

SAFETY INSURANCE GROUP INC

Form 10-Q

November 12, 2013

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2013

OR

- o 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 November 5, 2013, there were 15,389,412 shares of common stock with a par value of \$0.01 per share outstanding.

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SAFETY INSURANCE GROUP, INC.

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Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Consolidated Balance Sheets****(Dollars in thousands, except share data)**

| | September 30, 2013 | December 31, 2012 |
|---|-----------------------|----------------------|
| Assets | | |
| Investments: | | |
| Securities available for sale: | | |
| Fixed maturities, at fair value (amortized cost: \$1,100,077 and \$1,100,414) | \$ 1,124,982 | \$ 1,165,553 |
| Equity securities, at fair value (cost: \$52,879 and \$21,237) | 57,362 | 22,800 |
| Total investments | 1,182,344 | 1,188,353 |
| Cash and cash equivalents | 38,305 | 35,383 |
| Accounts receivable, net of allowance for doubtful accounts | 185,546 | 165,750 |
| Receivable for securities sold | 3,441 | 835 |
| Accrued investment income | 10,251 | 10,587 |
| Taxes recoverable | 151 | 5,529 |
| Receivable from reinsurers related to paid loss and loss adjustment expenses | 12,092 | 6,610 |
| Receivable from reinsurers related to unpaid loss and loss adjustment expenses | 58,568 | 52,185 |
| Ceded unearned premiums | 17,226 | 16,206 |
| Deferred policy acquisition costs | 67,088 | 60,665 |
| Deferred income taxes | 4,207 | |
| Equity and deposits in pools | 19,550 | 16,965 |
| Other assets | 15,268 | 15,278 |
| Total assets | \$ 1,614,037 | \$ 1,574,346 |
| Liabilities | | |
| Loss and loss adjustment expense reserves | \$ 438,496 | \$ 423,842 |
| Unearned premium reserves | 392,265 | 353,219 |
| Accounts payable and accrued liabilities | 51,246 | 65,458 |
| Payable for securities purchased | 11,277 | 2,630 |
| Payable to reinsurers | 17,674 | 7,056 |
| Deferred income taxes | | 8,202 |
| Other liabilities | 9,638 | 19,580 |
| Total liabilities | 920,596 | 879,987 |
| Commitments and contingencies (Note 7) | | |
| Shareholders equity | | |
| Common stock: \$0.01 par value; 30,000,000 shares authorized; 17,205,134 and 17,052,034 shares issued | 172 | 170 |
| Additional paid-in capital | 169,154 | 163,041 |
| Accumulated other comprehensive income, net of taxes | 19,103 | 43,356 |
| Retained earnings | 565,380 | 543,361 |
| Treasury Stock, at cost: 1,819,547 and 1,728,645 shares | (60,368) | (55,569) |
| Total shareholders equity | 693,441 | 694,359 |
| Total liabilities and shareholders equity | \$ 1,614,037 | \$ 1,574,346 |

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

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Consolidated Statements of Operations****(Unaudited)****(Dollars in thousands, except per share data)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|------------------|---------------------------------|------------------|
| | 2013 | 2012 | 2013 | 2012 |
| Net earned premiums | \$ 172,246 | \$ 162,493 | \$ 508,235 | \$ 477,099 |
| Net investment income | 10,023 | 10,142 | 30,137 | 30,551 |
| Net realized gains on investments | 657 | 153 | 1,199 | 1,226 |
| Finance and other service income | 4,768 | 4,743 | 13,920 | 13,769 |
| Total revenue | 187,694 | 177,531 | 553,491 | 522,645 |
| Losses and loss adjustment expenses | 109,183 | 106,445 | 328,304 | 307,184 |
| Underwriting, operating and related expenses | 52,940 | 50,054 | 154,505 | 146,602 |
| Interest expense | 23 | 22 | 66 | 66 |
| Total expenses | 162,146 | 156,521 | 482,875 | 453,852 |
| Income before income taxes | 25,548 | 21,010 | 70,616 | 68,793 |
| Income tax expense | 7,892 | 6,676 | 20,917 | 20,294 |
| Net income | \$ 17,656 | \$ 14,334 | \$ 49,699 | \$ 48,499 |
| Earnings per weighted average common share: | | | | |
| Basic | \$ 1.15 | \$ 0.94 | \$ 3.24 | \$ 3.17 |
| Diluted | \$ 1.14 | \$ 0.94 | \$ 3.23 | \$ 3.17 |
| Cash dividends paid per common share | \$ 0.60 | \$ 0.60 | \$ 1.80 | \$ 1.60 |
| Number of shares used in computing earnings per share: | | | | |
| Basic | 15,369,285 | 15,312,178 | 15,355,623 | 15,277,560 |
| Diluted | 15,429,809 | 15,319,885 | 15,395,434 | 15,284,400 |

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

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Consolidated Statements of Comprehensive Income****(Unaudited)****(Dollars in thousands)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|-----------|---------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| Net income | \$ 17,656 | \$ 14,334 | \$ 49,699 | \$ 48,499 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized holding (losses) gains during the period, net of tax (benefit) expense of (\$170), \$4,532, (\$12,640), and \$6,610 | (315) | 8,417 | (23,474) | 12,275 |
| Reclassification adjustment for gains included in net income, net of tax expense of (\$230), (\$53), (\$420), and (\$429) | (427) | (100) | (779) | (797) |
| Unrealized (losses) gains on securities available for sale | (742) | 8,317 | (24,253) | 11,478 |
| Comprehensive income | \$ 16,914 | \$ 22,651 | \$ 25,446 | \$ 59,977 |

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, 2011 | \$ 169 | \$ 157,167 | \$ 35,621 | \$ 518,925 | \$ (55,569) | \$ 656,313 |
| Net income, January 1 to September 30, 2012 | | | | 48,499 | | 48,499 |
| Other comprehensive income, net of deferred federal income taxes | | | 11,478 | | | 11,478 |
| Restricted share awards issued | 1 | 166 | | | | 167 |
| Recognition of employee share-based compensation, net of deferred federal income taxes | | 3,409 | | | | 3,409 |
| Exercise of options, net of federal income taxes | | 984 | | | | 984 |
| Dividends paid and accrued | | | | (24,441) | | (24,441) |
| Balance at September 30, 2012 | \$ 170 | \$ 161,726 | \$ 47,099 | \$ 542,983 | \$ (55,569) | \$ 696,409 |

| | Common Stock | Additional Paid-in Capital | Accumulated Other Comprehensive Income, Net of Taxes | Retained Earnings | Treasury Stock | Total Shareholders Equity |
|---|-----------------|----------------------------------|--|----------------------|-------------------|---------------------------------|
| Balance at December 31, 2012 | \$ 170 | \$ 163,041 | \$ 43,356 | \$ 543,361 | \$ (55,569) | \$ 694,359 |
| Net income, January 1 to September 30, 2013 | | | | 49,699 | | 49,699 |
| Other comprehensive loss, net of deferred federal income taxes | | | (24,253) | | | (24,253) |
| Restricted share awards issued | 1 | 187 | | | | 188 |
| Recognition of employee share-based compensation, net of deferred federal income taxes | | 3,517 | | | | 3,517 |
| Exercise of options, net of federal income taxes | 1 | 2,409 | | | | 2,410 |
| Dividends paid and accrued | | | | (27,680) | | (27,680) |
| Acquisition of treasury stock | | | | | (4,799) | (4,799) |
| Balance at September 30, 2013 | \$ 172 | \$ 169,154 | \$ 19,103 | \$ 565,380 | \$ (60,368) | \$ 693,441 |

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)

| | Nine Months Ended September 30, | |
|---|---------------------------------|------------------|
| | 2013 | 2012 |
| Cash flows from operating activities: | | |
| Net income | \$ 49,699 | \$ 48,499 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization, net | 11,085 | 10,691 |
| Provision for deferred income taxes | 650 | 550 |
| Gains on sale of fixed assets | (3) | |
| Net realized gains on investments | (1,199) | (1,226) |
| Changes in assets and liabilities: | | |
| Accounts receivable | (19,796) | (26,190) |
| Accrued investment income | 336 | 77 |
| Receivable from reinsurers | (11,865) | (5,577) |
| Ceded unearned premiums | (1,020) | (990) |
| Deferred policy acquisition costs | (6,423) | (7,189) |
| Other assets | 3,529 | 1,791 |
| Loss and loss adjustment expense reserves | 14,654 | 9,769 |
| Unearned premium reserves | 39,046 | 41,875 |
| Accounts payable and accrued liabilities | (14,212) | (3,312) |
| Payable to reinsurers | 10,618 | 9,539 |
| Other liabilities | (9,997) | (1,951) |
| Net cash provided by operating activities | 65,102 | 76,356 |
| Cash flows from investing activities: | | |
| Fixed maturities purchased | (171,967) | (234,335) |
| Equity securities purchased | (39,631) | (8,343) |
| Proceeds from sales and paydowns of fixed maturities | 139,970 | 132,576 |
| Proceeds from maturities, redemptions, and calls of fixed maturities | 34,264 | 48,014 |
| Proceed from sales of equity securities | 8,588 | 7,939 |
| Fixed assets purchased | (3,462) | (2,987) |
| Fixed assets sold | 3 | |
| Net cash used for investing activities | (32,235) | (57,136) |
| Cash flows from financing activities: | | |
| Proceeds from stock options exercised | 2,479 | 1,028 |
| Dividends paid to shareholders | (27,625) | (24,441) |
| Acquisition of treasury stock | (4,799) | |
| Net cash used for financing activities | (29,945) | (23,413) |
| Net increase (decrease) in cash and cash equivalents | 2,922 | (4,193) |
| Cash and cash equivalents at beginning of year | 35,383 | 37,890 |
| Cash and cash equivalents at end of period | \$ 38,305 | \$ 33,697 |

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

These interim 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, Whiteshirts Asset Management Corporation (WAMC), and Whiteshirts Management Corporation, which is WAMC s holding company. All intercompany transactions have been eliminated.

The financial information as of September 30, 2013 and for the three and nine months ended September 30, 2013 and 2012 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. 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 March 18, 2013.

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.

2. Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU 2013-02 requires entities to present in either a single note or

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parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and the income statement line items affected by the reclassification. Items not required to be reclassified to net income in their entirety are cross referenced to a related footnote for additional information. ASU 2013-02 was effective for interim and annual periods beginning after December 15, 2012. There was no impact to the Company's consolidated financial condition and results of operations upon its adoption of ASU 2013-02.

3. Earnings per Weighted Average Common Share

Basic earnings per weighted average common share (EPS) is calculated by dividing net income by the weighted average number of basic common shares outstanding during the period including unvested restricted shares which are considered participating securities. Diluted earnings per share amounts are based on the weighted average number of common shares including unvested restricted shares and the net effect of potentially dilutive common shares outstanding.

Table of Contents**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 September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|------------|---------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| Net income available to common shareholders for basic and diluted earnings per share | \$ 17,656 | \$ 14,334 | \$ 49,699 | \$ 48,499 |
| Weighted average common and common equivalent shares outstanding used to calculate basic earnings per share | 15,369,285 | 15,312,178 | 15,355,623 | 15,277,560 |
| Common equivalent shares- stock options | 4,051 | 7,707 | 6,244 | 6,840 |
| Common equivalent shares- non-vested stock grants | 56,473 | | 33,567 | |
| Weighted average common and common equivalent shares outstanding used to calculate diluted earnings per share | 15,429,809 | 15,319,885 | 15,395,434 | 15,284,400 |
| Basic earnings per share | \$ 1.15 | \$ 0.94 | \$ 3.24 | \$ 3.17 |
| Diluted earnings per share | \$ 1.14 | \$ 0.94 | \$ 3.23 | \$ 3.17 |

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 no anti-dilutive stock options for the three and nine months ended September 30, 2013. There were no anti-dilutive stock options for the three months ended September 30, 2012 and 71,800 anti-dilutive stock options for the nine months ended September 30, 2012.

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.

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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 September 30, 2013, there were 530,832 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).

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Notes to Unaudited Consolidated Financial Statements****(Dollars in thousands except per share and share data)**

The following table summarizes stock option activity under the Incentive Plan for the nine months ended September 30, 2013.

| | Shares Under Option | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|----------------------------------|---------------------------|---------------------------------------|--|---------------------------------|
| Outstanding at beginning of year | 87,500 | \$ 39.24 | | |
| Exercised | (63,475) | \$ 39.07 | | |
| Outstanding at end of period | 24,025 | \$ 39.69 | 2.2 years | \$ 319 |
| Exercisable at end of period | 24,025 | \$ 39.69 | 2.2 years | \$ 319 |

The aggregate intrinsic value in the preceding table represents the total pre-tax intrinsic value, which is the difference between the fair value based upon the Company's closing stock price on September 30, 2013 and the exercise price which would have been received by the option holders had all option holders exercised their options as of that date. The range of exercise prices on stock options outstanding under the Incentive Plan was \$18.50 to \$42.85 at September 30, 2013 and \$13.30 to \$42.85 at September 30, 2012. The total intrinsic value of options exercised during the nine months ended September 30, 2013 and 2012 was \$882 and \$383, respectively. Cash received from options exercised was \$2,479 and \$1,028 for the nine months ended September 30, 2013 and 2012, 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 as expense over the vesting period of each grant. Service-based restricted stock awards generally vest over a three-year period and unrestrict 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. Independent directors' stock awards cannot be sold, assigned, pledged, or otherwise transferred, encumbered or disposed of until the recipient is no longer a member of the Board of Directors.

In addition to service-based awards, the Company granted performance-based restricted shares in 2013 to certain employees. These performance shares will 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 remainder, which contain a performance condition, vest according to the level of Company's combined ratio results compared to its property-casualty insurance peers over the same three-year performance period.

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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 fiscal-year performance period ending at the end of 2015. Compensation expense for performance share awards 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 an award that has 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.

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Notes to Unaudited Consolidated Financial Statements****(Dollars in thousands except per share and share data)**

The following table summarizes restricted stock activity under the Incentive Plan during the nine months ended September 30, 2013, assuming a target payout for the 2013 performance-based shares.

| | Shares Under Restriction | Weighted Average Fair Value | Performance-based Shares Under Restriction | Weighted Average Fair Value |
|----------------------------------|--------------------------------|-----------------------------------|--|-----------------------------------|
| Outstanding at beginning of year | 263,883 | \$ 41.47 | | \$ |
| Granted | 57,632 | \$ 47.87 | 37,456 | \$ 44.13 |
| Vested and unrestricted | (103,788) | \$ 40.75 | | \$ |
| Forfeited | (5,463) | \$ 43.48 | | \$ |
| Outstanding at end of period | 212,264 | \$ 43.51 | 37,456 | \$ 44.13 |

As of September 30, 2013, there was \$7,440 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 1.2 years. The total fair value of the shares that were vested and unrestricted during the nine months ended September 30, 2013 and 2012 was \$4,230 and \$4,284, respectively. For the nine months ended September 30, 2013 and 2012, the Company recorded compensation expense related to restricted stock of \$2,239 and \$2,179, net of income tax benefits of \$1,205 and \$1,173, respectively.

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 were as follows for the periods indicated.

| | As of September 30, 2013 | | | | |
|--|------------------------------|------------------------------|--|--|----------------------------|
| | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Non-OTTI Unrealized Losses | Losses (2) OTTI Unrealized Losses (3) | Estimated Fair Value |
| U.S. Treasury securities | \$ 2,512 | \$ 5 | \$ (6) | \$ | \$ 2,511 |
| Obligations of states and political subdivisions | 457,228 | 13,621 | (2,823) | | 468,026 |
| Residential mortgage-backed securities (1) | 213,961 | 7,695 | (1,829) | | 219,827 |
| Commercial mortgage-backed securities | 36,851 | 404 | (15) | | 37,240 |
| Other asset-backed securities | 14,006 | 196 | (9) | | 14,193 |
| Corporate and other securities | 375,519 | 10,045 | (2,379) | | 383,185 |

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| | | | | |
|-------------------------------------|---------------------|------------------|-------------------|---------------------|
| Subtotal, fixed maturity securities | 1,100,077 | 31,966 | (7,061) | 1,124,982 |
| Equity securities | 52,879 | 4,667 | (184) | 57,362 |
| Totals | \$ 1,152,956 | \$ 36,633 | \$ (7,245) | \$ 1,182,344 |

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Notes to Unaudited Consolidated Financial Statements****(Dollars in thousands except per share and share data)**

| | As of December 31, 2012 | | | | Estimated Fair Value |
|--|------------------------------|------------------------------|--|--|----------------------------|
| | Cost or Amortized Cost | Gross Unrealized Gains | Gross Unrealized Non-OTTI Unrealized Losses | Losses (2) OTTI Unrealized Losses (3) | |
| U.S. Treasury securities | \$ 7,112 | \$ 43 | \$ | \$ | \$ 7,155 |
| Obligations of states and political subdivisions | 455,249 | 35,951 | (17) | | 491,183 |
| Residential mortgage-backed securities (1) | 215,438 | 11,465 | (1,006) | | 225,897 |
| Commercial mortgage-backed securities | 39,388 | 1,086 | | | 40,474 |
| Other asset-backed securities | 21,288 | 898 | | | 22,186 |
| Corporate and other securities | 361,939 | 16,988 | (269) | | 378,658 |
| Subtotal, fixed maturity securities | 1,100,414 | 66,431 | (1,292) | | 1,165,553 |
| Equity securities | 21,237 | 1,629 | (66) | | 22,800 |
| Totals | \$ 1,121,651 | \$ 68,060 | \$ (1,358) | \$ | \$ 1,188,353 |

(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) Our investment portfolio included 254 and 75 securities in an unrealized loss position at September 30, 2013 and December 31, 2012, respectively.

(3) Amounts in this column represent other-than-temporary impairment (OTTI) recognized in accumulated other comprehensive income.

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 September 30, 2013 | |
|--|--------------------------|-------------------------|
| | Amortized Cost | Estimated Fair Value |
| Due in one year or less | \$ 21,726 | \$ 22,182 |
| Due after one year through five years | 334,177 | 344,417 |
| Due after five years through ten years | 215,246 | 221,005 |
| Due after ten years | 264,110 | 266,118 |
| Asset-backed securities | 264,818 | 271,260 |
| Totals | \$ 1,100,077 | \$ 1,124,982 |

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------------|----------------------------------|--------|---------------------------------|----------|
| | 2013 | 2012 | 2013 | 2012 |
| Gross realized gains | | | | |
| Fixed maturity securities | \$ 211 | \$ 374 | \$ 685 | \$ 1,432 |
| Equity securities | 568 | | 655 | 266 |
| Gross realized losses | | | | |
| Fixed maturity securities | (92) | (221) | (108) | (447) |
| Equity securities | (30) | | (33) | (25) |
| Net realized gains on investments | \$ 657 | \$ 153 | \$ 1,199 | \$ 1,226 |

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Notes to Unaudited Consolidated Financial Statements****(Dollars in thousands except per share and share data)**

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 September 30, 2013 and December 31, 2012 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.

| | Less than 12 Months | | As of September 30, 2013 12 Months or More | | Total | |
|--|-------------------------|----------------------|---|----------------------|-------------------------|----------------------|
| | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses |
| U.S. Treasury securities | \$ 1,505 | \$ 6 | \$ | \$ | \$ 1,505 | \$ 6 |
| Obligations of states and political subdivisions | 77,923 | 2,823 | | | 77,923 | 2,823 |
| Residential mortgage-backed securities | 65,667 | 1,656 | 5,115 | 173 | 70,782 | 1,829 |
| Commercial mortgage-backed securities | 6,984 | 15 | | | 6,984 | 15 |
| Other asset-backed securities | 4,604 | 9 | | | 4,604 | 9 |
| Corporate and other securities | 102,848 | 2,345 | 865 | 34 | 103,713 | 2,379 |
| Subtotal, fixed maturity securities | 259,531 | 6,854 | 5,980 | 207 | 265,511 | 7,061 |
| Equity securities | 5,192 | 184 | | | 5,192 | 184 |
| Total temporarily impaired securities | \$ 264,723 | \$ 7,038 | \$ 5,980 | \$ 207 | \$ 270,703 | \$ 7,245 |

| | Less than 12 Months | | As of December 31, 2012 12 Months or More | | Total | |
|--|-------------------------|----------------------|--|----------------------|-------------------------|----------------------|
| | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses |
| Obligations of states and political subdivisions | \$ 2,868 | \$ 17 | \$ | \$ | \$ 2,868 | \$ 17 |
| Residential mortgage-backed securities | 50,779 | 966 | 3,938 | 40 | 54,717 | 1,006 |
| Commercial mortgage-backed securities | 107 | | | | 107 | |
| Corporate and other securities | 22,979 | 269 | | | 22,979 | 269 |
| Subtotal, fixed maturity securities | 76,733 | 1,252 | 3,938 | 40 | 80,671 | 1,292 |
| Equity securities | 1,145 | 23 | 303 | 43 | 1,448 | 66 |
| | \$ 77,878 | \$ 1,275 | \$ 4,241 | \$ 83 | \$ 82,119 | \$ 1,358 |

Total temporarily impaired securities

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.

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Notes to Unaudited Consolidated Financial Statements****(Dollars in thousands except per share and share data)**

The unrealized losses in the Company's fixed income and equity portfolio as of September 30, 2013 were reviewed for potential other-than-temporary asset impairments. The Company held no securities at September 30, 2013 with a material (20% or greater) unrealized loss for four or more consecutive quarters. 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 the unrealized losses recorded on the investment portfolio at September 30, 2013 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.

During the nine months ended September 30, 2013 and 2012, there was no significant deterioration in the credit quality of any of the Company's holdings and no OTTI charges were recorded related to the Company's portfolio of investment securities. At September 30, 2013 and December 31, 2012, 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 its 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 Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------|----------------------------------|-----------|---------------------------------|-----------|
| | 2013 | 2012 | 2013 | 2012 |
| Interest on fixed maturity securities | \$ 10,113 | \$ 10,570 | \$ 30,846 | \$ 31,571 |
| Dividends on equity securities | 493 | 187 | 936 | 327 |
| Interest on other assets | 21 | 20 | 118 | 49 |
| Interest on cash and cash equivalents | 1 | | 11 | 14 |
| Total investment income | 10,628 | 10,777 | 31,911 | 31,961 |
| Investment expenses | 605 | 635 | 1,774 | 1,410 |
| Net investment income | \$ 10,023 | \$ 10,142 | \$ 30,137 | \$ 30,551 |

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.

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

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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)

services to determine market valuations. The Company has processes designed to ensure that the values received from third-party pricing service are accurately recorded, that the data inputs and valuation techniques utilized are appropriate and consistently applied and that the assumptions are reasonable and consistent with the objective of determining fair value. 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 is a real estate investment trust equity investment whose fair value was determined using the trust's net asset value obtained from its audited financial statements; however, the Company is required to submit a request 45 days before a quarter end to dispose of the security. 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 and obligations of U.S. Government agencies, obligations of international government agencies, obligations of states and political subdivisions, corporate 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:

- *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.

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- *Corporate fixed maturities:* 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.
- *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.
- *Real estate investment trust (REIT):* net asset value per share derived from member ownership in capital venture to which a proportionate share of independently appraised net assets is attributed.

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Notes to Unaudited Consolidated Financial Statements****(Dollars in thousands except per share and share data)**

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.

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).

With the exception of the REIT which is 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 September 30, 2013. There were no significant changes to the valuation process during the nine months ending September 30, 2013. As of September 30, 2013 and December 31, 2012, no quotes or prices obtained were adjusted by management. All broker quotes obtained were non-binding.

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

| | As of September 30, 2013 | | | | |
|--|--------------------------|----------------|----------------|----------------|--|
| | Total | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | |
| U.S. Treasury securities | \$ 2,511 | \$ | \$ 2,511 | \$ | |
| Obligations of states and political subdivisions | 468,026 | | 468,026 | | |
| Residential mortgage-backed securities | 219,827 | | 219,827 | | |
| Commercial mortgage-backed securities | 37,240 | | 37,240 | | |
| Other asset-backed securities | 14,193 | | 14,193 | | |
| Corporate and other securities | 383,185 | | 383,185 | | |
| Equity securities | 57,362 | 51,595 | | 5,767 | |
| Total investment securities | \$ 1,182,344 | \$ 51,595 | \$ 1,124,982 | \$ 5,767 | |

| | As of December 31, 2012 | | | | |
|--|-------------------------|----------------|----------------|----------------|--|
| | Total | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | |
| U.S. Treasury securities | \$ 7,155 | \$ | \$ 7,155 | \$ | |
| Obligations of states and political subdivisions | 491,183 | | 491,183 | | |
| Residential mortgage-backed securities | 225,897 | | 225,897 | | |
| Commercial mortgage-backed securities | 40,474 | | 40,474 | | |

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| | | | | |
|--------------------------------|--------------|-----------|--------------|----------|
| Other asset-backed securities | 22,186 | | 22,186 | |
| Corporate and other securities | 378,658 | | 378,658 | |
| Equity securities | 22,800 | 17,454 | | 5,346 |
| Total investment securities | \$ 1,188,353 | \$ 17,454 | \$ 1,165,553 | \$ 5,346 |

There were no transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2013 and 2012.

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Notes to Unaudited Consolidated Financial Statements****(Dollars in thousands except per share and share data)**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|------|---------------------------------|------|
| | 2013 | 2012 | 2013 | 2012 |
| Balance at beginning of period | \$ 5,533 | \$ | \$ 5,346 | \$ |
| Net gains and losses included in earnings | | | | |
| Net gains included in other comprehensive income | 234 | | 421 | |
| Purchases and sales | | | | |
| Transfers into (out of) Level 3 | | | | |
| Balance at end of period | \$ 5,767 | \$ | \$ 5,767 | \$ |
| 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 the three and nine months ended September 30, 2013 and 2012. The Company held one Level 3 security at September 30, 2013 and no Level 3 securities at September 30, 2012.

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.

| | Nine Months Ended September 30, | |
|--|---------------------------------|------------|
| | 2013 | 2012 |
| Reserves for losses and LAE at beginning of year | \$ 423,842 | \$ 403,872 |
| Less receivable from reinsurers related to unpaid losses and LAE | (52,185) | (51,774) |
| Net reserves for losses and LAE at beginning of year | 371,657 | 352,098 |
| Incurred losses and LAE, related to: | | |
| Current year | 350,066 | 319,056 |
| Prior years | (21,762) | (11,872) |
| Total incurred losses and LAE | 328,304 | 307,184 |
| Paid losses and LAE related to: | | |
| Current year | 212,913 | 185,121 |
| Prior years | 107,120 | 112,635 |

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| | | | |
|--|----------------|----------------|------------|
| Total paid losses and LAE | 320,033 | | 297,756 |
| Net reserves for losses and LAE at end of period | 379,928 | | 361,526 |
| Plus receivable from reinsurers related to unpaid losses and LAE | 58,568 | | 52,115 |
| Reserves for losses and LAE at end of period | \$ | 438,496 | \$ 413,641 |

At the end of each period, the reserves were re-estimated for all prior accident years. The Company's prior year reserves decreased by \$21,762 and \$11,872 for the nine months ended September 30, 2013 and 2012, respectively, and resulted from re-estimations of prior years ultimate loss and LAE liabilities. The decrease in prior years reserves during the 2013 period is primarily composed of reductions in the Company's retained automobile reserves and retained homeowners reserves. The decrease in prior year reserves during the 2012 period is primarily composed of a reduction in the Company's automobile reserves, partially offset by an increase in the accident year 2011 reserves of homeowners and all other business lines.

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Safety Insurance Group, Inc. and Subsidiaries

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(Dollars in thousands except per share and share data)

The Company's private passenger automobile line of business reserves decreased for the nine months ended September 30, 2013 and 2012 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

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. Although the Company has not received written notice regarding 2013 actions to be taken by the Insolvency Fund, based upon existing knowledge that an assessment was approved by the Board of Directors of the Insolvency Fund at its October 26, 2013 meeting, the Company increased its estimated potential assessments to \$1,250 for the nine months ended September 30, 2013, which resulted in an increase to underwriting expenses of \$1,000 for the three months ended September 30, 2013. During the comparable 2012 period, similarly without receipt of written notice but based upon existing knowledge of the assessment amount approved by the Board of Directors of the Insolvency Fund at its October 20, 2012 meeting, the Company reduced its estimated potential assessments to \$0 for the nine months ended September 30, 2012, which resulted in a reduction to underwriting expenses of \$250 for the three months ended September 30, 2012.

It is anticipated that there will be additional assessments from time to time relating to various insolvencies. Although the 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

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On August 21, 2013, the Company extended its Revolving Credit Agreement (the Credit Agreement) with RBS Citizens, NA (RBS Citizens) to a maturity date of August 14, 2018. 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 RBS Citizens prime rate or 0.5% above the federal funds rate plus 1.25% per annum. Interest only is payable prior to maturity.

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 September 30, 2013, 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 September 30, 2013 and December 31, 2012. 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 September 30, 2013 and 2012.

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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)

9. Income Taxes

Federal income tax expense for the nine months ended September 30, 2013 and 2012 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 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 nine months ended September 30, 2013, 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 is currently under examination by the IRS. In the Company's opinion, adequate tax liabilities have been established for all years. However, the 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 2010 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 September 30, 2013, the Board of Directors had authorized increases to the existing share repurchase program of up to \$90,000 of the Company's outstanding common shares. On November 4, 2013, the Board of Directors again increased the existing share repurchase program by authorizing repurchase of up to \$150,000 of the Company's 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.

During the nine months ending September 30, 2013, the Company purchased 90,902 shares on the open market under the program at a cost of \$4,799. No share purchases were made under the program during the nine months ending September 30, 2012. As of September 30, 2013, the Company had purchased 1,819,547 shares on the open market at a cost of \$60,368. As of December 31, 2012, the Company had purchased 1,728,645 shares on the open market at a cost of \$55,569.

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 on February 10, 2018. The Company's original participation in the loan was \$2,500. The second loan, made to ARCAS Automotive (formally known as Sequa Auto) bears interest at the rate of 6.25% per annum and has a maturity date of November 15, 2018. The Company's original participation in the loan was \$1,200. Both loans amortized in equal quarterly installments of 0.25% of the principal amount per quarter. 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), Whiteshirts Asset Management Corporation (WAMC), and Whiteshirts Management Corporation, which is WAMC's holding company.

We are a leading provider of property and casualty insurance focused primarily on the Massachusetts market. Our principal product line is automobile insurance. In addition to private passenger automobile insurance (which represented 65.9% of our direct written premiums in 2012) and commercial automobile insurance (11.0% of 2012 direct written premiums), we offer a portfolio of other insurance products, including homeowners (18.9% of 2012 direct written premiums) and dwelling fire, umbrella and business owner policies (totaling 4.2% of 2012 direct written premiums). Operating exclusively in Massachusetts and New Hampshire 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 879 in 1,023 locations throughout Massachusetts and New Hampshire during 2012. 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 11.0% and 12.4% share, respectively, of the Massachusetts private passenger and commercial automobile markets in 2012 according to the Commonwealth Automobile Reinsurers (CAR).

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 nine months ended September 30, 2013 and 2012, we wrote \$10,084 and \$6,456, respectively, in direct written premiums in New Hampshire.

Massachusetts Automobile Insurance Market

We have been subject to extensive regulation in the private passenger automobile insurance industry in Massachusetts, which represented 65.9% of our direct written premiums in 2012. Private passenger automobile insurance has been heavily regulated in Massachusetts. In many respects, the private passenger automobile insurance market in Massachusetts prior to 2008 was unique, in comparison to other states. This was due to a number of factors, including unusual regulatory conditions, the market dominance of domestic companies, the relative absence of large national companies, and the heavy reliance on independent insurance agents as the market's principal distribution channel. Perhaps most significantly, prior to 2008, the Massachusetts Commissioner of Insurance (the Commissioner) fixed and established the premium rates and the rating plan to be used by all insurance companies doing business in the private passenger automobile insurance market and the Massachusetts private passenger automobile insurance residual market mechanism featured a reinsurance program run by CAR in which companies were assigned producers.

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In 2008, the Commissioner issued a series of decisions to introduce what she termed "managed competition" to Massachusetts automobile insurance premium rates and in doing so replaced the fixed and established regime with a prior approval rate review process, governed by regulations that set certain terms and conditions that insurers must comply with in establishing their rates. The Commissioner also replaced the former reinsurance program with an assigned risk plan.

These decisions removed many of the factors that had historically distinguished the Massachusetts private passenger automobile insurance market from the market in other states. However, certain of the historically unique factors have not been eliminated, including compulsory insurance, affinity group marketing, and the prominence of independent agents.

CAR runs a reinsurance pool for commercial automobile policies and, beginning January 1, 2006, CAR implemented a Limited Servicing Carrier Program (LSC) for ceded commercial automobile policies. CAR approved Safety Insurance and five other servicing carriers through a Request for Proposal to process ceded commercial automobile business, which was spread equitably among the six servicing carriers. In 2010, CAR reduced the number of servicing carriers to four, and CAR approved Safety Insurance and three other servicing carriers effective July 1, 2011 to continue the program. 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). On April 25, 2007, Safety Insurance submitted through a Request for Proposal a bid to process a portion of the Taxi/Limo Program. CAR approved Safety Insurance as one of the two servicing carriers for this program beginning January 1, 2008, and CAR again approved Safety Insurance beginning January 1, 2011 as one of the two servicing carriers.

During 2012, we increased our Massachusetts private passenger rates approximately 4.7%. On July 15, 2013, we began a new rating plan using 768 rating tiers which we expect will result in no change to our rate level. Our Massachusetts rates include a 13.0% commission rate for agents. Our direct automobile written premiums increased by 6.1% in 2012 with increased exposures and average written premium per exposure in our commercial automobile line of business.

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 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.

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| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------|----------------------------------|-------|---------------------------------|-------|
| | 2013 | 2012 | 2013 | 2012 |
| GAAP ratios: | | | | |
| Loss ratio | 63.4% | 65.5% | 64.6% | 64.4% |
| Expense ratio | 30.7 | 30.8 | 30.4 | 30.7 |
| Combined ratio | 94.1% | 96.3% | 95.0% | 95.1% |

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

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September 30, 2013, there were 530,832 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 nine months ended September 30, 2013 is as follows:

| Type of Equity Awarded | Effective Date | Number of Awards Granted | Fair Value per Share (1) | Vesting Terms |
|------------------------|----------------|--------------------------|--------------------------|------------------------|
| RS | March 11, 2013 | 28,988 | \$ 46.96 | 3 years, 30%-30%-40% |
| RS | March 11, 2013 | 4,000 | \$ 46.96 | No vesting period (1) |
| RS | March 11, 2013 | 35,429 | \$ 43.90 | 3 years, cliff vesting |
| RS | March 27, 2013 | 22,485 | \$ 48.65 | 5 years, 20% annually |
| RS | July 8, 2013 | 500 | \$ 51.63 | 5 years, 20% annually |
| RS | August 5, 2013 | 1,659 | \$ 54.26 | 3 years, 30%-30%-40% |
| RS | August 5, 2013 | 2,027 | \$ 48.27 | 3 years, cliff vesting |

(1) The shares cannot be sold, assigned, pledged, or otherwise transferred, encumbered or disposed of until the recipient is no longer a member of the Board of Directors.

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 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, 2013, we have purchased four layers of excess catastrophe reinsurance providing \$515,000 of coverage for property losses in excess of \$50,000 up to a maximum of \$565,000. Our reinsurers' co-participation is 50.0% of \$50,000 for the 1st layer, 80.0% of \$80,000 for the 2nd layer, 80.0% of \$250,000 for the 3rd layer, and 80.0% of \$135,000 for the 4th layer. As a result of the changes to the models and our revised reinsurance program, our catastrophe reinsurance in 2013 protects us in the event of a 127-year storm (that is, a storm of a severity expected to occur once in a 127-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) however in no case is a reinsurer rated below 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 has grown dramatically over the past few years as insurance carriers have reduced their exposure to coastal property. The FAIR Plan's exposure to catastrophe losses increased and as a result, the FAIR Plan decided to buy reinsurance to reduce their exposure to catastrophe losses. On July 1, 2013, the FAIR Plan purchased \$1,000,000 of catastrophe reinsurance for property losses in excess of

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\$200,000. At September 30, 2013, we had no material amounts recoverable from any reinsurer, excluding \$51,177 recoverable from CAR.

On March 10, 2005, our Board of Directors adopted a resolution that prohibits Safety from purchasing finite reinsurance (reinsurance that transfers only a finite or limited amount of risk to the reinsurer) without approval by the Board. To date, the Company has never purchased a finite reinsurance contract.

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.

Table of Contents**Results of Operations****Three and Nine Months Ended September 30, 2013 Months Compared to Three and Nine Months Ended September 30, 2012**

The following table shows certain of our selected financial results.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|----------------------------------|------------|---------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| Direct written premiums | \$ 186,627 | \$ 179,007 | \$ 571,056 | \$ 541,090 |
| Net written premiums | \$ 177,724 | \$ 171,692 | \$ 546,261 | \$ 517,983 |
| Net earned premiums | \$ 172,246 | \$ 162,493 | \$ 508,235 | \$ 477,099 |
| Net investment income | 10,023 | 10,142 | 30,137 | 30,551 |
| Net realized gains on investments | 657 | 153 | 1,199 | 1,226 |
| Finance and other service income | 4,768 | 4,743 | 13,920 | 13,769 |
| Total revenue | 187,694 | 177,531 | 553,491 | 522,645 |
| Loss and loss adjustment expenses | 109,183 | 106,445 | 328,304 | 307,184 |
| Underwriting, operating and related expenses | 52,940 | 50,054 | 154,505 | 146,602 |
| Interest expense | 23 | 22 | 66 | 66 |
| Total expenses | 162,146 | 156,521 | 482,875 | 453,852 |
| Income before income taxes | 25,548 | 21,010 | 70,616 | 68,793 |
| Income tax expense | 7,892 | 6,676 | 20,917 | 20,294 |
| Net income | \$ 17,656 | \$ 14,334 | \$ 49,699 | \$ 48,499 |
| Earnings per weighted average common share: | | | | |
| Basic | \$ 1.15 | \$ 0.94 | \$ 3.24 | \$ 3.17 |
| Diluted | \$ 1.14 | \$ 0.94 | \$ 3.23 | \$ 3.17 |
| Cash dividends paid per common share | \$ 0.60 | \$ 0.60 | \$ 1.80 | \$ 1.60 |

Direct Written Premiums. Direct written premiums for the quarter ended September 30, 2013 increased by \$7,620, or 4.3%, to \$186,627 from \$179,007 for the comparable 2012 period. Direct written premiums for the nine months ended September 30, 2013 increased by \$29,966, or 5.5%, to \$571,056 from \$541,090 for the comparable 2012 period. The increase for the quarter ended September 30, 2013 from the comparable 2012 period occurred primarily in our homeowners and commercial automobile business lines, which experienced increases of 5.2% and 3.5%, respectively, in average written premium per exposure and increases of 5.6% and 11.4%, respectively, in written exposures. The increase for the nine months ended September 30, 2013 from the comparable 2012 period occurred primarily in our homeowners, commercial automobile, and personal automobile business lines, which experienced increases of 5.6%, 2.1%, and 3.0%, respectively, in average written premium per exposure, increases of 5.5% and 12.2% in written exposures in our homeowners and commercial automobile business lines, and a slight decrease of 0.3% in written exposures in our personal automobile business line.

Net Written Premiums. Net written premiums for the quarter ended September 30, 2013 increased by \$6,032, or 3.5%, to \$177,724 from \$171,692 for the comparable 2012 period. Net written premiums for the nine months ended September 30, 2013 increased by \$28,278, or 5.5%, to \$546,261 from \$517,983 for the comparable 2012 period. The 2013 increases were primarily due to the factors that increased direct written premiums in our homeowners, commercial automobile, and personal automobile lines of business as discussed above.

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Net Earned Premiums. Net earned premiums for the quarter ended September 30, 2013 increased by \$9,753, or 6.0%, to \$172,246 from \$162,493 for the comparable 2012 period. Net earned premiums for the nine months ended September 30, 2013 increased by \$31,136, or 6.5% to \$508,235 from \$477,099 for the comparable 2012 period. The 2013 increase was primarily due to the factors that increased direct written premiums in our personal automobile and homeowners business lines as discussed above.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------------|----------------------------------|------------|---------------------------------|------------|
| | 2013 | 2012 | 2013 | 2012 |
| Written Premiums | | | | |
| Direct | \$ 186,627 | \$ 179,007 | \$ 571,056 | \$ 541,090 |
| Assumed | 4,163 | 4,505 | 15,426 | 13,234 |
| Ceded | (13,066) | (11,820) | (40,221) | (36,341) |
| Net written premiums | \$ 177,724 | \$ 171,692 | \$ 546,261 | \$ 517,983 |
| Earned Premiums | | | | |
| Direct | \$ 181,188 | \$ 170,616 | \$ 533,023 | \$ 499,890 |
| Assumed | 4,647 | 4,139 | 14,412 | 12,560 |
| Ceded | (13,589) | (12,262) | (39,200) | (35,351) |
| Net earned premiums | \$ 172,246 | \$ 162,493 | \$ 508,235 | \$ 477,099 |

Net Investment Income. Net investment income for the quarter ended September 30, 2013 decreased by \$119 or 1.2%, to \$10,023 from \$10,142 for the comparable 2012 period. Net investment income for the nine months ended September 30, 2013 decreased by \$414, or 1.4%, to \$30,137 from \$30,551 for the comparable 2012 period. Net effective annualized yield on the investment portfolio decreased to 3.4% and 3.5%, respectively, for the quarter and nine months ended September 30, 2013, from 3.6% and 3.7%, respectively, for the comparable 2012 periods. Our duration was 3.8 years at September 30, 2013 compared to 3.6 years at December 31, 2012.

Net Realized Gains on Investments. Net realized gains on investments were \$657 for the quarter ended September 30, 2013 compared to \$153 for the comparable 2012 period. Net realized gains on investments were \$1,199 for the nine months ended September 30, 2013 compared to \$1,226 for the comparable 2012 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 September 30, 2013 | | | | |
|--|--------------------------|------------------------|----------------------------|----------------------------|----------------------|
| | Cost or Amortized Cost | Gross Unrealized Gains | Non-OTTI Unrealized Losses | OTTI Unrealized Losses (3) | Estimated Fair Value |
| U.S. Treasury securities | \$ 2,512 | \$ 5 | \$ (6) | \$ | \$ 2,511 |
| Obligations of states and political subdivisions | 457,228 | 13,621 | (2,823) | | 468,026 |
| Residential mortgage-backed securities (1) | 213,961 | 7,695 | (1,829) | | 219,827 |
| Commercial mortgage-backed securities | 36,851 | 404 | (15) | | 37,240 |
| Other asset-backed securities | 14,006 | 196 | (9) | | 14,193 |
| Corporate and other securities | 375,519 | 10,045 | (2,379) | | 383,185 |
| Subtotal, fixed maturity securities | 1,100,077 | 31,966 | (7,061) | | 1,124,982 |
| Equity securities | 52,879 | 4,667 | (184) | | 57,362 |
| Totals | \$ 1,152,956 | \$ 36,633 | \$ (7,245) | \$ | \$ 1,182,344 |

(1) Residential mortgage-backed securities consists primarily of obligations of U.S. Government agencies including collateralized mortgage obligations and mortgage-backed securities 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) Our investment portfolio included 254 securities in an unrealized loss position at September 30, 2013.

(3) Amounts in this column represent other-than-temporary impairments recognized in accumulated other comprehensive income.

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

| | As of September 30, 2013 | |
|--|--------------------------|---------|
| | Estimated Fair Value | Percent |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 225,200 | 20.0% |
| Aaa/Aa | 483,045 | 42.9 |
| A | 188,464 | 16.8 |
| Baa | 88,562 | 7.9 |
| Ba | 49,486 | 4.4 |
| B | 60,835 | 5.4 |
| Caa | 7,300 | 0.6 |
| Not rated | 22,090 | 2.0 |
| Total | \$ 1,124,982 | 100.0% |

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 September 30, 2013, 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 comprised of variable rate secured debt, senior bank loans and high yield bonds. We have no exposure to European sovereign debt.

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 September 30, 2013.

| | Less than 12 Months | | As of September 30, 2013 12 Months or More | | Total | |
|--|----------------------|-------------------|---|-------------------|----------------------|-------------------|
| | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses | Estimated Fair Value | Unrealized Losses |
| U.S. Treasury securities | \$ 1,505 | \$ 6 | \$ | \$ | \$ 1,505 | \$ 6 |
| Obligations of states and political subdivisions | 77,923 | 2,823 | | | 77,923 | 2,823 |
| Residential mortgage-backed securities | 65,667 | 1,656 | 5,115 | 173 | 70,782 | 1,829 |
| Commercial mortgage-backed securities | 6,984 | 15 | | | 6,984 | 15 |
| Other asset-backed securities | 4,604 | 9 | | | 4,604 | 9 |
| Corporate and other securities | 102,848 | 2,345 | 865 | 34 | 103,713 | 2,379 |
| Subtotal, fixed maturity securities | 259,531 | 6,854 | 5,980 | 207 | 265,511 | 7,061 |
| Equity securities | 5,192 | 184 | | | 5,192 | 184 |
| Total temporarily impaired securities | \$ 264,723 | \$ 7,038 | \$ 5,980 | \$ 207 | \$ 270,703 | \$ 7,245 |

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As of September 30, 2013, we held insured investment securities of approximately \$105,965, which represented approximately 9.0% of our total investments. Approximately \$60,287 of these securities are pre-refunded, meaning that funds have been set aside in escrow to satisfy the future interest and principal obligations of the bond.

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The following table shows our insured investment securities that are backed by financial guarantors including pre-refunded securities as of September 30, 2013. We do not have any direct investment holdings in a financial guarantee insurance company.

| Financial Guarantor | As of September 30, 2013 | | |
|--|--------------------------|-------------------------|---|
| | Total | Pre-refunded Securities | Exposure Net of Pre-refunded Securities |
| Municipal bonds | | | |
| Ambac Assurance Corporation | \$ 17,952 | \$ 10,553 | \$ 7,399 |
| Financial Guaranty Insurance Company | 264 | 264 | |
| Assured Guaranty Municipal Corporation | 42,507 | 31,680 | 10,827 |
| National Public Finance Guaranty Corporation | 45,242 | 17,790 | 27,452 |
| Total | \$ 105,965 | \$ 60,287 | \$ 45,678 |

The Moody's rating of the Company's insured investments held at September 30, 2013 are essentially the same with or without the investment guarantees.

We reviewed the unrealized losses in our fixed income and equity portfolio as of September 30, 2013 for potential other-than-temporary asset impairments. We held no debt securities at September 30, 2013 with a material (20% or greater) unrealized loss for four or more consecutive quarters. Specific qualitative analysis was 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.

The unrealized losses recorded on the investment portfolio at September 30, 2013 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.

During the nine months ended September 30, 2013 and 2012, there was no significant deterioration in the credit quality of any of our holdings and no other-than-temporary impairment (OTTI) charges were recorded related to our portfolio of investment securities.

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

Finance and Other Service Income. Finance and other service income includes revenues from premium installment charges, which we recognize when earned, and other miscellaneous income and fees. Finance and other service income increased by \$25, or 0.5%, to \$4,768 for the three months ended September 30, 2013 from \$4,743 for the comparable 2012 period. Finance and other service income increased by \$151, or 1.1%, to \$13,920 for the nine months ended September 30, 2013 from \$13,769 for the comparable 2012 period.

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Losses and Loss Adjustment Expenses. Losses and loss adjustment expenses incurred for the three months ended September 30, 2013 increased by \$2,738, or 2.6%, to \$109,183 from \$106,445 for the comparable 2012 period. Losses and loss adjustment expenses incurred for the nine months ended September 30, 2013 increased by \$21,120, or 6.9%, to \$328,304 from \$307,184 for the comparable 2012 period. Our GAAP loss ratio for the three months ended September 30, 2013 decreased to 63.4% from 65.5% for the comparable 2012 period. Our GAAP loss ratio for the nine months ended September 30, 2013 increased to 64.6% from 64.4% for the comparable 2012 period. Our GAAP loss ratio excluding loss adjustment expenses for the three months ended September 30, 2013 decreased to 54.1% from 56.4% for the comparable 2012 period. Our GAAP loss ratio excluding loss adjustment expenses for the nine months ended September 30, 2013 increased to 55.5% from 55.2% for the comparable 2012 period. Total prior year favorable development included in the pre-tax results for the three and nine months ended September 30, 2013 was \$7,353 and \$21,762, respectively, compared to prior years favorable development of \$4,263 and \$11,872, respectively, for the comparable 2012 periods.

Underwriting, Operating and Related Expenses. Underwriting, operating and related expenses for the three months ended September 30, 2013 increased by \$2,886, or 5.8%, to \$52,940 from \$50,054 for the comparable 2012 period. Underwriting, operating and related expenses for the nine months ended September 30, 2013 increased by \$7,903, or 5.4%, to \$154,505 from \$146,602 for the comparable 2012 period. The 2013 increase is primarily due to an increase in commissions to agents. Our GAAP expense ratios for

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the three months ended September 30, 2013 decreased to 30.7% from 30.8% for the comparable 2012 period. Our GAAP expense ratios for the nine months ended September 30, 2013 decreased to 30.4% from 30.7% for the comparable 2012 period.

Interest Expenses. Interest expense was \$23 and \$22 for the three months ended September 30, 2013 and 2012, respectively. Interest expense was \$66 for both the nine months ended September 30, 2013 and 2012. The credit facility commitment fee included in interest expense for both the three and nine months ended September 30, 2013 and 2012 was \$19 and \$56, respectively.

Income Tax Expense. Our effective tax rate was 30.9% and 31.8% for the three months ended September 30, 2013 and 2012, respectively. Our effective tax rate was 29.6% and 29.5% for the nine months ended September 30, 2013 and 2012, respectively. These effective rates were lower than the statutory rate of 35.0% primarily due to adjustments for tax-exempt investment income.

Net Income. Net income for the three months ended September 30, 2013 was \$17,656 compared to \$14,334 for the comparable 2012 period. Net income for the nine months ended September 30, 2013 was \$49,699 compared to \$48,499 for the comparable 2012 period. The increase in net income for the three and nine months ended September 30, 2013 from the comparable 2012 periods was primarily attributable to the increase in net earned premiums, as discussed above.

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 \$65,102 and \$76,356 during the nine months ended September 30, 2013 and 2012, respectively. 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. These positive operating cash flows are expected to continue to meet our liquidity requirements.

Net cash used for investing activities was \$32,235 and \$57,136 during the nine months ended September 30, 2013 and 2012, respectively. Net cash used for investing activities is primarily the result of purchases of fixed maturity securities and equity securities exceeding proceeds from sales, paydowns, redemptions, calls and maturities of fixed maturity securities.

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Net cash used for financing activities was \$29,945 and \$23,413 during the nine months ended September 30, 2013 and 2012, respectively. Net cash used for financing activities is primarily comprised of dividend payments to shareholders and acquisition of treasury shares. The increase in net cash used for financing activities was primarily attributable to an increase in dividends paid to shareholders and the acquisitions of treasury stock during the nine months ended September 30, 2013 compared to the comparable 2012 period.

The Insurance Subsidiaries maintain a high degree of liquidity within their respective investment portfolios in fixed maturity and short-term investments. In recent years, global financial markets experienced unprecedented and challenging conditions, including a tightening in the availability of credit, the failure of several large financial institutions and concerns about the creditworthiness of the sovereign debt of several European and other countries. We believe that recent and ongoing government actions, including The Emergency Economic Stabilization Act of 2008, the 2009 American Recovery and Reinvestment Act and other U.S. and global government programs and the quality of the assets we hold will allow us to realize these securities' anticipated long-term economic value. Furthermore, as of September 30, 2013, we had the intent and ability to retain such investments for the period of time anticipated to allow for this expected recovery in fair value. 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.

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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 company's 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, 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, 2012, the statutory surplus of Safety Insurance was \$599,024, and its net income for 2012 was \$52,435. As a result, a maximum of \$59,902 is available in 2013 for such dividends without prior approval of the Commissioner. During the nine months ended September 30, 2013, Safety Insurance recorded dividends to Safety of \$27,618. As result of this Massachusetts statute, the Insurance Subsidiaries had restricted net assets in the amount of \$539,122 at December 31, 2012.

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 2013 were as follows:

| Declaration Date | Record Date | Payment Date | Dividend per Common Share | Total Dividends Paid and Accrued |
|-------------------|---------------|----------------|---------------------------|----------------------------------|
| February 15, 2013 | March 1, 2013 | March 15, 2013 | \$ 0.60 | \$ 9,200 |

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| | | | | | | |
|-----------------------|--------------------------|---------------------------|-----------|-------------|-----------|--------------|
| May 6, 2013 | June 3, 2013 | June 14, 2013 | \$ | 0.60 | \$ | 9,244 |
| August 7, 2013 | September 3, 2013 | September 13, 2013 | \$ | 0.60 | \$ | 9,236 |

On November 4, 2013, our Board approved and declared a cash dividend of \$0.60 per share which will be paid on December 13, 2013 to shareholders of record on December 2, 2013. We plan to continue to declare and pay quarterly cash dividends in 2013, depending on our financial position and the regularity of our cash flows.

On August 3, 2007, our Board approved a share repurchase program of up to \$30,000 of the Company's outstanding common shares. As of September 30, 2013, our Board had authorized increases to our existing share repurchase program of up to \$90,000 of the Company's outstanding common shares. On November 4, 2013, our Board again increased the existing share repurchase program by authorizing repurchase of up to \$150,000 of the Company's outstanding common shares. Under the program, we may repurchase shares of our 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 September 30, 2013 and December 31, 2012, the Company had purchased 1,819,547 and 1,728,645 shares on the open market at a cost of \$60,368 and \$55,569.

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

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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 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, 2012, the Insurance Subsidiaries had total adjusted capital of \$599,024, 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 \$85,639 at December 31, 2012.

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 unreported losses 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

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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 estimated losses incurred but not yet reported (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.

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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 \$356,000 to \$387,186 as of September 30, 2013. 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 \$379,928 as of September 30, 2013.

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 September 30, 2013.

| Line of Business | Low | Recorded | High |
|------------------------------|------------|------------|------------|
| Private passenger automobile | \$ 216,557 | \$ 228,109 | \$ 232,648 |
| Commercial automobile | 50,911 | 51,737 | 52,564 |
| Homeowners | 53,222 | 59,101 | 59,707 |
| All other | 35,310 | 40,981 | 42,267 |
| Total | \$ 356,000 | \$ 379,928 | \$ 387,186 |

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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 September 30, 2013.

| Line of Business | Case | IBNR | Total |
|---------------------------------------|------------|------------|------------|
| Private passenger automobile | \$ 234,107 | \$ (7,144) | \$ 226,963 |
| CAR assumed private passenger auto | 565 | 581 | 1,146 |
| Commercial automobile | 37,042 | 2,645 | 39,687 |
| CAR assumed commercial automobile | 6,724 | 5,326 | 12,050 |
| Homeowners | 35,437 | 17,290 | 52,727 |
| FAIR Plan assumed homeowners | 2,969 | 3,405 | 6,374 |
| All other | 21,056 | 19,925 | 40,981 |
| Total net reserves for losses and LAE | \$ 337,900 | \$ 42,028 | \$ 379,928 |

At September 30, 2013, our total IBNR reserves for our private passenger automobile line of business was comprised of \$28,590 related to estimated ultimate decreases in the case reserves, including anticipated recoveries (i.e. salvage and subrogation), and \$21,446 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 44.2% of our total reserves for CAR assumed commercial automobile business as of September 30, 2013 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 53.4% of our total reserves for FAIR Plan assumed homeowners at September 30, 2013 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 September 30, 2013.

| Line of Business | Retained | Assumed | Net |
|--|------------|-----------|------------|
| Private passenger automobile | \$ 226,963 | | |
| CAR assumed private passenger automobile | | \$ 1,146 | |
| Net private passenger automobile | | | \$ 228,109 |
| Commercial automobile | 39,687 | | |
| CAR assumed commercial automobile | | 12,050 | |
| Net commercial automobile | | | 51,737 |
| Homeowners | 52,727 | | |
| FAIR Plan assumed homeowners | | 6,374 | |
| Net homeowners | | | 59,101 |
| All other | 40,981 | | 40,981 |
| Total net reserves for losses and LAE | \$ 360,358 | \$ 19,570 | \$ 379,928 |

Residual Market Loss and Loss Adjustment Expense Reserves

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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. The portion of reserves based upon CAR estimates for private passenger automobile line of business has declined substantially over time as a result of the institution of the an assigned risk plan in Massachusetts and phase-out of the private passenger automobile CAR reinsurance pool on April 1, 2009.

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.

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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, both because of the delays in receiving data from the various residual markets. As a result, we are cautious in recording residual market reserves for the calendar years for which 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 nine months ended September 30, 2013, a 1 percentage-point change in the loss and LAE ratio would result in a change in reserves of \$5,082. Each 1 percentage-point change in the loss and loss expense ratio would have had a \$3,304 on net income, or \$0.21 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 nine months ended September 30, 2013. 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 1 percentage-point change in both our key assumptions would change estimated reserves within a range of plus or minus 2 percentage-points.

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| | -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 | \$ (4,539) | \$ (2,270) | \$ |
| Estimated increase in net income | 2,950 | 1,476 | |
| No Change in Severity | | | |
| Estimated (decrease) increase in reserves | (2,270) | | 2,270 |
| Estimated increase (decrease) in net income | 1,476 | | (1,476) |
| +1 Percent Change in Severity | | | |
| Estimated increase in reserves | | 2,270 | 4,539 |
| Estimated decrease in net income | | (1,476) | (2,950) |
| Commercial automobile retained loss and LAE reserves | | | |
| -1 Percent Change in Severity | | | |
| Estimated decrease in reserves | (794) | (397) | |
| Estimated increase in net income | 516 | 258 | |
| No Change in Severity | | | |
| Estimated (decrease) increase in reserves | (397) | | 397 |
| Estimated increase (decrease) in net income | 258 | | (258) |
| +1 Percent Change in Severity | | | |
| Estimated increase in reserves | | 397 | 794 |
| Estimated decrease in net income | | (258) | (516) |
| Homeowners retained loss and LAE reserves | | | |
| -1 Percent Change in Severity | | | |
| Estimated decrease in reserves | (1,055) | (527) | |
| Estimated increase in net income | 686 | 343 | |
| No Change in Severity | | | |
| Estimated (decrease) increase in reserves | (527) | | 527 |
| Estimated increase (decrease) in net income | 343 | | (343) |
| +1 Percent Change in Severity | | | |
| Estimated increase in reserves | | 527 | 1,055 |
| Estimated decrease in net income | | (343) | (686) |
| All other retained loss and LAE reserves | | | |
| -1 Percent Change in Severity | | | |
| Estimated decrease in reserves | (820) | (410) | |
| Estimated increase in net income | 533 | 267 | |
| No Change in Severity | | | |
| Estimated (decrease) increase in reserves | (410) | | 410 |
| Estimated increase (decrease) in net income | 267 | | (267) |
| +1 Percent Change in Severity | | | |
| Estimated increase in reserves | | 410 | 820 |
| Estimated decrease in net income | | (267) | (533) |

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.

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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 nine months ended September 30, 2013. 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.

| | -1 Percent Change in Estimation | +1 Percent Change in Estimation |
|---|---------------------------------------|---------------------------------------|
| CAR assumed private passenger automobile | | |
| Estimated (decrease) increase in reserves | \$ (11) | \$ 11 |
| Estimated increase (decrease) in net income | 7 | (7) |
| CAR assumed commercial automobile | | |
| Estimated (decrease) increase in reserves | (121) | 121 |
| Estimated increase (decrease) in net income | 79 | (79) |
| FAIR Plan assumed homeowners | | |
| Estimated (decrease) increase in reserves | (64) | 64 |
| Estimated increase (decrease) in net income | 42 | (42) |

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 \$21,762, and \$11,872 during the nine months ended September 30, 2013 and 2012, respectively.

The following table presents a comparison of prior year development of our net reserves for losses and LAE for the nine months ended September 30, 2013 and 2012. 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 | Nine Months Ended September 30, | |
|-----------------|---------------------------------|-------------|
| | 2013 | 2012 |
| 2003 & prior | \$ (366) | \$ (510) |
| 2004 | (517) | (638) |
| 2005 | (675) | (1,567) |
| 2006 | (1,222) | (1,174) |
| 2007 | (2,332) | (1,143) |
| 2008 | (3,516) | (2,374) |
| 2009 | (3,955) | (2,991) |
| 2010 | (3,290) | (4,806) |
| 2011 | (3,982) | 3,331 |
| 2012 | (1,907) | |
| All prior years | \$ (21,762) | \$ (11,872) |

The decreases in prior years' reserves during the nine months ended September 30, 2013 and 2012 resulted from re-estimations of prior year ultimate loss and LAE liabilities. The 2013 decrease is primarily composed of reductions of \$13,925 in our retained private passenger automobile reserves, \$2,931 in our retained commercial automobile reserves and \$4,140 in our retained homeowners reserves. The 2012

decrease is primarily composed of reductions of \$11,293 in our retained private passenger automobile reserves.

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The following table presents information by line of business for prior year development of our net reserves for losses and LAE for the nine months ended September 30, 2013.

| Accident Year | Private Passenger Automobile | Commercial Automobile | Homeowners | All Other | Total |
|-----------------|---------------------------------|--------------------------|------------|-----------|-------------|
| 2003 & prior | \$ (331) | \$ (4) | \$ (24) | \$ (7) | \$ (366) |
| 2004 | (273) | 4 | (216) | (32) | (517) |
| 2005 | (575) | (33) | (70) | 3 | (675) |
| 2006 | (1,175) | (58) | 8 | 3 | (1,222) |
| 2007 | (1,187) | (760) | (190) | (195) | (2,332) |
| 2008 | (2,967) | (475) | (81) | 7 | (3,516) |
| 2009 | (2,997) | 22 | (931) | (49) | (3,955) |
| 2010 | (1,873) | (65) | (1,491) | 139 | (3,290) |
| 2011 | (2,309) | (572) | (807) | (294) | (3,982) |
| 2012 | (982) | 38 | (912) | (51) | (1,907) |
| All prior years | \$ (14,669) | \$ (1,903) | \$ (4,714) | \$ (476) | \$ (21,762) |

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 nine months ended September 30, 2013; that is, all our reserves except for business ceded or assumed from CAR and other residual markets.

| Accident Year | Retained Private Passenger Automobile | Retained Commercial Automobile | Retained Homeowners | Retained All Other | Total |
|-----------------|---|--------------------------------------|------------------------|-----------------------|-------------|
| 2003 & prior | \$ (234) | \$ (3) | \$ (24) | \$ (7) | \$ (268) |
| 2004 | (166) | (1) | (216) | (32) | (415) |
| 2005 | (577) | (3) | (88) | 3 | (665) |
| 2006 | (880) | (2) | | 3 | (879) |
| 2007 | (1,090) | (760) | (188) | (195) | (2,233) |
| 2008 | (2,782) | (510) | (85) | 7 | (3,370) |
| 2009 | (3,032) | (38) | (911) | (49) | (4,030) |
| 2010 | (1,873) | (150) | (1,504) | 139 | (3,388) |
| 2011 | (2,309) | (760) | (623) | (294) | (3,986) |
| 2012 | (982) | (704) | (501) | (51) | (2,238) |
| All prior years | \$ (13,925) | \$ (2,931) | \$ (4,140) | \$ (476) | \$ (21,472) |

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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 nine months ended September 30, 2013.

| Accident Year | CAR Assumed Private Passenger Automobile | CAR Assumed Commercial Automobile | FAIR Plan Homeowners | Total |
|-----------------|--|---|-------------------------|----------|
| 2003 & prior | \$ (97) | \$ (1) | \$ | (98) |
| 2004 | (107) | 5 | | (102) |
| 2005 | 2 | (30) | 18 | (10) |
| 2006 | (295) | (56) | 8 | (343) |
| 2007 | (97) | | (2) | (99) |
| 2008 | (185) | 35 | 4 | (146) |
| 2009 | 35 | 60 | (20) | 75 |
| 2010 | | 85 | 13 | 98 |
| 2011 | | 188 | (184) | 4 |
| 2012 | | 742 | (411) | 331 |
| All prior years | \$ (744) | \$ 1,028 | \$ (574) | \$ (290) |

Our private passenger automobile line of business prior year reserves decreased by \$14,669 for the nine months ended September 30, 2013. The decrease was primarily due to improved retained private passenger results of \$11,086 for the accident years 2007 through 2011. The improved retained private passenger results were primarily due to fewer IBNR claims than previously estimated and better than previously estimated severity on our established bodily injury and property damage case reserves.

Our retained commercial automobile line of business prior year reserves decreased by \$2,931 for the nine months ended September 30, 2013 due primarily to fewer IBNR claims than previously estimated.

Our retained homeowners line of business prior year reserves decreased by \$4,140 for the nine months ended September 30, 2013. Our FAIR Plan homeowners line of business prior year reserves decreased by \$574 for the nine months ended September 30, 2013.

In estimating all our loss reserves, including CAR, we follow the guidance prescribed by Accounting Standards Codification (ASC) 944, *Financial Services-Insurance*.

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 six 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

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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 Realized Gains 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, projects, or words of similar meaning and expressions that indicate future 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, 2012.

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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.

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.

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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 September 30, 2013 | | | |
| Estimated fair value | \$ 1,167,357 | \$ 1,124,982 | \$ 1,079,886 |
| Estimated increase (decrease) in fair value | \$ 42,375 | | |