

SAFETY INSURANCE GROUP INC

Form 10-Q

November 02, 2018

Table of Contents

the

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2018

OR

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

For the transition period from _____ to _____

Commission File Number: 000-50070

SAFETY INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

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

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

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 every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 1, 2018 there were 15,286,610 shares of common stock with a par value of \$0.01 per share outstanding.

Table of Contents

SAFETY INSURANCE GROUP, INC.

TABLE OF CONTENTS

	Page No.
Part I. Financial Information	
Item 1. Consolidated Financial Statements	
<u>Consolidated Balance Sheets</u>	3
<u>Consolidated Statements of Operations</u>	4
<u>Consolidated Statements of Comprehensive Income</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity</u>	6
<u>Consolidated Statements of Cash Flows</u>	7
<u>Notes to Unaudited Consolidated Financial Statements</u>	8
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24
<u>Item 3. Quantitative and Qualitative Information about Market Risk</u>	43
<u>Item 4. Controls and Procedures</u>	43
Part II. Other Information	
<u>Item 1. Legal Proceedings</u>	45
<u>Item 1A. Risk Factors</u>	45
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	45
<u>Item 3. Defaults upon Senior Securities</u>	45
<u>Item 4. Mine Safety Disclosures</u>	45
<u>Item 5. Other Information</u>	45
<u>Item 6. Exhibits</u>	45
<u>EXHIBIT INDEX</u>	46
<u>SIGNATURE</u>	47

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands, except share data)

	September 30, 2018 (Unaudited)	December 31, 2017
Assets		
Investments:		
Fixed maturities, available for sale, at fair value (amortized cost: \$1,142,816 and \$1,156,697)	\$ 1,131,133	\$ 1,172,026
Equity securities, at fair value (cost: \$140,796 and \$90,481)	158,434	111,867
Other invested assets	25,961	23,162
Total investments	1,315,528	1,307,055
Cash and cash equivalents	51,317	41,708
Accounts receivable, net of allowance for doubtful accounts	209,470	190,649
Receivable for securities sold	984	1,380
Accrued investment income	9,137	8,876
Taxes recoverable	170	908
Receivable from reinsurers related to paid loss and loss adjustment expenses	24,340	24,776
Receivable from reinsurers related to unpaid loss and loss adjustment expenses	100,565	83,085
Ceded unearned premiums	34,414	32,175
Deferred policy acquisition costs	77,533	72,202
Deferred income taxes	3,423	—
Equity and deposits in pools	31,469	28,246
Other assets	20,280	16,219
Total assets	\$ 1,878,630	\$ 1,807,279
Liabilities		
Loss and loss adjustment expense reserves	\$ 582,957	\$ 574,054
Unearned premium reserves	460,405	428,257
Accounts payable and accrued liabilities	57,857	60,701
Payable for securities purchased	7,385	4,188
Payable to reinsurers	33,814	13,801
Deferred income taxes	—	2,917
Other liabilities	24,341	22,345
Total liabilities	1,166,759	1,106,263
Commitments and contingencies (Note 7)		
Shareholders' equity		
	176	175

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

Common stock: \$0.01 par value; 30,000,000 shares authorized; 17,566,180 and 17,499,544 shares issued		
Additional paid-in capital	193,991	189,714
Accumulated other comprehensive (loss) income, net of taxes	(9,229)	24,269
Retained earnings	610,768	570,693
Treasury stock, at cost: 2,279,570 shares	(83,835)	(83,835)
Total shareholders' equity	711,871	701,016
Total liabilities and shareholders' equity	\$ 1,878,630	\$ 1,807,279

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

3

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,	
	2018	2017	2018	2017
Net earned premiums	\$ 196,968	\$ 195,524	\$ 583,126	\$ 578,059
Net investment income	11,120	9,503	31,839	28,313
Earnings from partnership investments	1,188	351	6,539	1,233
Net realized gains on investments	53	2,717	2,948	4,826
Change in net unrealized gains on equity investments	2,444	—	(3,749)	—
Net impairment losses on investments (a)	(228)	(256)	(228)	(256)
Finance and other service income	4,362	4,690	13,121	13,373
Total revenue	215,907	212,529	633,596	625,548
Losses and loss adjustment expenses	116,693	123,792	367,564	369,271
Underwriting, operating and related expenses	62,496	62,994	184,925	183,643
Interest expense	22	22	67	67
Total expenses	179,211	186,808	552,556	552,981
Income before income taxes	36,696	25,721	81,040	72,567
Income tax expense	7,788	7,767	16,191	21,489
Net income	\$ 28,908	\$ 17,954	\$ 64,849	\$ 51,078
Earnings per weighted average common share:				
Basic	\$ 1.90	\$ 1.19	\$ 4.28	\$ 3.38
Diluted	\$ 1.88	\$ 1.18	\$ 4.24	\$ 3.36
Cash dividends paid per common share	\$ 0.80	\$ 0.80	\$ 2.40	\$ 2.20
Number of shares used in computing earnings per share:				
Basic	15,091,754	15,021,189	15,076,214	15,007,221
Diluted	15,250,332	15,161,962	15,217,927	15,124,044

(a) No portion of the other-than-temporary impairments recognized in the period indicated were included in Other Comprehensive Income.

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

4

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,	
	2018	2017	2018	2017
Net income	\$ 28,908	\$ 17,954	\$ 64,849	\$ 51,078
Other comprehensive (loss) income, net of tax:				
Unrealized holding (losses) gains during the period, net of income tax (benefit) expense of (\$704), \$1,985, (\$5,053) and \$7,358.	(2,647)	3,687	(19,010)	13,665
Reclassification adjustment for net realized gains on investments included in net income, net of income tax expense of (\$11), (\$951), (\$619) and (\$1,689).	(42)	(1,766)	(2,329)	(3,137)
Other comprehensive (loss) income, net of tax:	(2,689)	1,921	(21,339)	10,528
Comprehensive income	\$ 26,219	\$ 19,875	\$ 43,510	\$ 61,606

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

5

Table of Contents

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, 2016	\$ 174	\$ 184,549	\$ 15,843	\$ 553,995	\$ (83,835)	\$ 670,726
Net Income, January 1 to March 31, 2017				12,019		12,019
Unrealized gains on securities available for sale, net of deferred federal income taxes			4,255			4,255
Restricted share awards issued	1	294				295
Recognition of employee share-based compensation, net of deferred federal income taxes		1,228				1,228
Dividends paid and accrued				(10,674)		(10,674)
Balance March 31, 2017	175	186,071	20,098	555,340	(83,835)	677,849
Net Income, April 1 to June 30, 2017				21,105		21,105
Unrealized gains on securities available for sale, net of deferred federal income taxes			4,352			4,352
Recognition of employee share-based compensation, net of deferred federal income taxes		1,191				1,191
Dividends paid and accrued				(10,663)		(10,663)
Balance June 30, 2017	175	187,262	24,450	565,782	(83,835)	693,834

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

Net Income, July 1 to September 30, 2017				17,954		17,954
Unrealized gains on securities available for sale, net of deferred federal income taxes			1,921			1,921
Restricted share awards issued	—	68				68
Recognition of employee share-based compensation, net of deferred federal income taxes		1,246				1,246
Dividends paid and accrued				(12,184)		(12,184)
Balance September 30, 2017	\$ 175	\$ 188,576	\$ 26,371	\$ 571,552	\$ (83,835)	\$ 702,839

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss), Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2017	\$ 175	\$ 189,714	\$ 24,269	\$ 570,693	\$ (83,835)	\$ 701,016
Cumulative effect of adoption of updated accounting guidance for equity financial instruments at January 1, 2018			(16,895)	16,895		—
Reclassification of certain tax effects from accumulated other comprehensive income at January 1, 2018			4,736	(4,736)		—
Net income, January 1 to March 31, 2018				9,125		9,125
Unrealized losses on securities available for sale, net of deferred federal income taxes			(13,785)			(13,785)
Restricted share awards issued	1	375				376
Recognition of employee share-based compensation, net of		1,239				1,239

deferred federal income taxes						
Dividends paid and accrued				(12,326)		(12,326)
Balance at March 31, 2018	176	191,328	(1,675)	579,651	(83,835)	685,645
Net income, April 1 to June 30, 2018				26,816		26,816
Unrealized losses on securities available for sale, net of deferred federal income taxes			(4,865)			(4,865)
Recognition of employee share-based compensation, net of deferred federal income taxes		1,167				1,167
Dividends paid and accrued				(12,295)		(12,295)
Balance at June 30, 2018	176	192,495	(6,540)	594,172	(83,835)	696,468
Net income, July 1 to September 30, 2018				28,908		28,908
Unrealized losses on securities available for sale, net of deferred federal income taxes			(2,689)			(2,689)
Recognition of employee share-based compensation, net of deferred federal income taxes		1,496				1,496
Dividends paid and accrued				(12,312)		(12,312)
Balance at September 30, 2018	\$ 176	\$ 193,991	\$ (9,229)	\$ 610,768	\$ (83,835)	\$ 711,871

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

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

	Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$ 64,849	\$ 51,078
Adjustments to reconcile net income to net cash provided by operating activities:		
Investment amortization, net	3,943	5,069
Fixed Asset depreciation, net	3,839	3,591
Stock based compensation	4,277	4,027
Provision for deferred income taxes	(668)	3,826
Net realized (gains) on investments	(2,948)	(4,826)
Net impairment losses on investments	228	256
Earnings from partnership investments	(3,254)	(1,233)
Change in net unrealized gains on equity investments	3,749	—
Changes in assets and liabilities:		
Accounts receivable	(18,821)	(18,139)
Accrued investment income	(261)	(816)
Receivable from reinsurers	(17,044)	(22,579)
Ceded unearned premiums	(2,239)	(1,993)
Deferred policy acquisition costs	(5,331)	(5,462)
Taxes recoverable	738	(3,849)
Other assets	(610)	(7,254)
Loss and loss adjustment expense reserves	8,903	17,316
Unearned premium reserves	32,148	33,086
Taxes payable	—	(1,110)
Accounts payable and accrued liabilities	(3,110)	(15,669)
Payable to reinsurers	20,013	15,511
Other liabilities	1,996	(745)
Net cash provided by operating activities	90,397	50,085
Cash flows from investing activities:		
Fixed maturities purchased	(236,117)	(142,052)
Equity securities purchased	(61,573)	(20,650)
Other invested assets purchased	(3,333)	(5,681)
Proceeds from sales and paydowns of fixed maturities	197,147	114,040
Proceeds from maturities, redemptions, and calls of fixed maturities	51,155	24,638
Proceed from sales of equity securities	15,299	29,328
Proceeds from other invested assets redeemed	3,814	203

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

Fixed assets purchased	(10,513)	(4,662)
Net cash used for investing activities	(44,121)	(4,836)
Cash flows from financing activities:		
Dividends paid to shareholders	(36,667)	(33,367)
Net cash used for financing activities	(36,667)	(33,367)
Net increase in cash and cash equivalents	9,609	11,882
Cash and cash equivalents at beginning of year	41,708	20,052
Cash and cash equivalents at end of period	\$ 51,317	\$ 31,934

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

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

1. Basis of Presentation

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

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

The financial information for the three and nine months ended September 30, 2018 and 2017 is unaudited; however, in the opinion of the Company, the information includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial condition, results of operations, and cash flows for the periods. The financial information as of December 31, 2017 is derived from the audited financial statements included in the Company’s 2017 annual report on Form 10-K filed with the U.S. Securities and Exchange Commissions (“SEC”) on February 28, 2018.

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 SEC on February 28, 2018.

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

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

2. Recent Accounting Pronouncements

On August 17, 2018, the SEC adopted amendments to eliminate, integrate, update or modify certain of its disclosure requirements. The amendments which are focused on disclosure requirements that have become redundant, duplicative, overlapping, outdated, or superseded, are intended to facilitate the disclosure of information to investors and simplify compliance without significantly altering the total mix of information provided to investors. The amended rules generally reduce disclosures but some provisions added new disclosure requirements. The amendment is effective November 5, 2018 and the Company has elected to early adopt the amendment in this filing. The adoption of the new rules did not have a material impact on the Company's financial position, results of operations, cash flows, or disclosures.

In February 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The ASU permits a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the newly enacted

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

federal corporate income tax rate as a result of the 2017 Tax Cuts and Jobs Act (“TCJA”). The amount of the reclassification is the difference between the historical corporate income tax rate of thirty-five percent and the newly enacted twenty-one percent corporate income tax rate. The ASU is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. The Company adopted the updated guidance effective January 1, 2018 and elected to reclassify the income tax effects of the TCJA from accumulated other comprehensive income (“AOCI”) to retained earnings at the beginning of the period of adoption. This reclassification resulted in a decrease of \$4,736 in retained earnings as of January 1, 2018 and an increase in AOCI by the same amount.

In March 2017, the FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities, which requires certain premiums on callable debt securities to be amortized to the earliest call date. The amortization period for callable debt securities purchased at a discount will not be impacted. For public business entities with calendar year ends, the amendments in ASU No. 2017-08 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If early adopted in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period. The Company is evaluating the impact of ASU 2017-08 on its financial position and results of operations. The extent of the impact will depend upon the nature and characteristics of the Company’s portfolio at the adoption date.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 reduces diversity in practice in how certain transactions are classified in the statement of cash flows. The amendments in ASU 2016-15 provide guidance on specific cash flow issues including debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, and distributions received from equity method investees. ASU 2016-15 is effective for annual and interim periods beginning after December 15, 2017. The impact of the adoption of ASU 2016-15 was not material to the Company’s Consolidated Statements of Cash Flows.

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

evaluation, but will depend upon the nature and characteristics of the Company's portfolio at the adoption date, and the macroeconomic conditions and forecasts at the date.

In March 2016, the FASB issued ASU 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This ASC update requires all excess tax benefits and tax deficiencies to be recognized as income tax expense or benefit in the income statement, and be treated as discrete items in the reporting period in which they occur. Additionally, excess tax benefits will be classified with other income tax cash flows as an operating activity and cash paid by an employer when directly withholding shares for tax withholding purposes will be classified as a financing activity. Awards that are used to settle employee tax liabilities will be allowed to qualify for equity classification for withholdings up to the maximum statutory tax rates in applicable jurisdictions.

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

Regarding forfeitures, a company can make an entity-wide accounting policy election to either continue estimating the number of awards that are expected to vest or account for forfeitures when they occur. The updated guidance was effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods. The impact of the adoption of ASU 2016-09 was not material to the Company's financial position, results of operations or cash flows.

In February 2016, the FASB issued ASU 2016-02, Leases. ASU 2016-02 establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. In 2018, the FASB issued two additional updates, ASU 2018-10, Codification Improvements to Topic 842, Leases and ASU 2018-11, Leases (Topic 842): Targeted Improvements, both of which have the same effective date and transition requirements as ASU 2016-02. ASU 2018-10 makes sixteen technical corrections to alleviate unintended consequences from applying the new standard and does not make any substantive changes to the core provisions or principals of the new standard. ASU 2019-11 creates an additional transition method which allows companies to elect to not adjust their comparative period financial information and disclosures for the effects of the new lease standard and also creates a practical expedient for lessors to not separate lease and non-lease components. The Company is currently evaluating the impact of ASU 2016-02, ASU 2018-10 and ASU 2018-11 by reviewing its existing lease contracts. The Company expects a gross-up of its Consolidated Balance Sheets as a result of recognizing lease liabilities and right of use assets. The extent of such gross-up is under evaluation. The Company does not expect material changes to the Consolidated Statements of Operations.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in this ASC update address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01: (1) requires equity investments (except those accounted for under the equity method or those that result in the consolidation of the investee) to be measured at fair value with changes in the fair value recognized in net income; (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) requires the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and (4) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the notes to the financial statements. These amendments were effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted the updated guidance effective January 1, 2018 which resulted in the recognition of \$16,895 of net after-tax unrealized gains on equity investments as a cumulative effect adjustment that increased retained earnings as of January 1, 2018 and decreased AOCI by the same amount. At December 31, 2017, equity investments were classified as available-for-sale on the Company's Consolidated Balance

Sheets; however, upon adoption, the updated guidance eliminated the available-for-sale balance sheet classification for equity investments

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosures of Uncertainties about an Entity’s Ability as a Going Concern. ASU 2014-15 provides guidance on determining when and how to disclose going concern uncertainties in the financial statements, and requires management to perform interim and annual assessments of an entity’s ability to continue as a going concern within one year of the date the financial statements are issued. ASU 2014-15 was effective for annual periods ending after December 15, 2016 and interim periods thereafter. Management has assessed and concluded that there were no conditions or events, considered in the aggregate, that raise substantial doubt about the Company’s ability to continue as a going concern within one year after the date the financial statements were issued.

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 May 2014, the FASB issued as final, ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes virtually all existing revenue recognition guidance under GAAP. The update's core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The update was effective for interim and annual reporting periods in fiscal years beginning after December 15, 2017 and allows early adoption. ASU 2014-09 allows for the use of either the retrospective or modified retrospective approach of adoption. The Company adopted the updated guidance effective January 1, 2018 using the modified retrospective approach. The adoption of ASU 2014-09 did not have a material impact on the Company's financial position, results of operations, cash flows, or disclosures.

3. Earnings per Weighted Average Common Share

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

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,	
	2018	2017	2018	2017
Earnings attributable to common shareholders - basic and diluted:				
Net income from continuing operations	\$ 28,908	\$ 17,954	\$ 64,849	\$ 51,078
Allocation of income for participating shares	(170)	(111)	(389)	(323)
Net income from continuing operations attributed to common shareholders	\$ 28,738	\$ 17,843	\$ 64,460	\$ 50,755
Earnings per share denominator - basic and diluted				

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

Total weighted average common shares outstanding, including participating shares	15,181,196	15,114,355	15,167,153	15,102,608
Less: weighted average participating shares	(89,442)	(93,166)	(90,939)	(95,387)
Basic earnings per share denominator	15,091,754	15,021,189	15,076,214	15,007,221
Common equivalent shares- non-vested performance stock grants	158,578	140,773	141,713	116,823
Diluted earnings per share denominator	15,250,332	15,161,962	15,217,927	15,124,044
Basic earnings per share	\$ 1.90	\$ 1.19	\$ 4.28	\$ 3.38
Diluted earnings per share	\$ 1.88	\$ 1.18	\$ 4.24	\$ 3.36
Undistributed earnings attributable to common shareholders - basic and diluted:				
Net income from continuing operations attributable to common shareholders -Basic	\$ 1.90	\$ 1.19	\$ 4.28	\$ 3.38
Dividends declared	(0.80)	(0.80)	(2.40)	(2.20)
Undistributed earnings	\$ 1.10	\$ 0.39	\$ 1.88	\$ 1.18
Net income from continuing operations attributable to common shareholders -Diluted	\$ 1.88	\$ 1.18	\$ 4.24	\$ 3.36
Dividends declared	(0.80)	(0.80)	(2.40)	(2.20)
Undistributed earnings	\$ 1.08	\$ 0.38	\$ 1.84	\$ 1.16

There were no anti-dilutive shares related to non vested performance stock grants for the three and nine months ended September 30, 2018 and 2017.

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

4. Share-Based Compensation

2018 Long Term Incentive Plan

On April 2, 2018, the Company's Board of Directors adopted the Safety Insurance Group, Inc. 2018 Long-Term Incentive Plan ("the 2018 Plan"), which was subsequently approved by our shareholders at the 2018 Annual Meeting of Shareholders. The 2018 Plan enables the grant of stock awards, performance shares, cash-based performance units, other stock-based awards, stock options, stock appreciation rights, and stock unit awards, each of which may be granted separately or in tandem with other awards. Eligibility to participate includes officers, directors, employees and other individuals who provide bona fide services to the Company. The 2018 Plan supersedes the Company's 2002 Management Omnibus Incentive Plan ("the 2002 Incentive Plan").

The 2018 Plan establishes an initial pool of 350,000 shares of common stock available for issuance to our employees and other eligible participants. The Board of Directors and the Compensation Committee intend to issue awards under the 2018 Plan in the future.

The maximum number of shares of common stock between both the 2018 Plan and 2002 Incentive Plan with respect to which awards may be granted is 2,850,000. No further grants will be allowed under the 2002 Incentive Plan and there have been no grants issued under the 2018 Plan during the current year. At September 30, 2018, there were 350,000 shares available for future grant.

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).

Restricted Stock

Service-based restricted stock awarded in the form of unvested shares is recorded at the market value of the Company's common stock on the grant date and amortized ratably as compensation expense over the requisite service period. Service-based restricted stock awards generally vest over a three-year period and vest 30% on the first and second anniversaries of the grant date and 40% on the third anniversary of the grant date, except for non-executive employees' restricted stock awards granted prior to 2018 which vest ratably over a five-year service period and independent directors' stock awards which vest immediately. Our independent directors are subject to stock ownership guidelines, which require them to have a value four times their annual cash retainer.

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

Actual payouts can range from 0% to 200% of target shares awarded depending upon the level of achievement of the respective market and performance conditions during a three calendar-year performance period. Compensation

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

expense for share awards with a performance condition is based on the probable number of awards expected to vest using the performance level most likely to be achieved at the end of the performance period.

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

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

The following table summarizes restricted stock activity under the previously existing Incentive Plan during the nine months ended September 30, 2018 assuming a target payout for the 2018 performance-based shares.

	Shares Under Restriction	Weighted Average Fair Value	Performance-based Shares Under Restriction	Weighted Average Fair Value
Outstanding at beginning of year	93,086	\$ 63.13	105,660	\$ 62.75
Granted	39,451	75.05	31,832	75.14
Vested and unrestricted	(43,276)	62.46	(27,801)	61.50
Forfeited	(126)	70.63	(4,521)	62.41
Outstanding at end of period	89,135	\$ 68.70	105,170	\$ 66.79

As of September 30, 2018, there was \$7,203 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 1.6 years. The total fair value of the shares that were vested and unrestricted during the nine months ended September 30, 2018 and 2017 was \$4,413 and \$3,387, respectively. For the nine months ended September 30, 2018 and 2017, the Company recorded compensation expense related to restricted stock of \$3,379 and \$2,618, net of income tax benefits of \$898 and \$1,409, 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, including interests in mutual funds, and other invested assets were as follows for the periods indicated.

	As of September 30, 2018				
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Non-OTTI Losses	Gross Unrealized OTTI Losses (4)	Estimated Fair Value
U.S. Treasury securities	\$ 1,807	\$ —	\$ (53)	\$ —	\$ 1,754
Obligations of states and political subdivisions	266,755	4,929	(2,113)	—	269,571
Residential mortgage-backed securities (1)	299,172	1,158	(8,861)	—	291,469
Commercial mortgage-backed securities	49,816	9	(1,271)	—	48,554
Other asset-backed securities	54,815	83	(356)	—	54,542
Corporate and other securities	470,451	2,950	(8,158)	—	465,243
Subtotal, fixed maturity securities	1,142,816	9,129	(20,812)	—	1,131,133
Equity securities (2)	140,796	20,176	(2,538)	—	158,434
Other invested assets (5)	25,961	—	—	—	25,961
Totals	\$ 1,309,573	\$ 29,305	\$ (23,350)	\$ —	\$ 1,315,528

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, 2017					
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Non-OTTI Unrealized Losses (3)	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	\$ 1,809	\$ —	\$ (18)	\$ —	\$ —	\$ 1,791
Obligations of states and political subdivisions	391,806	12,244	(966)	—	—	403,084
Residential mortgage-backed securities (1)	223,257	2,352	(2,843)	—	—	222,766
Commercial mortgage-backed securities	39,268	415	(314)	—	—	39,369
Other asset-backed securities	72,665	173	(225)	—	—	72,613
Corporate and other securities	427,892	6,962	(2,451)	—	—	432,403
Subtotal, fixed maturity securities	1,156,697	22,146	(6,817)	—	—	1,172,026
Equity securities (2)	90,481	21,995	(609)	—	—	111,867
Other invested assets (5)	23,162	—	—	—	—	23,162
Totals	\$ 1,270,340	\$ 44,141	\$ (7,426)	\$ —	\$ —	\$ 1,307,055

- (1) Residential mortgage-backed securities consists primarily of obligations of U.S. Government agencies including collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank (FHLB).
- (2) Equity securities included interests in mutual funds held to fund the Company's executive deferred compensation plan.
- (3) Our investment portfolio included 638 and 367 securities in an unrealized loss position at September 30, 2018 and December 31, 2017, respectively.
- (4) Amounts in this column represent other-than-temporary impairment ("OTTI") recognized in accumulated other comprehensive income.
- (5) Other invested assets are accounted for under the equity method which approximated fair value.

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.

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

	As of September 30, 2018	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 33,305	\$ 33,313
Due after one year through five years	273,651	274,184
Due after five years through ten years	282,118	279,267
Due after ten years through twenty years	145,991	146,019
Due after twenty years	3,947	3,784
Asset-backed securities	403,804	394,566
Totals	\$ 1,142,816	\$ 1,131,133

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

	Three Months		Nine Months	
	Ended September 30, 2018	2017	Ended September 30, 2018	2017
Gross realized gains				
Fixed maturity securities	\$ 445	\$ 257	\$ 963	\$ 1,214
Equity securities	851	2,622	4,346	4,001
Gross realized losses				
Fixed maturity securities	(1,170)	(109)	(1,849)	(288)
Equity securities	(73)	(53)	(512)	(101)
Net realized gains on investments	\$ 53	\$ 2,717	\$ 2,948	\$ 4,826

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

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

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, 2018 and December 31, 2017 present the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities aggregated by investment category. The tables also present the length of time that they have been in a continuous unrealized loss position.

	As of September 30, 2018		12 Months or More		Total	
	Less than 12 Months Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. Treasury securities	\$ 1,458	\$ 48	\$ 296	\$ 5	\$ 1,754	\$ 53
Obligations of states and political subdivisions	65,952	1,009	13,444	1,104	79,396	2,113
Residential mortgage-backed securities	170,106	3,711	101,233	5,150	271,339	8,861
Commercial mortgage-backed securities	34,080	686	7,699	585	41,779	1,271
Other asset-backed securities	20,640	157	20,642	199	41,282	356
Corporate and other securities	233,430	5,585	46,155	2,573	279,585	8,158
Subtotal, fixed maturity securities	525,666	11,196	189,469	9,616	715,135	20,812
Equity securities	58,781	2,266	2,010	272	60,791	2,538
Total temporarily impaired securities	\$ 584,447	\$ 13,462	\$ 191,479	\$ 9,888	\$ 775,926	\$ 23,350

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

	As of December 31, 2017					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. Treasury securities	\$ 1,791	\$ 18	\$ —	\$ —	\$ 1,791	\$ 18
Obligations of states and political subdivisions	19,603	152	30,018	814	49,621	966
Residential mortgage-backed securities	126,713	1,724	39,638	1,119	166,351	2,843
Commercial mortgage-backed securities	5,457	30	8,027	284	13,484	314
Other asset-backed securities	25,769	167	18,270	58	44,039	225
Corporate and other securities	94,863	1,189	36,440	1,262	131,303	2,451
Subtotal, fixed maturity securities	274,196	3,280	132,393	3,537	406,589	6,817
Equity securities	4,730	361	2,420	248	7,150	609
Total temporarily impaired securities	\$ 278,926	\$ 3,641	\$ 134,813	\$ 3,785	\$ 413,739	\$ 7,426

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. 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, 2018 were reviewed for potential other-than-temporary asset impairments. As a result of the analysis, the Company recognized OTTI losses of \$228 and \$256 during the three and nine months ended September 30, 2018 and 2017, respectively, which consisted entirely of credit losses related to fixed maturity securities.

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

The qualitative analysis performed by the Company concluded that outside of the securities that were recognized through OTTI, the unrealized losses recorded on the investment portfolio at September 30, 2018 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.

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

	Three Months		Nine Months	
	Ended	September 30,	Ended	September 30,
	2018	2017	2018	2017
Credit losses on fixed maturity securities, beginning of period	\$ 616	\$ 988	\$ 616	\$ 1,094
Add: credit losses on OTTI not previously recognized	228	256	228	256
Less: credit losses on securities sold	—	—	—	(106)
Less: credit losses on securities impaired due to intent to sell	—	—	—	—
Add: credit losses on previously impaired securities	—	—	—	—
Less: increases in cash flows expected on previously impaired securities	—	—	—	—
Credit losses on fixed maturity securities, end of period	\$ 844	\$ 1,244	\$ 844	\$ 1,244

At September 30, 2018 and December 31, 2017, there were no amounts included in accumulated other comprehensive income related to securities which were considered by the Company to be other-than-temporarily impaired.

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

Net Investment Income

The components of net investment income were as follows:

	Three Months		Nine Months Ended	
	Ended September 30, 2018	2017	September 30, 2018	2017
Interest on fixed maturity securities	\$ 10,576	\$ 9,113	\$ 30,330	\$ 27,462
Dividends on equity securities	980	678	2,613	2,000
Equity in earnings of other invested assets	260	353	985	761
Interest on other assets	9	24	54	67
Total investment income	11,825	10,168	33,982	30,290
Investment expenses	705	665	2,143	1,977
Net investment income	\$ 11,120	\$ 9,503	\$ 31,839	\$ 28,313

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

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 services to determine market valuations. If the pricing service cannot provide fair value determinations, the Company obtains non-binding price quotes from broker-dealers. A minimum of two quoted prices is obtained for the majority of the Company’s available-for-sale fixed maturity securities in its investment portfolio. The Company uses a third-party pricing service as 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 custodian or 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 primary source is used in the financial statements for the security. If the variance between the primary and secondary price quotes exceeds an accepted tolerance level, the Company obtains a quote from an alternative source, if possible, and documents and resolves any differences between the pricing sources. In addition, the Company may

request that its investment managers and its traders provide input as to which vendor is providing prices that its traders believe are reflective of fair value for the security. Following this process, the Company may decide to value the security in its financial statements using the secondary or alternative source if it believes that pricing is more reflective of the security's value than the primary pricing provided by its custodian bank. The Company analyzes market valuations received to verify reasonableness, to understand the key assumptions used and their sources, and to determine an appropriate ASC 820 fair value hierarchy level based upon trading activity and the observability of market inputs. Based on this evaluation and investment class analysis, each price is classified into Level 1, 2 or 3.

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

The Company's Level 1 securities consist of equity securities whose values are based on quoted prices in active markets for identical assets. The Company's Level 2 securities are comprised of available-for-sale fixed maturity securities whose fair value was determined using observable market inputs. The Company's Level 3 security consists of an investment in the Federal Home Loan Bank of Boston related to Safety Insurance Company's membership stock, which is not redeemable in a short-term time frame. Fair values for securities for which quoted market prices were unavailable were estimated based upon reference to observable inputs such as benchmark interest rates, market

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

comparables, and other relevant inputs. Investments valued using these inputs include U.S. Treasury securities, obligations of states and political subdivisions, corporate and other securities, commercial and residential mortgage-backed securities, and other asset-backed securities. Inputs into the fair value application that are utilized by asset class include but are not limited to:

- Obligations of states and political subdivisions: overall credit quality, including assessments of market sectors and the level and variability of sources of payment such as general obligation, revenue or lease; credit support such as insurance, state or local economic and political base, prefunded and escrowed to maturity covenants.
- Corporate and other securities: overall credit quality, the establishment of a risk adjusted credit spread over the applicable risk-free yield curve for discounted cash flow valuations; assessments of the level of industry economic sensitivity, company financial policies, indenture restrictive covenants, and/or security and collateral.
- Residential mortgage-backed securities, U.S. agency pass-throughs, collateralized mortgage obligations (“CMOs”), non U.S. agency CMOs: estimates of prepayment speeds based upon historical prepayment rate trends, underlying collateral interest rates, original weighted average maturity, vintage year, borrower credit quality characteristics, interest rate and yield curve forecasts, U.S. government support programs, tax policies, and delinquency/default trends.
- Commercial mortgage-backed securities: overall credit quality, including assessments of the level and variability of credit support and collateral type such as office, retail, or lodging, predictability of cash flows for the deal structure, prevailing economic market conditions.
- Other asset-backed securities: overall credit quality, estimates of prepayment speeds based upon historical trends and characteristics of underlying loans, including assessments of the level and variability of collateral, revenue generating agreements, area licenses agreements, product sourcing agreements and equipment and property leases.
- Federal Home Loan Bank of Boston (“FHLB-Boston”): value is equal to the cost of the member stock purchased.

In order to ensure the fair value determination is representative of an exit price (consistent with ASC 820), the Company’s procedures for validating quotes or prices obtained from third parties include, but are not limited to, obtaining a minimum of two price quotes for each fixed maturity security if possible, as discussed above, the periodic testing of sales activity to determine if there are any significant differences between the market price used to value the

security as of the balance sheet date and the sales price of the security for sales that occurred around the balance sheet date, and the periodic review of reports provided by its external investment manager regarding those securities with ratings changes and securities placed on its "Watch List." In addition, valuation techniques utilized by pricing services and prices obtained from external sources are reviewed by the Company's external investment manager, whose investment professionals are familiar with the securities being priced and the markets in which they trade, to ensure the fair value determination is representative of an exit price (consistent with ASC 820).

All unadjusted estimates of fair value for our fixed maturities priced by the pricing services as described above are included in the amounts disclosed in Level 2. With the exception of the FHLB-Boston security, which is categorized as a Level 3 security, the Company's entire portfolio was priced based upon quoted market prices or other observable inputs as of September 30, 2018. There were no significant changes to the valuation process during the nine months ended September 30, 2018. As of September 30, 2018 and December 31, 2017, no quotes or prices obtained were adjusted by management. All broker quotes obtained were non-binding.

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

At September 30, 2018 and December 31, 2017, investments in fixed maturities classified as available-for-sale had a fair value which equaled carrying value of \$1,131,133 and \$1,172,026, respectively. We have no short-term investments. The carrying values of cash and cash equivalents and investment income accrued approximated fair value.

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

	As of September 30, 2018			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
U.S. Treasury securities	\$ 1,754	\$ —	\$ 1,754	\$ —
Obligations of states and political subdivisions	269,571	—	269,571	—
Residential mortgage-backed securities	291,469	—	291,469	—
Commercial mortgage-backed securities	48,554	—	48,554	—
Other asset-backed securities	54,542	—	54,542	—
Corporate and other securities	465,243	—	465,243	—
Equity securities	126,634	125,954	—	680
Total investment securities	\$ 1,257,767	\$ 125,954	\$ 1,131,133	\$ 680

	As of December 31, 2017			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
U.S. Treasury securities	\$ 1,791	\$ —	\$ 1,791	\$ —
Obligations of states and political subdivisions	403,084	—	403,084	—
Residential mortgage-backed securities	222,766	—	222,766	—
Commercial mortgage-backed securities	39,369	—	39,369	—
Other asset-backed securities	72,613	—	72,613	—
Corporate and other securities	432,403	—	432,403	—
Equity securities	87,737	87,057	—	680

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

Total investment securities	\$ 1,259,763	\$ 87,057	\$ 1,172,026	\$ 680
-----------------------------	--------------	-----------	--------------	--------

There were no transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2018 and 2017.

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,	
	2018	2017	2018	2017
	Level 3 Fair Value Securities	Level 3 Fair Value Securities	Level 3 Fair Value Securities	Level 3 Fair Value Securities
Balance at beginning of period	\$ 680	680	\$ 680	\$ 678
Net gains and losses included in earnings	—	—	—	—
Net gains included in other comprehensive income	—	—	—	—
Purchases	—	—	—	2
Sales	—	—	—	—
Transfers into Level 3	—	—	—	—
Transfers out of Level 3	—	—	—	—
Balance at end of period	\$ 680	\$ 680	\$ 680	\$ 680
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 nine months ended September 30, 2018 and 2017. The Company held one Level 3 security at September 30, 2018 and September 30, 2017.

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 September 30, 2018 and December 31, 2017, there were approximately \$31,800 and \$24,130, respectively, in a real estate investment trust (“REIT”). The REIT is excluded from the fair value hierarchy because the fair value is recorded using the net asset value per share practical expedient. The net asset value per share of this REIT is derived from member ownership in the capital venture to which a proportionate share of independently appraised net assets is attributed. The fair value was determined using the trust’s net asset value obtained from its quarterly financial statements. The Company is required to submit a request 45 days before a quarter end to dispose of the security.

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,	
	2018	2017
Reserves for losses and LAE at beginning of year	\$ 574,054	\$ 560,321
Less receivable from reinsurers related to unpaid losses and LAE	(83,085)	(83,724)
Net reserves for losses and LAE at beginning of year	490,969	476,597
Incurred losses and LAE, related to:		
Current year	406,912	400,437
Prior years	(39,348)	(31,166)
Total incurred losses and LAE	367,564	369,271
Paid losses and LAE related to:		
Current year	169,161	168,078
Prior years	206,980	193,095
Total paid losses and LAE	376,141	361,173
Net reserves for losses and LAE at end of period	482,392	484,695
Plus receivable from reinsurers related to unpaid losses and LAE	100,565	92,942
Reserves for losses and LAE at end of period	\$ 582,957	\$ 577,637

At the end of each period, the reserves were re-estimated for all prior accident years. The Company's prior year reserves decreased by \$39,348 and \$31,166 for the nine months ended September 30, 2018 and 2017, respectively, and resulted from re-estimations of prior year's ultimate loss and LAE liabilities. The decreases in prior years reserves during the nine months ended September 30, 2018 and 2017, are composed of reductions in our retained automobile, retained homeowners and retained other reserves.

The Company's automobile lines of business reserves decreased for the nine months ended September 30, 2018 and 2017, primarily due to fewer incurred but not yet reported claims than previously estimated and better than previously estimated severity on the Company's established bodily injury and property damage case reserves. Due to the nature of the risks that the Company underwrites and has historically underwritten, management does not believe that it has an exposure to asbestos or environmental pollution liabilities.

7. Commitments and Contingencies

On December 15, 2015, the Company filed for arbitration with a reinsurer in regards to the reinsurance recoverable resulting from the 2015 winter storm losses that are admissible under our contract. The total amount of recoverable in dispute, which was based on our total incurred loss, was \$20,918 at December 31, 2017. On January 8, 2018 the Company received a final order from a panel of arbitrators in which the reinsurer would pay the Company \$9,200 for settlement of all paid and outstanding losses. This amount has since been collected. The remaining unrecovered amount of \$11,718 was expensed in 2017.

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

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

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

On August 10, 2018, the Company extended its Revolving Credit Agreement (the "Credit Agreement") with Citizens Bank, N.A. (formerly known as RBS Citizens, N.A. ("Citizens Bank")) to a maturity date of August 10, 2023. The Credit Agreement provides a \$30,000 revolving credit facility with an accordion feature allowing for future expansion of the committed amount up to \$50,000. Loans under the credit facility bear interest at the Company's option at either (i) the LIBOR rate plus 1.25% per annum or (ii) the higher of Citizens Bank prime rate or 0.5% above the federal funds rate plus 1.25% per annum. Interest only is payable prior to maturity.

The 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, 2018, 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, 2018 and December 31, 2017. 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, 2018 and 2017.

The Company is a member of the FHLB-Boston. Membership in the FHLB-Boston allows the Company to borrow money at competitive interest rates provided the loan is collateralized by specific U.S Government residential mortgage backed securities. At September 30, 2018, the Company has the ability to borrow \$268,374 using eligible invested assets that would be used as collateral. The Company has no amounts outstanding from the FHLB-Boston at September 30, 2018 and at December 31, 2017.

9. Income Taxes

Federal income tax expense for the nine months ended September 30, 2018 and 2017 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect the current estimates of the annual effective tax rates. The effective rate in 2018 was lower than the statutory rate primarily due to effects of tax-exempt investment income.

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 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, 2018, 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 returns for the years ended December 31, 2015, 2014 and 2013 respectively, were examined by the IRS. This examination related to the refund claim for the 2015 Net Operating Loss that was carried back to prior years, which triggered a review by the Joint Committee on Taxation. No adjustments were noted as part of the examination. All tax years prior to 2015 are closed.

In the Company’s opinion, adequate tax liabilities have been established for all open 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.

On December 22, 2017, the TCJA was enacted, which significantly amends the Internal Revenue Code of 1986. The TCJA, among other things, reduces the corporate tax rate from a statutory rate of 35% to 21%, imposes additional limitations on net operating losses and executive compensation, allows for the full expensing of certain capital expenditures and enacts other changes impacting the insurance industry. The September 30, 2018 net deferred tax asset and the December 31, 2017 net deferred tax liability have been measured at the 21% tax rate.

The TCJA modified the provisions applicable to the determination of the tax basis of unpaid loss reserves. These modifications impact the payment pattern and applicable interest rate. The TCJA instructed the Treasury to provide discount factors and other guidance necessary to determine the necessary transition adjustment. This information has not been released; accordingly, we have applied the law existing prior to the enactment of the TCJA. These provisions had no effect on the Company’s net deferred tax liability or the total tax expense at December 31, 2017.

SEC Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act (which we refer to as “SAB 118”) describes three scenarios associated with a company’s status of accounting for income tax

reform. Under the SAB 118 guidance, we have determined that we are able to make reasonable estimates for certain effects of tax reform. We are continuing to evaluate the accounting impacts of the TCJA as we continue to assemble and analyze all the information required to prepare and analyze these effects and await additional guidance from the U.S. Treasury Department, IRS or other standard-setting bodies. Additionally, we continue to analyze other information and regulatory guidance and accordingly we may record additional provisional amounts or adjustments to provisional amounts in future periods.

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, 2018, the Board of Directors had cumulatively authorized increases to the existing share repurchase program of up to \$150,000 of its outstanding common shares. Under the program, the Company may repurchase shares of its common stock for cash in public or private transactions, in the open market or otherwise. The timing of such repurchases and actual number of shares repurchased will depend on a variety of factors including price, market conditions and applicable regulatory and corporate requirements. The program does not require the Company to repurchase any specific number of shares and it may be modified, suspended or terminated at any time without prior notice.

Table of Contents

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

No share purchases were made by the Company under the program during the nine months ended September 30, 2018 and 2017. As of September 30, 2018, the Company has purchased 2,279,570 shares at a cost of \$83,835.

11. Subsequent Event

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.

Table of Contents

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

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

Executive Summary and Overview

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

We are a leading provider of private passenger and commercial automobile insurance in Massachusetts. In addition to private passenger automobile insurance (which represented 56.7% of our direct written premiums in 2017), we offer a portfolio of other insurance products, including commercial automobile (15.7% of 2017 direct written premiums), homeowners (22.7% of 2017 direct written premiums) and dwelling fire, umbrella and business owner policies (totaling 4.9% of 2017 direct written premiums). Operating exclusively in Massachusetts, New Hampshire, and Maine through our insurance company subsidiaries, Safety Insurance, Safety Indemnity, and Safety P&C (together referred to as the "Insurance Subsidiaries"), we have established strong relationships with independent insurance agents,

who numbered 892 in 1,107 locations throughout Massachusetts, New Hampshire and Maine during 2017. We have used these relationships and our extensive knowledge of the Massachusetts market to become second largest commercial automobile insurance carrier and the fourth largest private passenger automobile carrier in Massachusetts, capturing an approximate 15.6% and 9.3% share, respectively, of the Massachusetts commercial and private passenger automobile markets in 2017 according to statistics compiled by the Commonwealth Automobile Reinsurers (“CAR”) based on automobile exposures. We are also the third largest homeowners insurance carrier in Massachusetts with a 7.3% share of the Massachusetts homeowners insurance market.

Our Insurance Subsidiaries began writing insurance in New Hampshire during 2008 and in Maine in 2016. The table below shows the amount of direct written premiums written in each state during the three and nine months ended September 30, 2018 and 2017.

Direct Written Premiums	Three Months		Nine Months Ended	
	Ended September 30, 2018	2017	September 30, 2018	2017
Massachusetts	\$ 211,507	\$ 208,159	\$ 634,696	\$ 621,786
New Hampshire	8,178	7,634	21,581	20,660
Maine	245	126	436	187
Total	\$ 219,930	\$ 215,919	\$ 656,713	\$ 642,633

Table of Contents

Recent Trends and Events

The following rate changes have been filed and approved by the insurance regulators of Massachusetts and New Hampshire in 2018 and 2017. Our Massachusetts private passenger automobile rates include a 13% commission rate for agents.

Line of Business	Effective Date	Rate Change
New Hampshire Homeowner	December 1, 2018	2.3%
Massachusetts Homeowner	November 1, 2018	2.6%
Massachusetts Private Passenger Automobile	September 1, 2018	2.3%
Massachusetts Commercial Automobile	June 1, 2018	3.7%
New Hampshire Commercial Automobile	March 1, 2018	4.6%
New Hampshire Homeowner	December 1, 2017	3.9%
New Hampshire Private Passenger Automobile	December 1, 2017	4.2%
Massachusetts Homeowner	November 1, 2017	3.8%
Massachusetts Private Passenger Automobile	July 15, 2017	3.6%
Massachusetts Commercial Automobile	April 1, 2017	3.8%
New Hampshire Commercial Automobile	March 1, 2017	6.1%

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.

Three Months		Nine Months	
Ended September 30,		Ended	
2018	2017	September 30,	2017

GAAP ratios:

Loss ratio	59.2	%	63.3	%	63.0	%	63.9	%
Expense ratio	31.7		32.2		31.7		31.8	
Combined ratio	90.9	%	95.5	%	94.7	%	95.7	%

Share-Based Compensation

On April 2, 2018, the Company’s Board of Directors adopted the Safety Insurance Group, Inc. 2018 Long-Term Incentive Plan (“the 2018 Plan”), which was subsequently approved by our shareholders at the 2018 Annual Meeting of Shareholders. The 2018 Plan enables the grant of stock awards, performance shares, cash based performance units, other stock based awards, stock options, stock appreciation rights, and stock unit awards, each of which may be granted separately or in tandem with other awards. Eligibility to participate includes officers, directors, employees and other individuals who provide bona fide services to the Company. The 2018 Plan supersedes the Company’s 2002 Management Omnibus Incentive Plan (“the 2002 Incentive Plan”).

The 2018 Plan establishes an initial pool of 350,000 shares of common stock available for issuance to our employees and other eligible participants. The Board of Directors and the Compensation Committee intend to issue awards under the 2018 Plan in the future.

The maximum number of shares of common stock between both the 2018 Plan and 2002 Incentive Plan with respect to which awards may be granted is 2,850,000. No further grants will be allowed under the 2002 Incentive Plan and there have been no grants issued under the 2018 Plan during the current year. At September 30, 2018, there were 350,000 shares available for future grant.

Table of Contents

A summary of share based awards granted under the previously existing Incentive Plan during the nine months ended September 30, 2018 is as follows:

Type of Equity Awarded	Effective Date	Number of Awards Granted	Fair Value per Share	Vesting Terms
RS - Service	February 26, 2018	34,451	\$ 75.05	(1) 3 years, 30%-30%-40%
RS - Performance	February 26, 2018	31,668	\$ 75.05	(1) 3 years, cliff vesting (3)
RS	February 26, 2018	5,000	\$ 75.05	(1) No vesting period (2)
RS - Performance	August 1, 2018	164	\$ 92.30	(1) No vesting period (4)

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

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 are selective in choosing our reinsurers, seeking only those companies that we consider to be financially stable and adequately capitalized. In an effort to minimize exposure to the insolvency of a reinsurer, we continually evaluate and review the financial condition of our reinsurers. Swiss Re, our primary reinsurer, maintains an A.M. Best rating of "A+" (Superior). Most of our other reinsurers have an A.M. Best rating of "A+" (Superior) or "A" (Excellent).

We maintain reinsurance coverage to help lessen the effect of losses from catastrophic events, maintaining coverage during 2018 that protects us in the event of a "137-year storm" (that is, a storm of a severity expected to occur once in a 137-year period). 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").

For 2018, we have purchased four layers of excess catastrophe reinsurance providing \$615,000 of coverage for property losses in excess of \$50,000 up to a maximum of \$665,000. Our reinsurers' co-participation is 50.0% of \$50,000 for the 1st layer, 80.0% of \$50,000 for the 2nd layer, 80.0% of \$250,000 for the 3rd layer and 80% of \$265,000 for the 4th layer.

We also have casualty excess of loss reinsurance for large casualty losses occurring in our automobile, homeowners, dwelling fire, business owners, and commercial package lines of business in excess of \$2,000 up to a maximum of \$10,000. We have property excess of loss reinsurance coverage for large property losses, with coverage in excess of \$2,000 up to a maximum of \$20,000, for our homeowners, business owners, and commercial package policies. In addition, we have liability excess of loss reinsurance for umbrella large losses in excess of \$1,000 up to a maximum of \$10,000. We also have various reinsurance agreements with Hartford Steam Boiler Inspection and Insurance Company, of which the primary contract is a quota share agreement under which we cede 100% of the premiums and losses for the equipment breakdown coverage under our business owner policies and commercial package policies.

In addition to the above mentioned reinsurance programs, 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

Table of Contents

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'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, 2018, the FAIR Plan purchased \$2,000,000 of catastrophe reinsurance for property losses with retention of \$100,000.

On December 15, 2015, the Company filed for arbitration with a reinsurer in regards to the reinsurance recoverable resulting from the 2015 winter storm losses that are admissible under our contract. The total amount of recoverable in dispute, which was based on our total incurred loss, was \$20,918 as of December 31, 2017. On January 8, 2018 the Company received a final order from the panel of arbitrators in which the reinsurer would pay the Company \$9,200 for settlement of all paid and outstanding losses. This amount has since been collected. The remaining unrecovered amount of \$11,718 was expensed in 2017.

At September 30, 2018, we also had \$107,713 recoverable from CAR comprising of loss adjustment expense reserves, unearned premiums and reinsurance recoverable.

Effects of Inflation

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

Non-GAAP Measures

Management has included certain non-generally accepted accounting principles ("non-GAAP") financial measures in presenting the Company's results. Management believes that these non-GAAP measures better explain the Company's results of operations and allow for a more complete understanding of the underlying trends in the Company's business. These measures should not be viewed as a substitute for those determined in accordance with generally accepted accounting principles ("GAAP"). In addition, our definitions of these items may not be comparable to the definitions used by other companies.

Non-GAAP operating income and non-GAAP operating income per diluted share consist of our GAAP net income adjusted by the net realized gains (losses), net impairment losses on investments, changes in net unrealized gains (losses) on equity securities and taxes related thereto. The adjustment for net unrealized gains and losses on equity securities is only applicable for 2018 due to the adoption of the accounting standard update referenced in Item 1 – Financial Statements, Note 2, Recent Accounting Pronouncements, of this Form 10-Q. Net income and earnings per diluted share are the GAAP financial measures that are most directly comparable to non-GAAP operating income and non-GAAP operating income per diluted share, respectively. A reconciliation of the GAAP financial measures to these non-GAAP measures is included in the 2018 financial highlights below.

Table of Contents

Results of Operations

Three and Nine Months Ended September 30, 2018 Compared to Three and Nine Months Ended September 30, 2017

The following table shows certain of our selected financial results.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Direct written premiums	\$ 219,930	\$ 215,919	\$ 656,713	\$ 642,633
Net written premiums	\$ 207,506	\$ 204,467	\$ 613,034	\$ 609,153
Net earned premiums	\$ 196,968	\$ 195,524	\$ 583,126	\$ 578,059
Net investment income	11,120	9,503	31,839	28,313
Earnings from partnership investments	1,188	351	6,539	1,233
Net realized gains on investments	53	2,717	2,948	4,826
Change in net unrealized gains on equity investments	2,444	—	(3,749)	—
Finance and other service income	4,362	4,690	13,121	13,373
Total revenue	215,907	212,529	633,596	625,548
Loss and loss adjustment expenses	116,693	123,792	367,564	369,271
Underwriting, operating and related expenses	62,496	62,994	184,925	183,643
Interest expense	22	22	67	67
Total expenses	179,211	186,808	552,556	552,981
Income before income taxes	36,696	25,721	81,040	72,567
Income tax expense	7,788	7,767	16,191	21,489
Net income	\$ 28,908	\$ 17,954	\$ 64,849	\$ 51,078
Earnings per weighted average common share:				
Basic	\$ 1.90	\$ 1.19	\$ 4.28	\$ 3.38
Diluted	\$ 1.88	\$ 1.18	\$ 4.24	\$ 3.36
Cash dividends paid per common share	\$ 0.80	\$ 0.80	\$ 2.40	\$ 2.20

Reconciliation of Net Income to Non-GAAP Operating Income:

Net income	\$ 28,908	\$ 17,954	\$ 64,849	\$ 51,078
Exclusions from net income:				
Net realized gains on investments	(53)	(2,717)	(2,948)	(4,826)
Change in net unrealized gains on equity investments	(2,444)	-	3,749	-
Net impairment losses on investments	228	256	228	256
Income tax (expense) benefit	476	861	(216)	1,600
Non-GAAP Operating income	\$ 27,115	\$ 16,354	\$ 65,662	\$ 48,108

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

Net income per diluted share	\$ 1.88	\$ 1.18	\$ 4.24	\$ 3.36
Exclusions from net income:				
Net realized gains on investments	-	(0.18)	(0.19)	(0.32)
Change in net unrealized gains on equity investments	(0.16)	-	0.25	-
Net impairment losses on investments	0.01	0.02	0.02	0.02
Income tax (expense) benefit	0.03	0.04	(0.03)	0.09
Non-GAAP Operating income per diluted share	\$ 1.76	\$ 1.06	\$ 4.29	\$ 3.15

Direct Written Premiums. Direct written premiums for the three months ended September 30, 2018 increased by \$4,011, or 1.9%, to \$219,930 from \$215,919 for the comparable 2017 period. Direct written premiums for the nine months ended September 30, 2018 increased by \$14,080, or 2.2%, to \$656,713 from \$642,633 for the comparable 2017 period. The 2018 increase occurred in our commercial passenger automobile and homeowners lines of business.

Net Written Premiums. Net written premiums for the three months ended September 30, 2018 increased by \$3,039, or 1.5%, to \$207,506 from \$204,467 for the comparable 2017 period. Net written premiums for the nine months ended September 30, 2018 increased by \$3,881, or 0.6%, to \$613,034 from \$609,153 for the comparable 2017 period.

Table of Contents

Net Earned Premiums. Net earned premiums for the three months ended September 30, 2018 increased by \$1,444, or 0.7%, to \$196,968 from \$195,524 for the comparable 2017 period. Net earned premiums for the nine months ended September 30, 2018 increased by \$5,067, or 0.9%, to \$583,126 from \$578,059 for the comparable 2017 period.

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

	Three Months		Nine Months	
	Ended September 30, 2018	2017	Ended September 30, 2018	2017
Written Premiums				
Direct	\$ 219,930	\$ 215,919	\$ 656,713	\$ 642,633
Assumed	7,750	8,291	23,995	25,326
Ceded	(20,174)	(19,743)	(67,674)	(58,806)
Net written premiums	\$ 207,506	\$ 204,467	\$ 613,034	\$ 609,153
Earned Premiums				
Direct	\$ 212,209	\$ 207,597	\$ 624,325	\$ 610,636
Assumed	7,469	7,525	24,236	24,237
Ceded	(22,710)	(19,598)	(65,435)	(56,814)
Net earned premiums	\$ 196,968	\$ 195,524	\$ 583,126	\$ 578,059

Net Investment Income. Net investment income for the three months ended September 30, 2018 increased by \$1,617, or 17.0%, to \$11,120 from \$9,503 for the comparable 2017 period. Net investment income for the nine months ended September 30, 2018 increased by \$3,526, or 12.5%, to \$31,839 from \$28,313 for the comparable 2017 period. The increase is a result of fixed maturity amortization and an increase in the average invested asset balance compared to the prior year. Net effective annualized yield on the investment portfolio was 3.4% for the three months ended September 30, 2018 compared to 3.0% for the three months ended September 30, 2017. Net effective annualized yield on the investment portfolio was 3.3% for the nine months ended September 30, 2018 compared to 3.0% for the nine months ended September 30, 2017. The investment portfolio's duration was 3.7 years at September 30, 2018 and December 31, 2017.

Earnings from Partnership Investments. Earnings from partnership investments was \$1,188 for the three months ended September 30, 2018 compared to \$351 for the comparable 2017 period. Earnings from partnership investments was \$6,539 for the nine months ended September 30, 2018 compared to \$1,233 for the comparable 2017 period. The 2018 increase was related to investment appreciation and cash proceeds received as return on capital.

Net Realized Gains on Investments. Net realized gains on investments was \$53 for the three months ended September 30, 2018 compared to net realized gains of \$2,717 for the comparable 2017 period. Net realized gains on investments was \$2,948 for the nine months ended September 30, 2018 compared to net realized gains of \$4,826 for

the comparable 2017 period.

29

Table of Contents

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

	As of September 30, 2018					
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Gross Unrealized Losses (3) Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	\$ 1,807	\$ —	\$ (53)	\$ —	\$ —	\$ 1,754
Obligations of states and political subdivisions	266,755	4,929	(2,113)	—	—	269,571
Residential mortgage-backed securities (1)	299,172	1,158	(8,861)	—	—	291,469
Commercial mortgage-backed securities	49,816	9	(1,271)	—	—	48,554
Other asset-backed securities	54,815	83	(356)	—	—	54,542
Corporate and other securities	470,451	2,950	(8,158)	—	—	465,243
Subtotal, fixed maturity securities	1,142,816	9,129	(20,812)	—	—	1,131,133
Equity securities (2)	140,796	20,176	(2,538)	—	—	158,434
Other invested assets (5)	25,961	—	—	—	—	25,961
Totals	\$ 1,309,573	\$ 29,305	\$ (23,350)	\$ —	\$ —	\$ 1,315,528

- (1) Residential mortgage-backed securities consists primarily of obligations of U.S. Government agencies including collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank (FHLB).
- (2) Equity securities include interests in mutual funds held to fund the Company's executive deferred compensation plan.
- (3) Our investment portfolio included 638 securities in an unrealized loss position at September 30, 2018.
- (4) Amounts in this column represent other-than-temporary impairments ("OTTI") recognized in accumulated other comprehensive income.
- (5) Other invested assets are accounted for under the equity method which approximated fair value.

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

	As of September 30, 2018	
	Estimated Fair Value	Percent
U.S. Treasury securities and obligations of U.S. Government agencies	\$ 293,224	25.9 %
Aaa/Aa	291,401	25.8
A	214,727	19.0

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

Baa	163,043	14.4
Ba	59,128	5.2
B	82,047	7.3
Caa/Ca	8,363	0.7
Not rated	19,200	1.7
Total	\$ 1,131,133	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, 2018, our portfolio of fixed maturity investments was comprised principally of investment grade corporate fixed maturity securities, U.S. government and agency securities, and asset-backed securities. The portion of our non-investment grade portfolio of fixed maturity investments is primarily comprised of variable rate secured and senior bank loans and high yield bonds.

Table of Contents

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, 2018.

	As of September 30, 2018					
	Less than 12 Months Estimated Fair Value	Unrealized Losses	12 Months or More Estimated Fair Value	Unrealized Losses	Total Estimated Fair Value	Unrealized Losses
U.S. Treasury securities	\$ 1,458	\$ 48	\$ 296	\$ 5	\$ 1,754	\$ 53
Obligations of states and political subdivisions	65,952	1,009	13,444	1,104	79,396	2,113
Residential mortgage-backed securities	170,106	3,711	101,233	5,150	271,339	8,861
Commercial mortgage-backed securities	34,080	686	7,699	585	41,779	1,271
Other asset-backed securities	20,640	157	20,642	199	41,282	356
Corporate and other securities	233,430	5,585	46,155	2,573	279,585	8,158
Subtotal, fixed maturity securities	525,666	11,196	189,469	9,616	715,135	20,812
Equity securities	58,781	2,266	2,010	272	60,791	2,538
Total temporarily impaired securities	\$ 584,447	\$ 13,462	\$ 191,479	\$ 9,888	\$ 775,926	\$ 23,350

The unrealized losses in the Company's fixed income and equity portfolio as of September 30, 2018 were reviewed for potential other-than-temporary asset impairments. The Company held three debt securities at September 30, 2018 and two debt securities at September 30, 2017 with a material (20% or greater) unrealized loss for four or more consecutive quarters that additionally had certain qualitative factors that led to an impairment assessment. The Company recognized \$228 and \$256 of OTTI losses during the three and nine months ended September 30, 2018 and 2017, which consisted entirely of credit losses related to fixed maturity securities.

Specific qualitative analysis was also performed for securities appearing on our "Watch List". 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 majority of these unrealized losses recorded on the investment portfolio at September 30, 2018 resulted from fluctuations in market interest rates and other temporary market conditions as opposed to fundamental changes in the credit quality of the issuers of such securities. Given our current level of liquidity, the fact that we do not intend to sell these securities, and that it is more likely than not that we will not be required to sell these securities prior to recovery of the cost basis of these securities, these decreases in values are viewed as being temporary.

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

Net Impairment Losses on Investments. The Company recognized \$228 and \$256 of net impairment losses on investments for the three and nine months ended September 30, 2018 and 2017, respectively.

Finance and Other Service Income. Finance and other service income include revenues from premium installment charges, which we recognize when earned, and other miscellaneous income and fees. Finance and other service income for the three months ended September 30, 2018 decreased by \$328, or 7.0%, to \$4,362 from \$4,690 for the comparable 2017 period. Finance and other service income for the nine months ended September 30, 2018 decreased by \$252, or 1.9%, to \$13,121 from \$13,373 for the comparable 2017 period.

Losses and Loss Adjustment Expenses. Losses and loss adjustment expenses incurred for the three months ended September 30, 2018 decreased by \$7,099, or 5.7%, to \$116,693 from \$123,792 for the comparable 2017 period. Losses and loss adjustment expenses incurred for the nine months ended September 30, 2018 decreased by \$1,707, or 0.5%, to \$367,564 from \$369,271 for the comparable 2017 period.

Our GAAP loss ratio for the three months ended September 30, 2018 decreased to 59.2% from 63.3% for the comparable 2017 period. Our GAAP loss ratio for the nine months ended September 30, 2018 decreased to 63.0% from 63.9% for the comparable 2017 period. Our GAAP loss ratio excluding loss adjustment expenses for the three months

Table of Contents

ended September 30, 2018 was 51.4% compared to 56.2% for the comparable 2017 period. Our GAAP loss ratio excluding loss adjustment expenses for the nine months ended September 30, 2018 was 55.2% compared to 56.1% for the comparable 2017 period. Total prior year favorable development included in the pre-tax results for the three months ended September 30, 2018 was \$13,048 compared to \$10,759 for the comparable 2017 period. Total prior year favorable development included in the pre-tax results for the nine months ended September 30, 2018 was \$39,348 compared to \$31,166 for the comparable 2017 period.

Underwriting, Operating and Related Expenses. Underwriting, operating and related expenses for the three months ended September 30, 2018 decreased by \$498, or 0.8%, to \$62,496 from \$62,994 for the comparable 2017 period. Underwriting, operating and related expenses for the nine months ended September 30, 2018 increased by \$1,282, or 0.7%, to \$184,925 from \$183,643 for the comparable 2017 period. Our GAAP expense ratio for the three months ended September 30, 2018 decreased to 31.7% from 32.2% for the comparable 2017 period. Our GAAP expense ratio for the nine months ended September 30, 2018 decreased to 31.7% from 31.8% for the comparable 2017 period.

Interest Expense. Interest expense was \$22 for the three months ended September 30, 2018 and 2017. Interest expense was \$67 for the nine months ended September 30, 2018 and 2017. The credit facility commitment fee included in interest expense was \$56 for the nine months ended September 30, 2018 and 2017.

Income Tax Expense. Our effective tax rate was 21.2% and 30.2% for the three months ended September 30, 2018 and 2017, respectively. Our effective tax rate was 20.0% and 29.6% for the nine months ended September 30, 2018 and 2017. The TCJA which became effective on December 22, 2017, reduced the corporate statutory tax rate from 35% to 21%. The effective tax rates for the three and nine months ended September 30, 2018 and 2017, were lower than the statutory rates primarily due to the effects of tax-exempt investment income.

Net Income. Net income for the three months ended September 30, 2018 was \$28,908 compared to net income of \$17,954 for the comparable 2017 period. Net income for the nine months ended September 30, 2018 was \$64,849 compared to net income of \$51,078 for the comparable 2017 period.

Non-GAAP Operating Income. Non-GAAP operating income as defined above was \$27,115 for the three months ended September 30, 2018 compared to \$16,354 for the comparable 2017 period. Non-GAAP operating income was \$65,662 for the nine months ended September 30, 2018 compared to \$48,108 for the comparable 2017 period. The increase in Non-GAAP operating income was primarily the result of increases in net earned premiums, net investment income, earnings from partnership investments and benefits from lower statutory federal income tax rates.

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 \$90,397 and \$50,085 during the nine months ended September 30, 2018 and 2017, 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. Positive operating cash flows are expected to continue in the future to meet our liquidity requirements.

Net cash used for investing activities was \$44,121 and \$4,836 during the nine months ended September 30, 2018 and 2017, respectively. Fixed maturities, equity securities, and other invested assets purchased were \$301,023 for

Table of Contents

the nine months ended September 30, 2018 compared to \$168,383 for the comparable prior year period. Proceeds from maturities, redemptions, calls and sales, of securities were \$267,415 during the nine months ended September 30, 2018 compared to \$168,209 for the comparable prior year period.

Net cash used for financing activities was \$36,667 and \$33,367 during the nine months ended September 30, 2018 and 2017, respectively. Net cash used for financing activities is comprised of dividend payments to shareholders.

The Insurance Subsidiaries maintain a high degree of liquidity within their respective investment portfolios in fixed maturity and equity securities. We do not anticipate the need to sell these securities to meet the Insurance Subsidiaries cash requirements. We expect the Insurance Subsidiaries to generate sufficient operating cash to meet all short-term and long-term cash requirements. However, there can be no assurance that unforeseen business needs or other items will not occur causing us to have to sell securities before their values fully recover; thereby causing us to recognize additional impairment charges in that time period.

Credit Facility

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

Recent Accounting Pronouncements

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

Regulatory Matters

Our Insurance Subsidiaries are subject to various regulatory restrictions that limit the maximum amount of dividends available to be paid to their parent without prior approval of the Commissioner. The Massachusetts statute limits the dividends an insurer may pay in any twelve-month period, without the prior permission of the Commissioner, 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, 2017, the statutory surplus of Safety Insurance was \$617,577, and its statutory net income for 2017 was \$57,982. As a result, a maximum of \$61,758 is available in 2018 for such dividends without prior approval of the Commissioner. As a result of this Massachusetts statute, the Insurance Subsidiaries had restricted net assets in the amount of \$555,819 at December 31, 2017. During the nine months ended September 30, 2018, Safety Insurance paid dividends to Safety of \$34,266.

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.

Table of Contents

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 2018 were as follows:

Declaration Date	Record Date	Payment Date	Dividend per Common Share	Total Dividends Paid and Accrued
February 15, 2018	March 1, 2018	March 15, 2018	\$ 0.80	\$ 12,326
May 2, 2018	June 1, 2018	June 15, 2018	\$ 0.80	\$ 12,295
August 1, 2018	September 4, 2018	September 14, 2018	\$ 0.80	\$ 12,312

On October 31, 2018, our Board approved and declared a dividend of \$0.80 per share which will be paid on December 14, 2018 to shareholders of record on December 3, 2018. We plan to continue to declare and pay quarterly cash dividends in 2018, depending on our financial position and the regularity of our cash flows.

On August 3, 2007, the Board of Directors approved a share repurchase program of up to \$30,000 of the Company's outstanding common shares. As of September 30, 2018, the Board of Directors had cumulatively authorized increases to the existing share repurchase program of up to \$150,000 of its outstanding common shares. Under the program, the Company may repurchase shares of its common stock for cash in public or private transactions, in the open market or otherwise. The timing of such repurchases and actual number of shares repurchased will depend on a variety of factors including price, market conditions and applicable regulatory and corporate requirements. The program does not require us to repurchase any specific number of shares and may be modified, suspended or terminated at any time without prior notice. As of September 30, 2018 and December 31, 2017, the Company had purchased 2,279,570 shares of common stock at a cost of \$83,835.

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

Risk-Based Capital Requirements

The NAIC has adopted a formula and model law to implement risk-based capital requirements for most property and casualty insurance companies, which are designed to determine minimum capital requirements and to raise the level of protection that statutory surplus provides for policyholder obligations. Under Massachusetts law, insurers 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, 2017, the Insurance Subsidiaries had total adjusted capital of \$617,577, 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 \$171,988 at December 31, 2017.

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

Table of Contents

risk support to, or engages in leasing, hedging or research and development services with us. We have no direct investments in real estate and no holdings of mortgages secured by commercial real estate. Accordingly, we have no material off-balance sheet arrangements.

Critical Accounting Policies and Estimates

Loss and Loss Adjustment Expense Reserves

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

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

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

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

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

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.

Table of Contents

- **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 \$429,336 to \$504,235 as of September 30, 2018. 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 \$482,392 as of September 30, 2018.

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, 2018.

Line of Business	As of September 30, 2018		
	Low	Recorded	High
Private passenger automobile	\$ 204,848	\$ 227,156	\$ 236,481
Commercial automobile	84,436	93,944	96,704
Homeowners	76,055	85,149	89,262
All other	63,997	76,143	81,788
Total	\$ 429,336	\$ 482,392	\$ 504,235

Line of Business	As of December 31, 2017		
	Low	Recorded	High
Private passenger automobile	\$ 215,048	\$ 244,057	\$ 246,950
Commercial automobile	82,929	90,083	93,377
Homeowners	81,395	88,954	92,894
All other	61,546	67,875	76,945
Total	\$ 440,918	\$ 490,969	\$ 510,166

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, 2018.

Line of Business	As of September 30, 2018		
	Case	IBNR	Total
Private passenger automobile	\$ 254,675	\$ (27,878)	\$ 226,797
CAR assumed private passenger auto	13	346	359
Commercial automobile	53,252	8,539	61,791
CAR assumed commercial automobile	16,950	15,203	32,153
Homeowners	67,495	8,389	75,884
FAIR Plan assumed homeowners	4,005	5,260	9,265
All other	45,336	30,807	76,143
Total net reserves for losses and LAE	\$ 441,726	\$ 40,666	\$ 482,392

At September 30, 2018, our total IBNR reserves for our private passenger automobile line of business was comprised of (\$48,823) related to estimated ultimate decreases in the case reserves, including anticipated recoveries (i.e. salvage and subrogation), and \$20,945 related to our estimation for not yet reported losses.

Table of Contents

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 47.3% of our total reserves for CAR assumed commercial automobile business as of September 30, 2018, 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 56.8% of our total reserves for FAIR Plan assumed homeowners at September 30, 2018, 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, 2018.

Line of Business	As of September 30, 2018		Net
	Retained	Assumed	
Private passenger automobile	\$ 226,797		
CAR assumed private passenger automobile		\$ 359	
Net private passenger automobile			\$ 227,156
Commercial automobile	61,791		
CAR assumed commercial automobile		32,153	
Net commercial automobile			93,944
Homeowners	75,884		
FAIR Plan assumed homeowners		9,265	
Net homeowners			85,149
All other	76,143	—	76,143
Total net reserves for losses and LAE	\$ 440,615	\$ 41,777	\$ 482,392

Residual Market Loss and Loss Adjustment Expense Reserves

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

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

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

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

Sensitivity Analysis

Establishment of appropriate reserves is an inherently uncertain process. There can be no certainty that currently established reserves based on our key assumptions regarding frequency and severity in our lines of business, or our assumptions regarding our share of the CAR loss will prove adequate in light of subsequent actual experience. To the extent that reserves are inadequate and are strengthened, the amount of such increase is treated as a charge to earnings in the period that the deficiency is recognized. To the extent that reserves are redundant and are released, the amount of the release is a credit to earnings in the period the redundancy is recognized. For the nine months ended September 30, 2018, a 1 percentage-point change in the loss and LAE ratio would result in a change in reserves of \$5,829. Each 1 percentage-point change in the loss and loss expense ratio would have had a \$4,605 effect on net income, or \$0.30 per diluted share.

Table of Contents

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, 2018. 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.

	-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	\$ (4,536)	\$ (2,268)	\$ —
Estimated increase in net income	3,583	1,792	—
No Change in Severity			
Estimated (decrease) increase in reserves	(2,268)	—	2,268
Estimated increase (decrease) in net income	1,792	—	(1,792)
+1 Percent Change in Severity			
Estimated increase in reserves	—	2,268	4,536
Estimated decrease in net income	—	(1,792)	(3,583)
Commercial automobile retained loss and LAE reserves			
-1 Percent Change in Severity			
Estimated decrease in reserves	(1,236)	(618)	—
Estimated increase in net income	976	488	—
No Change in Severity			
Estimated (decrease) increase in reserves	(618)	—	618
Estimated increase (decrease) in net income	488	—	(488)
+1 Percent Change in Severity			
Estimated increase in reserves	—	618	1,236
Estimated decrease in net income	—	(488)	(976)
Homeowners retained loss and LAE reserves			
-1 Percent Change in Severity			
Estimated decrease in reserves	(1,518)	(759)	—
Estimated increase in net income	1,199	599	—
No Change in Severity			
Estimated (decrease) increase in reserves	(759)	—	759
Estimated increase (decrease) in net income	599	—	(599)
+1 Percent Change in Severity			

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

Estimated increase in reserves	—	759	1,518
Estimated decrease in net income	—	(599)	(1,199)
All other retained loss and LAE reserves			
-1 Percent Change in Severity			
Estimated decrease in reserves	(1,523)	(761)	—
Estimated increase in net income	1,203	602	—
No Change in Severity			
Estimated (decrease) increase in reserves	(761)	—	761
Estimated increase (decrease) in net income	602	—	(602)
+1 Percent Change in Severity			
Estimated increase in reserves	—	761	1,523
Estimated decrease in net income	—	(602)	(1,203)

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

Table of Contents

basis for establishing our CAR reserves. Each of our assumptions could have a reasonably possible range of plus or minus 5 percentage-points for each estimation.

The following sensitivity table presents information of the effect each 1 percentage-point change in our assumptions on our share of reserves for CAR and other residual markets could have on our assumed loss and LAE reserves and net income for the nine months ended September 30, 2018. 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	\$ (4)	\$ 4
Estimated increase (decrease) in net income	3	(3)
CAR assumed commercial automobile		
Estimated (decrease) increase in reserves	(322)	322
Estimated increase (decrease) in net income	254	(254)
FAIR Plan assumed homeowners		
Estimated (decrease) increase in reserves	(93)	93
Estimated increase (decrease) in net income	73	(73)

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 \$39,348 and \$31,166 during the nine months ended September 30, 2018 and 2017, 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, 2018 and 2017. 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,	
	2018	2017
2008 & prior	\$ (1,882)	\$ (648)
2009	(860)	(533)
2010	(2,339)	(811)
2011	(2,430)	(2,334)
2012	(3,037)	(3,638)
2013	(3,730)	(5,284)
2014	(6,150)	(9,042)
2015	(3,478)	(3,562)
2016	(9,594)	(5,314)
2017	(5,848)	—
All prior years	\$ (39,348)	\$ (31,166)

The decreases in prior years' reserves during the nine months ended September 30, 2018 and 2017 resulted from re-estimations of prior year ultimate loss and LAE liabilities. The 2018 decrease is composed of reductions of \$22,363 in our retained private passenger automobile reserves, \$3,644 in our retained commercial automobile reserves, \$8,700 in our retained homeowners reserves and \$4,047 in our retained other lines reserves. The 2017 decrease is composed of reductions of \$17,293 in our retained private passenger automobile reserves, \$3,592 in our retained commercial automobile reserves, \$6,513 in our retained homeowners reserves and \$3,697 in our retained other lines reserves.

Table of Contents

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, 2018.

Accident Year	Private Passenger	Commercial	Homeowners	All Other	Total
	Automobile	Automobile			
2008 & prior	\$ (692)	\$ (258)	\$ (212)	\$ (720)	\$ (1,882)
2009	(368)	(54)	(144)	(294)	(860)
2010	(1,448)	(238)	(559)	(94)	(2,339)
2011	(1,578)	(87)	(550)	(215)	(2,430)
2012	(2,023)	(264)	(749)	(1)	(3,037)
2013	(1,636)	(309)	(1,463)	(322)	(3,730)
2014	(1,454)	(1,166)	(2,032)	(1,498)	(6,150)
2015	(3,560)	611	(571)	42	(3,478)
2016	(7,784)	(254)	(1,486)	(70)	(9,594)
2017	(1,820)	(1,110)	(2,043)	(875)	(5,848)
All prior years	\$ (22,363)	\$ (3,129)	\$ (9,809)	\$ (4,047)	\$ (39,348)

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, 2018 that is, all our reserves except for business ceded or assumed from CAR and other residual markets.

Accident Year	Retained Private Passenger	Retained Commercial	Retained Homeowners	Retained All Other	Total
	Automobile	Automobile			
2008 & prior	\$ (692)	\$ (258)	\$ (212)	\$ (720)	\$ (1,882)
2009	(368)	(54)	(144)	(294)	(860)
2010	(1,448)	(223)	(559)	(94)	(2,324)
2011	(1,578)	(116)	(550)	(215)	(2,459)
2012	(2,023)	(251)	(729)	(1)	(3,004)
2013	(1,636)	(346)	(1,428)	(322)	(3,732)
2014	(1,454)	(1,146)	(1,914)	(1,498)	(6,012)
2015	(3,560)	652	(333)	42	(3,199)

Edgar Filing: SAFETY INSURANCE GROUP INC - Form 10-Q

2016	(7,784)	(911)	(960)	(70)	(9,725)
2017	(1,820)	(991)	(1,871)	(875)	(5,557)
All prior years	\$ (22,363)	\$ (3,644)	\$ (8,700)	\$ (4,047)	\$ (38,754)

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, 2018.

Accident Year	CAR Assumed Private Passenger Automobile	CAR Assumed Commercial Automobile	FAIR Plan Homeowners	Total
2008 & prior	\$ —	\$ —	\$ —	\$ —
2009	—	—	—	—
2010	—	(15)	—	(15)
2011	—	29	—	29
2012	—	(13)	(20)	(33)
2013	—	37	(35)	2
2014	—	(20)	(118)	(138)
2015	—	(41)	(238)	(279)
2016	—	657	(526)	131
2017	—	(119)	(172)	(291)
All prior years	\$ —	\$ 515	\$ (1,109)	\$ (594)

Our private passenger automobile line of business prior year reserves decreased by \$22,363 for the nine months ended September 30, 2018. The decrease was primarily due to improved private passenger results of \$21,303 for the accident years 2010 through 2017. The improved private passenger results were primarily due to fewer IBNR claims

Table of Contents

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

Our commercial automobile line of business prior year reserves decreased by \$3,129 for the nine months ended September 30, 2018. The decrease was primarily due to improved retained commercial results of \$2,137 for the accident years 2014 and 2017.

Our retained homeowners and our retained other lines of business prior year reserves decreased by \$8,700 and \$4,047 for the nine months ended September 30, 2018 due primarily to fewer IBNR claims than previously estimated.

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

Other-Than-Temporary Impairments.

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

In our determination of whether a decline in fair value below amortized cost is an OTTI, we consider and evaluate several factors and circumstances including the issuer’s overall financial condition, the issuer’s credit and financial strength ratings, a weakening of the general market conditions in the industry or geographic region in which the issuer operates, a prolonged period (typically twelve 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. In instances where no credit loss exists but it is more likely than not that the Company will have to sell the debt security prior to the anticipated recovery, the decline in market value below amortized cost is recognized as an OTTI in earnings. In periods after the recognition of an OTTI on debt securities, the Company accounts for such securities as if they had been purchased on the measurement date of the OTTI at an amortized cost basis equal to the previous amortized cost basis less the OTTI recognized in earnings. For debt securities for which

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

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

Forward-Looking Statements

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

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

Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include words such as “believe,” “expect,” “anticipate,” “intend,” “plan,” “estimate,” “aim,” “projects,” or w similar meaning and expressions that indicate future events and trends, or future or conditional

Table of Contents

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, 2017.

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.

Table of Contents

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

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

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

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

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

	-100 Basis Point Change	No Change	+100 Basis Point Change
As of September 30, 2018			
Estimated fair value	\$ 1,170,947	\$ 1,131,133	\$ 1,088,329
Estimated increase (decrease) in fair value	\$ 39,814	\$ —	\$ (42,804)

With respect to floating rate debt, we are exposed to the effects of changes in prevailing interest rates. At September 30, 2018, we had no debt outstanding under our credit facility. Assuming the full utilization of our current available credit facility, a 2.0% increase in the prevailing interest rate on our variable rate debt would result in interest expense increasing approximately \$600 for 2018, assuming that all of such debt is outstanding for the entire year.

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

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

Item 4. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

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

Table of Contents

be disclosed in such reports is accumulated and communicated to management, including our CEO and CFO, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Control over Financial Reporting

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

44

Table of Contents

Part II. OTHER INFORMATION

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

Item 1A. Risk Factors

There have been no subsequent material changes from the risk factors previously disclosed in the Company’s 2017 Annual Report on Form 10-K.

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

On August 3, 2007, the Board of Directors approved a share repurchase program of up to \$30,000 of the Company’s outstanding common shares. As of September 30, 2018, the Board of Directors had cumulatively authorized increases to the existing share repurchase program of up to \$150,000 of its outstanding common shares. Under the program, the Company may repurchase shares of its common stock for cash in public or private transactions, in the open market or otherwise. The timing of such repurchases and actual number of shares repurchased will depend on a variety of factors including price, market conditions and applicable regulatory and corporate requirements. The program does not require the Company to repurchase any specific number of shares and it may be modified, suspended or terminated at any time without prior notice. No share repurchases were made by the Company during the nine months ended September 30, 2018.

Item 3. Defaults upon Senior Securities - None.

Item 4. Mine Safety Disclosures — None.

Item 5. Other Information - None.

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

Table of Contents

SAFETY INSURANCE GROUP, INC.

EXHIBIT INDEX

Exhibit Number	Description
10.1	<u>2018 Long-Term Incentive Plan (1)</u>
11.0	Statement re Computation of Per Share Earnings (2)
31.1	<u>CEO Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes Oxley Act of 2002(3)</u>
31.2	<u>CFO Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes Oxley Act of 2002(3)</u>
32.1	<u>CEO Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes Oxley Act of 2002(3)</u>
32.2	<u>CFO Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes Oxley Act of 2002(3)</u>
101.INS	XBRL Instance Document(3)
101.SCH	XBRL Taxonomy Extension Schema(3)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase(3)
101.DEF	XBRL Taxonomy Extension Definition Linkbase(3)
101.LAB	XBRL Taxonomy Extension Label Linkbase(3)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase(3)

-
- (1) Incorporated herein by reference to the Registrant’s Definitive Proxy Statement filed on April 11, 2018.
 (2) Not included herein as the information is included as part of this Form 10-Q, Item 1 - Financial Statements, Note 3, earnings per Weighted Average Common Share.
 (3) Included herein.

Table of Contents

SIGNATURE

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

November 2, 2018 SAFETY INSURANCE GROUP, INC. (Registrant)

By: /s/ WILLIAM J. BEGLEY, JR.

William J. Begley, Jr.

Vice President, Chief Financial Officer, Secretary and Principal Accounting Officer