

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

REPORT OF EXAMINATION OF

NATIONAL SECURITY FIRE & CASUALTY COMPANY

ELBA, ALABAMA

AS OF DECEMBER 31, 2009

**PARTICIPATION:
SOUTHEASTERN ZONE, NAIC
ALABAMA**

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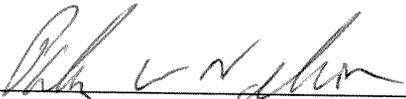
EXAMINER'S AFFIDAVIT

**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 Fire & Casualty 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 Fire & Casualty Company was performed in a manner consistent with the standards and procedures required by the State of Alabama.

The affiant says nothing further.

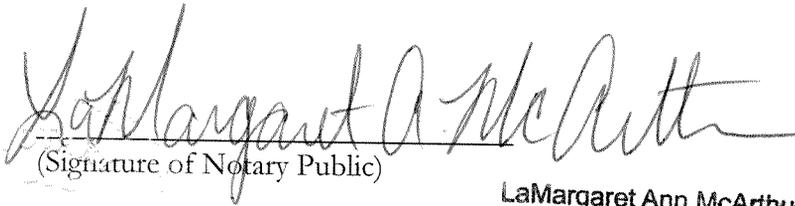


Examiner-in-charge

Subscribed and sworn before me by PALMER W. NELSON on this
20th

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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CHARLES M. ANGELL (acting)

CHIEF OF STAFF
RAGAN INGRAM

CHIEF EXAMINER
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STATE FIRE MARSHAL
EDWARD S. PAULK

GENERAL COUNSEL
REYN NORMAN

Elba, Alabama
May 20, 2011

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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 Fire & Casualty 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 Fire & Casualty 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 under examination. The Company was audited by Barfield, Murphy, Shank & Smith for the previous years under examination. 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 January 1, 1959, under the laws of the State of Alabama, as a wholly owned subsidiary of National Security Insurance Company.

Various changes in the amounts and par value of the Company's capital stock occurred between the date of incorporation and 1985. From 1985 through 1991, the authorized capital remained 1,500,000 shares of \$1.00 par value common stock of which 1,000,000 shares were issued and outstanding.

On December 31, 1990, all of the Company's outstanding capital stock was contributed to a newly formed holding company, The National Security Group, Inc. (NSG), a Delaware corporation. Simultaneously, an extraordinary cash dividend of \$10,000,000 was declared by the Company's Board of Directors payable to NSG.

On June 30, 1992, the Company paid a stock dividend for 500,000 shares to NSG, thereby increasing the Company's paid up capital to \$1,500,000 consisting of 1,500,000 shares of \$1.00 par value common stock.

During 2005, the Company received a capital contribution of \$6,000,000 from its sole owner, The National Security Group, Inc. The Company's capital structure at December 31, 2009 consisted of 1,500,000 shares of common stock, issued and outstanding, for a total common stock par value of \$1,500,000. The Company also had \$6,677,190 in gross paid in and contributed surplus and reported \$20,564,417 of unassigned funds.

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>
Jack Edward Brunson	Elba, Alabama	President of National Security Fire & Casualty Company and Omega One Insurance Company
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>
Jack Edward Brunson	President
Brian Richard Mcleod	Treasurer
Tonya Mathews Jones	Secretary
Mickey Lane Murdock	Senior Vice President
Robert Glover	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 relinquished all of its employees to its affiliate, National Security Insurance Company (NSIC) to become employees of NSIC. The Company in turn, agreed to reimburse NSIC for all expenses involved in the employment of personnel who operated the Company. The stated purpose of the agreement was to bring the Company's employees under the benefit plans that NSIC 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 NSIC on the basis of the ratio of gross written premiums. The agreement also provides that the Company will pay rent for office space based on a formula tied to NSIC's cost in the building and the number of the employees allocated to the Company.

The agreement was amended June 1, 1994, to include the Company'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 the Company's personnel.

Agreement for Claims Adjustment Services

Effective July, 1981, NSIC agreed to provide and train claims adjustors for the Company, to adjust claims for the Company and to be reimbursed by the Company 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.

The agreement for the allocation of general and administrative expenses between the Company, NSIC and Omega and the adjustors training agreement between the Company and NSIC and the tax allocation agreement between NSG and the Company, NSIC, 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 examination period. There were no conflicts disclosed.

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

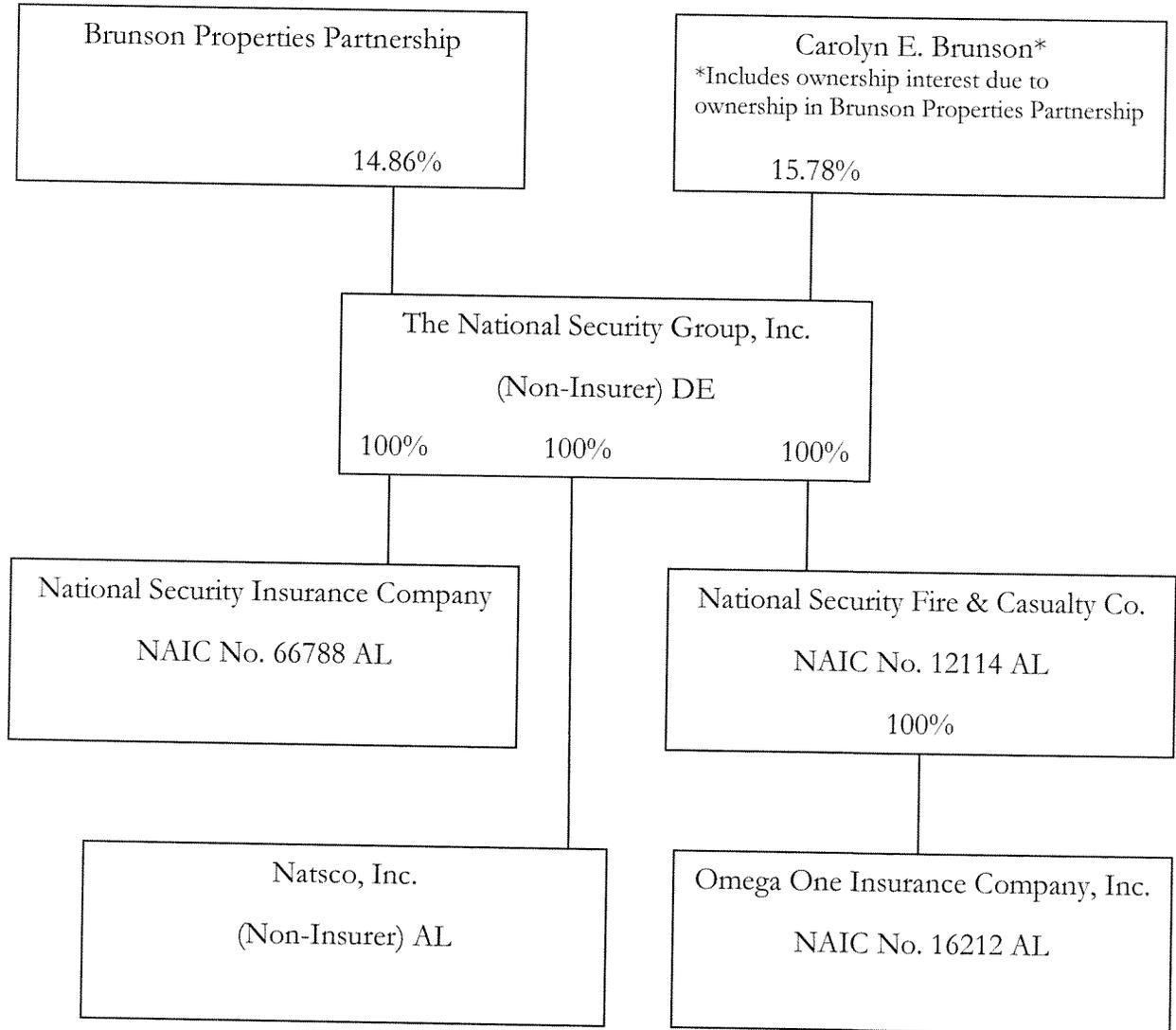
The Company paid stockholder dividends in the following amounts during the period under examination.

<u>Year</u>	<u>Dividends Paid</u>
2009	\$2,600,000
2008	\$0
2007	\$3,000,000
2006	\$1,000,000
2005	\$1,800,000

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

The Company did not have any employees at December 31, 2009; therefore it had no employee benefit plans. All functions of the Company were performed by employees of National Security Insurance Company via the terms of an administrative services agreement. See "Management and Services Agreements" on Page 4 where this was discussed. The Company utilizes an independent agent distribution system.

U.S. Code Title 18 § 1033 Compliance

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 contractor 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	\$745,112	\$803,672
Georgia	45,9112	47,969
Louisiana	124,672	131,001
South Carolina	508,884	512,813

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	\$51,353,481	\$57,947,082	\$64,017,730	\$70,812,647	\$69,451,090	\$69,462,530
Liabilities	28,325,447	30,738,068	31,434,299	36,690,749	42,668,076	40,720,923
Gross Written Premium	48,438,335	51,199,187	55,905,451	62,683,796	59,622,505	54,983,883
Net Losses Incurred	25,563,257	29,118,680	28,062,438	28,478,812	33,993,658	26,595,577
Net Loss Adjustment Expenses Incurred	3,301,286	3,674,995	3,344,602	3,307,488	5,301,640	4,050,395
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	677,190	6,677,190	6,677,190	6,677,190	6,677,190	6,677,190
Unassigned Funds	20,850,842	19,031,823	24,406,241	25,944,708	18,605,827	20,564,417

*Per Examination

MARKET CONDUCT ACTIVITIES

Plan of Operation

The Company wrote the following lines of business during the examination period: dwelling fire, mobile home, limited homeowners, comprehensive mobile homeowners, dwelling tenant schedule options and private passenger auto business.

At December 31, 2009, the Company's agency force consisted of approximately 1600 independent agents. 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 the following states:

Alabama
Arkansas
California
Florida
Georgia
Kentucky
Mississippi
Oklahoma
South Carolina
Tennessee
West Virginia

The Company wrote business on a surplus lines basis in Louisiana, Missouri, and Texas.

Policy Forms and Underwriting

Policy Forms

The examination indicated that all of the forms, endorsements and premium rates utilized in Alabama during the examination period had been properly filed and approved by the Alabama Department of Insurance.

Underwriting Practices

The review of the Company's underwriting practices included a review of the Company's underwriting guidelines and the Company's procedures for handling policy declinations and cancellations. A sample of declinations, cancellations, and non-renewals was reviewed. The Company properly utilized its underwriting guidelines and had valid reasons for declining applications, cancelling policies, or non-renewing policies. The Company properly mailed the cancellation notices that were required to be sent to policyholders to give prior notice of cancellation.

Rates and Statistical Reporting

The Company reports all written premium, paid and unpaid losses to Independent Statistical Service (ISS). The Company also subscribes to Insurance Services Office (ISO) and American Association of Insurance Services (AAIS) manuals, forms and symbols. The Company independently filed changes to ISO forms with the Departments of Insurance in states the Company wrote business.

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) provided information such as: product information, access to claim forms, finding an agent, learning how to become an agent, investor information, and other information about NSG. 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 review of the closed claim files indicated that claims were paid in accordance with policy provisions and that settlements were made promptly upon receipt of evidence of the Company's liability. The Company resisted claims only in cases where there appeared to be justifiable cause for further investigation or denial. However, there was one noteworthy exception found. A sample of 107 paid claims was selected from 5,135 claims paid in Alabama during the examination period. One of the claims was not paid in a timely manner in accordance with ALA. ADMIN CODE 482-1-125 (6)(2003) (1), which states: "The insurer shall tender payment within thirty (30) days or the time specified in the policy, after accepting liability, reaching an agreement on the amount of the claim and receipt of any documents necessary to consummate the settlement." It took the Company 86 days to issue payment from the date the Company had adequate information to tender payment. There was not a notice sent to the insured indicating that the claim was being delayed and explaining the reason for the delay.

Policyholder Complaints

There were eighteen complaints recorded in the Company's Alabama Complaint Register during the examination period. The Company fully responded to and addressed all of the complaints recorded in its register. However, for two of the complaints reviewed, the Company did not respond in a timely manner in accordance with ALA. ADMIN CODE 482-1-118.06 (2003), which states:

The insurer shall provide, within ten (10) working days, any record or response requested in writing by any duly appointed deputy, assistant, employee or examiner of the commissioner. When the requested record or response is not produced or cannot be produced by the insurer within ten working days, the nonproduction shall be deemed a violation of this rule, unless the Commissioner or duly appointed person making the request grants an extension in writing or the insurer can demonstrate to the satisfaction of the Commissioner that there is a reasonable justification for the delay.

Compliance with Producer Licensing Requirements

The examiners performed a review to determine whether all agents that produced Alabama business were properly licensed and appointed. The examiners compared the Company's list of agents appointed in Alabama with the list of appointed agents provided by the Alabama Department of Insurance. No discrepancies were identified. The examiners selected a sample of 2009 new business issued in Alabama. The examiners review of the sample of policies did not identify any new business that was written in Alabama by agents that were not 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 were sent to existing policyholders annually and were provided to new policyholders at the issuance of the policy. The privacy notice indicated the types of information collected, the way that the information was used and the manner in which the information was collected. The notice also informed the customer that the Company did 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 or medical information.

REINSURANCE

Reinsurance Ceded

The Company had three reinsurance programs during the examination period. The Company's catastrophe reinsurance program was provided for by two catastrophe excess of loss reinsurance agreements. The Company also had an ocean marine excess of loss reinsurance agreement and a private passenger automobile excess of loss reinsurance agreement.

Catastrophe Excess Reinsurance Program (two agreements, four layers)

The Company's subsidiary, Omega One Insurance Company (Omega), was also covered under the contracts. The limits of the reinsurance were applicable to the combined losses of the Company and Omega. The pertinent terms of the reinsurance contracts in effect at the examination date were as follows.

Business Covered – Dwelling and commercial fire, allied lines, homeowners (section I only), mobile homes, inland marine, special multi-peril (section I only) and industrial fire.

Term – January 1, 2009 to January 1, 2010, with respect to all losses occurring during the term of the contract.

First Layer – 95% of \$6.5 million each occurrence, in excess of \$3.5 million, not to exceed 95% of \$13 million or \$12.35 million, in respect to all losses during the term of the agreement.

Second Layer – 95% of \$7.5 million each occurrence, in excess of \$10 million, not to exceed 95% of \$15 million or \$14.25 million, in respect to all losses during the term of the agreement.

Third Layer – 100% of \$25 million each occurrence, in excess of \$17.5 million, not to exceed \$50 million, in respect to all losses during the term of the agreement.

Fourth Layer – 100% of \$30 million each occurrence, in excess of \$42.5 million, not to exceed \$60 million, in respect to all losses during the term of the agreement.

Reinsurers and percentage of participation:

<u>Participating Reinsurer</u>	<u>1st Layer</u>	<u>2nd Layer</u>	<u>3rd Layer</u>	<u>4th Layer</u>
Lloyds, London Syndicates*	45%	43%	50%	38%
R+V Versicherung AG	20%	19%	20%	12.5%
IPCRC Limited	20%	20%	20%	14.17%
Arch Reinsurance Company	8.5%	8.5%	8.5%	4.5%
Catlin Insurance Company Limited	5%	4%		
Employers Mutual Casualty Company	.75%	.75%	.75%	.25%
Hannover Re Limited		4%		2.5%
Converium limited aka Scor, Switzerland				6.5%
Lloyds Syndicate No. 0382 HDU				5%
Everest Reinsurance Company				16.33%
American Agricultural Insurance Company	.75%	.75%	.75%	.25%

*The Lloyds, London Syndicates were shared at the following levels: Syndicate 2987 – 37%, Syndicate 4444 – 22%, Syndicate 2007 – 10%, Syndicate 958 – 30%, Syndicate 4020 – 1%.

The catastrophe reinsurance was administered by reinsurance intermediary, Guy Carpenter. Interest and liability contracts with the subscribing reinsurers were a part of the agreement. Guy Carpenter was recognized as the intermediary negotiating the agreement. All communications between the parties were transmitted through the intermediary. Payments by the Company to the intermediary were deemed to constitute payment to the reinsurers. Payments by the reinsurers to the intermediary were deemed to constitute payment to the Company, only to the extent that such payments were actually received by the Company.

Ocean Marine Excess of Loss Reinsurance

Business covered – Marine business produced by Pro-Mar Insurance Underwriters, Inc., and underwritten by George W. Zanthos. The agreement covers the combined losses of the Company and Omega One Insurance Company.

Term – July 1, 2009 to July 1, 2010.

Territory – Inland and coastal waters of the 48 contiguous states of the United States of America as respects policies written in the States of Florida, Georgia, Alabama, Mississippi, Louisiana, and Texas.

Retention and limits – \$250,000 excess of \$250,000, any one occurrence.

Participating reinsurers:

Lloyds Syndicate 1221 – 27.78%

Lloyds Syndicate 1861 – 27.78%

Lloyds Syndicate 1274 – 16.66%

Federal Insurance Company – 27.78%

Private Passenger Automobile Excess of Loss Reinsurance

Business covered – Private passenger automobile. The agreement covers the combined losses of the Company and Omega One Insurance Company.

Term – October 1, 2009 to September 30, 2010.

Retention and limits – \$200,000 excess of \$100,000, any one occurrence, not to exceed \$800,000 during the term of the contract.

Reinsurer – Odyssey American Reinsurance Corporation.

All of the Company's ceded reinsurance agreements contained the usual solvency clause, which provides for reinsurance payments to a liquidator, receiver or statutory successor without diminution because of the insolvency of the ceding insurer.

The date that the reinsurer signed the ocean marine reinsurance contract between the reinsurer and the Company was not documented in the contract with a July 1, 2009 effective date. There is a specific statutory deadline in which the contract must be signed by all parties for the corresponding transactions to be accounted for using reinsurance accounting. SSAP No. 62 states, in part, "...if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by both parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement."

Reinsurance Assumed

Affiliated

The Company had a catastrophe reinsurance agreement with its affiliate, Omega One Insurance Company (Omega) effective January 1, 2006. This agreement was automatically renewable for one year terms every January 1, unless cancelled by either party by giving the other 90 days notice of cancellation. The agreement covers Omega's business known as dwelling fire, allied lines, homeowners (section I only), and mobile home. Under the terms of the agreement the Company agrees to reinsure catastrophe losses in excess of \$600,000 from any one occurrence.

The Company's reinsurance agreement with Omega One Insurance Company does not evidence the date that the agreement was signed. SSAP No. 62, paragraph 24 states, in part, "... if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties, within nine months after the

commencement of the policy period covered by the reinsurance agreement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement.”

The Company provided a response to the examination finding in the form of correspondence with the Alabama Department of Insurance and a Form D filing that was prepared September 18, 2006. The Form D filing indicated that the reinsurance agreement was signed by both parties on September 18, 2006, which is within nine months of the effective date of the agreement. The correspondence file provided indicated that there was some disagreement between the Company and the Analyst, but it was ultimately determined that Omega One Insurance Company’s retention was being increased above the threshold of 5% of surplus; therefore ALA. CODE § 27-29-5 (b) (3) (1975) applied and the Company should have submitted the agreement at least thirty days prior to entering into the transaction, if the Commissioner did not disapprove the agreement during the review period. ALA. CODE § 27-29-5 (b) (1975) states:

The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into such transaction at least 30 days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period... Reinsurance agreements or modifications thereto in which the reinsurance premium or a change in the insurer’s liabilities equals or exceeds five percent of the insurer’s surplus as regards policyholders, as of the 31st day of December next preceding...

The Company did not accurately report its assumed premiums in the Annual Statement. The Company did not report its assumed premiums in Schedule F, Part 1 of the 2009 Annual Statement. The Company did not accurately report its assumed premiums from affiliates in the Underwriting and Investment Exhibit, Part 1B. The examination indicated that the assumed premiums were included in the Company’s direct written premiums, and the net premiums written were accurately reported. The assumed premiums were \$168,115.

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, Averitt, Kimbrough & Marino, a certified public accounting firm of Birmingham, Alabama for the final year of the examination period. The Company was audited in the previous years under examination by Barfield, Murphy, Shank & Smith.

Unclaimed Property

The Company provided its unclaimed property detail at December 31, 2009. The detail consisted of a listing of checks. The Company could not provide all of the dates as to when these checks were issued or the payee’s state of residence for the outstanding items. However,

these outstanding items were reflected as a reduction of cash in the 2009 Annual Statement balance sheet. There were 241 checks totaling \$99,638 that did not have issue dates; and 926 checks totaling \$579,493 that were issued prior to July 1, 2006. It was determined that the Company did not keep complete records of its transactions in with ALA. CODE § 27-27-29 (a)(1975) which states: "Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions, and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

Company management represented that some of the outstanding checks were not unclaimed property, rather they were checks that should have been voided and cancelled because a replacement check was issued or the check was an offer to a settlement whereby acceptance (of the settlement) had not been confirmed or denied. The examiners concluded that the items that were included as a reduction of cash that were not obligations to pay should have been cancelled at the time that the obligation no longer existed. Additionally, there was no information provided indicating that any of the outstanding items (reducing cash) were no longer obligations of the Company.

Further, those items (within the detail) that were outstanding for three years or more that were issued to Alabama residents should have been escheated to the State of Alabama as unclaimed property. ALA. CODE § 35-12-72 (1975) states: "(a) Property is presumed abandoned if its unclaimed by the apparent owner during the time set forth below for the particular property...(18) All other property, three years after the owner's right to demand the property or after the obligation to pay or distribute the property arises, whichever first occurs." All Alabama unclaimed property is to be included in the unclaimed property reports in accordance with the reporting procedures described in ALA. CODE § 35-12-76 (1975).

Reporting of Loans to Affiliates

The Company made three loans to an affiliate, National Security Insurance Company, that were outstanding on financial reporting dates. All of these dates were at quarter end, none were at year end. The Company did not accurately report these investments in the line item "Other invested assets." The investments were included in the Receivable from parent, subsidiaries and affiliates.

Annual Statement Exhibits

In a review of the reporting of the special deposits of the Company in Schedule E - Part 3 - Special Deposits of the Annual Statements for the period under examination, the examiner determined 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 has no employees. The Company's operational functions are performed by employees of National Security Insurance Company under the provisions of an administrative agreement. The examination included a review of the Company's information technology (IT) systems and controls. The following items were identified as a result of the review performed.

The Company's IT 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 IT 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 20 and 21
Summary of Operations	Page 22
Capital and Surplus Account	Page 23

National Security Fire & Casualty Company
Statement of Assets, Liabilities, Surplus and Other Funds
for the Year Ended December 31, 2009

Assets

	Assets	Non- admitted Assets	Admitted Assets
Bonds	\$33,347,698	\$ 0	\$33,347,698
Preferred stocks	20,050	0	20,050
Common stocks	9,275,453	0	9,275,453
Real Estate: Properties held for the production of income	4,812,412	0	4,812,412
Cash and short-term investments (Note 1)	2,486,017	0	2,486,017
Other invested assets	3,558,368	33,668	3,524,700
Receivable for securities	4,004	0	4,004
Investment income due and accrued	359,976	0	359,976
Premiums and considerations: Uncollected premiums and agents' balances in the course of collection (Note 2)	786,392	6,885	779,507
Premiums and considerations: Deferred premiums, agents' balances and installments booked but deferred and not yet due (Note 3)	7,443,625	119	7,443,506
Reinsurance: Amounts recoverable from reinsurers	234,535	214,140	20,396
Net deferred tax asset	2,377,683	647,015	1,730,668
Electronic data processing equipment and software	69,815	761	69,054
Furniture and equipment, including health care delivery assets	23,244	23,244	0
Receivables from parent, subsidiaries and affiliates (Note 2)	392,132	0	392,132
Aggregate write-ins for other than invested assets:			
Suspense items	62,009	62,009	0
Cash value of company owned life insurance	5,196,958	0	5,196,958
Premium tax overpayments	12,627	12,627	0
Total Assets	<u>\$70,462,998</u>	<u>\$1,000,468</u>	<u>\$69,462,530</u>

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

Liabilities, Surplus and Other Funds

Losses (Note 4)	\$9,774,320
Reinsurance payable on paid losses and loss adjustment expenses	731
Loss adjustment expenses (Note 4)	1,266,859
Commissions payable, contingent commissions and other similar charges	1,063,773
Other expenses	1,212,243
Taxes, licenses and fees	328,688
Current federal and foreign income taxes	626,494
Unearned premiums (Note 5)	25,337,409
Advance premium (Note 5)	0
Ceded reinsurance premiums payable	761,030
Funds held by company under reinsurance treaties (Note 6)	99,311
Amounts withheld or retained by company for account of others (Note 6)	40,286
Provision for reinsurance	15,000
Payable to parent, subsidiaries and affiliates	194,779
Total Liabilities	\$40,720,923
Common capital stock	\$ 1,500,000
Gross paid in and contributed surplus	6,677,190
Unassigned funds (Note 7)	20,564,417
Surplus as regards policyholders	\$28,741,607
Totals	\$69,462,530

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

National Security Fire & Casualty Company
Summary of Operations
for the Years Ended December 31, 2005, 2006, 2007, 2008, and 2009

	2005	2006	2007	2008	2009
Underwriting Income					
Premiums earned	\$43,823,727	\$49,436,372	\$52,877,694	\$47,739,217	\$49,936,662
Deductions:					
Losses incurred	29,118,680	28,062,438	28,478,812	33,993,658	26,595,577
Loss adjustment expenses incurred	3,674,995	3,344,602	3,307,488	5,301,640	4,050,395
Other underwriting expenses incurred	15,987,824	16,277,495	18,323,645	18,914,898	17,299,782
Aggregate write-ins for other underwriting deductions: Premiums waived	0	0	23,461	88,921	16,371
Total underwriting deductions	48,781,498	47,684,535	50,133,406	\$58,299,116	\$47,962,125
Net underwriting gain or (loss)	(4,957,771)	1,751,837	2,744,288	(10,559,899)	1,974,537
Investment Income					
Net investment income earned	1,793,728	2,054,973	2,326,907	\$2,180,776	\$2,677,294
Net realized capital gains or (losses) less capital gains tax	3,097,666	1,189,875	895,132	405,832	197,963
Net investment gain (loss)	4,891,394	3,244,849	3,222,039	\$2,586,608	\$2,875,257
Other Income:					
Net gain (loss) from agents' or premium balances charged off	(6,381)	(14,664)	(4,456)	(4,645)	(96,691)
Finance and service charges not included in premiums	1,002,384	939,193	865,191	800,676	652,791
Aggregate write-ins for miscellaneous income:					
Miscellaneous income	63,907	24,527	10,112	54,988	8,769
Returned check fees	10,414	13,679	11,301	16,265	18,361
Total other income	1,070,324	962,735	882,148	\$867,284	\$583,230
Net income, after dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes	1,003,947	5,959,421	6,848,474	(7,106,008)	5,433,024
Federal and foreign income taxes incurred	275,165	1,737,213	2,239,454	(1,376,469)	1,254,119
Net income	728,782	\$4,222,207	\$4,609,020	\$(5,729,539)	\$4,178,906

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

National Security Fire & Casualty Company
Capital and Surplus
for the Years Ended December 31, 2005, 2006, 2007, 2008, and 2009

	2005	2006	2007	2008	2009
Surplus as regards policyholders, December 31 prior year	\$23,766,127	\$27,209,005	\$32,583,424	\$34,121,894	\$26,783,013
Net income	728,782	4,222,207	4,609,020	(5,729,539)	4,178,906
Change in net unrealized capital gains or (losses)	(1,257,375)	558,786	(859,360)	(3,655,434)	933,467
Change in net deferred income tax	1,139,573	518,492	856,442	2,008,298	(262,098)
Change in nonadmitted assets	249,698	(441,957)	(92,032)	488,393	(789,084)
Change in provision for reinsurance	(1,617,800)	1,872,600	24,400	(450,600)	497,400
Surplus adjustments: Paid in	6,000,000	0	0	0	0
Dividends to stockholders	(1,800,000)	(1,000,000)	(3,000,000)	0	(2,600,000)
Examination correction write-in		(355,709)			
Change in surplus as regards policyholders	<u>3,442,878</u>	<u>5,374,419</u>	<u>1,538,470</u>	<u>(7,338,882)</u>	<u>1,958,590</u>
Surplus as regards policyholders, December 31 current year	<u>27,209,005</u>	<u>32,583,424</u>	<u>34,121,894</u>	<u>\$26,783,013</u>	<u>\$28,741,603</u>

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

NOTES TO FINANCIAL STATEMENTS

Note 1 - Cash and short-term investments \$ 2,486,017

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

While reviewing the cash accounts of the Company, it was noted that the return deposit items in the cash deposit account that were returned for non sufficient funds just prior to the end of the reporting period, were not being included as a reduction of the cash balance in the 2nd Quarter 2009 Quarterly Statement. It was determined that these items were recorded in the general ledger cash account as a reduction of the cash balance in the first week of July 2009. The Company should reflect all reversed deposit items as a reduction in the Cash and short-term investments balance that it reports in its financial statements. The amount of the return deposit items was immaterial, and no adjustment to the financial statements was necessary.

Note 2 – Premiums and considerations: Uncollected premiums and agents’ balances in course of collection \$ 779,507

Receivable from parent, subsidiaries and affiliates \$ 392,132

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

The Company reported assumed reinsurance premium receivables due from its subsidiary within the line item “Receivable from parent, subsidiaries and affiliates.” The assumed reinsurance premium receivables should have been reported in the line item “Premiums and considerations: Uncollected premiums and agents’ balances in course of collection” in accordance with SSAP No. 62, paragraph 35, which states, “Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as agents’ balances or uncollected premiums.”

The misclassification has no effect on the Company’s surplus. Due to there being no effect on surplus, no changes were made to the financial statements included in this report.

Note 3 – Premiums and considerations: Deferred premiums, agents’ balances and installments booked but deferred and not yet due \$7,443,506

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

In a review of a sample of 2009 quarterly reconciliations of deferred premiums, agents’ balances and installments booked but deferred amounts included in the ARiS Policy System with the amounts included for the same item in the Great Plains general ledger, the examination determined that the Company was using the balance included in the Great Plains general ledger account as of the end of the period, which did not include any adjustments for items with effective dates within the quarter which were not included on the ARiS Policy System as of the end of the quarter. The amount reported for the Deferred premiums, agents’ balances and

installments booked but deferred and not yet due on the Quarterly Statements/Annual Statements of the Company should include adjusting items with effective dates that are within the reporting period in order to report the Deferred premiums, agents' balances and installments booked but deferred and not yet due line item on an accrual basis. The amount of the difference was immaterial, and the financial statements were not adjusted for the purposes of the examination.

Note 4 – Losses

Loss adjustment expenses

\$9,774,320

\$1,266,859

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

The Company did not provide all of its 2006 paid claims coded by line of business and accident year. It is necessary to identify the paid claims allocated by line of business and accident year to prepare or audit Schedule P. The data provided indicated that \$135,654 of the 2006 paid losses could not be retrieved from the Company's back up information. ALA. CODE § 27-27-29 (a) (1975) states "Every domestic insurer shall have, and maintain its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions, and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

Note 5 – Unearned premiums

Advance premium

\$25,337,409

\$ 0

The above captioned amounts are the same as reported by the Company in the 2009 Annual Statement.

Issues 1 and 2 below relate to Unearned premiums only and Issue 3 relates to Unearned premiums and Advance premium.

Issue 1

In a review of the reconciliation of the unearned premiums as of December 31, 2009, it was determined that the Company used both the daily pro rata method and the monthly pro rata method to calculate the unearned premiums of the policies of the Company. The Company should use either one or the other method to calculate unearned premiums for the policies of the Company, and not both methods. This should be performed to be in compliance with paragraph 7 of SSAP No. 53 of the NAIC *Accounting Practices and Procedures Manual*, which states: "One of the following methods shall be used for computation of the unearned premium reserve: ...Daily pro rata method...Monthly pro rata method."

In addition, ALA. CODE §27-36-3 states, in part:

... The portions of the gross premium in force, less applicable reinsurance in solvent reinsurers, to be held as an unearned premium reserve, shall be computed according to the following table ... (c) In lieu of computation according to the table in subsection (b)

of this section, the insurer at its option, may compute all of such reserves on a monthly or more frequent basis. (d) After adopting a method for computing such reserve, an insurer shall not change methods without approval of the insurance supervisory official of its state of domicile.

It was determined by the examiners that the Company's improper use of two different methods to calculate unearned premiums did not have a material impact on the Company's financial statements. No changes to the financial statements were necessary.

Issue 2

In review of the calculation and reconciliation of the 2009 unearned premiums for the Vesta Fire line of business, the examiner determined that the Company was reporting an estimated amount of unearned premiums for this line of business, instead of using one of the two methods to calculate unearned premiums that are prescribed by paragraph 7 of SSAP No. 53 of the NAIC *Accounting Practices and Procedures Manual*. The Company should use either the daily pro rata method or the monthly pro rata method to calculate the unearned premiums for the Vesta Fire line of business in accordance with paragraph 7 of SSAP No. 53 of the NAIC *Accounting Practices and Procedures Manual*, which states: "One of the following methods shall be used for computation of the unearned premium reserve: Daily pro rata method ... Monthly pro rata method..."

It was recommended in the previous report of examination that the Company use one of the two prescribed methods when calculating the unearned premiums for the Vesta Fire line of business. The Company did not comply with the recommendation from the prior report of examination. However, the Company did start using the daily pro rata method to calculate the Vesta Fire line of business unearned premiums as of December 31, 2009. Therefore, no adjustment to the financial statements was necessary.

Issue 3

The Company did not report a liability for advance premium in the 2009 Annual Statement. In a review of a sample of policies with effective dates of January 1, 2010 through January 15, 2010, it was determined that there were policies with effective dates in 2010, for which renewal premiums were received on or before December 31, 2009. Advance premiums should have been reported for the initial premiums or renewal premiums that were received on or before December 31, 2009 for policies with effective dates on or after January 1, 2010. The examination indicated that the Company recorded and reported a liability for these policies in the "Unearned premiums" line item, instead of recording an amount for the advance premiums in the "Advance premium" line item. SSAP No. 53, paragraph 13 of the NAIC *Accounting Practices and Procedures Manual* states: "Advance premiums result when the policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are reported as a liability in the statutory financial statement and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve."

The error was determined to be a misclassification and there was no effect on the Company's surplus. Due to no effect on surplus, no changes to the financial statements were determined to be necessary for this issue.

<u>Note 6 – Funds held by company under reinsurance treaties</u>	<u>\$ 99,311</u>
<u>Amounts withheld or retained by company for account of others</u>	<u>\$ 40,286</u>

The above captioned amounts are the same as reported by the Company in the 2009 Annual Statement.

The Company reported some funds held in connection with reinsurance agreements in the line item “Funds held or retained by company for account of others.” The NAIC *Annual Statement Instructions* for P & C Insurers indicate the following.

Line 13 - Funds withheld or retained by company for account of others

Include: Employees’ FICA and unemployment contributions and other withholdings as well as accounts held in escrow for payment of taxes, insurance, etc., under F.H.A. or other mortgage loans; and any other funds that the company holds in a fiduciary capacity for the account of others (excluding reinsurance funds held).

Line 14 - Funds held by company under reinsurance treaties

Include: Reinsurance premiums withheld by the company as specified in the reinsurance contract (for example, funds withheld equal to the unearned premiums and loss reserves) or advances to the company by the payment of losses before the company makes an accounting.

The funds held in connection with reinsurance agreements should have been reported in the line item “Funds held by company under reinsurance treaties.” The reinsurance balances were misclassified. The misclassification had no effect on the Company’s surplus. Therefore, no changes were made to the financial statements included in this report.

<u>Note 7 – Unassigned funds</u>	<u>\$20,564,417</u>
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The above captioned amount is the same as reported by the Company in the 2009 Annual Statement.

Unassigned funds per Company	\$20,564,417
Examination increase/(decrease) to assets:	
Examination decrease/(increase) to liabilities:	
Total Unassigned funds per examination	<u>\$20,564,417</u>

COMMENTS AND RECOMMENDATIONS

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. ...”

Claims Review – Page 12

It is recommended that the Company provide a delay notification to claimants when claims processing takes longer than 30 days to accept or deny the claims in accordance with ALA. ADMIN CODE 482-1-125 (2)(2003), which states:

“If the insurer needs more time to determine whether a first party claim should be accepted or denied, it shall so notify the first party claimant within thirty (30) days or the time period specified in the policy after receipt of the proofs of loss, giving the reasons more time is needed. If the investigation remains incomplete, the insurer shall, forty-five (45) days from the initial notification and every forty-five (45) days thereafter, notify the first party claimant in writing, verbally or electronically (e-mail) of the reasons additional time is needed for investigation. Where there is a reasonable basis supported by specific information available for review by the insurance regulatory authority for suspecting that the first party claimant has fraudulently caused or contributed to the loss, the insurer is relieved from the requirements of this paragraph; provided, however, that the claimant shall be advised of the acceptance or denial of the claim by the insurer within a reasonable time for full investigation after receipt by the insurer of a properly executed proof of loss.

It is recommended that the Company tender payment within thirty days after the Company has the necessary documentation to consummate the settlement in accordance with ALA. ADMIN CODE 482-1-125 (6)(2003), which states: “The insurer shall tender payment within thirty (30) days or the time specified in the policy, after accepting liability, reaching an agreement on the amount of the claim and receipt of any documents necessary to consummate the settlement.”

Policyholder Complaints – Page 12

It is recommended that the Company respond to policyholder complaints in a timely manner in accordance with ALA. ADMIN CODE 482-1-118.06 (2003), which states:

The insurer shall provide, within ten (10) working days, any record or response requested in writing by any duly appointed deputy, assistant, employee or examiner of the

commissioner. When the requested record or response is not produced or cannot be produced by the insurer within ten working days, the nonproduction shall be deemed a violation of this rule, unless the Commissioner or duly appointed person making the request grants an extension in writing or the insurer can demonstrate to the satisfaction of the Commissioner that there is a reasonable justification for the delay.

Reinsurance Ceded – Page 13

It is recommended that the Company make certain that the signatures in the reinsurance contracts are dated to document the date that the agreement was signed. It is further recommended that the transactions associated with agreements that do not include dated signatures evidencing that the agreement was signed within nine months of the effective date be accounted for as retroactive reinsurance, in accordance with SSAP No. 62 which states, in part “... if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by both parties within nine months after the commencement of the policy period covered by the reinsurance arrangement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement.”

Reinsurance Assumed – Page 15

It is recommended that the Company amend its reinsurance agreement with Omega One Insurance Company to evidence that the agreement is signed by all signors within nine months of the effective date or account for the corresponding reinsurance transactions in accordance with the guidance for accounting for retroactive reinsurance in SSAP No. 62. Agreements that do not include evidence of execution within nine months of the effective date are to be accounted for as retroactive reinsurance in accordance with SSAP No. 62, paragraph 24 which states, in part, “... if an agreement entered into, renewed or amended on or after January 1, 1994 has not been finalized, reduced to a written form and signed by the parties, within nine months after the commencement of the policy period covered by the reinsurance agreement, then the arrangement is presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement.”

It is recommended that the Company submit all transactions within its holding company system that require prior approval to the commissioner at least thirty days prior to entering into such transactions in accordance with ALA. CODE § 27-29-5(b) which states:

The following transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into such transaction at least 30 days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period... Reinsurance agreements or modifications thereto in which the reinsurance premium or a change in the insurer's liabilities equals or exceeds five percent of the insurer's surplus as regards policyholders, as of the 31st day of December next preceding...

It is recommended that the Company accurately report its assumed premiums in Schedule F Part 1 and the Underwriting & Investment Exhibit Part 1B.

Accounts and Records – Page 16

It is recommended that the Company keep complete records of its transactions in accordance with ALA. CODE § 27-27-29(a) (1975) which requires, “Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions, and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted.”

It is recommended that the Company properly include all unclaimed property in its unclaimed property filings to the respective states. Alabama unclaimed property is defined in ALA. CODE § 35-12-72 (a) (1975), which states, “Property is presumed abandoned if its unclaimed by the apparent owner during the time set forth below for the particular property ... (18) All other property, three years after the owner’s right to demand the property or after the obligation to pay or distribute the property arises, whichever first occurs.” All Alabama unclaimed property is to be included in the unclaimed property reports in accordance with the reporting procedures described in ALA. CODE Section 35-12-76.

It is recommended that the Company accurately report its investments of loans in the line item “Other invested assets.”

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.

Cash and short-term investments – Page 24

It is again recommended that the Company reflect all reversed deposit items as a reduction in the Cash and short-term investments balance that it reports in its financial statements.

Premiums and considerations: Uncollected premiums and agents’ balances in course of collection; Receivable from parent, subsidiaries and affiliates – Page 24

It is recommended that the Company report its assumed reinsurance premiums receivable in the line item “Premiums and considerations: Uncollected premiums and agents’ balances in course of collection” in accordance with SSAP No. 62, paragraph 35, which states, “Reinsurance premiums receivable at the end of the accounting period are combined with direct business receivables and reported as agents’ balances or uncollected premiums.”

Premiums and considerations: Deferred premiums, agents' balances and installments booked but deferred and not yet due – Page 24

It is recommended that the amount reported for the Deferred premiums, agents' balances and installments booked but deferred and not yet due on the Quarterly Statements/Annual Statements of the Company should include adjusting items with effective dates that are within the reporting period in order to report the Deferred premiums, agents' balances and installments booked but deferred and not yet due line item on an accrual basis.

Losses, Loss adjustment expenses – Page 25

It is recommended that the Company retain complete records of its paid claims that supports the allocation of paid claims in schedule P by accident year and line of business in accordance with ALA CODE § 27-27-29(a), which states, "Every domestic insurer shall have, and maintain its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions, and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

Unearned premiums and Advance premium – Page 25

It is recommended that the Company use either the daily pro rata method or the monthly pro rata method to calculate the unearned premiums of the policies of the Company, and not both methods in order to be in compliance with paragraph 7 of SSAP No. 53 of the NAIC *Accounting Practices and Procedures Manual*, which states: "One of the following methods shall be used for computation of the unearned premium reserve: ...Daily pro rata method ... Monthly pro rata method." ALA. CODE § 27-36-3 states, in part:

... The portions of the gross premium in force, less applicable reinsurance in solvent reinsurers, to be held as an unearned premium reserve, shall be computed according to the following table ... (c) In lieu of computation according to the table in subsection (b) of this section, the insurer at its option, may compute all of such reserves on a monthly or more frequent basis. (d) After adopting a method for computing such reserve, an insurer shall not change methods without approval of the insurance supervisory official of its state of domicile.

It is further recommended that the Company obtain the Commissioner's approval of any changes to its methods of calculating its unearned premium reserves in accordance with ALA. CODE § 27-36-3. It will be necessary to change the Company's methods for segments of its business in order to comply with all of the recommendations included under this heading "Unearned premiums."

It is again recommended that the Company properly calculate its unearned premiums for the book of business known internally by the Company as Vesta business utilizing one of the prescribed methods of SSAP No. 53, paragraph 7, which requires, "One of the following methods shall be used for computation of the unearned premium reserve: Daily pro rata method ...Monthly pro rata method..." The Company did start using the daily pro rata method to calculate the Vesta Fire line of business unearned premiums as of December 31, 2009.

It is recommended that the Company report liabilities for advance premiums for policies with effective dates in the next reporting period, but for which the Company has received initial premiums or renewal premiums in the current reporting period, to be in compliance with SSAP No. 53, paragraph 13 of the NAIC *Accounting Practices and Procedures Manual*, which states: “Advance premiums result when the policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are reported as a liability in the statutory financial statement and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve.”

Funds held by company under reinsurance treaties, Amounts withheld or retained by company for account of others – Page 27

It is recommended that the Company properly report funds held in connection with reinsurance agreements in the line item “Funds held under reinsurance treaties” in accordance with the NAIC Annual Statement Instructions, which state

Line 13 - Funds withheld or retained by company for account of others

Include: Employees’ FICA and unemployment contributions and other withholdings as well as accounts held in escrow for payment of taxes, insurance, etc., under F.H.A. or other mortgage loans; and any other funds that the company holds in a fiduciary capacity for the account of others (excluding reinsurance funds held).

Line 14 - Funds held by company under reinsurance treaties

Include: Reinsurance premiums withheld by the company as specified in the reinsurance contract (for example, funds withheld equal to the unearned premiums and loss reserves) or advances to the company by the payment of losses before the company makes an accounting.

Compliance with Previous Recommendations – Page 32

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

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.

It was recommended in the previous report that the Company respond to complaints received from the Alabama Department of Insurance within ten business days in accordance with Alabama Insurance Regulation 118 §(6)(s). The Company did not comply with the recommendation. Further discussion of the complaints that were received from the Department that were not responded to within ten business days is included in the report under the caption "Policyholder Complaints."

The previous report of examination included a recommendation for the Company to identify and properly escheat its unclaimed property in accordance with the unclaimed property laws. The examination indicated that the Company did not identify and escheat all of the unclaimed property. Further discussion of the issue is included in this report under the caption "ACCOUNTS AND RECORDS."

The previous report of examination included a recommendation for the Company to properly include all reverse deposit items as a reduction in the Cash and short-term investments balance that it reports in financial statements. The examination indicated that the Company did not comply with the recommendation. Further discussion of the issue is included in this report under the caption "NOTES TO FINANCIAL STATEMENTS."

The previous report of recommendation included a recommendation for the Company to properly report assumed reinsurance premium receivables in the line item "Premiums and considerations: Uncollected premiums and agents' balances in course of collection" in accordance with SSAP No. 62, paragraph 35. Further discussion of the issue is included in this report under the caption "NOTES TO FINANCIAL STATEMENTS."

The previous report of examination included a recommendation for the Company to comply with the statutory accounting principle and use the daily pro rata method or the monthly pro rata method and not a method involving estimating the unearned premium reserves for the Vesta business. The examination indicated that the Company did not comply with the recommendation during the course of the examination period, but had changed its method and was in compliance at December 31, 2009. Further discussion of the issue is included in this report under the caption "NOTES TO FINANCIAL STATEMENTS."

The previous report included an examination finding that reinsurance balances were reported in the line item "Amounts withheld or retained by company for account of others," and the balances should have been reported in the line item "Funds held under reinsurance treaties." The examination indicated that the Company did not comply with the recommendation to properly classify its reinsurance related balances in the line item "Funds held under reinsurance treaties" in accordance with the NAIC Annual Statement Instructions. Further discussion of the issue is included in this report under the caption "NOTES TO FINANCIAL STATEMENTS."

SUBSEQUENT EVENTS

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

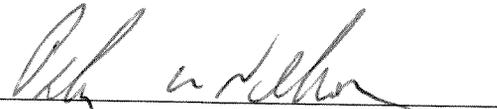
CONCLUSION

Acknowledgement is hereby made of the courtesy and cooperation extended by all persons representing National Security Fire & Casualty 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 Randall Ross, FCAS, MAAA, and Brent Sallay, FCAS, MAAA, Consulting Actuaries; all representing the Alabama Department of Insurance, participated in the examination of National Security Fire & Casualty Company.

Respectfully submitted,



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Examiner-in-charge
Alabama Department of Insurance
Southeastern Zone, NAIC