SAFETY INSURANCE GROUP INC
Form 10-Q
May 12, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2014

OR

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

For the transition period from to

Commission File Number: 000-50070

SAFETY INSURANCE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**13-4181699**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

20 Custom House Street, Boston, Massachusetts 02110

(Address of principal executive offices including zip code)

(617) 951-0600

(Registrant s telephone number, including area code)

Not Applicable

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

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

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

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o	Smaller reporting company o

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

Yes o No x

As of May 2, 2014, there were 15,467,324 shares of common stock with a par value of $0.01 per share outstanding.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands, except share data)

	March 31, 2014 (Unaudited)	December 31, 2013
Assets		
Investments:		
Securities available for sale:		
Fixed maturities, at fair value (amortized cost: $1,097,908 and $1,087,232)	**$ 1,125,506**	$ 1,104,957
Equity securities, at fair value (cost: $83,884 and $83,134)	**93,739**	91,871
Other invested assets	**6,471**	5,748
Total investments	**1,225,716**	1,202,576
Cash and cash equivalents	**15,670**	55,877
Accounts receivable, net of allowance for doubtful accounts	**175,120**	169,304
Receivable for securities sold	**1,423**	1,320
Accrued investment income	**10,275**	10,329
Taxes recoverable	**5,474**	709
Receivable from reinsurers related to paid loss and loss adjustment expenses	**5,782**	4,588
Receivable from reinsurers related to unpaid loss and loss adjustment expenses	**60,610**	60,346
Ceded unearned premiums	**18,675**	17,900
Deferred policy acquisition costs	**64,812**	63,388
Deferred income taxes	**70**	3,984
Equity and deposits in pools	**22,094**	18,733
Other assets	**16,104**	16,403
Total assets	**$ 1,621,825**	$ 1,625,457
Liabilities		
Loss and loss adjustment expense reserves	**$ 461,022**	$ 455,014
Unearned premium reserves	**381,412**	370,583
Accounts payable and accrued liabilities	**47,053**	66,508
Payable for securities purchased	**4,365**	13,327
Payable to reinsurers	**7,441**	7,094
Other liabilities	**13,717**	17,744
Total liabilities	**915,010**	930,270
Commitments and contingencies (Note 7)		
Shareholders equity		
Common stock: $0.01 par value; 30,000,000 shares authorized; 17,286,871 and 17,207,929 shares issued	**173**	172
Additional paid-in capital	**171,989**	170,391
Accumulated other comprehensive income, net of taxes	**24,345**	17,200
Retained earnings	**570,676**	567,792
Treasury stock, at cost: 1,819,547 shares	**(60,368)**	(60,368)
Total shareholders equity	**706,815**	695,187
Total liabilities and shareholders equity	**$ 1,621,825**	$ 1,625,457

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended March 31, 2014	2013
Net earned premiums	**$ 175,970**	$ 166,439
Net investment income	**10,573**	10,387
Net realized gains on investments	**20**	402
Finance and other service income	**4,524**	4,568
Total revenue	**191,087**	181,796
Losses and loss adjustment expenses	**120,888**	112,145
Underwriting, operating and related expenses	**53,407**	50,098
Interest expense	**22**	22
Total expenses	**174,317**	162,265
Income before income taxes	**16,770**	19,531
Income tax expense	**4,645**	5,547
Net income	**$ 12,125**	$ 13,984
Earnings per weighted average common share:		
Basic	**$ 0.79**	$ 0.91
Diluted	**$ 0.79**	$ 0.91
Cash dividends paid per common share	**$ 0.60**	$ 0.60
Number of shares used in computing earnings per share:		
Basic	**15,359,989**	15,339,690
Diluted	**15,421,159**	15,356,754

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(Unaudited)

(Dollars in thousands)

	Three Months Ended March 31, 2014	2013
Net income	**$ 12,125**	$ 13,984
Other comprehensive income, net of tax:		
Unrealized holding gains (losses) during the period, net of tax expense (benefit) of $3,854 and ($2,388)	**7,158**	(4,435)
Reclassification adjustment for gains included in net income, net of tax expense of ($7) and ($141)	**(13)**	(261)
Unrealized (losses) gains on securities available for sale	**7,145**	(4,696)
Comprehensive income	**$ 19,270**	$ 9,288

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders Equity

(Unaudited)

(Dollars in thousands)

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income, Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders Equity
Balance at December 31, 2012	$ 170	$ 163,041	$ 43,356	$ 543,361	$ (55,569)	$ 694,359
Net income, January 1 to March 31, 2013				13,984		13,984
Other comprehensive income, net of deferred federal income taxes			(4,696)			(4,696)
Restricted share awards issued	1	187				188
Recognition of employee share-based compensation, net of deferred federal income taxes		1,310				1,310
Exercise of options, net of federal income taxes		536				536
Dividends paid				(9,200)		(9,200)
Balance at March 31, 2013	$ 171	$ 165,074	$ 38,660	$ 548,145	$ (55,569)	$ 696,481

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income, Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders Equity
Balance at December 31, 2013	**$ 172**	**$ 170,391**	**$ 17,200**	**$ 567,792**	**$ (60,368)**	**$ 695,187**
Net income, January 1 to March 31, 2014				**12,125**		**12,125**
Other comprehensive loss, net of deferred federal income taxes			**7,145**			**7,145**
Restricted share awards issued	**1**	**217**				**218**
Recognition of employee share-based compensation, net of deferred federal income taxes		**1,311**				**1,311**
Exercise of options, net of federal income taxes		**70**				**70**
Dividends paid and accrued				**(9,241)**		**(9,241)**
Balance at March 31, 2014	**$ 173**	**$ 171,989**	**$ 24,345**	**$ 570,676**	**$ (60,368)**	**$ 706,815**

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

	Three Months Ended March 31, 2014	2013
Cash flows from operating activities:		
Net income	**$ 12,125**	$ 13,984
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	**3,345**	3,474
Provision for deferred income taxes	**67**	59
Net realized gains on investments	**(20)**	(402)
Changes in assets and liabilities:		
Accounts receivable	**(5,816)**	(7,580)
Accrued investment income	**54**	500
Receivable from reinsurers	**(1,458)**	(744)
Ceded unearned premiums	**(775)**	(328)
Deferred policy acquisition costs	**(1,424)**	(1,392)
Other assets	**(7,866)**	3,128
Loss and loss adjustment expense reserves	**6,008**	7,954
Unearned premium reserves	**10,829**	12,577
Accounts payable and accrued liabilities	**(19,455)**	(20,836)
Payable to reinsurers	**347**	(683)
Other liabilities	**(4,056)**	(4,853)
Net cash (used for) / provided by operating activities	**(8,095)**	4,858
Cash flows from investing activities:		
Fixed maturities purchased	**(65,549)**	(41,969)
Equity securities purchased	**(4,302)**	(13,040)
Other invested assets purchased	**(750)**	
Proceeds from sales and paydowns of fixed maturities	**28,201**	48,202
Proceeds from maturities, redemptions, and calls of fixed maturities	**16,116**	14,069
Proceed from sales of equity securities	**3,928**	1,820
Fixed assets purchased	**(615)**	(955)
Net cash (used for) / provided by investing activities	**(22,971)**	8,127
Cash flows from financing activities:		
Proceeds from stock options exercised	**61**	519
Excess tax benefit from stock options exercised	**9**	17
Dividends paid to shareholders	**(9,211)**	(9,200)
Net cash used for financing activities	**(9,141)**	(8,664)
Net (decrease) increase in cash and cash equivalents	**(40,207)**	4,321
Cash and cash equivalents at beginning of year	**55,877**	35,383
Cash and cash equivalents at end of period	**$ 15,670**	$ 39,704

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

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

1. Basis of Presentation

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

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

The financial information as of March 31, 2014 and for the three months ended March 31, 2014 and 2013 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 and results of operations for the periods. These unaudited consolidated financial statements may not be indicative of financial results for the full year and should be read in conjunction with the audited financial statements included in the Company s annual report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) on March 17, 2014.

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

The Insurance Subsidiaries began writing private passenger automobile and homeowners insurance in New Hampshire during 2008, personal umbrella insurance in New Hampshire during 2009, and commercial automobile insurance in New Hampshire during 2011.

2. Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board issued Accounting Standards Update ("ASU") 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU 2013-02 requires entities to present in either a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and the income statement line items affected by the reclassification. Items not required to be reclassified to net income in their entirety are cross referenced to a related footnote for additional information. ASU 2013-02 was effective for interim and annual periods beginning after December 15, 2012. The impact of adoption was not material to the Company s consolidated financial condition and results of operations.

3. Earnings per Weighted Average Common Share

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

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

	Three Months Ended March 31, 2014	2013
Net income available to common shareholders for basic and diluted earnings per share	**$ 12,125**	$ 13,984
Weighted average common and common equivalent shares outstanding used to calculate basic earnings per share	**15,359,989**	15,339,690
Common equivalent shares - stock options	**2,929**	8,797
Common equivalent shares - non-vested stock grants	**58,241**	8,267
Weighted average common and common equivalent shares outstanding used to calculate diluted earnings per share	**15,421,159**	15,356,754
Basic earnings per share	**$ 0.79**	$ 0.91
Diluted earnings per share	**$ 0.79**	$ 0.91

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

Diluted EPS excludes stock options with exercise prices and exercise tax benefits greater than the average market price of the Company s common stock during the period because their inclusion would be anti-dilutive. There were no anti-dilutive stock options for the three months ended March 31, 2014 and 2013, respectively.

4. Share-Based Compensation

Management Omnibus Incentive Plan

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

The maximum number of shares of common stock with respect to which awards may be granted is 2,500,000. The Incentive Plan was amended in March of 2013 to remove "share recycling" plan provisions. Hence, shares of stock covered by an award under the Incentive Plan that are forfeited are no longer available for issuance in connection with future grants of awards. At March 31, 2014, there were 454,920 shares available for future grant. The Board of Directors and the Compensation Committee intend to issue more awards under the Incentive Plan in the future.

Accounting and Reporting for Stock-Based Awards

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

The following table summarizes stock option activity under the Incentive Plan for the three months ended March 31, 2014.

Weighted

	Shares Under Option		Weighted Average Exercise Price	Average Remaining Contractual Term		Aggregate Intrinsic Value
Outstanding at beginning of year	**20,200**	**$**	**41.64**			
Exercised	**(2,000)**	**$**	**30.68**			
Outstanding at end of period	**18,200**	**$**	**42.85**	**1.9 years**	**$**	**200**
Exercisable at end of period	**18,200**	**$**	**42.85**	**1.9 years**	**$**	**200**

The aggregate intrinsic value in the preceding table represents the total pre-tax intrinsic value, which is the difference between the fair value based upon the Company s closing stock price on March 31, 2014 and the exercise price which would have been received by the option holders had all option holders exercised their options as of that date. The exercise price on stock options outstanding under the Incentive Plan at March 31, 2014 was $42.85. The range of exercise prices on stock options outstanding at March 31, 2013 was $18.50 to $42.85. The total intrinsic value of options exercised during the three months ended March 31, 2014 and 2013 was $46 and $201, respectively. Cash received from options exercised was $61 and $519 for the three months ended March 31, 2014 and 2013, respectively.

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Restricted Stock

Service-based restricted stock awarded to employees 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 unrestrict 30% on the first and second anniversaries of the grant date and 40% on the third anniversary of the grant date, except for non-executive employees restricted stock awards which vest ratable over a five-year service period and independent directors stock awards which vest immediately. Independent directors stock awards cannot be sold, assigned, pledged, or otherwise transferred, encumbered or disposed of until the recipient is no longer a member of the Board of Directors.

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

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

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

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

The following tables summarize service-based and performance-based restricted stock activity under the Incentive Plan.

	Service-based Shares Under Restriction	Weighted Average Fair Value	Performance-based Shares Under Restriction	Weighted Average Fair Value
Outstanding at beginning of year	**211,234**	**$ 43.51**	**37,456**	**$ 44.13**

Granted	**49,014**	$	**54.05**	**27,928**	$	**58.09**
Vested and unrestricted	**(81,149)**	$	**43.80**		$	
Outstanding at end of period	**179,099**	$	**46.28**	**65,384**	$	**50.10**

As of March 31, 2014, there was $9,764 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 2.1 years. The total fair value of the shares that were vested and unrestricted during the three months ended March 31, 2014 and 2013 was $3,554 and $4,230, respectively. For the three months ended March 31, 2014 and 2013, the Company recorded compensation expense related to restricted stock of $794 and $803, net of income tax benefits of $428 and $433, 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.

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	As of March 31, 2014				
			Gross Unrealized Losses (3)		
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	**$ 1,510**	**$**	**$ (7)**	**$**	**$ 1,503**
Obligations of states and political subdivisions	**447,792**	**14,502**	**(1,411)**		**460,883**
Residential mortgage-backed securities (1)	**198,160**	**7,090**	**(2,376)**		**202,874**
Commercial mortgage-backed securities	**26,441**	**275**	**(14)**		**26,702**
Other asset-backed securities	**20,655**	**417**	**(21)**		**21,051**
Corporate and other securities	**403,350**	**10,585**	**(1,442)**		**412,493**
Subtotal, fixed maturity securities	**1,097,908**	**32,869**	**(5,271)**		**1,125,506**
Equity securities (2)	**83,884**	**10,055**	**(200)**		**93,739**
Other invested assets (5)	**6,471**				**6,471**
Totals	**$ 1,188,263**	**$ 42,924**	**$ (5,471)**	**$**	**$ 1,225,716**

	As of December 31, 2013				
			Gross Unrealized Losses (3)		
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	$ 1,510	$	$ (7)	$	$ 1,503
Obligations of states and political subdivisions	461,256	10,248	(4,179)		467,325
Residential mortgage-backed securities (1)	205,053	6,879	(3,230)		208,702
Commercial mortgage-backed securities	31,885	342	(8)		32,219
Other asset-backed securities	13,357	124	(36)		13,445
Corporate and other securities	374,171	9,882	(2,290)		381,763
Subtotal, fixed maturity securities	1,087,232	27,475	(9,750)		1,104,957
Equity securities (2)	83,134	8,821	(84)		91,871
Other invested assets (5)	5,748				5,748
Totals	$ 1,176,114	$ 36,296	$ (9,834)	$	$ 1,202,576

(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 includes interests in mutual funds held to fund the Company s executive deferred compensation plan.

(3) Our investment portfolio included 167 and 220 securities in an unrealized loss position at March 31, 2014 and December 31, 2013, 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 approximates 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.

	As of March 31, 2014	
	Amortized Cost	**Estimated Fair Value**
Due in one year or less	**$ 54,481**	**$ 55,561**
Due after one year through five years	**321,446**	**330,245**
Due after five years through ten years	**208,275**	**213,802**
Due after ten years	**268,450**	**275,271**
Asset-backed securities	**245,256**	**250,627**
Totals	**$ 1,097,908**	**$ 1,125,506**

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

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

	Three Months Ended March 31, 2014	2013
Gross realized gains		
Fixed maturity securities	**$ 174**	$ 379
Equity securities	**411**	26
Gross realized losses		
Fixed maturity securities	**(530)**	(2)
Equity securities	**(35)**	(1)
Net realized gains on investments	**$ 20**	$ 402

In the normal course of business, the Company enters into transactions involving various types of financial instruments, including investments in fixed maturities and equity securities. Investment transactions have credit exposure to the extent that a counter party may default on an obligation to the Company. Credit risk is a consequence of carrying, trading and investing in securities. To manage credit risk, the Company focuses on higher quality fixed income securities, reviews the credit strength of all companies in which it invests, limits its exposure in any one investment and monitors the portfolio quality, taking into account credit ratings assigned by recognized statistical rating organizations.

The following tables as of March 31, 2014 and December 31, 2013 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 March 31, 2014					
	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	**$ 1,503**	**$ 7**	**$**	**$**	**$ 1,503**	**$ 7**
Obligations of states and political subdivisions	**65,313**	**1,244**	**3,465**	**167**	**68,778**	**1,411**
Residential mortgage-backed securities	**39,518**	**965**	**35,997**	**1,412**	**75,515**	**2,377**
Commercial mortgage-backed securities	**6,504**	**14**			**6,504**	**14**
Other asset-backed securities	**3,251**	**19**	**4,613**	**1**	**7,864**	**20**
Corporate and other securities	**77,940**	**1,310**	**4,558**	**132**	**82,498**	**1,442**
Subtotal, fixed maturity securities	**194,029**	**3,559**	**48,633**	**1,712**	**242,662**	**5,271**
Equity securities	**4,962**	**194**	**330**	**6**	**5,292**	**200**
Total temporarily impaired securities	**$ 198,991**	**$ 3,753**	**$ 48,963**	**$ 1,718**	**$ 247,954**	**$ 5,471**

	As of December 31, 2013					
	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	$ 1,503	$ 7	$	$	$ 1,503	$ 7
Obligations of states and political subdivisions	131,114	3,898	3,362	281	134,476	4,179
Residential mortgage-backed securities	50,048	1,570	37,166	1,660	87,214	3,230
Commercial mortgage-backed securities	6,008	8			6,008	8
Other asset-backed securities	3,240	31	4,608	5	7,848	36
Corporate and other securities	86,312	2,223	2,235	67	88,547	2,290
Subtotal, fixed maturity securities	278,225	7,737	47,371	2,013	325,596	9,750
Equity securities	3,933	73	299	11	4,232	84
Total temporarily impaired securities	$ 282,158	$ 7,810	$ 47,670	$ 2,024	$ 329,828	$ 9,834

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

Other-Than-Temporary Impairments

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

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

The unrealized losses in the Company s fixed income and equity portfolio as of March 31, 2014 were reviewed for potential other-than-temporary asset impairments. The Company held no securities at March 31, 2014 with a material (20% or greater) unrealized loss for four or more consecutive quarters. Specific qualitative analysis was also performed for any additional securities appearing on the Company s Watch List, if any. Qualitative analysis considered such factors as the financial condition and the near term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, changes to the rating of the security by a rating agency and the historical volatility of the fair value of the security.

The qualitative analysis performed by the Company concluded that the unrealized losses recorded on the investment portfolio at March 31, 2014 resulted from fluctuations in market interest rates and other temporary market conditions as opposed to fundamental changes in the credit quality of the issuers of such securities. Therefore, decreases in fair values of the Company s securities are viewed as being temporary.

During the three months ended March 31, 2014 and 2013, there was no significant deterioration in the credit quality of any of the Company s holdings and no OTTI charges were recorded related to the Company s portfolio of investment securities. At March 31, 2014 and December 31, 2013, there were no amounts included in accumulated other comprehensive income related to securities which were considered by the Company to be other-than-temporarily impaired.

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

Net Investment Income

The components of net investment income were as follows:

	Three Months Ended March 31,	
	2014	**2013**
Interest on fixed maturity securities	**$ 10,404**	$ 10,700
Dividends on equity securities	**657**	171
Equity in earnings of other invested assets	**121**	
Interest on other assets	**20**	74
Interest on cash and cash equivalents	**1**	8
Total investment income	**11,203**	10,953
Investment expenses	**630**	566
Net investment income	**$ 10,573**	$ 10,387

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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 s custodian bank is its primary provider of quoted prices from third-party pricing services and broker-dealers. To provide reasonable assurance of the validity of each price or quote, a secondary third-party pricing service or broker-dealer quote is obtained from the Company s investment managers. An examination of the pricing data is then performed for each security. If the variance between the primary and secondary price quotes for a security is within an accepted tolerance level, the quoted price obtained from the Company s custodian bank is used in the financial statements for the security. If the variance between the primary and secondary price quotes exceeds an accepted tolerance level, the Company obtains a quote from an alternative source, if possible, and documents and resolves any differences between the pricing sources. In addition, the Company may request that its investment managers and their traders provide input as to which vendor is providing prices that its traders believe are reflective of fair value for the security. Following this process, the Company may decide to value the security in its financial statements using the secondary or alternative source if it believes that pricing is more reflective of the security s value than the primary pricing provided by its custodian bank. The Company analyzes market valuations received to verify reasonableness, to understand the key assumptions used and their sources, and to determine an appropriate ASC 820 fair value hierarchy level based upon trading activity and the observability of market inputs. Based on this evaluation and investment class analysis, each price is classified into Level 1, 2 or 3.

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

The Company s Level 1 securities consist of equity securities whose values are based on quoted prices in active markets for identical assets. The Company s Level 2 securities are comprised of available-for-sale fixed maturity securities whose fair value was determined using observable market inputs. The Company s Level 3 security is a real estate investment trust equity investment whose fair value is determined using the trust s net asset value obtained from its audited financial statements; however, the Company is required to submit a request 45 days before quarter end to dispose of the security. Fair values for securities for which quoted market prices were unavailable were estimated based upon reference to observable inputs such as benchmark interest rates, market comparables, and other relevant inputs. Investments valued using these inputs include U.S. Treasury securities and obligations of U.S. Government agencies, obligations of international government agencies, obligations of states and political subdivisions, corporate securities, commercial and residential mortgage-backed securities, and other asset-backed securities. Inputs into the fair value application that are utilized by asset class include but are not limited to:

- *States and political subdivisions*: overall credit quality, including assessments of market sectors and the level and variability of sources of payment such as general obligation, revenue or lease; credit support such as insurance, state or local economic and political base, prefunded and escrowed to maturity covenants.

- *Corporate fixed maturities*: overall credit quality, the establishment of a risk adjusted credit spread over the applicable risk free yield curve for discounted cash flow valuations; assessments of the level of industry economic sensitivity, company financial policies, indenture restrictive covenants, and/or security and collateral.

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- *Residential mortgage-backed securities*, U.S. agency pass-throughs, collateralized mortgage obligations (CMOs), non U.S. agency CMOs: estimates of prepayment speeds based upon historical prepayment rate trends, underlying collateral interest rates, original weighted average maturity, vintage year, borrower credit quality characteristics, interest rate and yield curve forecasts, U.S. government support programs, tax policies, and delinquency/default trends.

- *Commercial mortgage-backed securities*: overall credit quality, including assessments of the level and variability of credit support and collateral type such as office, retail, or lodging, predictability of cash flows for the deal structure, prevailing economic market conditions.

- *Other asset-backed securities*: overall credit quality, estimates of prepayment speeds based upon historical trends and characteristics of underlying loans, including assessments of the level and variability of collateral, revenue generating agreements, area licenses agreements, product sourcing agreements and equipment and property leases.

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

All unadjusted estimates of fair value for our fixed maturities priced by the pricing services as described above are included in the amounts disclosed in Level 2.

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

With the exception of the REIT which is categorized as a Level 3 security, the Company s entire available-for-sale portfolio was priced based upon quoted market prices or other observable inputs as of March 31, 2014. There were no significant changes to the valuation process during the period ended March 31, 2014. As of March 31, 2014 and December 31, 2013, no quotes or prices obtained were adjusted by management. All broker quotes obtained were non-binding.

At March 31, 2014 and December 31, 2013, investments in fixed maturities and equity securities classified as available-for-sale had a fair value which equaled carrying value of $1,219,245 and $1,196,828, respectively. At March 31, 2014 and December 31, 2013, we held no short-term investments. The carrying values of cash and cash equivalents and investment income accrued approximate fair value.

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

	As of March 31, 2014			
	Total	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs
U.S. Treasury securities	$ 1,503	$	$ 1,503	$
Obligations of states and political subdivisions	460,883		460,883	
Residential mortgage-backed securities	202,874		202,874	
Commercial mortgage-backed securities	26,702		26,702	
Other asset-backed securities	21,051		21,051	
Corporate and other securities	412,493		412,493	
Equity securities	93,739	77,545		16,194
Total investment securities	$ 1,219,245	$ 77,545	$ 1,125,506	$ 16,194

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	As of December 31, 2013			
	Total	**Level 1 Inputs**	**Level 2 Inputs**	**Level 3 Inputs**
U.S.				