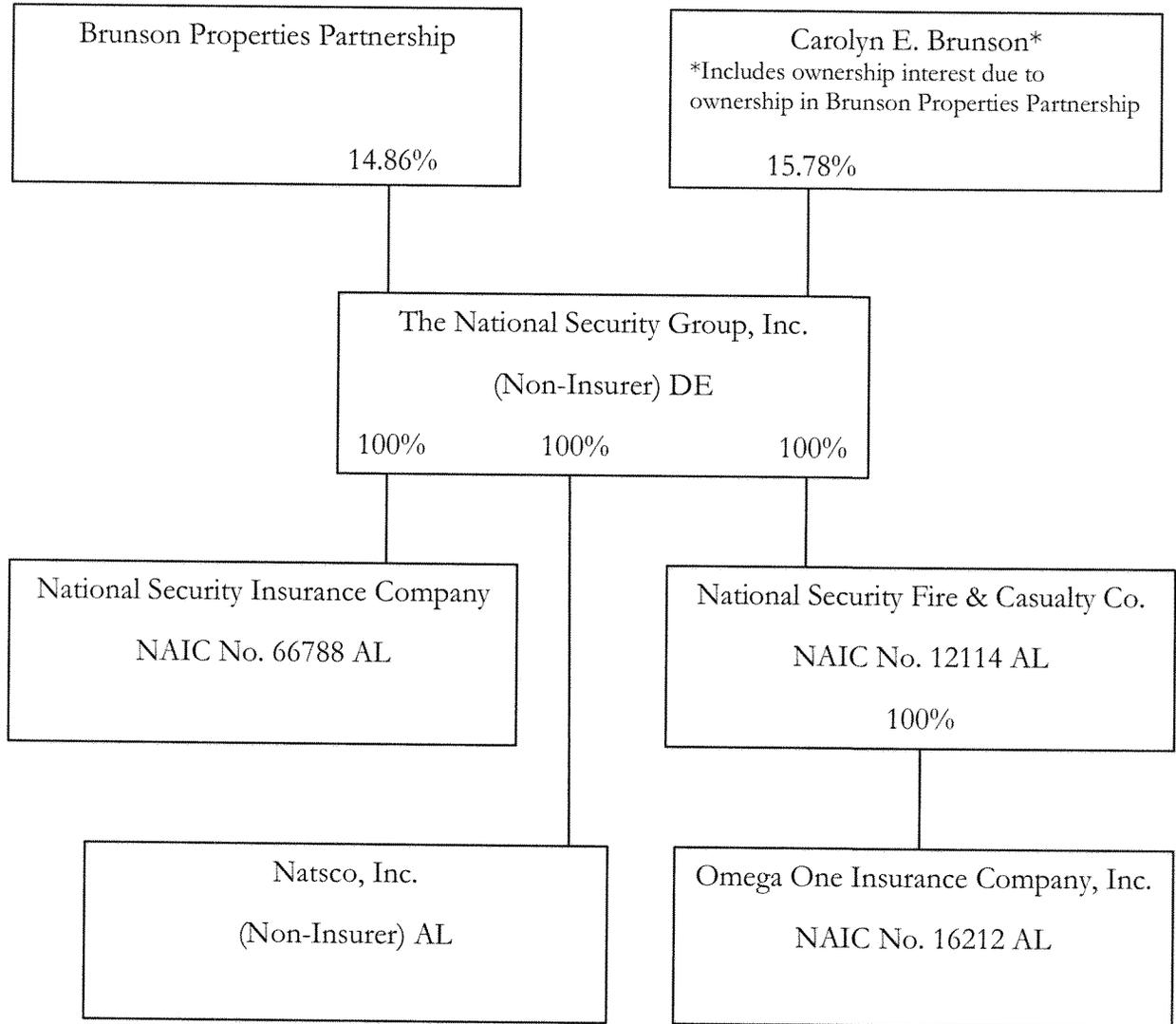
During the period under examination the following policyholder dividends were paid to policyholders.

<u>Year</u>	<u>Dividends Paid</u>
2005	\$3,711
2006	\$4,770
2007	\$4,435
2008	\$6,150
2009	\$3,316

**Organizational Chart**

The following chart presents the identities and interrelationships among all affiliated persons within the Insurance Holding Company System at December 31, 2009.

Organizational Chart



## **FIDELITY BONDS AND OTHER INSURANCE**

The Company was insured by a Financial Institution Bond issued by Fidelity and Deposit Company of Maryland; Baltimore, Maryland at December 31, 2009. The bond provided dishonesty and fraud coverage for salaried officers, employees and contractors. The bond did not provide coverage for forgery or alteration and securities. The amount of the fidelity bond maintained by the Company exceeded the minimum amount suggested in the NAIC *Financial Condition Examiners Handbook*.

In addition, to the above coverage, the Company was named insured under policies affording the following protections at December 31, 2009.

- Property
- General Liability
- Commercial Automobile
- Umbrella Policy
- Vacant Land Liability
- Vacant Land Umbrella
- Workers Compensation

The coverages and limits of the Company's insurance program were reviewed and were deemed to adequately protect the Company's interests.

## **EMPLOYEE AND AGENT WELFARE**

Employee and Agent Welfare

Benefits provided by the Company to its employees included the following at December 31, 2009:

- Group hospitalization plan
- Paid holidays
- Retirement 401(k)
- Medical benefits
- Funeral leave
- Life Insurance
- Paid time off

### Compliance with ALA. ADMIN. CODE 482-1-146 (2009)

ALA. ADMIN. CODE 482-1-146-.11 (2009) states:

- (1) A Section 1033 insurer subject to the Commissioner's examination authority shall have and apply the following:
  - (a) An internal procedure for determining, by means of background checks or investigations or otherwise, whether applicants for employment or individuals with whom the insurer intends to contract for activities in the business of insurance, whether

or not in a capacity requiring a license, have a felony conviction for a Section 1033 offense.

(b) An internal procedure after initial employment or contracting, applied on a periodic basis, to ascertain the existence of a felony conviction for a Section 1033 offense.

The Company did not comply with section (b) of this regulation as it did not have internal procedures in place to periodically ascertain if existing employees had been convicted of a Section 1033 offense since the date of hire.

### **STATUTORY DEPOSITS**

At December 31, 2009, as required or permitted by law, the Company maintained deposits with the respective statutory authorities as follows.

<u>State</u>	<u>Book/Adjusted Carrying Value</u>	<u>Fair Value</u>
Alabama	\$1,020,813	\$1,069,959
Georgia	49,885	49,719
South Carolina	150,000	163,547

### **FINANCIAL CONDITION/GROWTH OF COMPANY**

The following information presents significant items that reflect the growth of the Company for the years indicated.

	2004*	2005	2006	2007	2008	2009*
Admitted Assets	\$42,136,732	\$42,251,590	\$41,940,503	\$43,166,732	\$41,367,758	\$43,883,533
Liabilities	31,838,720	32,320,939	32,597,669	34,277,574	33,163,207	34,757,733
Premiums Earned	6,172,677	6,234,102	6,549,759	7,031,038	6,956,241	7,198,992
Common Capital Stock	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000	1,500,000
Gross Paid in and Contributed Surplus	401,752	401,752	401,752	401,752	401,752	401,752
Unassigned Funds	8,396,260	8,028,899	7,441,082	6,987,405	6,302,799	7,224,044

\*Per Examination

### **MARKET CONDUCT ACTIVITIES**

The examiners identified a discrepancy between the number of policies issued during the year reported in the Company's Market Conduct Annual Statement and the actual number of policies issued during the year. Company management indicated "The Market Conduct Annual Statement includes all policies issued during the year, but the Company omitted the policies that were issued and lapsed during the year." The Company was not in compliance with ALA. ADMIN CODE 482-1-97-4 (2009) which states:

When submitting required financial reports to the Department, all insurers shall use the appropriate NAIC Annual Statement Blank. Annual and quarterly statements, including market conduct statements, shall be prepared in accordance with the NAIC's Annual Statement Instructions, the NAIC's Accounting Practices and Procedures Manual, and Market Conduct Annual Statement Instructions from the NAIC as the same apply to

property and casualty insurance companies, life and accident and health insurance companies, hospital medical indemnity companies, title insurance companies, fraternal benefit societies, and health maintenance organizations, and as the same may be updated by the NAIC from time to time, except when in conflict with Alabama statutes or other Alabama Insurance Department Regulations. Copies of the manuals are available for purchase from the NAIC, and are available for inspection during regular business hours at the offices of the Examination Division of the Alabama Department of Insurance.

### **Plan of Operation**

The Company wrote Life and Accident & Health insurance. The types of life products written were whole life, term life and group life. For the accident and health lines, the products were accident, illness, cancer, disability, and hospital confinement.

As of December 31, 2009, the Company's agency force consisted of a small staff of nine home service agents and 870 independent agents. The agency force was under the direction of one home service manager and the overall supervision of the company's Agency Director and Marketing Director. The Company's claims office was located at its home office in Elba, Alabama.

### **Territory**

At December 31, 2009, the Company was licensed to transact business in following states:

- Alabama
- Georgia
- Florida
- Mississippi
- South Carolina
- Texas

The Certificates of Authority from the respective jurisdictions were inspected and found to be in order.

### **Policy Forms and Underwriting**

#### **Underwriting Practices**

Samples of the following were reviewed to determine compliance with Alabama statutes and regulations: policies issued, rejected applications for insurance, policy reinstatements, and lapsed policies. The following was noted during the review: (1) applicants were denied insurance based on valid underwriting conditions and all of the denials were nondiscriminatory in nature; (2) cancellations were handled in a timely manner without an excessive amount of paperwork required to cancel the policy; (3) policies and endorsements were issued to applicants in a timely manner; (4) reinstatements were applied consistently and in a nondiscriminatory manner; and (5) the correct policy options were applied to lapsed policies. Additionally, a sample of in-force policies was selected and the policy premium for each sample selected was re-

calculated. It was determined that the premium was calculated in accordance with the Company's underwriting guidelines and filed rates.

### Policy Forms

The Company filed 38 policy forms and one rate filing during the examination period with the Alabama Department of Insurance. The forms filed during the examination period were approved by the Department.

### Advertising and Marketing

The National Security Group, Inc. (NSG), the holding Company, did general corporate advertising with very little specific advertisement of its products. The Company had a limited number of advertisements appearing in insurance periodicals during the examination period. Brochures and advertising materials were distributed to potential customers through the Company's agents. The Company filed certificates of compliance by an authorized officer of the Company with its annual statements.

The Company's website ([www.nationalsecuritygroup.com](http://www.nationalsecuritygroup.com)) provided information such as information about its products, access to claim forms, directions on finding an agent, directions on learning how to become an agent, investor information, and other information about NSG. It was determined that the Company's internet advertising was not misleading and contained appropriate language to identify the policy form(s) that was being advertised.

### Claims Review

The examiner reviewed the Alabama paid and closed, closed without payment, and resisted claims during the examination period. The Company indicated that they did not have any litigated claims during the examination period. The examiner reviewed the samples of Alabama claims for complete documentation and timeliness of payment in accordance with ALA. ADMIN CODE 482-1-124 (2003), which stipulates the requirement for payment of life and accident and health claims. There were no exceptions noted.

### Policyholder Complaints

The Company's complaint register indicated that there were eight complaints filed against the Company during the examination period. The Company fully addressed the complaints in its complaints register and properly documented its complaint files.

### Compliance with Producer Licensing Requirements

The examiner compared the Company's list of agent appointments to the Alabama Department of Insurance's listing and determined that the two listings of appointments matched. The Company had 232 licensed and appointed agents at December 31, 2009. The examiners inspected the Company's producer records to determine if agents representing the Company were properly licensed and appointed with the Alabama Department of Insurance. A random sample was selected of premiums written in Alabama. The examiners verified that the agents that wrote business in Alabama were properly licensed and appointed.

## **Privacy Standards**

### **Compliance with ALA. ADMIN. CODE 482-1-122 (2002)**

The Company's Privacy Notice, was reviewed for compliance with ALA. ADMIN. CODE 482-1-122 (2002). Privacy notices are sent to existing policyholders annually and are promptly provided to new policyholders at the issuance of a policy. The privacy notice indicated the types of information collected, the way the information was used and the manner in which the information was collected. The notice also informed the customer that the Company does not disclose any information to any nonaffiliated third parties.

The Company's privacy notice emphasized and explained the Company's policies. The Company does not share customer and/or consumer personal information with any nonaffiliated third parties. The Company had proper controls in place for employees and producers for the disclosure of nonpublic personal financial, health and medical information.

## **REINSURANCE**

### **Reinsurance Ceded**

The Company had ceded reinsurance provided by reinsurance agreements with three reinsurers as of December 31, 2009. The total reserve credits taken at December 31, 2009, in relation to the ceded business was \$31,288. In 2009, the Company had coinsurance reinsurance provided by Optimum Re and General Re – Life Corporation. The Company had yearly renewable term reinsurance provided by Swiss Re and Optimum Re.

The Optimum Re reinsurance agreement became effective January 1, 2001. Under the Optimum Re reinsurance agreement, the Company's retention for automatic reinsurance on any one life is 50% up to a maximum of \$50,000 for insureds under 45. The retention is 50% up to a maximum of \$25,000 for insureds age 45 and older. The automatic reinsurance limit is four times the Company's retention to a maximum of \$200,000. The automatic reinsurance reinsures policies written on a ten year level term plan, renewable to age 70, and convertible at age 65. The policies written under this plan are reinsured on a coinsurance basis. All cases in which business submitted does not meet the criteria for automatic reinsurance may be submitted for facultative assessment. The facultative reinsurance limit is \$1,000,000. The jumbo limit is \$4,000,000.

The General Reassurance Corporation (later Life Re and now Swiss Re) agreement has been effective since April 1, 1986. The agreement cedes group life business. The agreement also allows for facultative submissions for reinsurance.

The Company has a group life and accidental death and dismemberment reinsurance agreement with General Re. The agreement became effective January 1, 2004. For submissions meeting the contractually stated criteria, the reinsurance is automatic. The agreement also allows for facultative submissions for reinsurance. The agreement reinsures on an automatic basis new and in-force Basic Group Term Life and Basic Accidental Death and Dismemberment (AD&D) policies issued to employers. The Company cedes 50% quota share of the first \$100,000 per

insured. The maximum reinsurance is \$250,000 per insured. For group AD&D, 50% quota share for the first \$100,000 and 100% of the amount over \$100,000 up to a maximum of \$250,000.

The Company also has an agreement with American United Life Insurance Company effective May 15, 1987 that is in run off.

### **ACCOUNTS AND RECORDS**

The Company maintained its accounting, premiums and losses data electronically. The Company maintained additional electronic workpapers, reconciliations and statements in its database of imaged records.

The Company's independent audit was performed by Warren, Averett, Kimbrough & Marino, a certified public accounting firm of Birmingham, Alabama for the final year of the examination period. The audits of the Company for the previous years under examination were performed by Barfield, Murphy, Shank & Smith.

### **Reporting of Borrowed Money from Affiliates**

The Company did not correctly report borrowed money in its quarterly statements. The Company borrowed money from its affiliate, National Security Fire & Casualty Company. The borrowed money was reported as a payable to an affiliate in the quarterly statements. The borrowed money should have been reported in the liability line item "Borrowed money."

### **Annual Statement Exhibits**

The review of the reporting of the special deposits in Schedule E - Part 3 - Special Deposits of the Annual Statements for the period under examination indicated that the amounts of the special deposits for the states other than Alabama were reported under the column with the heading of "Deposits for the Benefit of All Policyholders" in the 2008 and 2009 Annual Statements. The amounts of the special deposits for the states other than the state of Alabama should be reported under the column with the heading "All Other Special Deposits" to be in compliance with page 430 of the 2009 NAIC Annual Statement Instructions, which states: "Columns 3 and 4 - Deposits for the Benefit of All Policyholders Report only the statutory deposit held for the benefit of all policyholders. Do Not Include deposits held for a special purpose. Insurers must report these special purpose deposits in Columns 5 and 6."

### **Information Technology Controls**

The Company's information systems (IS) controls governing disaster recovery were reviewed. It was determined the Company was storing its "off-site" backup tapes in its Conference Center building, a building located approximately 200 yards from the primary IS site. Discussions with management indicated they were aware of the increased risk and were looking for a suitable off-site location. Until a suitable off-site location is found and procedures implemented, the Company is at a significantly increased risk that a localized adverse event, such as a tornado, could destroy both the operational and backups of the Company's data. The impact of loss of both operational and backup data would be severe.

Interviews with senior management revealed periodic disaster recovery testing had not been accomplished during the period under examination because other higher priority projects had taken precedence. Also, the current disaster recovery document was more of a high level disaster recovery discussion as opposed to being a document that provided detailed guidance. An inadequately designed and tested disaster recovery plan significantly increases the risk that the Company will not be able to efficiently recover from an adverse event. If the Company experienced a widespread catastrophe coupled with a localized event, such as a hurricane that caused a surge in claims along with a tornado that destroyed its home office, the resulting adverse public sentiment caused by an excessive recovery time could severely impact the Company.

## FINANCIAL STATEMENTS

The financial statements included in this report were reported on the basis of the Company's records, and the valuations and determinations made during the examination for the year 2009. Amounts shown in the comparative years 2005, 2006, 2007 and 2008 were compiled from the Company's copies of the filed Annual Statements. The statements were presented in the following order.

Statement of Assets, Liabilities, Surplus and Other Funds	Pages 17 and 18
Summary of Operations	Page 19
Capital and Surplus Account	Page 20

**National Security Insurance Company**  
**Statement of Assets, Liabilities, Surplus and Other Funds**  
**for the Year Ended December 31, 2009**

Assets

	Assets	Non- admitted Assets	Admitted Assets
Bonds	\$33,057,689	\$ 0	\$33,057,689
Common stocks	4,100,953	0	4,100,953
Mortgage loans on real estate: First liens	1,040,914	0	1,040,914
Real estate: Properties occupied by the company	1,895,139	0	1,895,139
Real estate: Properties held for sale	2,523	0	2,523
Cash and short-term investments	555,933	0	555,933
Contract loans	1,018,114	0	1,018,114
Other invested assets	3,875,000	3,623,174	251,826
Receivable for securities	92,500	0	92,500
Investment income due and accrued	354,518	0	354,518
Premiums and considerations: Uncollected premiums and agents' balances in the course of collection	118,232	0	118,232
Premiums and considerations: Deferred premiums, agents' balances and installments booked but deferred and not yet due	1,183,941	123,691	1,060,250
Net deferred tax asset	590,979	590,979	0
Electronic data processing equipment and software	224,334	84,171	140,162
Furniture and equipment, including health care delivery assets	169,865	169,865	0
Receivables from parent, subsidiaries and affiliates	194,779	0	194,779
Aggregate write-ins for other than invested assets:			
Prepaid expense	39,778	39,778	0
Utility deposits	459	459	0
Clearing account	11,861	11,861	0
<b>Total Assets</b>	<b>\$48,527,511</b>	<b>\$4,643,979</b>	<b>\$43,883,533</b>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

### Liabilities, Surplus and Other Funds

Aggregate reserve for life contracts <b>(Note 1)</b>	\$29,536,054
Aggregate reserve for accident and health contracts <b>(Note 2)</b>	1,214,573
Liability for deposit-type contracts	1,342,311
Contract claims: Life <b>(Note 3)</b>	450,000
Contract claims: Accident and health	85,000
Policyholders' dividends and coupons due and unpaid	4,323
Premiums and annuity considerations for life and accident and health contracts received in advance	15,762
Interest Maintenance Reserve	597,022
Commissions to agents due or accrued	25,537
General expenses due or accrued	482,700
Taxes, licenses and fees due or accrued	38,304
Current federal and foreign income taxes	96,935
Unearned investment income	30,527
Amounts withheld or retained by company as agent or trustee	6,502
Amounts held for agents' account	16,944
Remittances and items not allocated	57,900
Asset valuation reserve	516,556
Payable to parent, subsidiaries and affiliates	<u>240,782</u>
<b>Total Liabilities</b>	<b>\$34,757,733</b>
Common capital stock	\$1,500,000
Gross paid in and contributed surplus	401,752
Unassigned funds <b>(Note 4)</b>	<u>7,224,044</u>
<b>Total Capital and Surplus</b>	<b>\$9,125,796</b>
<b>Totals</b>	<b><u>\$43,883,529</u></b>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

**National Security Insurance Company**  
**Summary of Operations**  
**for the Years Ended December 31, 2005, 2006, 2007, 2008, and 2009**

	2005	2006	2007	2008	2009
Premiums and annuity considerations for life and accident and health contracts	\$6,234,102	\$6,549,759	\$7,031,038	\$6,956,241	\$7,198,992
Net investment income	1,685,267	1,863,290	1,924,762	2,219,290	2,397,651
Amortization of Interest Maintenance Reserve	92,886	72,822	59,928	47,185	41,473
Aggregate write-ins for miscellaneous income:					
Adjuster's fees	378,933	158,606	33,508	539,038	564,650
Miscellaneous income	51,628	6,899	6,472	59,843	2,636
Totals	8,442,815	8,651,375	9,055,708	9,821,597	10,205,402
Death benefits	2,150,733	2,404,716	2,929,946	2,839,447	3,027,452
Matured endowments	6,493	(45)	(125)		
Disability benefits and benefits under accident and health contracts	533,192	551,157	492,830	581,785	414,508
Surrender benefits and withdrawals for life contracts	425,217	390,247	455,428	537,585	616,891
Interest and adjustments on contract or deposit-type contract funds	113,960	83,726	67,572	61,354	49,357
Increase in aggregate reserves for life and accident and health contracts	698,348	2,495,424	1,009,880	952,578	795,868
Totals	3,927,943	5,925,225	4,955,531	4,972,749	4,904,076
Commissions on premiums, annuity considerations and deposit-type contract funds	1,954,028	1,977,221	1,882,483	1,574,081	1,509,951
General insurance expense	2,129,008	2,568,906	2,305,375	2,024,571	2,272,079
Insurance taxes, licenses and fees	364,424	283,335	288,132	283,656	239,768
Increase in loading on deferred and uncollected premiums	78,899	6,771	129,758	(135,602)	(47,066)
Aggregate write-ins for deductions: Litigation	230,000	361,289	0	0	0
Totals	8,684,302	11,122,747	9,561,279	8,719,455	8,878,808
Net gain from operations before dividends to policyholders and federal income taxes	(241,487)	(2,471,373)	(505,571)	1,102,142	1,326,594
Dividends to policyholders	3,711	4,770	4,435	6,150	3,316
Net gain from operations after dividends to policyholders and before federal income taxes	(245,197)	(2,476,143)	(510,006)	1,095,992	1,323,278
Federal and foreign income taxes incurred	(44,294)	(461,868)	8,271	(311,955)	73,093
Net gain from operations after dividends to policyholders and federal income taxes and before realized capital gains or (losses)	(200,903)	(2,014,275)	(518,277)	1,407,947	1,250,185
Net realized capital gains less capital gains tax	99,554	433,679	167,000	(1,849,482)	64,030
Net income	(101,349)	(1,580,595)	(351,277)	\$(441,535)	\$1,314,215

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

**National Security Insurance Company**  
**Capital and Surplus**  
**for the Years Ended December 31, 2005, 2006, 2007, 2008, and 2009**

	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
Surplus as regards policyholders, December 31 prior year	\$10,298,011	\$9,930,651	\$9,342,833	\$8,889,158	\$8,204,550
Net income	(101,349)	(1,580,595)	(351,277)	(441,535)	1,314,215
Change in net unrealized capital gains (losses)	90,776	160,928	(71,975)	(1,488,869)	118,062
Change in net deferred income tax	10,774	(156,178)	16,656	443,648	466,608
Change in nonadmitted assets	25,013	(46,662)	19,005	(27,952)	(452,576)
Change in reserve on account of change in valuation basis, (increase) or decrease	0	1,644,783	0	0	0
Change in asset valuation reserve	307,426	(110,094)	(66,083)	830,099	(325,064)
Dividends to stockholders	(700,000)	(500,000)	0	0	(200,000)
Change in surplus as regards policyholders	<u>(367,360)</u>	<u>(587,818)</u>	<u>(453,675)</u>	<u>(684,609)</u>	<u>921,246</u>
Surplus as regards policyholders, December 31 current year	<u>9,930,651</u>	<u>9,342,833</u>	<u>8,889,158</u>	<u>\$8,204,550</u>	<u>\$9,125,795</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART THEREOF.

## **NOTES TO FINANCIAL STATEMENTS**

### **Note 1 – Aggregate reserve for life contracts**

**\$29,536,054**

The above captioned amount is the same as reported by the Company in its 2009 Annual Statement.

The Company did not complete Notes to Financial Statements, Paragraph 30 Reserve for Life Contracts and Deposit-Type Contracts, Item (3) correctly. The Note was completed to indicate “The reserves on policies in which the gross premiums exceeded net premiums was \$0.” The Note should have been completed to read, “The reserves on policies in which the gross premiums exceeded net premiums was \$126,305.” This issue was a disclosure issue and no adjustment to the financial statements was necessary.

### **Note 2 – Aggregate reserve for accident and health contracts**

**\$ 1,214,573**

The above captioned amount is the same as reported by the Company in its 2009 Annual Statement.

The Exhibit of Life Insurance for Accident and Health Insurance indicated that there were 9,322 policies in force at year-end 2009; however, there were actually 9,367 accident and health policies in-force at year-end 2009. The Company inadvertently failed to include 45 policies in its year-end in-force count. The Company did not accurately report the number of policies in-force in accordance with ALA. CODE § 27-3-26 (1975) which states, “(a) Each authorized insurer shall, annually...file with the commissioner a full and true statement of its financial condition, transactions and affairs as of the December 31, preceding... .”

The amount of reserves reported remains unchanged as the policies were included in the premiums in-force and reserving calculations.

### **Note 3 – Contract claims: Life**

**\$ 450,000**

The above captioned amount is the same as reported in the Company’s 2009 Annual Statement.

The Company did not record a claims adjustment expense liability for life claims. The examination indicated that the life claims adjustment expense liability is approximately \$9,000, which is immaterial. Due to immateriality, no adjustments were made for this examination finding in the financial statements included in this report.

### **Note 4 – Unassigned funds**

**\$ 7,224,044**

The above captioned amount is the same as reported by the Company in its 2009 Annual Statement. The following is a reconciliation of Unassigned funds per the examination.

Unassigned funds per Company	\$7,224,044
Examination increase/(decrease) to assets:	
Examination decrease/(increase) to liabilities:	
Total Unassigned funds per examination	<u>\$7,224,044</u>

**COMMENTS AND RECOMMENDATIONS**

**Management and Service Agreements – Page 4**

**It is recommended** that the Company revise its agreements between affiliates to specify due dates of amounts owed or not admit all receivables in connection with balances due the Company in connection with the agreements with affiliates in accordance with SSAP No. 96, which states

Transactions between related parties must be in the form of a written agreement. The written agreement must provide for timely settlement of amounts owed, with a specified due date. Amounts owed to the reporting entity over ninety days from the written agreement due date shall be nonadmitted, except to the extent this is specifically addressed by other statements of statutory accounting principles (SSAPs). If the due date is not addressed by the written agreement, any uncollected receivable is nonadmitted.

**Organizational Chart – Page 7**

**It is recommended** that the Company complete Schedule Y accurately to identify all controlling owners that have a controlling interest of ten percent or more in accordance with the NAIC Annual Statement Instructions which state: “If you are required to file a registration statement under the provisions of your domiciliary state’s Insurance Holding Company System Regulatory Act, the Schedule Y, Part 1, Organizational Chart must be included in the Annual Statement.” The Form B holding company filing requires disclosure of entities with a controlling interest of ten percent or more.

**Employee and Agent Welfare – Page 9**

**It is recommended** that the Company establish internal procedures after initial employment or contracting, applied on a periodic basis, to ascertain the existence of a felony conviction for a Section 1033 offense in accordance with ALA. ADMIN. CODE 482-1-146-.11(2009) which states, “(1) A Section 1033 insurer subject to the Commissioner’s examination authority shall have and apply the following... (b) An internal procedure after initial employment or contracting, applied on a periodic basis, to ascertain the existence of a felony conviction for a Section 1033 offense. ...”

### Market Conduct Activities – Page 10

**It is recommended** that the Company report the correct number of policies issued during the year in its Market Conduct Annual Statement in accordance with ALA ADMIN CODE 482-1-97-4(2009) which states,

When submitting required financial reports to the Department, all insurers shall use the appropriate NAIC Annual Statement Blank. Annual and quarterly statements, including market conduct statements, shall be prepared in accordance with the NAIC's Annual Statement Instructions, the NAIC's Accounting Practices and Procedures Manual, and Market Conduct Annual Statement Instructions from the NAIC as the same apply to property and casualty insurance companies, life and accident and health insurance companies, hospital medical indemnity companies, title insurance companies, fraternal benefit societies, and health maintenance organizations, and as the same may be updated by the NAIC from time to time, except when in conflict with Alabama statutes or other Alabama Insurance Department Regulations. Copies of the manuals are available for purchase from the NAIC, and are available for inspection during regular business hours at the offices of the Examination Division of the Alabama Department of Insurance.

### Accounts and Records – Page 14

**It is recommended** that the Company report borrowed money in the line item "Borrowed money" in its quarterly and annual statements.

**It is recommended** that the Company report the amounts of the special deposits for the states other than the state of Alabama under the column with the heading "All Other Special Deposits" in Schedule E - Part 3 - Special Deposits to be in compliance with page 430 of the 2009 NAIC Annual Statement Instructions, which states: "Columns 3 and 4 - Deposits for the Benefit of All Policyholders Report only the statutory deposit held for the benefit of all policyholders. Do Not Include deposits held for a special purpose. Insurers must report these special purpose deposits in Columns 5 and 6."

**It is recommended** that the Company store its data backups at a suitable off-site location.

**It is recommended** that the Company develop and test a disaster recovery plan that provides detailed guidance for personnel to efficiently recover from reasonable adverse events.

### Aggregate reserve for life contracts – Page 21

**It is recommended** that the Company use correct language in Section 3 of the Annual Statement Note 30 Reserves for Life Contracts and Deposit-Type Contracts. For year-end 2009, the correct language that should have been used was, "The reserves on policies in which the net premiums exceeded gross premiums was \$126,305." This language should be used in all future annual statements with only the amount of the premium deficiency being changed.

### **Aggregate reserve for accident and health contracts – Page 21**

**It is recommended** that the Company accurately report the number of accident and health policies in-force at year-end in its Exhibit of Life Insurance in accordance with ALA. CODE § 27-3-26 (1975) which states, “(a) Each authorized insurer shall, annually...file with the commissioner a full and true statement of its financial condition, transactions and affairs as of the December 31, preceding...”

### **Contract claims: Life – Page 21**

**It is recommended** that the Company record a claims adjustment expense liability for outstanding life claims.

### **Compliance With Previous Recommendations – Page 24**

**It is recommended** that the Company comply with the recommendations of the Report of Examination.

### **CONTINGENT LIABILITIES AND PENDING LITIGATION**

The review of the contingent liabilities and pending litigation included an inspection of representations made by the Company’s managers, a review of the Company’s records and files for the period under examination, and a review of the records subsequent to the examination date. The reviews performed did not identify any items that would have a material effect on the Company’s financial condition in the event of an adverse outcome.

### **COMPLIANCE WITH PREVIOUS RECOMMENDATIONS**

A review was performed to determine if the Company had complied with the recommendations made in the last examination report. The review indicated that the Company had complied with the recommendations contained in the most recent Report of Examination with the exception of the items noted below.

The previous report of examination included a recommendation for the Company to explicitly record claims adjustment expense liabilities for life and accident and health insurance claims. The examination indicated that the Company did not record any reserves for unpaid claims adjustment expenses for life contracts.

### **SUBSEQUENT EVENTS**

The review of the events subsequent to December 31, 2009, did not reveal anything material in amount or noteworthy in nature.

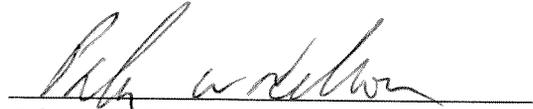
## CONCLUSION

Acknowledgement is hereby made of the courtesy and cooperation extended by all persons representing National Security Insurance Company during the examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed in connection with the verification and valuation of assets and the determination of liabilities set forth in this report.

In addition to the undersigned, Toni Bean, CFE, Theo Goodin, MCM, Thomas W. Salo, Robert S. Thompson, Charles Turner, CISA, Examiners; and Harland Dyer, FSA, MAAA, Consulting Actuary; all representing the Alabama Department of Insurance, participated in the examination of National Security Insurance Company.

Respectfully submitted,



Palmer W. Nelson, CFE  
Examiner-in-charge  
Alabama Department of Insurance  
Southeastern Zone, NAIC