

SAFETY INSURANCE GROUP INC

Form 10-Q

August 05, 2016

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2016

OR

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

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

Commission File Number: 000-50070

SAFETY INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of incorporation or organization)

13-4181699  
(I.R.S. Employer Identification No.)

20 Custom House Street, Boston, Massachusetts 02110

(Address of principal executive offices including zip code)

(617) 951-0600

(Registrant's telephone number, including area code)

Not Applicable

(Former name or former address, if changed since last report)

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

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

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

Large accelerated filer      Accelerated filer

Non-accelerated filer      Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of August 1, 2016 there were 15,158,074 shares of common stock with a par value of \$0.01 per share outstanding.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands, except share data)

	June 30, 2016 (Unaudited)	December 31, 2015
Assets		
Investments:		
Securities available for sale:		
Fixed maturities, at fair value (amortized cost: \$1,068,806 and \$1,063,971)	\$ 1,112,277	\$ 1,081,637
Equity securities, at fair value (cost: \$103,898 and \$102,541 )	116,961	110,204
Other invested assets	19,304	17,602
Total investments	1,248,542	1,209,443
Cash and cash equivalents	44,053	47,494
Accounts receivable, net of allowance for doubtful accounts	195,509	178,567
Receivable for securities sold	518	260
Accrued investment income	8,469	8,922
Taxes recoverable	17,037	15,497
Receivable from reinsurers related to paid loss and loss adjustment expenses	26,444	40,972
Receivable from reinsurers related to unpaid loss and loss adjustment expenses	78,043	68,261
Ceded unearned premiums	28,886	23,222
Deferred policy acquisition costs	72,386	68,937
Deferred income taxes	—	4,430
Equity and deposits in pools	27,695	23,558
Other assets	16,917	14,306
Total assets	\$ 1,764,499	\$ 1,703,869
Liabilities		
Loss and loss adjustment expense reserves	\$ 544,082	\$ 553,977
Unearned premium reserves	428,135	401,961
Accounts payable and accrued liabilities	51,762	53,722
Payable for securities purchased	7,093	8,607
Payable to reinsurers	23,177	11,547
Deferred income taxes	7,117	—
Other liabilities	23,098	29,556
Total liabilities	1,084,464	1,059,370
Commitments and contingencies (Note 7)		
Shareholders' equity		
	174	174

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Common stock: \$0.01 par value; 30,000,000 shares authorized; 17,437,644 and 17,373,643 shares issued		
Additional paid-in capital	182,278	179,896
Accumulated other comprehensive income, net of taxes	36,746	16,464
Retained earnings	544,672	531,800
Treasury stock, at cost: 2,279,570 shares	(83,835)	(83,835)
Total shareholders' equity	680,035	644,499
Total liabilities and shareholders' equity	\$ 1,764,499	\$ 1,703,869

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net earned premiums	\$ 187,393	\$ 182,447	\$ 373,047	\$ 365,011
Net investment income	9,641	10,317	19,268	20,874
Earnings from partnership investments	1,409	577	2,287	577
Net realized gains (losses) on investments	360	(173)	37	238
Net impairment losses on investments (a)	(137)	—	(429)	—
Finance and other service income	4,284	4,434	8,569	8,941
Total revenue	202,950	197,602	402,779	395,641
Losses and loss adjustment expenses	115,144	147,026	241,123	355,350
Underwriting, operating and related expenses	57,513	52,198	113,470	104,295
Interest expense	23	23	45	45
Total expenses	172,680	199,247	354,638	459,690
Income (loss) before income taxes	30,270	(1,645)	48,141	(64,049)
Income tax expense (credit)	8,905	(592)	14,106	(27,925)
Net income (loss)	\$ 21,365	\$ (1,053)	\$ 34,035	\$ (36,124)
Earnings (loss) per weighted average common share:				
Basic	\$ 1.42	\$ (0.07)	\$ 2.26	\$ (2.43)
Diluted	\$ 1.41	\$ (0.07)	\$ 2.25	\$ (2.43)
Cash dividends paid per common share	\$ 0.70	\$ 0.70	\$ 1.40	\$ 1.40
Number of shares used in computing earnings (loss) per share:				
Basic	14,960,516	14,879,047	14,932,237	14,851,742
Diluted	15,041,077	14,879,047	14,988,546	14,851,742

(a) No portion of the other-than-temporary impairments recognized in the period indicated were included in comprehensive income



The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (Loss)

(Unaudited)

(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income (loss)	\$ 21,365	\$ (1,053)	\$ 34,035	\$ (36,124)
Other comprehensive income, net of tax:				
Unrealized holding gains or losses during the period, net of income tax expense (benefit) of \$5,426, (\$5,508), \$10,934 and (\$3,616).	10,077	(10,230)	20,306	(6,715)
Reclassification adjustment for losses or gains included in net income, net of income tax (expense) benefit of (\$126), \$60, (\$13) and (\$83).	(234)	112	(24)	(155)
Unrealized gains on securities available for sale	9,843	(10,118)	20,282	(6,870)
Comprehensive income (loss)	\$ 31,208	\$ (11,171)	\$ 54,317	\$ (42,994)

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders' Equity

(Unaudited)

(Dollars in thousands)

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income, Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2014	\$ 173	\$ 175,583	\$ 28,715	\$ 587,647	\$ (83,835)	\$ 708,283
Net loss, January 1 to June 30, 2015				(36,124)		(36,124)
Unrealized losses on securities available for sale, net of deferred federal income taxes			(6,870)			(6,870)
Restricted share awards issued	1	246				247
Recognition of employee share-based compensation, net of deferred federal income taxes		1,584				1,584
Exercise of options, net of federal income taxes		152				152
Dividends paid and accrued				(20,930)		(20,930)
Acquisition of treasury stock					—	—
Balance at June 30, 2015	\$ 174	\$ 177,565	\$ 21,845	\$ 530,593	\$ (83,835)	\$ 646,342

	Common	Additional Paid-in	Accumulated Other Comprehensive Income,	Retained	Treasury	Total Shareholders'
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	Stock	Capital	Net of Taxes	Earnings	Stock	Equity
Balance at December 31, 2015	\$ 174	\$ 179,896	\$ 16,464	\$ 531,800	\$ (83,835)	\$ 644,499
Net income, January 1 to June 30, 2016				34,035		34,035
Unrealized gains on securities available for sale, net of deferred federal income taxes			20,282			20,282
Restricted share awards issued		280				280
Recognition of employee share-based compensation, net of deferred federal income taxes		1,851				1,851
Exercise of options, net of federal income taxes		251				251
Dividends paid and accrued				(21,163)		(21,163)
Balance at June 30, 2016	\$ 174	\$ 182,278	\$ 36,746	\$ 544,672	\$ (83,835)	\$ 680,035

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

	Six Months Ended June 30,	
	2016	2015
Cash flows from operating activities:		
Net income (loss)	\$ 34,035	\$ (36,124)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Depreciation and amortization, net	6,356	5,635
Provision (credit) for deferred income taxes	626	(2,171)
Net realized gains on investments	(37)	(238)
Net impairment losses on investments	429	—
Earnings from partnership investments	(2,287)	(577)
Changes in assets and liabilities:		
Accounts receivable	(16,942)	(16,522)
Accrued investment income	453	960
Receivable from reinsurers	4,746	(59,149)
Ceded unearned premiums	(5,664)	(1,564)
Deferred policy acquisition costs	(3,449)	(3,944)
Taxes recoverable	(1,540)	(29,129)
Other assets	(6,328)	(4,542)
Loss and loss adjustment expense reserves	(9,895)	78,423
Unearned premium reserves	26,174	26,020
Accounts payable and accrued liabilities	(1,936)	(21,285)
Payable to reinsurers	11,630	9,574
Other liabilities	(6,458)	19,194
Net cash provided by (used for) operating activities	29,913	(35,439)
Cash flows from investing activities:		
Fixed maturities purchased	(117,678)	(95,378)
Equity securities purchased	(10,705)	(20,102)
Other invested assets purchased	(2,013)	(3,404)
Proceeds from sales and paydowns of fixed maturities	43,085	70,432
Proceeds from maturities, redemptions, and calls of fixed maturities	64,462	67,028
Proceed from sales of equity securities	10,150	18,674
Proceeds from other invested assets redeemed	2,656	—
Fixed assets purchased	(2,375)	(2,139)
Net cash (used for) provided by investing activities	(12,418)	35,111
Cash flows from financing activities:		

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Proceeds from stock options exercised	257	150
Excess tax (expense) benefit from stock options exercised	(6)	2
Dividends paid to shareholders	(21,187)	(20,986)
Net cash used for financing activities	(20,936)	(20,834)
Net decrease in cash and cash equivalents	(3,441)	(21,162)
Cash and cash equivalents at beginning of year	47,494	42,455
Cash and cash equivalents at end of period	\$ 44,053	\$ 21,293

The accompanying notes are an integral part of these financial statements.

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

1. Basis of Presentation

The consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America (“GAAP”). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

The consolidated financial statements include Safety Insurance Group, Inc. and its subsidiaries (the “Company”). The subsidiaries consist of Safety Insurance Company, Safety Indemnity Insurance Company, Safety Property and Casualty Insurance Company, Safety Asset Management Corporation (“SAMC”), and Safety Management Corporation, which is SAMC’s holding company. All intercompany transactions have been eliminated.

The financial information for the quarter and year ended June 30, 2016 and 2015 is unaudited; however, in the opinion of the Company, the information includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial condition, results of operations, and cash flows for the periods. The financial information as of December 31, 2015 is derived from the audited financial statements included in the Company's 2015 annual report on Form 10-K filed with the SEC on February 26, 2016.

These unaudited interim consolidated financial statements may not be indicative of financial results for the full year and should be read in conjunction with the audited financial statements included in the Company’s annual report on Form 10-K filed with the U.S. Securities and Exchange Commission (“SEC”) on February 26, 2016.

The Company is a leading provider of property and casualty insurance focused primarily on the Massachusetts market. The Company’s principal product line is automobile insurance. The Company operates through its insurance company subsidiaries, Safety Insurance Company, Safety Indemnity Insurance Company, and Safety Property and Casualty Insurance Company (together referred to as the “Insurance Subsidiaries”).



The Insurance Subsidiaries began writing private passenger automobile and homeowners insurance in New Hampshire during 2008, personal umbrella insurance in New Hampshire during 2009, and commercial automobile insurance in New Hampshire during 2011. The Insurance Subsidiaries began writing all of these lines of business in Maine during 2016.

## 2. Recent Accounting Pronouncements

In June 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Statements, which amends the guidance for the impairment of financial instruments and is expected to result in more timely recognition of impairment losses. The update introduces an impairment model referred to as the current expected credit loss (CECL) model. The impairment model is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses. The ASU is also intended to reduce the complexity of the current guidance by decreasing the number of credit impairment models that entities use to account for debt instruments. For public business entities that are SEC filers, the amendments in ASU No. 2016-13 are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Entities may adopt the amendments in this update earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is assessing the impact that adoption of ASU No. 2016-13 will have on its financial position, results of operations and cash flows.

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(Dollars in thousands except per share and share data)

In March 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This ASC update requires all excess tax benefits and tax deficiencies to be recognized as income tax expense or benefit in the income statement, and be treated as discreet items in the reporting period in which they occur. Additionally, excess tax benefits will be classified with other income tax cash flows as an operating activity and cash paid by an employer when directly withholding shares for tax withholding purposes will be classified as a financing activity. Awards that are used to settle employee tax liabilities will be allowed to qualify for equity classification for withholdings up to the maximum statutory tax rates in applicable jurisdictions. Regarding forfeitures, a company can make an entity-wide accounting policy election to either continue estimating the number of awards that are expected to vest or account for forfeitures when they occur. The updated guidance is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods. Early adoption is permitted. The impact of the adoption of ASU 2016-01 to the Company’s financial position and results of operations is currently being evaluated.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”). The amendments in this ASU update address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01: (1) requires equity investments (except those accounted for under the equity method or those that result in the consolidation of the investee) to be measured at fair value with changes in the fair value recognized in net income; (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) requires the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and (4) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the notes to the financial statements. These amendments are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The impact of the adoption of ASU 2016-01 to the Company’s financial position and results of operations is currently being evaluated.

In May 2015, the FASB issued ASU 2015-09, Disclosures about Short-Duration Contracts (“ASU 2015-09”). ASU 2015-09 requires companies that issue short duration contracts to disclose additional information, including: (i) incurred and paid claims development tables; (ii) frequency and severity of claims; and (iii) information about material changes in judgments made in calculating the liability for unpaid claim adjustment expenses, including reasons for the change and the effects on the financial statements. ASU 2015-09 is effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016. The amendments in ASU 2015-09 should be applied retrospectively by providing comparative disclosures for each period presented, except for those requirements that apply only to the current period. As the requirements of this literature are disclosure only, the application of this guidance will not impact our financial condition, results of operations or cash flows.

In May 2015, the FASB issued ASU 2015-07, Fair Value Measurement Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent) (“ASU 2015-07”). ASU 2015-07 removes the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the net asset value per share practical expedient. The reporting entity should continue to disclose information on investments for which fair value is measured at net asset value (or its equivalent) as a practical expedient to help users understand the nature and risks of the investments and whether the investments, if sold, are probable of being sold at amounts different from net asset value. ASU 2015-07 is effective for fiscal years beginning after December 31, 2015. The Company adopted the updated accounting guidance retrospectively. The Company adjusted its previously reported financial information included herein to reflect the change in accounting guidance for assets measured using the net asset value. The impact of adopting the new accounting standard resulted in excluding a real estate investment trust of \$19,481 and \$19,097 from the fair value level disclosures as of June 30, 2016 and December 31, 2015.

In April 2015, the FASB issued ASU No. 2015-03, Imputation of Interest (“ASU 2015-03”). ASU 2015-03 simplifies the presentation of debt issuance costs as the amendments in this update require that debt issuance costs be

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

presented in the balance sheet as a direct deduction from the carrying amount of debt liability, consistent with debt discounts or premiums. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this update. ASU 2015-03 is effective for annual and interim reporting periods beginning after December 15, 2015. The standard requires a retrospective approach where the balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. The standard also requires compliance with applicable disclosures for a change in an accounting principle. The Company's adoption of ASU 2015-03 had no impact on the Company's financial position, results of operations or cash flows.

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosures of Uncertainties about an Entity's Ability as a Going Concern" ("ASU 2014-15"). ASU 2014-15 provides guidance on determining when and how to disclose going concern uncertainties in the financial statements, and requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued. ASU 2014-15 is effective for annual periods ending after December 15, 2016 and interim periods thereafter. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have any impact on its financial position, results of operations, or cash flows.

In June 2014, the FASB issued ASU No. 2014-12, "Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period" ("ASU 2014-12"), which revises the accounting treatment for stock compensation tied to performance targets. ASU 2014-12 is effective for calendar years beginning after December 15, 2015. The impact of adoption was not material to the Company's financial position, results of operations or cash flows.

In May 2014, the FASB issued as final, ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)" which supersedes virtually all existing revenue recognition guidance under GAAP. The update's core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The update is effective for interim and annual reporting periods in fiscal years beginning after December 15, 2017 and allows early adoption. ASU 2014-09 allows for the use of either the retrospective or modified retrospective approach of adoption. The Company does not expect the adoption of ASU 2014-09 to have a material impact on its financial position, results of operations, or cash flows.

3. Earnings (loss) per Weighted Average Common Share

Basic earnings (loss) per weighted average common share (“EPS”) are calculated by dividing net income (loss) by the weighted average number of basic common shares outstanding during the period. Diluted earnings (loss) per share amounts are based on the weighted average number of common shares including non-vested performance stock grants and the net effect of potentially dilutive common stock options.

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

The following table sets forth the computation of basic and diluted EPS for the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Earnings attributable to common shareholders - basic and diluted:				
Net income (loss) from continuing operations	\$ 21,365	\$ (1,053)	\$ 34,035	\$ (36,124)
Allocation of income for participating shares	(138)	—	(319)	—
Net income (loss) from continuing operations attributed to common shareholders	\$ 21,227	\$ (1,053)	\$ 33,716	\$ (36,124)
Earnings per share denominator - basis and diluted				
Total weighted average common shares outstanding, including participating shares	15,057,436	14,991,232	15,073,479	14,977,378
Less: weighted average participating shares	(96,920)	(112,185)	(141,242)	(125,636)
Basic earnings per share denominator	14,960,516	14,879,047	14,932,237	14,851,742
Common equivalent shares- stock options	—	—	(1) 269	—
Common equivalent shares- non-vested performance stock grants	80,561	—	(2) 56,040	—
Diluted earnings per share denominator	15,041,077	14,879,047	14,988,546	14,851,742
Basic earnings (loss) per share	\$ 1.42	\$ (0.07)	\$ 2.26	\$ (2.43)
Diluted earnings (loss) per share	\$ 1.41	\$ (0.07)	\$ 2.25	\$ (2.43)
Undistributed earnings (loss) attributable to common shareholders - basic and diluted:				
Net income (loss) from continuing operations attributable to common shareholders -Basic	\$ 1.42	\$ (0.07)	\$ 2.26	\$ (2.43)
Dividends declared	(0.70)	(0.70)	(1.40)	(1.40)
Undistributed earnings (loss)	\$ 0.72	\$ (0.77)	\$ 0.86	\$ (3.83)
Net income (loss) from continuing operations attributable to common shareholders -Diluted	\$ 1.41	\$ (0.07)	\$ 2.25	\$ (2.43)
Dividends declared	(0.70)	(0.70)	(1.40)	(1.40)
Undistributed earnings (loss)	\$ 0.71	\$ (0.77)	\$ 0.85	\$ (3.83)

- (1) Excludes 1,713 of common equivalent shares related to stock options because their inclusion would be anti dilutive due to the net loss of the Company.
- (2) Excludes 45,976 of common equivalent shares related to non-vested performance stock grants because their inclusion would be anti dilutive due to the net loss of the Company
- (3) Excludes 1,971 of common equivalent shares related to stock options because their inclusion would be anti dilutive due to the net loss of the Company.
- (4) Excludes 71,327 of common equivalent shares related to non-vested performance stock grants because their inclusion would be anti dilutive due to the net loss of the Company

Diluted EPS excludes stock options with exercise prices and exercise tax benefits greater than the average market price of the Company's common stock during the period because their inclusion would be anti-dilutive. There were 53 and 1,271 anti-dilutive shares related to non vested performance stock grants for the three and six months ended June 30, 2016, respectively.

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

4. Share-Based Compensation

Management Omnibus Incentive Plan

Long-term incentive compensation is provided under the Company's 2002 Management Omnibus Incentive Plan ("the Incentive Plan") which provides for a variety of share-based compensation awards, including nonqualified stock options, incentive stock options, stock appreciation rights and restricted stock ("RS") awards.

The maximum number of shares of common stock with respect to which awards may be granted is 2,500,000. The Incentive Plan was amended in March of 2013 to remove "share recycling" plan provisions. Hence, shares of stock covered by an award under the Incentive Plan that are forfeited are no longer available for issuance in connection with 2013 and future grants of awards. At June 30, 2016, there were 279,067 shares available for future grant. The Board of Directors and the Compensation Committee intend to issue more awards under the Incentive Plan in the future.

Accounting and Reporting for Stock-Based Awards

Accounting Standards Codification ("ASC") 718, Compensation —Stock Compensation requires the Company to measure and recognize the cost of employee services received in exchange for an award of equity instruments. Under the provisions of ASC 718, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period (generally the vesting period of the equity grant).

The following table summarizes stock option activity under the Incentive Plan for the six months ended June 30, 2016.



	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	6,200	\$ 42.85		
Exercised	(6,000)	\$ 42.85		
Forfeitures	(200)	\$ 42.85		
Outstanding at end of period	—	\$ —	none	\$ —
Exercisable at end of period	—	\$ —	none	\$ —

As of June 30, 2016, all stock option awards have expired and all compensation expense related to stock option awards has been recognized. The total intrinsic value of options exercised during the six months ended June 30, 2016 and 2015 was \$85 and \$74, respectively. Cash received from stock options exercised was \$257 and \$150 for the six months ended June 30, 2016 and 2015, respectively.

#### Restricted Stock

Service-based restricted stock awarded in the form of unvested shares is recorded at the market value of the Company's common stock on the grant date and amortized ratably as compensation expense over the requisite service period. Service-based restricted stock awards generally vest over a three-year period and vest 30% on the first and second anniversaries of the grant date and 40% on the third anniversary of the grant date, except for non-executive employees' restricted stock awards which vest ratably over a five-year service period and independent directors' stock awards which vest immediately. Our independent directors are subject to stock ownership guidelines, which require them to have a value four times their annual cash retainer.

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In addition to service-based awards, the Company grants performance-based restricted shares to certain employees. These performance shares cliff vest after a three-year performance period provided certain performance measures are attained. A portion of these awards, which contain a market condition, vest according to the level of total shareholder return achieved by the Company compared to its property-casualty insurance peers over a three-year period. The remainders, which contain a performance condition, vest according to the level of Company's combined ratio results compared to a target based on its property-casualty insurance peers.

Actual payouts can range from 0% to 200% of target shares awarded depending upon the level of achievement of the respective market and performance conditions during a three calendar-year performance period. Compensation expense for share awards with a performance condition is based on the probable number of awards expected to vest using the performance level most likely to be achieved at the end of the performance period.

Performance-based awards with market conditions are accounted for and measured differently from awards that have a performance or service condition. The effect of a market condition is reflected in the award's fair value on the grant date. That fair value is recognized as compensation cost over the requisite service period regardless of whether the market-based performance objective has been satisfied.

All of the Company's restricted stock awards are issued as incentive compensation and are equity classified.

The following table summarizes restricted stock activity under the Incentive Plan during the six months ended June 30, 2016, assuming a target payout for the 2016 performance-based shares.

	Shares Under Restriction	Weighted Average Fair Value	Performance-based Shares Under Restriction	Weighted Average Fair Value
Outstanding at beginning of year	112,024	\$ 54.44	99,101	\$ 55.55

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Granted	46,556	56.09	44,626	60.87
Vested and unrestricted	(56,279)	53.43	(15,289)	47.42
Forfeited	(5,520)	48.86	(27,661)	49.93
Outstanding at end of period	96,781	\$ 55.85	100,777	\$ 57.85

As of June 30, 2016, there was \$8,562 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 2.3 years. The total fair value of the shares that were vested and unrestricted during the six months ended June 30, 2016 and 2015 was \$3,732 and \$2,897, respectively. For the six months ended June 30, 2016 and 2015, the Company recorded compensation expense related to restricted stock of \$1,321 and \$990, net of income tax benefits of \$711 and \$533, respectively.

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## 5. Investments

The gross unrealized gains and losses on investments in fixed maturity securities, including redeemable preferred stocks that have characteristics of fixed maturities, and equity securities, including interests in mutual funds, and other invested assets were as follows for the periods indicated.

	As of June 30, 2016		Gross Unrealized Losses (3)		Estimated Fair Value
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	
U.S. Treasury securities	\$ 6,875	\$ 91	\$ —	\$ —	\$ 6,966
Obligations of states and political subdivisions	365,367	28,489	(175)	—	393,681
Residential mortgage-backed securities (1)	258,996	7,809	(75)	—	266,730
Commercial mortgage-backed securities	34,623	1,250	(12)	—	35,861
Other asset-backed securities	30,551	351	—	—	30,902
Corporate and other securities	372,394	9,935	(4,192)	—	378,137
Subtotal, fixed maturity securities	1,068,806	47,925	(4,454)	—	1,112,277
Equity securities (2)	103,898	16,874	(3,811)	—	116,961
Other invested assets (5)	19,304	—	—	—	19,304
Totals	\$ 1,192,008	\$ 64,799	\$ (8,265)	\$ —	\$ 1,248,542

## As of December 31, 2015

	Cost or Amortized	Gross Unrealized	Gross Unrealized Losses (3)		Estimated Fair
			Non-OTTI Unrealized	OTTI Unrealized	

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	Cost	Gains	Losses	Losses (4)	Value
U.S. Treasury securities	\$ 1,805	\$ —	\$ (4)	\$ —	\$ 1,801
Obligations of states and political subdivisions	377,188	21,160	(426)	—	397,922
Residential mortgage-backed securities (1)	237,896	5,188	(1,628)	—	241,456
Commercial mortgage-backed securities	28,851	30	(218)	—	28,663
Other asset-backed securities	24,037	39	(145)	—	23,931
Corporate and other securities	394,194	4,191	(10,521)	—	387,864
Subtotal, fixed maturity securities	1,063,971	30,608	(12,942)	—	1,081,637
Equity securities (2)	102,541	13,498	(5,835)	—	110,204
Other invested assets (5)	17,602	—	—	—	17,602
Totals	\$ 1,184,114	\$ 44,106	\$ (18,777)	\$ —	\$ 1,209,443

- (1) Residential mortgage-backed securities consists primarily of obligations of U.S. Government agencies including collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank (FHLB).
- (2) Equity securities included interests in mutual funds held to fund the Company's executive deferred compensation plan.
- (3) Our investment portfolio included 259 and 514 securities in an unrealized loss position at June 30, 2016 and December 31, 2015, respectively.
- (4) Amounts in this column represent other-than-temporary impairment ("OTTI") recognized in accumulated other comprehensive income.
- (5) Other invested assets are accounted for under the equity method which approximated fair value.

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The amortized cost and the estimated fair value of fixed maturity securities, by maturity, are shown below for the period indicated. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	As of June 30, 2016	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 30,606	\$ 30,764
Due after one year through five years	254,828	258,737
Due after five years through ten years	171,530	176,936
Due after ten years through twenty years	283,751	308,136
Due after twenty years	3,922	4,212
Asset-backed securities	324,169	333,492
Totals	\$ 1,068,806	\$ 1,112,277

The gross realized losses and gains on sales of investments were as follows for the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Gross realized gains				
Fixed maturity securities	\$ 172	\$ 82	\$ 224	\$ 265
Equity securities	685	506	1,111	1,443
Gross realized losses				
Fixed maturity securities	(409)	(727)	(991)	(1,218)
Equity securities	(88)	(34)	(307)	(252)
Net realized gains (losses) on investments	\$ 360	\$ (173)	\$ 37	\$ 238

In the normal course of business, the Company enters into transactions involving various types of financial instruments, including investments in fixed maturities and equity securities. Investment transactions have credit

exposure to the extent that a counter party may default on an obligation to the Company. Credit risk is a consequence of carrying, trading and investing in securities. To manage credit risk, the Company focuses on higher quality fixed income securities, reviews the credit strength of all companies in which it invests, limits its exposure in any one investment and monitors the portfolio quality, taking into account credit ratings assigned by recognized statistical rating organizations.

The following tables as of June 30, 2016 and December 31, 2015 present the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities aggregated by investment category. The tables also present the length of time that they have been in a continuous unrealized loss position.

	As of June 30, 2016		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. Treasury securities	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Obligations of states and political subdivisions	14,643	175	—	—	14,643	175
Residential mortgage-backed securities	6,361	37	5,918	38	12,279	75
Commercial mortgage-backed securities	1,597	12	—	—	1,597	12
Other asset-backed securities	—	—	—	—	—	—
Corporate and other securities	34,152	1,001	32,495	3,191	66,647	4,192
Subtotal, fixed maturity securities	56,753	1,225	38,413	3,229	95,166	4,454
Equity securities	8,188	656	18,306	3,155	26,494	3,811
Total temporarily impaired securities	\$ 64,941	\$ 1,881	\$ 56,719	\$ 6,384	\$ 121,660	\$ 8,265

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	As of December 31, 2015					
	Less than 12 Months Estimated Fair Value	Unrealized Losses	12 Months or More Estimated Fair Value	Unrealized Losses	Total Estimated Fair Value	Unrealized Losses
U.S. Treasury securities	\$ 1,801	\$ 4	\$ —	\$ —	\$ 1,801	\$ 4
Obligations of states and political subdivisions	34,837	342	4,777	84	39,614	426
Residential mortgage-backed securities	85,561	860	32,845	768	118,406	1,628
Commercial mortgage-backed securities	26,113	218	—	—	26,113	218
Other asset-backed securities	14,454	145	—	—	14,454	145
Corporate and other securities	173,493	5,528	33,522	4,993	207,015	10,521
Subtotal, fixed maturity securities	336,259	7,097	71,144	5,845	407,403	12,942
Equity securities	19,409	1,739	12,054	4,096	31,463	5,835
Total temporarily impaired securities	\$ 355,668	\$ 8,836	\$ 83,198	\$ 9,941	\$ 438,866	\$ 18,777

## Other-Than-Temporary Impairments

ASC 320, Investments – Debt and Equity Securities requires entities to separate an OTTI of a debt security into two components when there are credit related losses associated with the impaired debt security for which the Company asserts that it does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its cost basis. Under ASC 320, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors is recorded as a component of other comprehensive income (loss). In instances where no credit loss exists but it is more likely than not that the Company will have to sell the debt security prior to the anticipated recovery, the decline in market value below amortized cost is recognized as an OTTI in earnings. In periods after the recognition of an OTTI on debt securities, the Company accounts for such securities as if they had been purchased on the measurement date of the OTTI at an amortized cost basis equal to the previous amortized cost basis less the OTTI recognized in earnings. For debt securities for which OTTI was recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected will be accreted or amortized into net investment income.



The Company holds no subprime mortgage debt securities. All of the Company's holdings in mortgage-backed securities are either U.S. Government or Agency guaranteed or are rated investment grade by either Moody's or Standard & Poor's.

The unrealized losses in the Company's fixed income and equity portfolio as of June 30, 2016 were reviewed for potential other-than-temporary asset impairments. The Company held four debt securities at December 31, 2015 with a material (20% or greater) unrealized loss for four or more consecutive quarters that additionally had certain qualitative factors that led to an impairment charge. As a result of our analysis, during the three and six months ended June 30, 2016, the Company recognized OTTI of \$137 and \$429, respectively, which consisted entirely of credit losses related to fixed maturity securities. There was no OTTI related to fixed maturity securities during the six months ended June 30, 2015.

Specific qualitative analysis was also performed for any additional securities appearing on the Company's "Watch List," if any. Qualitative analysis considered such factors as the financial condition and the near term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, changes to the rating of the security by a rating agency and the historical volatility of the fair value of the security.

The qualitative analysis performed by the Company concluded that outside of the securities that were recognized through OTTI, the unrealized losses recorded on the investment portfolio at June 30, 2016 resulted from fluctuations in market interest rates and other temporary market conditions as opposed to fundamental changes in the credit quality of the issuers of such securities. Therefore, decreases in fair values of the Company's securities are viewed as being temporary.

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The following table summarizes the credit loss recognized in earnings related to fixed maturity securities.

	Three Months		Six Months	
	Ended	June 30,	Ended	June 30,
	2016	2015	2016	2015
Credit losses on fixed maturity securities, beginning of period	\$ 918	\$ -	\$ 796	\$ -
Add: credit losses on OTTI not previously recognized	137	-	429	-
Less: credit losses on securities sold	-	-	(170)	-
Less: credit losses on securities impaired due to intent to sell	-	-	-	-
Add: credit losses on previously impaired securities	-	-	-	-
Less: increases in cash flows expected on previously impaired securities	-	-	-	-
Credit losses on fixed maturity securities, end of period	\$ 1,055	\$ -	\$ 1,055	\$ -

At June 30, 2016 and December 31, 2015, there were no amounts included in accumulated other comprehensive income related to securities which were considered by the Company to be other-than-temporarily impaired.

Based upon the qualitative analysis performed, the Company's decision to hold these securities, the Company's current level of liquidity and our history of positive operating cash flows, management believes it is more likely than not that it will not be required to sell any of its securities before the anticipated recovery in the fair value to its amortized cost basis.

## Net Investment Income

The components of net investment income were as follows:

Three Months		Six Months Ended	
Ended	June 30,	June 30,	June 30,
2016	2015	2016	2015

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Interest on fixed maturity securities	\$ 9,260	\$ 9,971	\$ 18,529	\$ 20,157
Dividends on equity securities	753	729	1,560	1,422
Equity in earnings of other invested assets	257	258	416	591
Interest on other assets	16	22	32	40
Interest on cash and cash equivalents	32	1	43	2
Total investment income	10,318	10,981	20,580	22,212
Investment expenses	677	664	1,312	1,338
Net investment income	\$ 9,641	\$ 10,317	\$ 19,268	\$ 20,874

Fair Value Measurements

ASC 820, Fair Value Measurements and Disclosure provides a revised definition of fair value, establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value information. Under ASC 820, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (an exit price). ASC 820 establishes a fair value hierarchy that distinguishes between inputs based on market data from independent sources (“observable inputs”) and a reporting entity’s internal assumptions based upon the best information available when external market data is limited or unavailable (“unobservable inputs”). The fair value hierarchy in ASC 820 prioritizes fair value measurements into three levels based on the nature of the inputs as follows:

Level 1 — Valuations based on quoted prices in active markets for identical assets and liabilities;

Level 2 — Valuations based on observable inputs that do not meet the criteria for Level 1, including quoted prices in inactive markets and quoted prices in active markets for similar, but not identical instruments; and

Level 3 — Valuations based on unobservable inputs.

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Fair values for the Company's fixed maturity securities are based on prices provided by its custodian bank and its investment managers. Both the Company's custodian bank and investment managers use a variety of independent, nationally recognized pricing services to determine market valuations. If the pricing service cannot provide fair value determinations, the Company obtains non-binding price quotes from broker-dealers. A minimum of two quoted prices is obtained for the majority of the Company's available-for-sale fixed maturity securities in its investment portfolio. The Company's custodian bank is its primary provider of quoted prices from third-party pricing services and broker-dealers. To provide reasonable assurance of the validity of each price or quote, a secondary third-party pricing service or broker-dealer quote is obtained from the Company's investment managers. An examination of the pricing data is then performed for each security. If the variance between the primary and secondary price quotes for a security is within an accepted tolerance level, the quoted price obtained from the Company's custodian bank is used in the financial statements for the security. If the variance between the primary and secondary price quotes exceeds an accepted tolerance level, the Company obtains a quote from an alternative source, if possible, and documents and resolves any differences between the pricing sources. In addition, the Company may request that its investment managers and its traders provide input as to which vendor is providing prices that its traders believe are reflective of fair value for the security. Following this process, the Company may decide to value the security in its financial statements using the secondary or alternative source if it believes that pricing is more reflective of the security's value than the primary pricing provided by its custodian bank. The Company analyzes market valuations received to verify reasonableness, to understand the key assumptions used and their sources, and to determine an appropriate ASC 820 fair value hierarchy level based upon trading activity and the observability of market inputs. Based on this evaluation and investment class analysis, each price is classified into Level 1, 2 or 3.

Fair values of instruments are based on (i) quoted prices in active markets for identical assets (Level 1), (ii) quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-derived valuations in which all significant inputs are observable in active markets (Level 2) or (iii) valuations derived from valuation techniques in which one or more significant inputs are unobservable in the marketplace (Level 3).

The Company's Level 1 securities consist of equity securities whose values are based on quoted prices in active markets for identical assets. The Company's Level 2 securities are comprised of available-for-sale fixed maturity securities whose fair value was determined using observable market inputs. The Company's Level 3 security consists of an investment in the Federal Home Loan Bank of Boston related to Safety Insurance Company's membership stock, which is not redeemable in a short-term time frame. Fair values for securities for which quoted market prices were unavailable were estimated based upon reference to observable inputs such as benchmark interest rates, market comparables, and other relevant inputs. Investments valued using these inputs include U.S. Treasury securities, obligations of states and political subdivisions, corporate and other securities, commercial and residential mortgage-backed securities, and other asset-backed securities. Inputs into the fair value application that are utilized by asset class include but are not limited to:

- Obligations of states and political subdivisions: overall credit quality, including assessments of market sectors and the level and variability of sources of payment such as general obligation, revenue or lease; credit support such as insurance, state or local economic and political base, prefunded and escrowed to maturity covenants.
- Corporate and other securities: overall credit quality, the establishment of a risk adjusted credit spread over the applicable risk-free yield curve for discounted cash flow valuations; assessments of the level of industry economic sensitivity, company financial policies, indenture restrictive covenants, and/or security and collateral.
- Residential mortgage-backed securities, U.S. agency pass-throughs, collateralized mortgage obligations (“CMOs”), non U.S. agency CMOs: estimates of prepayment speeds based upon historical prepayment rate trends, underlying collateral interest rates, original weighted average maturity, vintage year, borrower credit quality characteristics, interest rate and yield curve forecasts, U.S. government support programs, tax policies, and delinquency/default trends.

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- Commercial mortgage-backed securities: overall credit quality, including assessments of the level and variability of credit support and collateral type such as office, retail, or lodging, predictability of cash flows for the deal structure, prevailing economic market conditions.
- Other asset-backed securities: overall credit quality, estimates of prepayment speeds based upon historical trends and characteristics of underlying loans, including assessments of the level and variability of collateral, revenue generating agreements, area licenses agreements, product sourcing agreements and equipment and property leases.
- Federal Home Loan Bank of Boston (“FHLB-Boston”): value is equal to the cost of the member stock purchased.

In order to ensure the fair value determination is representative of an exit price (consistent with ASC 820), the Company’s procedures for validating quotes or prices obtained from third parties include, but are not limited to, obtaining a minimum of two price quotes for each fixed maturity security if possible, as discussed above, the periodic testing of sales activity to determine if there are any significant differences between the market price used to value the security as of the balance sheet date and the sales price of the security for sales that occurred around the balance sheet date, and the periodic review of reports provided by its investment manager regarding those securities with ratings changes and securities placed on its “Watch List.” In addition, valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by the Company’s external investment manager, whose investment professionals are familiar with the securities being priced and the markets in which they trade, to ensure the fair value determination is representative of an exit price (consistent with ASC 820).

All unadjusted estimates of fair value for our fixed maturities priced by the pricing services as described above are included in the amounts disclosed in Level 2. With the exception of the FHLB-Boston security, which are categorized as a Level 3 security, the Company’s entire available-for-sale portfolio was priced based upon quoted market prices or other observable inputs as of June 30, 2016. There were no significant changes to the valuation process during the six months ended June 30, 2016. As of June 30, 2016 and December 31, 2015, no quotes or prices obtained were adjusted by management. All broker quotes obtained were non-binding.

At June 30, 2016 and December 31, 2015, investments in fixed maturities and equity securities classified as available-for-sale had a fair value which equaled carrying value of \$1,229,238 and \$1,191,841, respectively. We have no short-term investments. The carrying values of cash and cash equivalents and investment income accrued approximated fair value.

The following tables summarize the Company’s total fair value measurements for available-for-sale investments for the periods indicated.

	As of June 30, 2016			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
U.S. Treasury securities	\$ 6,966	\$ —	\$ 6,966	\$ —
Obligations of states and political subdivisions	393,681	—	393,681	—
Residential mortgage-backed securities	266,730	—	266,730	—
Commercial mortgage-backed securities	35,861	—	35,861	—
Other asset-backed securities	30,902	—	30,902	—
Corporate and other securities	378,137	—	378,137	—
Equity securities	97,480	96,802	—	678
Total investment securities	\$ 1,209,757	\$ 96,802	\$ 1,112,277	\$ 678

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	As of December 31, 2015			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
U.S. Treasury securities	\$ 1,801	\$ —	\$ 1,801	\$ —
Obligations of states and political subdivisions	397,922	—	397,922	—
Residential mortgage-backed securities	241,456	—	241,456	—
Commercial mortgage-backed securities	28,663	—	28,663	—
Other asset-backed securities	23,931	—	23,931	—
Corporate and other securities	387,864	—	387,864	—
Equity securities	91,107	90,560	—	547
Total investment securities	\$ 1,172,744	\$ 90,560	\$ 1,081,637	\$ 547

There were no transfers between Level 1 and Level 2 during the three and six months ended June 30, 2016 and 2015.

The following table summarizes the changes in the Company's Level 3 fair value securities for the periods indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	Level 3 Fair Value Securities	Level 3 Fair Value Securities	Level 3 Fair Value Securities	Level 3 Fair Value Securities
Balance at beginning of period	\$ 547	505	\$ 547	\$ 505
Net gains and losses included in earnings	—	—	—	—
Net gains included in other comprehensive income	—	—	—	—
Purchases	131	42	131	42
Sales	—	—	—	—
Transfers into Level 3	—	—	—	—
Transfers out of Level 3	—	—	—	—
Balance at end of period	\$ 678	\$ 547	\$ 678	\$ 547
Amount of total losses included in earnings attributable to the change in unrealized losses related to assets still held at end of period	\$ —	\$ —	\$ —	\$ —



Transfers in and out of Level 3 are attributable to changes in the ability to observe significant inputs in determining fair value exit pricing. As noted in the table above, no transfers were made in or out of Level 3 during 2016 and 2015. The Company held one Level 3 security at June 30, 2016 and June 30, 2015.

As of June 30, 2016 and December 31, 2015, there were approximately \$19,481 and \$19,097 in a real estate investment trust ("REIT"). The REIT is excluded from the fair value hierarchy because the fair value is recorded using the net asset value per share practical expedient. The net asset value per share of this REIT is derived from member ownership in the capital venture to which a proportionate share of independently appraised net assets is attributed. The fair value was determined using the trust's net asset value obtained from its audited financial statements. The Company is required to submit a request 45 days before a quarter end to dispose of the security.

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## 6. Loss and Loss Adjustment Expense Reserves

The following table sets forth a reconciliation of beginning and ending reserves for losses and loss adjustment expenses (“LAE”), as shown in the Company’s consolidated financial statements for the periods indicated.

	Six Months Ended	
	June 30,	
	2016	2015
Reserves for losses and LAE at beginning of year	\$ 553,977	\$ 482,012
Less receivable from reinsurers related to unpaid losses and LAE	(68,261)	(61,245)
Net reserves for losses and LAE at beginning of year	485,716	420,767
Incurred losses and LAE, related to:		
Current year	262,990	367,361
Prior years	(21,867)	(12,011)
Total incurred losses and LAE	241,123	355,350
Paid losses and LAE related to:		
Current year	138,530	214,397
Prior years	122,270	88,681
Total paid losses and LAE	260,800	303,078
Net reserves for losses and LAE at end of period	466,039	473,039
Plus receivable from reinsurers related to unpaid losses and LAE	78,043	87,396
Reserves for losses and LAE at end of period	\$ 544,082	\$ 560,435

At the end of each period, the reserves were re-estimated for all prior accident years. The Company’s prior year reserves decreased by \$21,867 and \$12,011 for the six months ended June 30, 2016 and 2015, respectively, and resulted from re-estimations of prior years ultimate loss and LAE liabilities. The decreases in prior years reserves during the six months ended June 30, 2016 and 2015, periods are primarily composed of reductions in our retained automobile and retained homeowners reserves.

The Company's automobile lines of business reserves decreased for the six months ended June 30, 2016 and 2015, primarily due to fewer incurred but not yet reported claims than previously estimated and better than previously estimated severity on the Company's established bodily injury and property damage case reserves. Due to the nature of the risks that the Company underwrites and has historically underwritten, management does not believe that it has an exposure to asbestos or environmental pollution liabilities.

## 7. Commitments and Contingencies

On December 15, 2015, the Company filed for arbitration with a reinsurer in regards to the reinsurance recoverable resulting from the 2015 winter storm losses that are admissible under our contract. The total amount of recoverable in dispute, which is based on our total incurred loss, is \$22,838. No provision for collectability has been recorded in the financial statements as we believe the recoverable is valid and will be recovered.

Various claims, generally incidental to the conduct of normal business, are pending or alleged against the Company from time to time. In the opinion of management, based in part on the advice of legal counsel, the ultimate resolution of such claims will not have a material adverse effect on the Company's consolidated financial statements. However, if estimates of the ultimate resolutions of those proceedings are revised, liabilities related to those proceedings could be adjusted in the near term.

Massachusetts law requires that insurers licensed to do business in Massachusetts participate in the Massachusetts Insurers Insolvency Fund ("Insolvency Fund"). Members of the Insolvency Fund are assessed a proportionate share of the obligations and expenses of the Insolvency Fund in connection with an insolvent insurer. It is anticipated that there will be additional assessments from time to time relating to various insolvencies. Although the

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timing and amounts of any future assessments are not known, based upon existing knowledge, management's opinion is that such future assessments are not expected to have a material effect upon the financial position of the Company.

8. Debt

The Company has a Revolving Credit Agreement (the "Credit Agreement") with Citizens Bank, N.A. (formerly known as RBS Citizens, N.A. ("Citizens Bank")). The Credit Agreement provides a \$30,000 revolving credit facility with an accordion feature allowing for future expansion of the committed amount up to \$50,000. Loans under the credit facility bear interest at the Company's option at either (i) the LIBOR rate plus 1.25% per annum or (ii) the higher of Citizens Bank prime rate or 0.5% above the federal funds rate plus 1.25% per annum. Interest only is payable prior to maturity. The Credit Agreement has a maturity date of August 14, 2018.

The Company's obligations under the credit facility are secured by pledges of its assets and the capital stock of its operating subsidiaries. The credit facility is guaranteed by the Company's non-insurance company subsidiaries. The credit facility contains covenants including requirements to maintain minimum risk-based capital ratios and statutory surplus of Safety Insurance Company as well as limitations or restrictions on indebtedness, liens, and other matters. As of June 30, 2016, the Company was in compliance with all covenants. In addition, the credit facility includes customary events of default, including a cross-default provision permitting the lenders to accelerate the facility if the Company (i) defaults in any payment obligation under debt having a principal amount in excess of \$10,000 or (ii) fails to perform any other covenant permitting acceleration of all such debt.

The Company had no amounts outstanding on its credit facility at June 30, 2016 and December 31, 2015. The credit facility commitment fee included in interest expense was computed at a rate of 0.25% per annum on the \$30,000 commitment at June 30, 2016 and 2015.

Safety Insurance Company is a member of the FHLB-Boston. Membership in the FHLB-Boston allows the Company to borrow money at competitive interest rates provided the loan is collateralized by specific U.S Government residential mortgage backed securities. At June 30, 2016, the Company has the ability to borrow \$197,337 using eligible invested assets that would be used as collateral. The Company has no amounts outstanding from the FHLB-Boston at June 30, 2016 and at December 31, 2015.

## 9. Income Taxes

Federal income tax expense for the six months ended June 30, 2016 and 2015 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect the current estimates of the annual effective tax rates. The effective rate in 2016 was lower than the statutory rate primarily due to adjustments for tax-exempt investment income. The 2015 effective rate is the result of the expected tax benefit related to net losses incurred by the Company during the year end December 31, 2015, calculated under ASC 740, Income Taxes (ASC 740-270-55), and adjustments for tax-exempt investment income.

The Company believes that the positions taken on its income tax returns for open tax years will be sustained upon examination by the Internal Revenue Service ("IRS"). Therefore, the Company has not recorded any liability for uncertain tax positions under ASC 740, Income Taxes.

During the six months ended June 30, 2016, there were no material changes to the amount of the Company's unrecognized tax benefits or to any assumptions regarding the amount of its ASC 740 liability.

The Company's U.S. federal tax return for the year ended December 31, 2011 was examined by the IRS with no findings. In the Company's opinion, adequate tax liabilities have been established for all open years. However, the

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

amount of these tax liabilities could be revised in the near term if estimates of the Company's ultimate liability are revised. Tax years prior to 2012 are closed.

10. Share Repurchase Program

On August 3, 2007, the Board of Directors approved a share repurchase program of up to \$30,000 of the Company's outstanding common shares. As of June 30, 2016, the Board of Directors had cumulatively authorized increases to the existing share repurchase program of up to \$150,000 of its outstanding common shares. Under the program, the Company may repurchase shares of its common stock for cash in public or private transactions, in the open market or otherwise. The timing of such repurchases and actual number of shares repurchased will depend on a variety of factors including price, market conditions and applicable regulatory and corporate requirements. The program does not require the Company to repurchase any specific number of shares and it may be modified, suspended or terminated at any time without prior notice.

No share purchases were made by the Company under the program during the six months ended June 30, 2016 and 2015. As of June 30, 2016, the Company has purchased 2,279,570 shares at a cost of \$83,835.

11. Related Party Transactions

Mr. A. Richard Caputo, Jr., a member of the Company's Board of Directors and the Chairman of its Investment Committee, is a principal of The Jordan Company, LP ("Jordan"). In 2012, the Company participated as a lender in two loans made by syndicates of lenders to a portfolio company in which funds managed by Jordan are controlling or a significant investor. The first loan, made to Vantage Specialties, Inc., currently bears interest at a rate of 5.00% per annum and matures in February 2019. The Company's participation in the loan was \$1,415 and \$1,405 at June 30, 2016 and December 31, 2015, respectively. The loan amortizes in equal quarterly installments of 0.25% of the principal amount per quarter. The second loan, made to ARCAS Automotive (formerly known as Sequa Auto), was disposed of in 2015. The Company made the loans on the same terms as the other lenders participating in the syndicate. The loans were subject to the approval of the Company's full Investment Committee.

12. Subsequent Events

The Company has evaluated subsequent events for recognition or disclosure in the consolidated financial statements filed on Form 10-Q with the SEC and no events have occurred that require recognition or disclosure.

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Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our accompanying consolidated financial statements and notes thereto, which appear elsewhere in this document. In this discussion, all dollar amounts are presented in thousands, except share and per share data.

The following discussion contains forward-looking statements. We intend statements which are not historical in nature to be, and are hereby identified as "forward-looking statements" to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. In addition, the Company's senior management may make forward-looking statements orally to analysts, investors, the media and others. This safe harbor requires that we specify important factors that could cause actual results to differ materially from those contained in forward-looking statements made by or on behalf of us. We cannot promise that our expectations in such forward-looking statements will turn out to be correct. Our actual results could be materially different from and worse than our expectations. See "Forward-Looking Statements" below for specific important factors that could cause actual results to differ materially from those contained in forward-looking statements.

Executive Summary and Overview

In this discussion, "Safety" refers to Safety Insurance Group, Inc. and "our Company," "we," "us" and "our" refer to Safety Insurance Group, Inc. and its consolidated subsidiaries. Our subsidiaries consist of Safety Insurance Company ("Safety Insurance"), Safety Indemnity Insurance Company ("Safety Indemnity"), Safety Property and Casualty Insurance Company ("Safety P&C"), Safety Asset Management Corporation ("SAMC"), and Safety Management Corporation, which is SAMC's holding company.

We are a leading provider of private passenger and commercial automobile insurance in Massachusetts. In addition to private passenger automobile insurance (which represented 59.6% of our direct written premiums in 2015), we offer a portfolio of other insurance products, including commercial automobile (13.8% of 2015 direct written premiums), homeowners (21.7% of 2015 direct written premiums) and dwelling fire, umbrella and business owner policies (totaling 4.9% of 2015 direct written premiums). Operating exclusively in Massachusetts, New Hampshire, and Maine through our insurance company subsidiaries, Safety Insurance, Safety Indemnity, and Safety P&C (together referred to as the "Insurance Subsidiaries"), we have established strong relationships with independent insurance agents,



who numbered 924 in 1,102 locations throughout Massachusetts and New Hampshire during 2015. We have used these relationships and our extensive knowledge of the Massachusetts market to become the third largest private passenger automobile and the third largest commercial automobile insurance carrier in Massachusetts, capturing an approximate 10.2% and 14.1% share, respectively, of the Massachusetts private passenger and commercial automobile markets in 2015 according to statistics compiled by the Commonwealth Automobile Reinsurers (“CAR”) based on automobile exposures. We are also the fourth largest homeowners insurance carrier in Massachusetts with a 7.2% share of the Massachusetts homeowners insurance market.

The Insurance Subsidiaries began writing private passenger automobile and homeowners insurance in New Hampshire during 2008, personal umbrella insurance in New Hampshire during 2009, and commercial automobile insurance in New Hampshire during 2011. During the six months ended June 30, 2016 and 2015, we wrote \$12,230 and \$10,500, respectively, in direct written premiums in New Hampshire.

On February 9, 2015, the Insurance Subsidiaries each received a license to begin writing our property and casualty insurance products in the state of Maine. We began writing new business in Maine in 2016.

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## Recent Trends and Events

For the quarter ended June 30, 2016, loss and loss adjustment expense incurred decreased by \$31,882, or 21.7%, to \$115,144 from \$147,026 for the comparable 2015 period. The decrease is primarily due to the winter snowfall catastrophe losses experienced in 2015.

The following rate changes have been filed and approved by the insurance regulators of Massachusetts and New Hampshire in 2016 and 2015. Our Massachusetts private passenger automobile rates include a 13% commission rate for agents.

Line of Business	Effective Date	Rate Change
New Hampshire Homeowner	December 1, 2016	4.4%
New Hampshire Private Passenger Automobile	December 1, 2016	4.1%
Massachusetts Private Passenger Automobile	July 15, 2016	5.8%
Massachusetts Commercial Automobile	March 15, 2016	5.5%
Massachusetts Homeowner	November 1, 2015	9.1%
New Hampshire Private Passenger Automobile	November 1, 2015	5.0%
New Hampshire Homeowner	November 1, 2015	7.9%
New Hampshire Commercial Auto	August 1, 2015	7.9%
Massachusetts Private Passenger Automobile	June 1, 2015	3.8%
Massachusetts Commercial Automobile	February 1, 2015	3.5%

## Massachusetts Automobile Insurance Market

Private passenger automobile insurance, which represented 59.6% of our direct written premiums in 2015, is generally considered to be more heavily regulated in Massachusetts than in other states, under what the Massachusetts Commissioner of Insurance calls Managed Competition. Since 2008, Massachusetts automobile insurance premium rates are strictly regulated under a prior approval rate review process, governed by regulations that set certain terms and conditions that insurers must comply with in establishing their rates. Certain historically unique factors in Massachusetts exist, including compulsory insurance, affinity group marketing, and the prominence of independent agents.

CAR runs a reinsurance pool for ceded commercial automobile policies through a Limited Servicing Carrier Program ("LSC"). CAR has approved Safety and three other servicing carriers to process ceded commercial automobile insurance. Approximately \$140,000 of ceded premium is spread equitably among the four servicing carriers under a five year term ending December 31, 2016. CAR has reappointed Safety for an additional five year term ending December 31, 2021. Subject to the Commissioner's review, CAR sets the premium rates for commercial automobile

policies reinsured through CAR and this reinsurance pool can generate an underwriting result that is a profit or deficit based upon CAR's rate level. This underwriting result is allocated among every Massachusetts commercial automobile insurance company, including us, based on a company's commercial automobile voluntary market share.

CAR also runs a reinsurance pool for Taxi, Limousine and Car Service risks (the "Taxi/Limo Program"). CAR approved Safety as one of the two servicing carriers for a five year term for this program ending December 31, 2016. CAR has reappointed Safety for an additional five year term ending December 31, 2021. Approximately \$10,000 of ceded premium was spread equitably between the two servicing carriers.

We are assigned independent agents by CAR who can submit commercial business to us in the LSC and Taxi/Limo Program, and we classify those agents as commercial LSC producers.

#### Insurance Ratios

The property and casualty insurance industry uses the combined ratio as a measure of underwriting profitability. The combined ratio is the sum of the loss ratio (losses and loss adjustment expenses incurred as a percent of net earned premiums) plus the expense ratio (underwriting and other expenses as a percent of net earned premiums, calculated on a GAAP basis). The combined ratio reflects only underwriting results and does not include income from

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investments or finance and other service income. Underwriting profitability is subject to significant fluctuations due to competition, catastrophic events, weather, economic and social conditions, and other factors.

Our GAAP insurance ratios are outlined in the following table.

	Three Months		Six Months	
	Ended	June 30,	Ended	June 30,
	2016	2015	2016	2015
GAAP ratios:				
Loss ratio	61.4 %	80.6 %	64.6 %	97.4 %
Expense ratio	30.7	28.6	30.4	28.6
Combined ratio	92.1 %	109.2 %	95.0 %	126.0 %

## Share-Based Compensation

Long-term incentive compensation is provided under the Company's 2002 Management Omnibus Incentive Plan ("the Incentive Plan") which provides for a variety of share-based compensation awards, including nonqualified stock options, incentive stock options, stock appreciation rights and restricted stock ("RS") awards.

The maximum number of shares of common stock with respect to which awards may be granted is 2,500,000. The Incentive Plan was amended in March of 2013 to remove "share recycling" plan provisions. Hence, shares of stock covered by an award under the Incentive Plan that are forfeited are no longer available for issuance in connection with 2013 and future grants of awards. At June 30, 2016, there were 279,067 shares available for future grant. The Board of Directors and the Compensation Committee intend to issue more awards under the Incentive Plan in the future.

A summary of share based awards granted under the Incentive Plan during the six months ended June 30, 2016 is as follows:

Type of Equity	Number of Awards	Fair Value per
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Awarded	Effective Date	Granted	Share	Vesting Terms
RS	February 23, 2016	4,000	\$ 56.07	(1) No vesting period (3)
RS	March 31, 2016	1,000	\$ 57.06	(1) No vesting period (3)
RS - Service	February 23, 2016	24,479	\$ 56.07	(1) 3 years, 30%-30%-40%
RS - Service	February 23, 2016	17,077	\$ 56.07	(1) 5 years, 20% annually (5)
RS - Performance	February 23, 2016	34,626	\$ 60.72	(2) 3 years, cliff vesting (4)
RS - Performance	April 1, 2016	10,000	\$ 61.38	(2) 3 years, cliff vesting (4)

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- (1) The fair value per share of the restricted stock grant is equal to the closing price of our common stock on the grant date.
  - (2) The fair value per share of the restricted stock grant is equal to the performance-based restricted stock award calculation.
  - (3) Board of Director members must maintain stock ownership equal to at least four times their annual retainer. This requirement must be met within five years of becoming a director.
  - (4) The shares represent performance-based restricted shares award. Vesting of these shares is dependent upon the attainment of pre-established performance objectives, and any difference between shares granted and shares earned at the end of the performance period will be reported at the conclusion of the performance period.
  - (5) The shares represent awards granted to non-executive employees and vest ratably over a five-year service period.

#### Reinsurance

We reinsure with other insurance companies a portion of our potential liability under the policies we have underwritten, thereby protecting us against an unexpectedly large loss or a catastrophic occurrence that could produce large losses, primarily in our homeowners line of business. We use various software products to measure our exposure to catastrophe losses and the probable maximum loss to us for catastrophe losses such as hurricanes. The models include estimates for our share of the catastrophe losses generated in the residual market for property insurance by the Massachusetts Property Insurance Underwriting Association ("FAIR Plan"). The reinsurance market has seen from the various software modelers, increases in the estimate of damage from hurricanes in the southern and northeast portions of the United States due to revised estimations of increased hurricane activity and increases in the estimation of demand

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surge in the periods following a significant event. We continue to manage and model our exposure and adjust our reinsurance programs as a result of the changes to the models. As of January 1, 2016, we have purchased four layers of excess catastrophe reinsurance providing \$615,000 of coverage for property losses in excess of \$50,000 up to a maximum of \$665,000. Our reinsurers' co-participation is 65.0% of \$100,000 for the 1st layer, 80.0% of \$280,000 for the 2nd layer, 80.0% of \$135,000 for the 3rd layer and 80.0% of \$100,000 for the 4th layer. As a result of the changes to the models, and our revised reinsurance program, our catastrophe reinsurance in 2016 protects us in the event of a "133-year storm" (that is, a storm of a severity expected to occur once in a 133-year period). Swiss Re, our primary reinsurer, maintains an A.M. Best rating of "A" (Excellent). Most of our other reinsurers have an A.M. Best rating of "A+" (Excellent) or "A" (Excellent).

We are a participant in CAR, a state-established body that runs the residual market reinsurance programs for commercial automobile insurance in Massachusetts under which premiums, expenses, losses and loss adjustment expenses on ceded business are shared by all insurers writing automobile insurance in Massachusetts. We also participate in the FAIR Plan in which premiums, expenses, losses and loss adjustment expenses on homeowners business that cannot be placed in the voluntary market are shared by all insurers writing homeowners insurance in Massachusetts. The FAIR Plan buys reinsurance to reduce their exposure to catastrophe losses. On July 1, 2015, the FAIR Plan purchased \$1,325,000 of catastrophe reinsurance for property losses with retention of \$100,000.

At June 30, 2016, our total expected reinsurance recovery from reinsurers under our catastrophe reinsurance program related to the 2015 snow event is \$67,934. Amounts recoverable from reinsurers are billed to the reinsurer as claims are paid by the Company. At June 30, 2016, the reinsurance recoverable on paid and unpaid loss and loss adjustment expense related to the 2015 snow event is \$33,353.

On December 15, 2015, the Company filed for arbitration with a reinsurer in regards to the reinsurance recoverable resulting from the 2015 winter storm losses that are admissible under our contract. The total amount of recoverable in dispute, which is based on our total incurred loss, is \$22,838. No provision for collectability has been recorded in the financial statements as we believe the recoverable is valid and will be recovered.

We also had \$66,959 recoverable from CAR comprising of loss adjustment expense reserves, unearned premiums and reinsurance recoverable.

## Effects of Inflation

We do not believe that inflation has had a material effect on our consolidated results of operations, except insofar as inflation may affect interest rates.



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## Results of Operations

## Six Months Ended June 30, 2016 Compared to Six Months Ended June 30, 2015

The following table shows certain of our selected financial results.

	Three Months		Six Months Ended	
	Ended June 30,		June 30,	
	2016	2015	2016	2015
Direct written premiums	\$ 221,359	\$ 213,246	\$ 417,311	\$ 407,979
Net written premiums	\$ 207,906	\$ 204,177	\$ 393,558	\$ 389,467
Net earned premiums	\$ 187,393	\$ 182,447	\$ 373,047	\$ 365,011
Net investment income	9,641	10,317	19,268	20,874
Earnings from partnership investments	1,409	577	2,287	577
Net realized gains (losses) on investments	360	(173)	37	238
Net impairment losses on investments (a)	(137)	—	(429)	—
Finance and other service income	4,284	4,434	8,569	8,941
Total revenue	202,950	197,602	402,779	395,641
Loss and loss adjustment expenses	115,144	147,026	241,123	355,350
Underwriting, operating and related expenses	57,513	52,198	113,470	104,295
Interest expense	23	23	45	45
Total expenses	172,680	199,247	354,638	459,690
Income (loss) before income taxes	30,270	(1,645)	48,141	(64,049)
Income tax expense (credit)	8,905	(592)	14,106	(27,925)
Net income (loss)	\$ 21,365	\$ (1,053)	\$ 34,035	\$ (36,124)
Earnings (loss) per weighted average common share:				
Basic	\$ 1.42	\$ (0.07)	\$ 2.26	\$ (2.43)
Diluted	\$ 1.41	\$ (0.07)	\$ 2.25	\$ 2.43
Cash dividends paid per common share	\$ 0.70	\$ 0.70	\$ 1.40	\$ 1.40

**Direct Written Premiums.** Direct written premiums for the quarter ended June 30, 2016 increased by \$8,113, or 3.8%, to \$221,359 from \$213,246 for the comparable 2015 period. Direct written premiums for the six months ended June 30, 2016 increased by \$9,332, or 2.3%, to \$417,311 from \$407,979 for the comparable 2015 period. The 2016 increase occurred primarily in our homeowners and commercial automobile lines of business, which experienced increases in average written premium per exposure of 8.4% and 7.4%, respectively.



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Net Written Premiums. Net written premiums for the quarter ended June 30, 2016 increased by \$3,729, or 1.8%, to \$207,906 from \$204,177 for the comparable 2015 period. Net written premiums for the six months ended June 30, 2016 increased by \$4,091, or 1.1%, to \$393,558 from \$389,467 for the comparable 2015 period.

Net Earned Premiums. Net earned premiums for the quarter ended June 30, 2016 increased by \$4,946, or 2.7%, to \$187,393 from \$182,447 for the comparable 2015 period. Net earned premiums for the six months ended June 30, 2016 increased by \$8,036, or 2.2%, to \$373,047 from \$365,011 for the comparable 2015 period.

The effect of reinsurance on net written and net earned premiums is presented in the following table.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Written Premiums				
Direct	\$ 221,359	\$ 213,246	\$ 417,311	\$ 407,979
Assumed	8,414	6,640	15,554	13,932
Ceded	(21,867)	(15,709)	(39,307)	(32,444)
Net written premiums	\$ 207,906	\$ 204,177	\$ 393,558	\$ 389,467
Earned Premiums				
Direct	\$ 197,090	\$ 192,574	\$ 391,385	\$ 383,285
Assumed	7,631	5,762	15,306	12,600
Ceded	(17,328)	(15,889)	(33,644)	(30,874)
Net earned premiums	\$ 187,393	\$ 182,447	\$ 373,047	\$ 365,011

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**Net Investment Income.** Net investment income for the quarter ended June 30, 2016 decreased by \$676, or 6.6%, to \$9,641 from \$10,317 for the comparable 2015 period. Net investment income for the six months ended June 30, 2016 decreased by \$1,606, or 7.7%, to \$19,268 from \$20,874 for the comparable 2015 period. The decrease is a result of changes in the average invested asset balance as a result of investment proceeds used in the payment of claims resulting from the 2015 winter events. Net effective annualized yield on the investment portfolio was 3.2% for both the quarter and the six months ended June 30, 2016. The investment portfolio's duration was 4.0 years at June 30, 2016 compared to 4.1 years at December 31, 2015.

**Earnings from Partnership Investments.** Earnings from partnership investments was \$1,409 for the quarter ended June 30, 2016 compared to earnings from partnership investment of \$577 for the comparable 2015 period. Earnings from partnership investments was \$2,287 for the six months ended June 30, 2016 compared to \$577 for the comparable 2015 period.

**Net Realized Gains (Losses) on Investments.** Net realized gains on investments was \$360 for the quarter ended June 30, 2016 compared to net realized losses of \$173 for the comparable 2015 period. Net realized gains on investments was \$37 for the six months ended June 30, 2016 compared to net realized gains of \$238 for the comparable 2015 period.

The gross unrealized gains and losses on investments in fixed maturity securities, equity securities, including interests in mutual funds, and other invested assets were as follows:

	As of June 30, 2016		Gross Unrealized Losses (3)		Estimated Fair Value
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	
U.S. Treasury securities	\$ 6,875	\$ 91	\$ —	\$ —	\$ 6,966
Obligations of states and political subdivisions	365,367	28,489	(175)	—	393,681
Residential mortgage-backed securities (1)	258,996	7,809	(75)	—	266,730
Commercial mortgage-backed securities	34,623	1,250	(12)	—	35,861
Other asset-backed securities	30,551	351	—	—	30,902
Corporate and other securities	372,394	9,935	(4,192)	—	378,137
Subtotal, fixed maturity securities	1,068,806	47,925	(4,454)	—	1,112,277
Equity securities (2)	103,898	16,874	(3,811)	—	116,961
Other invested assets (5)	19,304	—	—	—	19,304

Totals	\$ 1,192,008	\$ 64,799	\$ (8,265)	\$ —	\$ 1,248,542
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- (1) Residential mortgage-backed securities consists primarily of obligations of U.S. Government agencies including collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank (FHLB).
- (2) Equity securities include interests in mutual funds held to fund the Company's executive deferred compensation plan.
- (3) Our investment portfolio included 259 securities in an unrealized loss position at June 30, 2016.
- (4) Amounts in this column represent other-than-temporary impairments ("OTTI") recognized in accumulated other comprehensive income.
- (5) Other invested assets are accounted for under the equity method which approximated fair value.

The composition of our fixed income security portfolio by Moody's rating was as follows:

	As of June 30, 2016		
	Estimated Fair Value	Percent	
U.S. Treasury securities and obligations of U.S. Government agencies	\$ 273,764	24.7	%
Aaa/Aa	389,602	35.0	
A	211,835	19.0	
Baa	105,560	9.5	
Ba	48,675	4.4	
B	65,867	5.9	
Caa	8,264	0.7	
CA	276	-	
D	793	0.1	
Not rated	7,641	0.7	
Total	\$ 1,112,277	100.0	%

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Ratings are generally assigned upon the issuance of the securities and are subject to revision on the basis of ongoing evaluations. Ratings in the table are as of the date indicated.

As of June 30, 2016, our portfolio of fixed maturity investments was comprised principally of investment grade corporate fixed maturity securities, U.S. government and agency securities, and asset-backed securities. The portion of our non-investment grade portfolio of fixed maturity investments is primarily comprised of variable rate secured and senior bank loans and high yield bonds.

The following table illustrates the gross unrealized losses included in our investment portfolio and the fair value of those securities, aggregated by investment category. The table also illustrates the length of time that they have been in a continuous unrealized loss position as of June 30, 2016.

	As of June 30, 2016		As of June 30, 2016		As of June 30, 2016	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. Treasury securities	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Obligations of states and political subdivisions	14,643	175	—	—	14,643	175
Residential mortgage-backed securities	6,361	37	5,918	38	12,279	75
Commercial mortgage-backed securities	1,597	12	—	—	1,597	12
Other asset-backed securities	—	—	—	—	—	—
Corporate and other securities	34,152	1,001	32,495	3,191	66,647	4,192
Subtotal, fixed maturity securities	56,753	1,225	38,413	3,229	95,166	4,454
Equity securities	8,188	656	18,306	3,155	26,494	3,811
Total temporarily impaired securities	\$ 64,941	\$ 1,881	\$ 56,719	\$ 6,384	\$ 121,660	\$ 8,265

As of June 30, 2016, we held insured investment securities of approximately \$9,187, which represented approximately 0.7% of our total investments. Approximately \$4,675 of these securities is pre-refunded, meaning that funds have been set aside in escrow to satisfy the future interest and principal obligations of the bond.

The following table shows our insured investment securities that are backed by financial guarantors including pre-refunded securities as of June 30, 2016. We do not have any direct investment holdings in a financial guarantee insurance company.

	As of June 30, 2016		
	Total	Pre-refunded Securities	Exposure Net of Pre-refunded Securities
Municipal bonds			
Ambac Assurance Corporation	\$ -	\$ -	\$ -
Financial Guaranty Insurance Company	241	241	-
Assured Guaranty Municipal Corporation	-	-	-
National Public Finance Guaranty Corporation	8,946	4,434	4,512
Total	\$ 9,187	\$ 4,675	\$ 4,512

The Moody's ratings of the Company's insured investments held at June 30, 2016 are essentially the same with or without the investment guarantees.

We reviewed the unrealized losses in our fixed income and equity portfolio as of June 30, 2016 for potential other-than-temporary asset impairments. The Company held three debt securities at June 30, 2016 with a material (20% or greater) unrealized loss for four or more consecutive quarters. As a result of our analysis, during the three and six months ended June 30, 2016, the Company recognized OTTI of \$137 and \$429, respectively, which consisted entirely of credit losses related to fixed maturity securities. There was no OTTI related to fixed maturity securities during the six months ended June 30, 2015.

Specific qualitative analysis was also performed for securities appearing on our "Watch List," if any. Qualitative analysis considered such factors as the financial condition and the near term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, changes to the rating of the security by a rating agency and the historical volatility of the fair value of the security.

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The majority of these unrealized losses recorded on the investment portfolio at June 30, 2016 resulted from fluctuations in market interest rates and other temporary market conditions as opposed to fundamental changes in the credit quality of the issuers of such securities. Given our current level of liquidity, the fact that we do not intend to sell these securities, and that it is more likely than not that we will not be required to sell these securities prior to recovery of the cost basis of these securities, these decreases in values are viewed as being temporary.

For information regarding fair value measurements of our investment portfolio, refer to Item 1-Financial Statements, Note 5, Investments, of this Form 10-Q.

**Net Impairment Losses on Investments.** Net impairment losses on investments were \$137 and \$429 for the quarter ended June 30, 2016 and for the six months ended June 30, 2016, respectively. There were no impairment losses on investments for the six months ended June 30, 2015.

**Finance and Other Service Income.** Finance and other service income include revenues from premium installment charges, which we recognize when earned, and other miscellaneous income and fees. Finance and other service income decreased by \$150, or 3.4%, to \$4,284 for the quarter ended June 30, 2016 from \$4,434 for the comparable 2015 period. Finance and other service income decreased by \$372, or 4.2%, to \$8,569 for the six months ended June 30, 2016 from \$8,941 for the comparable 2015 period.

**Losses and Loss Adjustment Expenses.** Losses and loss adjustment expenses incurred for the quarter ended June 30, 2016 decreased by \$31,882, or 21.7%, to \$115,144 from \$147,026 for the comparable 2015 period. Losses and loss adjustment expenses incurred for the six months ended June 30, 2016 decreased by \$114,227, or 32.1%, to \$241,123 from \$355,350 for the comparable 2015 period. These decreases are primarily due to the winter snowfall catastrophe losses experienced in 2015.

Our GAAP loss ratio for the quarter ended June 30, 2016 decreased to 61.4% from 80.6% for the comparable 2015 period. Our GAAP loss ratio for the six months ended June 30, 2016 decreased to 64.6% from 97.4% for the comparable 2015 period. Our GAAP loss ratio excluding loss adjustment expenses for the quarter ended June 30, 2016 decreased to 53.2% from 72.0% for the comparable 2015 period. Our GAAP loss ratio excluding loss adjustment expenses for the six months ended June 30, 2016 decreased to 55.9% from 85.7% for the comparable 2015 period. Total prior year favorable development included in the pre-tax results for the three and six months ended June 30, 2016 was \$11,818 and \$21,867, respectively. Total prior year favorable development included in the pre-tax results for the quarter and six months ended June 30, 2015 was \$7,924 and \$12,011, respectively.

Underwriting, Operating and Related Expenses. Underwriting, operating and related expenses for the quarter ended June 30, 2016 increased by \$5,315, or 10.2%, to \$57,513 from \$52,198 for the comparable 2015 period. Underwriting, operating and related expenses for the six months ended June 30, 2016 increased by \$9,175, or 8.8%, to \$113,470 from \$104,295 for the comparable 2015 period. Our GAAP expense ratio for the quarter ended June 30, 2016 increased to 30.7% from 28.6% for the comparable 2015 period. Our GAAP expense ratio for the six months ended June 30, 2016 increased to 30.4% from 28.6% for the comparable 2015 period. The increase in underwriting, operating, and related expenses and the expense ratio is attributable to increases in contingent commissions and bonus compensation.

Interest Expense. Interest expense was \$23 for the quarter ended June 30, 2016 and 2015. Interest expense was \$45 for the six months ended June 30, 2016 and 2015. The credit facility commitment fee included in interest expense was \$37 for the six months ended June 30, 2016 and 2015.

Income Tax Expense (Credit). Our effective tax rate was 29.4% and 36.0% for the quarter ended June 30, 2016 and 2015, respectively. Our effective tax rate was 29.3% and 43.6% for the six months ended June 30, 2016 and 2015, respectively. The effective rate in 2016 was lower than the statutory rate of 35.0% primarily due to adjustments for tax-exempt investment income. The effective rate in 2015 is the result of the expected tax benefit related to the net loss of the Company, which is increased by the adjustments for tax-exempt investment income.

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Net Income (Loss). Net income for the quarter ended June 30, 2016 was \$21,365 compared to a net loss of \$1,053 for the comparable 2015 period. Net income for the six months ended June 30, 2016 was \$34,035 compared to a net loss of \$36,124 for the comparable 2016 period. The increase in net income for the six months ended June 30, 2016 compared to the six months ended June 30, 2015 was attributable primarily to catastrophic losses related to record snowfalls in 2015.

## Liquidity and Capital Resources

As a holding company, Safety's assets consist primarily of the stock of our direct and indirect subsidiaries. Our principal source of funds to meet our obligations and pay dividends to shareholders, therefore, is dividends and other permitted payments from our subsidiaries, principally Safety Insurance. Safety is the borrower under our credit facility.

Safety Insurance's sources of funds primarily include premiums received, investment income, and proceeds from sales and redemptions of investments. Safety Insurance's principal uses of cash are the payment of claims, operating expenses and taxes, the purchase of investments, and the payment of dividends to Safety.

Net cash provided by operating activities was \$29,913 during the six months ended 2016. Net cash used for operating activities was \$35,439 during the six months ended June 30, 2015. Our operations typically generate positive cash flows from operations as most premiums are received in advance of the time when claim and benefit payments are required. The net cash used by operating activities for the six months ended June 30, 2015 was the result of claims paid related to the increase in loss expense due to the significant snowfall totals experienced. Positive operating cash flows are expected to continue in the future to meet our liquidity requirements.

Net cash used for investing activities was \$12,418 during the six months ended June 30, 2016 compared to net cash provided by investing activities of \$35,111 during the six months ended June 30, 2015. Proceeds from maturities, redemptions, calls and sales, of securities were \$120,353 during the six months ended June 30, 2016 compared to \$156,134 for the comparable prior year period.

Net cash used for financing activities was \$20,936 and \$20,834 during the six months ended June 30, 2016 and 2015, respectively. Net cash used for financing activities is primarily comprised of dividend payments to shareholders.

The Insurance Subsidiaries maintain a high degree of liquidity within their respective investment portfolios in fixed maturity and equity securities. We do not anticipate the need to sell these securities to meet the Insurance Subsidiaries cash requirements. We expect the Insurance Subsidiaries to generate sufficient operating cash to meet all short-term



and long-term cash requirements. However, there can be no assurance that unforeseen business needs or other items will not occur causing us to have to sell securities before their values fully recover; thereby causing us to recognize additional impairment charges in that time period.

#### Credit Facility

For information regarding our Credit Facility, please refer to Item 1- Financial Statements, Note 8, Debt, of this Form 10-Q.

#### Recent Accounting Pronouncements

For information regarding Recent Accounting Pronouncements, please refer to Item 1- Financial Statements, Note 2, Recent Accounting Pronouncements, of this Form 10-Q.

#### Regulatory Matters

Our Insurance Subsidiaries are subject to various regulatory restrictions that limit the maximum amount of dividends available to be paid to their parent without prior approval of the Commissioner. The Massachusetts statute limits the dividends an insurer may pay in any twelve-month period, without the prior permission of the Commissioner,

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to the greater of (i) 10% of the insurer's surplus as of the preceding December 31 or (ii) the insurer's net income for the twelve-month period ending the preceding December 31, in each case determined in accordance with statutory accounting practices. Our insurance company subsidiaries may not declare an "extraordinary dividend" (defined as any dividend or distribution that, together with other distributions made within the preceding twelve months, exceeds the limits established by Massachusetts statute) until thirty days after the Commissioner has received notice of the intended dividend and has not objected. As historically administered by the Commissioner, this provision requires the Commissioner's prior approval of an extraordinary dividend. Under Massachusetts law, an insurer may pay cash dividends only from its unassigned funds, also known as earned surplus, and the insurer's remaining surplus must be both reasonable in relation to its outstanding liabilities and adequate to its financial needs. At year-end December 31, 2015, the statutory surplus of Safety Insurance was \$571,038, and its statutory net loss for 2015 was \$12,209. As a result, a maximum of \$57,104 is available in 2016 for such dividends without prior approval of the Commissioner. As result of this Massachusetts statute, the Insurance Subsidiaries had restricted net assets in the amount of \$533,785 at December 31, 2015. During the six months ended June 30, 2016, Safety Insurance paid dividends to Safety of \$19,851.

The maximum dividend permitted by law is not indicative of an insurer's actual ability to pay dividends, which may be constrained by business and regulatory considerations, such as the impact of dividends on surplus, which could affect an insurer's ratings or competitive position, the amount of premiums that can be written and the ability to pay future dividends.

Since the initial public offering of its common stock in November 2002, the Company has paid regular quarterly dividends to shareholders of its common stock. Quarterly dividends paid during 2016 were as follows:

Declaration Date	Record Date	Payment Date	Dividend per Common Share	Total Dividends Paid and Accrued
February 16, 2016	March 1, 2016	March 15, 2016	\$ 0.70	\$ 10,554
May 3, 2016	June 1, 2016	June 15, 2016	\$ 0.70	10,609

On August 3, 2016, our Board approved and declared a dividend of \$0.70 per share which will be paid on September 15, 2016 to shareholders of record on September 1, 2016. We plan to continue to declare and pay quarterly cash dividends in 2016, depending on our financial position and the regularity of our cash flows.

On August 3, 2007, the Board of Directors approved a share repurchase program of up to \$30,000 of the Company's outstanding common shares. As of June 30, 2016, the Board of Directors had cumulatively authorized increases to the existing share repurchase program of up to \$150,000 of its outstanding common shares. Under the program, the Company may repurchase shares of its common stock for cash in public or private transactions, in the open market or

otherwise. The timing of such repurchases and actual number of shares repurchased will depend on a variety of factors including price, market conditions and applicable regulatory and corporate requirements. The program does not require us to repurchase any specific number of shares and may be modified, suspended or terminated at any time without prior notice. As of June 30, 2016 and December 31, 2015, the Company had purchased 2,279,570 shares of common stock at a cost of \$83,835.

Management believes that the current level of cash flow from operations provides us with sufficient liquidity to meet our operating needs over the next 12 months. We expect to be able to continue to meet our operating needs after the next 12 months from internally generated funds. Since our ability to meet our obligations in the long term (beyond such twelve-month period) is dependent upon such factors as market changes, insurance regulatory changes and economic conditions, no assurance can be given that the available net cash flow will be sufficient to meet our operating needs. We expect that we would need to borrow or issue capital stock if we needed additional funds, for example, to pay for an acquisition or a significant expansion of our operations. There can be no assurance that sufficient funds for any of the foregoing purposes would be available to us at such time.

#### Risk-Based Capital Requirements

The NAIC has adopted a formula and model law to implement risk-based capital requirements for most property and casualty insurance companies, which are designed to determine minimum capital requirements and to raise the level of protection that statutory surplus provides for policyholder obligations. Under Massachusetts law, insurers

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having less total adjusted capital than that required by the risk-based capital calculation will be subject to varying degrees of regulatory action, depending on the level of capital inadequacy. The risk-based capital law provides for four levels of regulatory action. The extent of regulatory intervention and action increases as the level of total adjusted capital to risk-based capital falls. As of December 31, 2015, the Insurance Subsidiaries had total adjusted capital of \$571,038, which is in excess of amounts requiring company or regulatory action at any prescribed risk-based capital action level. Minimum statutory capital and surplus, or company action level risk-based capital, was \$101,243 at December 31, 2015.

## Off-Balance Sheet Arrangements

We have no material obligations under a guarantee contract meeting the characteristics identified in ASC 460, Guarantees. We have no material retained or contingent interests in assets transferred to an unconsolidated entity. We have no material obligations, including contingent obligations, under contracts that would be accounted for as derivative instruments. We have no obligations, including contingent obligations, arising out of a variable interest in an unconsolidated entity held by, and material to, us, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with us. We have no direct investments in real estate and no holdings of mortgages secured by commercial real estate. Accordingly, we have no material off-balance sheet arrangements.

## Critical Accounting Policies and Estimates

### Loss and Loss Adjustment Expense Reserves

Significant periods of time can elapse between the occurrence of an insured loss, the reporting to us of that loss and our final payment of that loss. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities. Our reserves represent estimates of amounts needed to pay reported and estimated losses incurred but not yet reported (“IBNR”) and the expenses of investigating and paying those losses, or loss adjustment expenses. Every quarter, we review our previously established reserves and adjust them, if necessary.

When a claim is reported, claims personnel establish a “case reserve” for the estimated amount of the ultimate payment. The amount of the reserve is primarily based upon an evaluation of the type of claim involved, the circumstances surrounding each claim and the policy provisions relating to the loss. The estimate reflects the informed judgment of such personnel based on general insurance reserving practices and on the experience and knowledge of the claims person. During the loss adjustment period, these estimates are revised as deemed necessary by our claims department based on subsequent developments and periodic reviews of the cases. When a claim is closed with or without a payment, the difference between the case reserve and the settlement amount creates a reserve deficiency if the payment exceeds the case reserve or a reserve redundancy if the payment is less than the case reserve.

In accordance with industry practice, we also maintain reserves for IBNR. IBNR reserves are determined in accordance with commonly accepted actuarial reserving techniques on the basis of our historical information and experience. We review and make adjustments to incurred but not yet reported reserves quarterly. In addition, IBNR reserves can also be expressed as the total loss reserves required less the case reserves on reported claims.

When reviewing reserves, we analyze historical data and estimate the impact of various loss development factors, such as our historical loss experience and that of the industry, trends in claims frequency and severity, our mix of business, our claims processing procedures, legislative enactments, judicial decisions, legal developments in imposition of damages, and changes and trends in general economic conditions, including the effects of inflation. A change in any of these factors from the assumption implicit in our estimate can cause our actual loss experience to be better or worse than our reserves, and the difference can be material. There is no precise method, however, for evaluating the impact of any specific factor on the adequacy of reserves, because the eventual development of reserves is affected by many factors.

In estimating all our loss reserves, we follow the guidance prescribed by Accounting Standards Codification (“ASC”) 944, Financial Services – Insurance.

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Management determines our loss and LAE reserves estimate based upon the analysis of our actuaries. A reasonable estimate is derived by selecting a point estimate within a range of indications as calculated by our actuaries using generally accepted actuarial techniques. The key assumption in most actuarial analysis is that past patterns of frequency and severity will repeat in the future, unless a significant change in the factors described above takes place. Our key factors and resulting assumptions are the ultimate frequency and severity of claims, based upon the most recent ten years of claims reported to the Company, and the data CAR reports to us to calculate our share of the residual market, as of the date of the applicable balance sheet. For each accident year and each coverage within a line of business our actuaries calculate the ultimate losses incurred. Our total reserves are the difference between the ultimate losses incurred and the cumulative loss and loss adjustment payments made to date. Our IBNR reserves are calculated as the difference between our total reserves and the outstanding case reserves at the end of the accounting period. To determine ultimate losses, our actuaries calculate a range of indications and select a point estimation using such actuarial techniques as:

- Paid Loss Indications: This method projects ultimate loss estimates based upon extrapolations of historic paid loss trends. This method tends to be used on short tail lines such as automobile physical damage.
- Incurred Loss Indications: This method projects ultimate loss estimates based upon extrapolations of historic incurred loss trends. This method tends to be used on long tail lines of business such as automobile liability and homeowner's liability.
- Bornhuetter-Ferguson Indications: This method projects ultimate loss estimates based upon extrapolations of an expected amount of IBNR, which is added to current incurred losses or paid losses. This method tends to be used on small, immature, or volatile lines of business, such as our BOP and umbrella lines of business.
- Bodily Injury Code Indications: This method projects ultimate loss estimates for our private passenger and commercial automobile bodily injury coverage based upon extrapolations of the historic number of accidents and the historic number of bodily injury claims per accident. Projected ultimate bodily injury claims are then segregated into expected claims by type of injury (e.g. soft tissue injury vs. hard tissue injury) based on past experience. An ultimate severity, or average paid loss amounts, is estimated based upon extrapolating historic trends. Projected ultimate loss estimates using this method are the aggregate of estimated losses by injury type.

Such techniques assume that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting our ultimate losses, total reserves, and resulting IBNR reserves. It is possible that the final outcome may fall above or below these amounts as a result of a number of factors, including immature data, sparse data, or significant growth in a line of business. Using these methodologies our actuaries established a range of reasonably possible estimations for net reserves of approximately \$421,019 to \$476,460 as of June 30, 2016. In general, the low and high values of the ranges represent reasonable minimum and maximum values of the indications based on the techniques described above. Our selected point estimate of net loss and LAE reserves based upon the analysis of our actuaries was \$466,039 as of June 30, 2016.

The following table presents the point estimation of the recorded reserves and the range of estimations by line of business for net loss and LAE reserves as of June 30, 2016.

As of June 30, 2016

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Line of Business	Low	Recorded	High
Private passenger automobile	\$ 221,860	\$ 238,333	\$ 238,863
Commercial automobile	65,676	74,052	74,872
Homeowners	70,710	80,748	86,352
All other	62,773	72,906	76,373
Total	\$ 421,019	\$ 466,039	\$ 476,460

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The following table presents our total net reserves and the corresponding case reserves and IBNR reserves for each line of business as of June 30, 2016.

Line of Business	As of June 30, 2016		
	Case	IBNR	Total
Private passenger automobile	\$ 260,922	\$ (22,952)	\$ 237,970
CAR assumed private passenger auto	108	255	363
Commercial automobile	44,782	10,179	54,961
CAR assumed commercial automobile	9,368	9,723	19,091
Homeowners	62,830	7,394	70,224
FAIR Plan assumed homeowners	4,118	6,406	10,524
All other	37,962	34,944	72,906
Total net reserves for losses and LAE	\$ 420,090	\$ 45,949	\$ 466,039

At June 30, 2016, our total IBNR reserves for our private passenger automobile line of business was comprised of (\$43,652) related to estimated ultimate decreases in the case reserves, including anticipated recoveries (i.e. salvage and subrogation), and \$20,700 related to our estimation for not yet reported losses.

Our IBNR reserves consist of our estimate of the total loss reserves required less our case reserves. The IBNR reserves for CAR assumed commercial automobile business are 50.9% of our total reserves for CAR assumed commercial automobile business as of June 30, 2016, due to the reporting delays in the information we receive from CAR, as described further in the section on Residual Market Loss and Loss Adjustment Expense Reserves. Our IBNR reserves for FAIR Plan assumed homeowners are 60.9% of our total reserves for FAIR Plan assumed homeowners at June 30, 2016, due to similar reporting delays in the information we receive from FAIR Plan.



The following table presents information by line of business for our total net reserves and the corresponding retained (i.e. direct less ceded) reserves and assumed reserves as of June 30, 2016.

Line of Business	As of June 30, 2016		Net
	Retained	Assumed	
Private passenger automobile	\$ 237,970		
CAR assumed private passenger automobile		\$ 363	
Net private passenger automobile			\$ 238,333
Commercial automobile	54,961		
CAR assumed commercial automobile		19,091	
Net commercial automobile			74,052
Homeowners	70,224		
FAIR Plan assumed homeowners		10,524	
Net homeowners			80,748
All other	72,906	-	72,906
Total net reserves for losses and LAE	\$ 436,061	\$ 29,978	\$ 466,039

#### Residual Market Loss and Loss Adjustment Expense Reserves

We are a participant in CAR, the FAIR Plan and other various residual markets and assume a portion of losses and LAE on business ceded by the industry participants to the residual markets. We estimate reserves for assumed losses and LAE that have not yet been reported to us by the residual markets. Our estimations are based upon the same factors we use for our own reserves, plus additional factors due to the nature of and the information we receive.

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Residual market deficits, consists of premium ceded to the various residual markets less losses and LAE, and is allocated among insurance companies based on a various formulas (the “Participation Ratio”) that takes into consideration a company’s voluntary market share.

Because of the lag in the various residual market estimations, and in order to try to validate to the extent possible the information provided, we must try to estimate the effects of the actions of our competitors in order to establish our Participation Ratio.

Although we rely to a significant extent in setting our reserves on the information the various residual markets provide, we are cautious in our use of that information, because of the delays in receiving data from the various residual markets. As a result, we have to estimate our Participation Ratio and these reserves are subject to significant judgments and estimates.

## Sensitivity Analysis

Establishment of appropriate reserves is an inherently uncertain process. There can be no certainty that currently established reserves based on our key assumptions regarding frequency and severity in our lines of business, or our assumptions regarding our share of the CAR loss will prove adequate in light of subsequent actual experience. To the extent that reserves are inadequate and are strengthened, the amount of such increase is treated as a charge to earnings in the period that the deficiency is recognized. To the extent that reserves are redundant and are released, the amount of the release is a credit to earnings in the period the redundancy is recognized. For the six months ended June 30, 2016, a 1 percentage-point change in the loss and LAE ratio would result in a change in reserves of \$3,730. Each 1 percentage-point change in the loss and loss expense ratio would have had a \$2,424 effect on net income, or \$0.16 per diluted share.

Our assumptions consider that past experience, adjusted for the effects of current developments and anticipated trends, are an appropriate basis for establishing our reserves. Our individual key assumptions could each have a reasonable possible range of plus or minus 5 percentage-points for each estimation, although there is no guarantee that our assumptions will not have more than a 5 percentage point variation. The following sensitivity tables present information for each of our primary lines of business on the effect each 1 percentage-point change in each of our key assumptions on unpaid frequency and severity could have on our retained (i.e., direct minus ceded) loss and LAE reserves and net income for the six months ended June 30, 2016. In evaluating the information in the table, it should be noted that a 1 percentage-point change in a single assumption would change estimated reserves by 1 percentage-point. A



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1 percentage-point change in both our key assumptions would change estimated reserves within a range of plus or minus 2 percentage-points.

	-1 Percent Change in Frequency	No Change in Frequency	+1 Percent Change in Frequency
Private passenger automobile retained loss and LAE reserves			
-1 Percent Change in Severity			
Estimated decrease in reserves	\$ (4,759)	\$ (2,380)	\$ —
Estimated increase in net income	3,094	1,547	—
No Change in Severity			
Estimated (decrease) increase in reserves	(2,380)	—	2,380
Estimated increase (decrease) in net income	1,547	—	(1,547)
+1 Percent Change in Severity			
Estimated increase in reserves	—	2,380	4,760
Estimated decrease in net income	—	(1,547)	(3,094)
Commercial automobile retained loss and LAE reserves			
-1 Percent Change in Severity			
Estimated decrease in reserves	(1,099)	(550)	—
Estimated increase in net income	714	357	—
No Change in Severity			
Estimated (decrease) increase in reserves	(550)	—	550
Estimated increase (decrease) in net income	357	—	(358)
+1 Percent Change in Severity			
Estimated increase in reserves	—	550	1,099
Estimated decrease in net income	—	(357)	(714)
Homeowners retained loss and LAE reserves			
-1 Percent Change in Severity			
Estimated decrease in reserves	(1,404)	(702)	—
Estimated increase in net income	913	456	—
No Change in Severity			
Estimated (decrease) increase in reserves	(702)	—	702
Estimated increase (decrease) in net income	456	—	(456)
+1 Percent Change in Severity			
Estimated increase in reserves	—	702	1,404
Estimated decrease in net income	—	(456)	(913)
All other retained loss and LAE reserves			
-1 Percent Change in Severity			
Estimated decrease in reserves	(1,458)	(729)	—
Estimated increase in net income	948	474	—
No Change in Severity			
Estimated (decrease) increase in reserves	(729)	—	729
Estimated increase (decrease) in net income	474	—	(474)

+1 Percent Change in Severity			
Estimated increase in reserves	—	729	1,458
Estimated decrease in net income	—	(474)	(948)

Our estimated share of CAR loss and LAE reserves is based on assumptions about our Participation Ratio, the size of CAR, and the resulting deficit (similar assumptions apply with respect to the FAIR Plan). Our assumptions consider that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for establishing our CAR reserves. Each of our assumptions could have a reasonably possible range of plus or minus 5 percentage-points for each estimation.

The following sensitivity table presents information of the effect each 1 percentage-point change in our assumptions on our share of reserves for CAR and other residual markets could have on our assumed loss and LAE reserves and net income for the six months ended June 30, 2016. In evaluating the information in the table, it should be noted that a 1 percentage-point change in our assumptions would change estimated reserves by 1 percentage-point.

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	-1 Percent Change in Estimation	+1 Percent Change in Estimation
CAR assumed private passenger automobile		
Estimated (decrease) increase in reserves	\$ (4)	\$ 4
Estimated increase (decrease) in net income	2	(2)
CAR assumed commercial automobile		
Estimated (decrease) increase in reserves	(191)	191
Estimated increase (decrease) in net income	124	(124)
FAIR Plan assumed homeowners		
Estimated (decrease) increase in reserves	(105)	105
Estimated increase (decrease) in net income	68	(68)

## Reserve Development Summary

The changes we have recorded in our reserves in the past illustrate the uncertainty of estimating reserves. Our prior year reserves decreased by \$21,867 and \$12,011 during the six months ended June 30, 2016 and 2015, respectively.

The following table presents a comparison of prior year development of our net reserves for losses and LAE for the six months ended June 30, 2016 and 2015. Each accident year represents all claims for an annual accounting period in which loss events occurred, regardless of when the losses are actually reported, booked or paid. Our financial statements reflect the aggregate results of the current and all prior accident years.

Accident Year	Six Months Ended June 30,	
	2016	2015
2006 & prior	\$ (272)	\$ (1,002)
2007	(266)	(230)
2008	(1,164)	(386)
2009	(544)	(777)
2010	(1,486)	(2,191)
2011	(2,980)	(2,270)
2012	(4,220)	(4,117)
2013	(7,493)	(2,456)

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2014	(3,280)	1,418
2015	(162)	—
All prior years	\$ (21,867)	\$ (12,011)

The decreases in prior years' reserves during the six months ended June 30, 2016 and 2015 resulted from re-estimations of prior year ultimate loss and LAE liabilities. The 2016 decrease is primarily composed of reductions of \$9,015 in our retained private passenger automobile reserves, \$2,605 in our retained commercial automobile reserves, \$7,382 in our retained homeowners reserves and \$2,110 in our retained other lines reserves. The 2015 decrease is primarily composed of reductions of \$6,185 in our retained private passenger automobile reserves, \$2,241 in our retained commercial automobile reserves, \$3,287 in our retained homeowners reserves and \$1,165 in our retained other lines reserves.

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The following table presents information by line of business for prior year development of our net reserves for losses June 30, 2016.

Accident Year	Private Passenger	Commercial	Homeowners	All Other	Total
	Automobile	Automobile			
2006 & prior	\$ (106)	\$ (2)	\$ (40)	\$ (124)	\$ (272)
2007	20	-	(188)	(98)	(266)
2008	(738)	(287)	(138)	(1)	(1,164)
2009	(512)	(32)	—	—	(544)
2010	(917)	(174)	(395)	—	(1,486)
2011	(846)	(263)	(1,084)	(787)	(2,980)
2012	(2,066)	(222)	(1,454)	(478)	(4,220)
2013	(1,954)	(1,120)	(3,647)	(772)	(7,493)
2014	(1,489)	(879)	(939)	27	(3,280)
2015	(407)	(41)	163	123	(162)
All prior years	\$ (9,015)	\$ (3,020)	\$ (7,722)	\$ (2,110)	\$ (21,867)

To further clarify the effects of changes in our reserve estimates for CAR and other residual markets, the next two tables break out the information in the table above by source of the business (i.e., non-residual market vs. residual market).

The following table presents information by line of business for prior year development of retained reserves for losses and LAE for the six months ended June 30, 2016 that is, all our reserves except for business ceded or assumed from CAR and other residual markets.

Accident Year	Retained	Retained	Retained	Retained	Total
	Private Passenger Automobile	Commercial Automobile			
2006 & prior	\$ (106)	\$ (2)	\$ (40)	\$ (124)	\$ (272)
2007	20	-	(188)	(98)	(266)
2008	(738)	(309)	(138)	(1)	(1,186)
2009	(512)	(37)	—	—	(549)
2010	(917)	(153)	(391)	—	(1,461)
2011	(846)	(190)	(1,041)	(787)	(2,864)
2012	(2,066)	(121)	(1,377)	(478)	(4,042)
2013	(1,954)	(1,133)	(3,530)	(772)	(7,389)



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2014	(1,489)	(912)	(851)	27	(3,225)
2015	(407)	252	174	123	142
All prior years	\$ (9,015)	\$ (2,605)	\$ (7,382)	\$ (2,110)	\$ (21,112)

The following table presents information by line of business for prior year development of reserves assumed from residual markets for losses and LAE for the six months ended June 30, 2016.

Accident Year	CAR Assumed Private Passenger Automobile	CAR Assumed Commercial Automobile	FAIR Plan Homeowners	Total
2006 & prior	\$ —	\$ —	\$ —	\$ —
2007	—	—	—	—
2008	—	22	—	22
2009	—	5	—	5
2010	—	(22)	(4)	(26)
2011	—	(73)	(43)	(116)
2012	—	(101)	(78)	(179)
2013	—	13	(117)	(104)
2014	—	34	(88)	(54)
2015	—	(293)	(10)	(303)
All prior years	\$ —	\$ (415)	\$ (340)	\$ (755)

Our private passenger automobile line of business prior year reserves decreased by \$9,015 for the six months ended June 30, 2016. The decrease was primarily due to improved retained private passenger results of \$5,509 for the accident years 2012 through 2014. The improved retained private passenger results were primarily due to fewer IBNR

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claims than previously estimated and better than previously estimated severity on our established bodily injury and property damage case reserves.

Our commercial automobile line of business prior year reserves decreased by \$3,020 for the six months ended June 30, 2016. The decrease was primarily due to improved retained commercial results of \$2,045 for the accident years 2013 and 2014.

Our retained homeowners and our retained other lines of business prior year reserves decreased by \$7,382 and \$2,110 respectively for the six months ended June 30, 2016 due primarily to fewer IBNR claims than previously estimated.

For further information, see “Results of Operations: Losses and Loss Adjustment Expenses.”

Other-Than-Temporary Impairments.

We use a systematic methodology to evaluate declines in fair values below cost or amortized cost of our investments. This methodology ensures that we evaluate available evidence concerning any declines in a disciplined manner.

In our determination of whether a decline in fair value below amortized cost is an OTTI, we consider and evaluate several factors and circumstances including the issuer’s overall financial condition, the issuer’s credit and financial strength ratings, a weakening of the general market conditions in the industry or geographic region in which the issuer operates, a prolonged period (typically nine months or longer) in which the fair value of an issuer’s securities remains below our amortized cost, and any other factors that may raise doubt about the issuer’s ability to continue as a going concern.

ASC 320, Investments — Debt and Equity Securities requires entities to separate an OTTI of a debt security into two components when there are credit related losses associated with the impaired debt security for which the Company asserts that it does not have the intent to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of its cost basis. Under ASC 320, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors is recorded as a component of other comprehensive income (loss). In instances where no credit loss exists but it is more likely than not that the Company will have to sell the debt security prior to the anticipated recovery, the decline in market value below amortized cost is recognized as an OTTI in earnings. In periods after the recognition of an OTTI on debt securities, the Company accounts for such securities as if they had been purchased on the measurement date of the OTTI at an amortized cost basis equal to the previous amortized cost basis less the OTTI recognized in earnings. For debt securities for which

OTTI was recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected will be accreted or amortized into net investment income.

For further information, see “Results of Operations: Net Impairment Losses on Investments.”

#### Forward-Looking Statements

Forward-looking statements might include one or more of the following, among others:

- Projections of revenues, income, earnings per share, capital expenditures, dividends, capital structure or other financial items;
- Descriptions of plans or objectives of management for future operations, products or services;
- Forecasts of future economic performance, liquidity, need for funding and income;
  - Descriptions of assumptions underlying or relating to any of the foregoing; and
- Future performance of credit markets.

Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include words such as “believe,” “expect,” “anticipate,” “intend,” “plan,” “estimate,” “aim,”

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“projects,” or words of similar meaning and expressions that indicate future events and trends, or future or conditional verbs such as “will,” “would,” “should,” “could,” or “may.” All statements that address expectations or projections about the future, including statements about the Company’s strategy for growth, product development, market position, expenditures and financial results, are forward-looking statements.

Forward-looking statements are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. There are a number of factors, many of which are beyond our control, that could cause actual future conditions, events, results or trends to differ significantly and/or materially from historical results or those projected in the forward-looking statements. These factors include but are not limited to the competitive nature of our industry and the possible adverse effects of such competition. Although a number of national insurers that are much larger than we are do not currently compete in a material way in the Massachusetts private passenger automobile market, if one or more of these companies decided to aggressively enter the market it could have a material adverse effect on us. Other significant factors include conditions for business operations and restrictive regulations in Massachusetts, the possibility of losses due to claims resulting from severe weather, the possibility that the Commissioner may approve future Rule changes that change the operation of the residual market, the possibility that existing insurance-related laws and regulations will become further restrictive in the future, our possible need for and availability of additional financing, and our dependence on strategic relationships, among others, and other risks and factors identified from time to time in our reports filed with the SEC. Refer to Part I, Item 1A — Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2015.

Some other factors, such as market, operational, liquidity, interest rate, equity and other risks, are described elsewhere in this Quarterly Report on Form 10-Q. Factors relating to the regulation and supervision of our Company are also described or incorporated in this report. There are other factors besides those described or incorporated in this report that could cause actual conditions, events or results to differ from those in the forward-looking statements.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date on which they are made. We do not undertake any obligation to update publicly or revise any forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made.

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## Item 3. Quantitative and Qualitative Information about Market Risk (Dollars in thousands)

**Market Risk.** Market risk is the risk that we will incur losses due to adverse changes in market rates and prices. We have exposure to market risk through our investment activities and our financing activities. Our primary market risk exposure is to changes in interest rates. We use both fixed and variable rate debt as sources of financing. We have not entered, and do not plan to enter, into any derivative financial instruments for trading or speculative purposes.

**Interest Rate Risk.** Interest rate risk is the risk that we will incur economic losses due to adverse changes in interest rates. Our exposure to interest rate changes primarily results from our significant holdings of fixed rate investments and from our financing activities. Our fixed maturity investments include U.S. and foreign government bonds, securities issued by government agencies, obligations of state and local governments and governmental authorities, corporate bonds and asset-backed securities, most of which are exposed to changes in prevailing interest rates.

We manage our exposure to risks associated with interest rate fluctuations through active review of our investment portfolio by our management and Board and consultation with third-party financial advisors. As a general matter, we do not attempt to match the durations of our assets with the durations of our liabilities, and the majority of our liabilities are “short tail.” Our goal is to maximize the total after-tax return on all of our investments. An important strategy that we employ to achieve this goal is to try to hold enough in cash and short-term investments in order to avoid liquidating longer-term investments to pay claims.

Based upon the results of interest rate sensitivity analysis, the following table shows the interest rate risk of our investments in fixed maturities, measured in terms of fair value (which is equal to the carrying value for all our fixed maturity securities).

	-100 Basis Point Change	No Change	+100 Basis Point Change
As of June 30, 2016			
Estimated fair value	\$ 1,148,385	\$ 1,112,277	\$ 1,072,727
Estimated increase (decrease) in fair value	\$ 36,108	\$ —	\$ (39,550)

With respect to floating rate debt, we are exposed to the effects of changes in prevailing interest rates. At June 30, 2016, we had no debt outstanding under our credit facility. Assuming the full utilization of our current available credit facility, a 2.0% increase in the prevailing interest rate on our variable rate debt would result in interest expense increasing approximately \$600 for 2016, assuming that all of such debt is outstanding for the entire year.

In addition, in the current market environment, our investments can also contain liquidity risks.

**Equity Risk.** Equity risk is the risk that we will incur economic losses due to adverse changes in equity prices. Our exposure to changes in equity prices results from our holdings of common stock and mutual funds held to fund the executive deferred compensation plan. We continuously evaluate market conditions and we expect in the future to purchase additional equity securities. We principally manage equity price risk through industry and issuer diversification and asset allocation techniques.

#### Item 4. Controls and Procedures

##### Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), we evaluated the effectiveness of the design and operation of our disclosure controls and procedures [as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”)] as of the end of the period covered by this report. Based on that evaluation, our CEO and CFO have concluded that our disclosure controls and procedures are adequate and effective and ensure that all information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded,

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processed, summarized and reported within the time periods specified in the SEC's rules and that information required to be disclosed in such reports is accumulated and communicated to management, including our CEO and CFO, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Part II. OTHER INFORMATION

Item 1. Legal Proceedings - Please see “Item 1 — Financial Statements - Note 7, Commitments and Contingencies.”

Item 1A. Risk Factors

There have been no subsequent material changes from the risk factors previously disclosed in the Company’s 2015 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds (Dollars in thousands)

On August 3, 2007, the Board of Directors approved a share repurchase program of up to \$30,000 of the Company’s outstanding common shares. As of September 30, 2014, the Board of Directors had cumulatively authorized increases to the existing share repurchase program of up to \$150,000 of its outstanding common shares. Under the program, the Company may repurchase shares of its common stock for cash in public or private transactions, in the open market or otherwise. The timing of such repurchases and actual number of shares repurchased will depend on a variety of factors including price, market conditions and applicable regulatory and corporate requirements. The program does not require the Company to repurchase any specific number of shares and it may be modified, suspended or terminated at any time without prior notice. No share repurchases were made by the Company during the six months ended June 30, 2016.

Item 3. Defaults upon Senior Securities - None.

Item 4. Mine Safety Disclosures — None.

Item 5. Other Information - None.

Item 6. Exhibits - The exhibits are contained herein as listed in the Exhibit Index.





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SIGNATURE

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

August 5, 2016 SAFETY INSURANCE GROUP, INC. (Registrant)

By: /s/ WILLIAM J. BEGLEY, JR.  
William J. Begley, Jr.  
Vice President, Chief Financial Officer, Secretary and Principal Accounting Officer

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SAFETY INSURANCE GROUP, INC.

EXHIBIT INDEX

Exhibit Number	Description
10.1	Employment Agreement by and between Safety Insurance Group, Inc. and George M. Murphy as of April 1, 2016 (2) (3)
10.2	Employment Agreement by and between Safety Insurance Group, Inc. and John P. Drago as of April 1, 2016 (2) (3)
11.0	Statement re: Computation of Per Share Earnings (loss) (1)
31.1	CEO Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes Oxley Act of 2002(2)
31.2	CFO Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes Oxley Act of 2002(2)
32.1	CEO Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes Oxley Act of 2002(2)
32.2	CFO Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes Oxley Act of 2002(2)
101.INS	XBRL Instance Document(2)
101.SCH	XBRL Taxonomy Extension Schema(2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase(2)
101.DEF	XBRL Taxonomy Extension Definition Linkbase(2)

101.LAB XBRL Taxonomy Extension Label Linkbase(2)

101.PRE XBRL Taxonomy Extension Presentation Linkbase(2)

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- (1) Not included herein as the information is included as part of this Form 10-Q, Item 1 - Financial Statements, Note 3, earnings (loss) per Weighted Average Common Share.
- (2) Included herein.
- (3) Denotes management contract or compensation plan or arrangement.

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