

SAFETY INSURANCE GROUP INC  
Form 10-Q  
August 09, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2007**

**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.)

**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)

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 is large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐



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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of August 3, 2007, there were 16,234,663 shares of common stock with a par value of \$0.01 per share outstanding.

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SAFETY INSURANCE GROUP, INC.

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## Safety Insurance Group, Inc. and Subsidiaries

## Consolidated Balance Sheets

(Dollars in thousands, except share data)

	June 30, 2007 (Unaudited)	December 31, 2006
<b>Assets</b>		
Investment securities available for sale:		
Fixed maturities, at fair value (amortized cost: \$892,012 and \$936,534)	\$ 879,105	\$ 936,280
Equity securities, at fair value (cost: \$6,481 and \$4,038)	6,848	4,325
Total investment securities	885,953	940,605
Cash and cash equivalents	92,451	26,283
Accounts receivable, net of allowance for doubtful accounts	175,475	158,190
Receivable for securities sold	5,582	
Accrued investment income	9,765	9,776
Taxes recoverable		1,781
Receivable from reinsurers related to paid loss and loss adjustment expenses	13,976	13,282
Receivable from reinsurers related to unpaid loss and loss adjustment expenses	79,457	78,464
Ceded unearned premiums	33,135	33,042
Deferred policy acquisition costs	52,367	47,404
Deferred income taxes	21,132	16,868
Equity and deposits in pools	39,966	26,166
Other assets	9,230	3,887
<b>Total assets</b>	<b>\$ 1,418,489</b>	<b>\$ 1,355,748</b>
<b>Liabilities</b>		
Loss and loss adjustment expense reserves	\$ 458,234	\$ 449,444
Unearned premium reserves	356,509	333,404
Accounts payable and accrued liabilities	30,169	48,666
Taxes payable	835	
Outstanding claims drafts	17,299	16,279
Payable to reinsurers	23,570	11,568
Payable for securities purchased	1,720	
Capital lease obligations		39
<b>Total liabilities</b>	<b>888,336</b>	<b>859,400</b>
<b>Commitments and contingencies (Note 7)</b>		
<b>Shareholders' equity</b>		
Common stock: \$0.01 par value; 30,000,000 shares authorized; 16,233,463 and 16,096,004 shares issued and outstanding, respectively	162	161
Additional paid-in capital	132,297	129,785
Accumulated other comprehensive (loss) income, net of taxes	(8,151)	21
Retained earnings	405,845	366,381
<b>Total shareholders' equity</b>	<b>530,153</b>	<b>496,348</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 1,418,489</b>	<b>\$ 1,355,748</b>

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







## Safety Insurance Group, Inc. and Subsidiaries

## Consolidated Statements of Operations

(Unaudited)

(Dollars in thousands, except per share and share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net earned premiums	\$ 153,925	\$ 156,261	\$ 307,515	\$ 314,039
Net investment income	10,780	9,834	21,819	19,212
Net realized losses on investments	(162 )	(187 )	(91 )	(261 )
Finance and other service income	3,995	3,720	7,988	7,579
Total revenue	168,538	169,628	337,231	340,569
Losses and loss adjustment expenses	92,769	84,604	185,327	170,355
Underwriting, operating and related expenses	43,021	41,757	83,719	82,152
Interest expenses	19	20	41	44
Total expenses	135,809	126,381	269,087	252,551
Income before income taxes	32,729	43,247	68,144	88,018
Income tax expense	9,813	14,109	20,580	28,078
Net income	\$ 22,916	\$ 29,138	\$ 47,564	\$ 59,940
<b>Earnings per weighted average common share:</b>				
Basic	\$ 1.43	\$ 1.84	\$ 2.97	\$ 3.80
Diluted	\$ 1.42	\$ 1.81	\$ 2.95	\$ 3.75
<b>Cash dividends paid per common share</b>				
	\$ 0.25	\$ 0.18	\$ 0.50	\$ 0.36
<b>Weighted average number of common shares outstanding:</b>				
Basic	16,052,236	15,826,992	16,022,487	15,769,133
Diluted	16,127,154	16,056,362	16,096,412	15,992,337

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



## 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/(Loss), Net of Taxes	Retained Earnings	Total Shareholders Equity
Balance at December 31, 2005	\$ 158	\$ 120,451	\$ (833)	\$ 268,173	\$ 387,949
Net income, January 1 to June 30, 2006				59,940	59,940
Other comprehensive loss, net of deferred federal income taxes			(11,882)		(11,882)
Exercise of options and unearned compensation on restricted stock, net of deferred federal income taxes	2	5,086			5,088
Dividends paid				(5,721)	(5,721)
Balance at June 30, 2006	\$ 160	\$ 125,537	\$ (12,715)	\$ 322,392	\$ 435,374

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income/(Loss), Net of Taxes	Retained Earnings	Total Shareholders Equity
Balance at December 31, 2006	\$ 161	\$ 129,785	\$ 21	\$ 366,381	\$ 496,348
Net income, January 1 to June 30, 2007				47,564	47,564
Other comprehensive loss, net of deferred federal income taxes			(8,172)		(8,172)
Exercise of options and unearned compensation on restricted stock, net of deferred federal income taxes	1	2,512			2,513
Dividends paid				(8,100)	(8,100)
Balance at June 30, 2007	\$ 162	\$ 132,297	\$ (8,151)	\$ 405,845	\$ 530,153

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



## Safety Insurance Group, Inc. and Subsidiaries

## Consolidated Statements of Comprehensive Income

(Unaudited)

(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<b>Net income</b>	<b>\$ 22,916</b>	<b>\$ 29,138</b>	<b>\$ 47,564</b>	<b>\$ 59,940</b>
<b>Other comprehensive losses, net of taxes:</b>				
Unrealized holding losses during the period, net of tax benefit of \$(5,079), \$(3,004), \$(4,433) and \$(6,489)	(9,432)	(5,578)	(8,231)	(12,052)
Reclassification adjustment for losses included in net income, net of tax benefit of \$57, \$65, \$32 and \$91	105	122	59	170
Unrealized losses on securities available for sale	(9,327)	(5,456)	(8,172)	(11,882)
<b>Comprehensive income</b>	<b>\$ 13,589</b>	<b>\$ 23,682</b>	<b>\$ 39,392</b>	<b>\$ 48,058</b>

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



## Safety Insurance Group, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

	Six Months Ended June 30,	
	2007	2006
<b>Cash flows from operating activities:</b>		
Net income	\$ 47,564	\$ 59,940
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	4,673	4,286
Provision (benefit) for deferred income taxes	136	(176)
Net realized losses on investments	91	261
Changes in assets and liabilities:		
Accounts receivable	(17,285)	(7,654)
Accrued investment income	11	(1,190)
Receivable from reinsurers	(1,687)	5,850
Ceded unearned premiums	(93)	321
Deferred policy acquisition costs	(4,963)	(5,020)
Other assets	(12,272)	(16,902)
Loss and loss adjustment expense reserves	8,790	(21,095)
Unearned premium reserves	23,105	21,283
Accounts payable and accrued liabilities	(18,497)	(14,309)
Payable to reinsurers	12,002	14,606
Other liabilities	2,023	(1,810)
Net cash provided by operating activities	43,598	38,391
<b>Cash flows from investing activities:</b>		
Fixed maturities purchased	(125,306)	(270,442)
Equity securities purchased	(3,329)	(2,455)
Proceeds from sales of fixed maturities	152,385	93,154
Proceeds from maturities of fixed maturities	11,000	12,200
Proceeds from sales of equity securities	979	485
Fixed assets purchased	(5,488)	(501)
Net cash provided by (used for) investing activities	30,241	(167,559)
<b>Cash flows from financing activities:</b>		
Proceeds and excess tax benefits from exercise of stock options	429	3,405
Dividends paid to shareholders	(8,100)	(5,721)
Net cash used for financing activities	(7,671)	(2,316)
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>66,168</b>	<b>(131,484)</b>
Cash and cash equivalents at beginning of year	26,283	163,027
<b>Cash and cash equivalents at end of period</b>	<b>\$ 92,451</b>	<b>\$ 31,543</b>

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







**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. Prior period amounts have been reclassified to conform to the current period presentation.

The financial information as of June 30, 2007 and for the three and six months ended June 30, 2007 and 2006 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 1, 2007.

The Company is a leading provider of personal lines property and casualty insurance focused exclusively on the Massachusetts market. The Company 's principal product line is private passenger automobile insurance, which accounted for 76.0% of its direct written premiums in 2006. The Company operates through its insurance company subsidiaries, Safety Insurance Company, Safety Indemnity Insurance Company and Safety Property and Casualty Insurance Company.

**2. Recent Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140 ( FAS 155 ). This statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. This statement also adds clarity regarding interest-only strips and principal-only strips that are not subject to the requirements of Statement No. 133, and requires companies to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments containing an embedded derivative that requires bifurcation. FAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity 's first fiscal year that begins after September 15, 2006. The Company adopted FAS 155 on January 1, 2007. The adoption of FAS 155 did not have a material impact on the Company 's consolidated results of operations or financial position.

For information regarding the Company 's adoption of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109 ( FIN 48 ), see Note 9.

**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 EPS are calculated by dividing net income by the weighted average number of basic common shares outstanding and the net effect of potentially dilutive common shares. At June 30, 2007 and 2006, the Company 's potentially dilutive instruments consisted of common shares under options of 356,268 and 480,797, respectively, and common shares under restriction of 176,781 and 118,790, respectively.



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Basic and diluted EPS for the three and six months ended June 30, 2007 and 2006 were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<b>Earnings per weighted average common share:</b>				
Basic	\$ 1.43	\$ 1.84	\$ 2.97	\$ 3.80
Diluted	\$ 1.42	\$ 1.81	\$ 2.95	\$ 3.75
<b>Weighted average number of common shares outstanding:</b>				
Basic	16,052,236	15,826,992	16,022,487	15,769,133
Effect of dilutive securities:				
Stock options	62,909	196,168	65,644	197,381
Restricted stock	12,009	33,202	8,281	25,823
Diluted	16,127,154	16,056,362	16,096,412	15,992,337

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 185,825 anti-dilutive stock options for both the three and six months ended June 30, 2007. There were 191,225 anti-dilutive stock options for both the three and six months ended June 30, 2006.

Diluted EPS also excludes common shares under restriction with a fair value on the grant effective date greater than the average market price of the Company's common stock during the period because their inclusion would be anti-dilutive. There were 65,760 anti-dilutive shares under restriction for both the three and six months ended June 30, 2007. There were no anti-dilutive shares under restriction for both the three and six months ended June 30, 2006.

#### 4. Stock-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 stock-based compensation awards, including nonqualified stock options, incentive stock options, stock appreciation rights and restricted stock (RS) awards.

On March 10, 2006, the Board of Directors approved amendments to the Incentive Plan, subject to shareholder approval, to (i) increase the number of shares of common stock available for issuance by 1,250,000 shares, (ii) remove obsolete provisions, and (iii) make other non-material changes. A total of 1,250,000 shares of common stock had previously been authorized for issuance under the Incentive Plan. The Incentive Plan, as amended, was approved by the shareholders at the 2006 Annual Meeting of Shareholders which was held on May 19, 2006.

The maximum number of shares of common stock with respect to which awards may be granted under the Incentive Plan is 2,500,000. Shares of stock covered by an award under the Incentive Plan that are forfeited will again be available for issuance in connection with future grants of awards under the plan. At June 30, 2007, there were 1,170,260 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.



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A summary of stock-based awards granted under the Incentive Plan during the six months ended June 30, 2007 is as follows:

Type of Equity Awarded	Effective Date	Number of Awards Granted	Fair Value per Share(1)	Vesting Terms
RS	February 26, 2007	65,760	\$ 45.62	3 years, 30%-30%-40%
RS	February 26, 2007	4,000	\$ 45.62	No vesting period(2)
RS	March 22, 2007	49,971	\$ 38.78	5 years, 20% annually

(1) The fair value per share of the restricted stock grant is equal to the closing price of the Company's common stock on the grant date.

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

### Accounting and Reporting for Stock-Based Awards

Effective January 1, 2006, the Company adopted FAS 123R (revised 2004), Share-Based Payment, which 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 FAS 123R, 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).

As permitted by FAS 123R, the Company elected the modified prospective transition method. Under the modified prospective transition method, (i) compensation expense for share-based awards granted prior to January 1, 2006 is recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under FAS 123 as adjusted to incorporate forfeiture assumptions under FAS 123R, and (ii) compensation expense for all share-based awards granted subsequent to December 31, 2005 is based on the grant date fair value estimated in accordance with the provisions of FAS 123R.

As a result of adopting FAS 123R on January 1, 2006, the Company's net income for the three and six months ended June 30, 2007 was lowered by \$169 and \$307, net of income tax benefit of \$91 and \$165, respectively. The impact on both basic and diluted EPS for the three and six months ended June 30, 2007 was a reduction of \$0.01 and \$0.02 per share, respectively. For the three and six months ended June 30, 2006, the Company's net income was lowered by \$137 and \$275, net of income tax benefits of \$73 and \$148, respectively. The impact on both basic and diluted EPS for the three and six months ended June 30, 2006 was a reduction of \$0.01 and \$0.02 per share, respectively.

### Stock Options

The fair value of stock options used to compute net income and earnings per share for the three and six months ended June 30, 2007 and 2006 is the estimated fair value at grant date using the Black-Scholes option-pricing model with the following assumptions:

	Three and Six Months Ended June 30, 2007	2006
Expected dividend yield	1.36% - 2.52%	1.36% - 2.52%
Expected volatility	0.20 - 0.36	0.20 - 0.36
Risk-free interest rate	3.23% - 4.76%	3.23% - 4.76%
Expected holding period	6.5 - 7 years	6.5 - 7 years

Expected dividend yield is the Company's dividend yield on the measurement date and is based on the assumption that the current yield will continue in the future. Expected volatility is based on historical volatility of the Company's common stock as well as the volatility of a peer group of property and casualty insurers measured for a period equal to the expected holding period of the option. The risk-free interest rate is based upon the yield on the measurement date of a zero-coupon U.S. Treasury bond with a maturity period equal to the expected holding period of the option. The expected holding period is based upon the simplified method provided in SEC Staff Accounting Bulletin No. 107.

Share-Based Payment, which utilizes the mid-points between the vesting dates and the expiration date of the option award to calculate the overall expected term.







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The following table summarizes stock option activity under the Incentive Plan for the six months ended June 30, 2007.

	Shares Under Option	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of year	373,996	\$ 27.53		
Exercised	(17,728 )	16.14		
Outstanding, end of quarter	356,268	28.10	7.2 years	\$ 4,920
Exercisable, end of quarter	81,392	\$ 28.25	7.3 years	\$ 1,107

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based upon the Company's closing stock price of \$41.40 on June 29, 2007, which would have been received by the option holders had all option holders exercised their options as of that date. The range of exercise prices on stock options outstanding under the Incentive Plan was \$12.00 to \$42.85 at June 30, 2007 and 2006. There were no stock options granted during the six months ended June 30, 2007. The weighted average grant date fair value of options granted during the six months ended June 30, 2006 was estimated at \$16.05. The total intrinsic value of options exercised during the six months ended June 30, 2007 and 2006 was \$448 and \$4,625, respectively.

A summary of the status of non-vested options as of June 30, 2007 is presented below:

	Number of Shares	Weighted Average Grant Date Exercise Price
Non-vested, beginning of year	347,721	\$ 28.27
Vested	(72,845 )	29.06
Non-vested, end of quarter	274,876	\$ 28.06

As of June 30, 2007, there was \$2,070 of unrecognized compensation expense related to non-vested option awards that is expected to be recognized over a weighted average period of 2.0 years.

Cash received from options exercised was \$286 and \$1,980 for the six months ended June 30, 2007 and 2006, respectively.

## Restricted Stock

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 expense over the requisite service period.

The following table summarizes restricted stock activity under the Incentive Plan during the six months ended June 30, 2007.

	Shares Under Restriction	Weighted Average Fair Value
Outstanding, beginning of year	126,790	\$ 35.67
Granted	119,731	42.77
Vested and unrestricted	(57,740 )	34.57
Outstanding, end of quarter	188,781	\$ 41.82



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As of June 30, 2007, there was \$6,544 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 1.7 years. The total fair value of the shares that became vested and unrestricted during the six months ended June 30, 2007 and 2006 was \$1,996 and \$882, respectively. For the six months ended June 30, 2007 and 2006, the Company recorded compensation expense related to restricted stock of \$914 and \$572, net of income tax benefits of \$492 and \$308, respectively.

## 5. Investments

The gross unrealized appreciation (depreciation) of investments in fixed maturities securities and equity securities, including interests in mutual funds, was as follows:

	June 30, 2007			
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. Government agencies(1)	\$ 213,233	\$ 39	\$ (5,243 )	\$ 208,029
Obligations of states and political subdivisions	489,466	1,500	(5,475 )	485,491
Asset-backed securities(1)	111,370	26	(2,203 )	109,193
Corporate and other securities	77,943	239	(1,790 )	76,392
Subtotal, fixed maturity securities	892,012	1,804	(14,711 )	879,105
Equity securities	6,481	377	(10 )	6,848
Totals	\$ 898,493	\$ 2,181	\$ (14,721 )	\$ 885,953

(1) Obligations of U.S. Government agencies include 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 Small Business Administration (SBA). The total of these fixed maturity securities was \$203,238 at amortized cost and \$198,120 at estimated fair value as of June 30, 2007. As such, the asset-backed securities presented exclude such issuers already presented under U.S. Treasury securities and obligations of U.S. Government agencies.

The amortized cost and the estimated fair value of fixed maturity securities, by maturity, are shown below. 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.

	June 30, 2007	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 30,971	\$ 30,713
Due after one year through five years	155,717	153,715
Due after five years through ten years	179,767	178,059
Due after ten years through twenty years	202,646	200,913
Due after twenty years	8,303	8,392
Asset-backed securities	314,608	307,313
Totals	\$ 892,012	\$ 879,105



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The gross realized gains (losses) on sales of fixed maturities and equity securities were as follows for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Gross realized gains				
Fixed maturity securities	\$ 9	\$ 340	\$ 852	\$ 377
Equity securities		13	93	31
Gross realized losses				
Fixed maturity securities	(171 )	(531 )	(1,036 )	(660 )
Equity securities		(9 )		(9 )
Net realized losses on investments	\$ (162 )	\$ (187 )	\$ (91 )	\$ (261 )

Proceeds from fixed maturities maturing were \$6,000 and \$3,200 for the three months ended June 30, 2007 and 2006, respectively. Proceeds from fixed maturities maturing were \$11,000 and \$12,200 for the six months ended June 30, 2007 and 2006, respectively.

The following tables illustrate the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities aggregated by investment category. The table also illustrates the length of time that they have been in a continuous unrealized loss position.

	As of June 30, 2007					
	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 and obligations of U.S. Government agencies	\$ 104,547	\$ 1,865	\$ 101,754	\$ 3,378	\$ 206,301	\$ 5,243
Obligations of states and political subdivisions	253,223	2,705	103,974	2,770	357,197	5,475
Asset-backed securities	44,983	1,006	52,796	1,197	97,779	2,203
Corporate and other securities	27,525	558	38,381	1,232	65,906	1,790
Subtotal, fixed maturity securities	430,278	6,134	296,905	8,577	727,183	14,711
Equity securities	626	10			626	10
Total temporarily impaired securities	\$ 430,904	\$ 6,144	\$ 296,905	\$ 8,577	\$ 727,809	\$ 14,721

The Company's investment portfolio included 260 securities in an unrealized loss position at June 30, 2007. The Company's methodology of assessing other-than-temporary impairment is based upon analysis of each security as of the balance sheet date and considers various factors including the length of time and the extent to which fair value has been less than the cost, the financial condition and the near term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, and the Company's intent and ability to hold the investment for a period of time sufficient to allow for recovery of its costs.

As of June 30, 2007, the Company's portfolio of fixed maturity investments was comprised entirely of investment grade corporate fixed maturity securities, U.S. Government and Agency securities and asset-backed securities (i.e., all securities received a rating assigned by Moody's Investors Service, Inc. of Baa or higher, except the few securities not rated by Moody's which received S&P ratings of A- or higher, as well as a rating assigned by the Securities Valuation Office of the National Association of Insurance Commissioners of 1 or 2). 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 Aaa/AAA. Management expects the recent subprime mortgage market deterioration to have little or no effect on the Company's portfolio. The unrealized losses recorded on the fixed maturity investment portfolio at June 30, 2007, resulted from fluctuations in market interest rates as opposed to fundamental changes in the credit quality of the issuers of such securities. Therefore, these decreases in values are viewed



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as being temporary as the Company has the intent and ability to retain such investments for a period of time sufficient to allow for recovery in market value.

During the three and six months ended June 30, 2007 and 2006, there was no significant deterioration in the credit quality of any of the Company's holdings and no other-than-temporary impairment charges were recorded related to the Company's portfolio of investment securities.

## Net Investment Income

The components of net investment income were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Interest and dividends on fixed maturities	\$ 10,240	\$ 9,584	\$ 21,111	\$ 17,924
Dividends on equity securities	79	31	105	38
Interest on cash and cash equivalents	785	511	1,253	1,831
Total investment income	11,104	10,126	22,469	19,793
Investment expenses	324	292	650	581
Net investment income	\$ 10,780	\$ 9,834	\$ 21,819	\$ 19,212

## 6. Loss and Loss Adjustment Expense ( LAE ) Reserves

The following table sets forth a reconciliation of beginning and ending reserves for losses and LAE, as shown in the Company's consolidated financial statements for the periods indicated:

	Six Months Ended June 30,	
	2007	2006
Reserves for losses and LAE, beginning of year	\$ 449,444	\$ 450,716
Less reinsurance recoverable on unpaid losses and LAE	(78,464)	(80,550)
Net reserves for losses and LAE, beginning of year	370,980	370,166
Incurring losses and LAE, related to:		
Current year	200,048	195,734
Prior years	(14,721)	(25,379)
Total incurred losses and LAE	185,327	170,355
Paid losses and LAE related to:		
Current year	93,315	100,113
Prior years	84,215	86,855
Total paid losses and LAE	177,530	186,968
Net reserves for losses and LAE, end of quarter	378,777	353,553
Plus reinsurance recoverables on unpaid losses and LAE	79,457	76,068
Reserves for losses and LAE, end of quarter	\$ 458,234	\$ 429,621

At the end of each period, the reserves were re-estimated for all prior accident years. The Company's prior year reserves decreased by \$14,721 and \$25,379 for the six months ended June 30, 2007 and 2006, respectively. The decreases in prior years reserves during the six months ended June 30, 2007 and June 30, 2006 resulted from re-estimations of prior year ultimate loss and LAE liabilities. The decrease in prior year reserves during the 2007 period is primarily composed of reductions of \$7,813 in Commonwealth Automobile Reinsurers ( CAR ) assumed reserves and \$6,028 in the Company's retained automobile reserves.







The decrease in prior year reserves during the 2006 period is primarily composed of reductions of \$10,261 in CAR assumed reserves, \$11,721 in the Company's automobile reserves and \$2,605 in the Company's homeowners 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**

An eighth amendment to a lease agreement for the lease of office space between the Company and Aman, Inc. was executed on April 5, 2007. Under the provisions of this amendment, additional space will be occupied and the lease term will be extended an additional ten years commencing on January 1, 2009, with an option to renew for one additional five year term.

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, liabilities related to those proceedings could be established in the near term if estimates of the ultimate resolutions of those proceedings are revised.

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 will not have a material effect upon the financial position of the Company.

## **8. Debt**

The Company has a \$30,000 revolving credit facility with Citizens Bank of Massachusetts which expires on June 17, 2008. Loans under the credit facility bear interest at our option at either (i) the LIBOR rate plus 1.5% per annum or (ii) the higher of Citizens Bank of Massachusetts prime rate or 0.5% above the federal funds rate plus 1.5% per annum. Interest only is payable prior to maturity. The obligations of the Company under the credit facility are secured by pledges of the Company's assets and the capital stock of its operating subsidiaries. The credit facility is guaranteed by the non-insurance company subsidiaries of the Company. 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, dividends, and other matters. As of June 30, 2007, the Company was in compliance with all such covenants.

The Company had no amounts outstanding on its credit facility at June 30, 2007 and at December 31, 2006. The credit facility commitment fee included in interest expenses was computed at a rate of 0.25% on the \$30,000 commitment at June 30, 2007 and 2006.

## **9. Income Taxes**

Federal income tax expense for the three and six months ended June 30, 2007 and 2006 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect the current estimates of the annual effective tax rates.

The Company adopted the provisions of FIN 48 on January 1, 2007. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires that the Company determine whether the benefits of its tax positions are more likely than not of being sustained upon audit based upon the technical merits of the tax position. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. As a result of the implementation of FIN 48, the Company recognized no adjustment to its consolidated balance sheet or statement of operations.

As of January 1, 2007, the Company had no unrecognized tax benefits, and none which if recognized would affect the effective tax rate. The Company does not currently anticipate significant changes in the amount of unrecognized income tax benefits during the next twelve months.



The Company records interest and penalties associated with audits as a component of Income before income taxes. Penalties are recorded in Underwriting, operating and other expenses, and interest expense is recorded in Interest expenses in the consolidated statement of operations. The Company had no interest and penalties accrued as of the adoption date.

As of June 30, 2007 and December 31, 2006, the Company was no longer subject to examination of its U.S. federal tax returns for years prior to 2003.



**Item 2.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

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

**Executive Summary and Overview**

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

We are a leading provider of private passenger automobile insurance in Massachusetts. In addition to private passenger automobile insurance (which represented 76.0% of our direct written premiums in 2006), we offer a portfolio of other insurance products, including commercial automobile (14.0% of 2006 direct written premiums), homeowners (7.9% of 2006 direct written premiums), dwelling fire, umbrella and business owner policies (totaling 2.1% of 2006 direct written premiums). Operating exclusively in Massachusetts through our insurance company subsidiaries, Safety Insurance, Safety Indemnity, and Safety P&C, which was formed in December 2006 but has not yet commenced writing business directly (together referred to as the Insurance Subsidiaries), we have established strong relationships with 652 independent insurance agents in 760 locations throughout Massachusetts. We have used these relationships and our extensive knowledge of the Massachusetts market to become the second largest private passenger automobile and third largest commercial automobile insurance carrier in Massachusetts, capturing an approximate 11.6% and 12.4% share, respectively, of the Massachusetts private passenger and commercial automobile markets in 2007, according to the Commonwealth Automobile Reinsurers (CAR) Cession Volume Analysis Report of July 25, 2007, based on automobile exposures. These statistics total, for each vehicle insured, the number of months during the year insurance for that vehicle is in effect, to arrive at an aggregate number of car-months for each insurer; this aggregate number, divided by 12, equals the insurer's number of car-years, a measure we refer to in this discussion as automobile exposures.

*Massachusetts Automobile Insurance Market*

We are subject to the extensive regulation of the private passenger automobile insurance industry in Massachusetts, which represented 76.0% of our direct written premiums in 2006. Owners of registered automobiles in Massachusetts are required to maintain minimum automobile insurance coverage. The Commissioner of Insurance (the Commissioner) has fixed and established the maximum rates that could be charged for private passenger automobile insurance. We are required to participate in a state-mandated reinsurance program run by CAR to which we cede certain unprofitable risks and from which we are allocated a portion of the overall losses. As a servicing carrier of CAR, we are required to issue a policy to all qualified applicants. This program operates at an underwriting deficit. This deficit is allocated among every Massachusetts automobile insurance company, including us, based on a complex formula that takes into consideration a company's voluntary market share, the rate at which it cedes business to CAR, and the company's utilization of a credit system CAR has designed to encourage carriers to reduce their use of CAR. In addition, based on our market share, we are assigned certain licensed producers by CAR that have been unable to obtain a voluntary contract with another insurer. We call these agents Exclusive Representative Producers, or ERPs.

On July 16, 2007, the Commissioner issued two decisions that significantly change how private passenger automobile insurance will be regulated in Massachusetts. In the first decision, the Commissioner announced that she will not fix and establish the maximum premium rates that can be charged for private passenger automobile insurance policies issued or renewed after April 1, 2008. In a letter accompanying the decision, the Commissioner stated that in place of the fixed and established system, she intends to institute a system that introduces managed competition to the private passenger automobile insurance market.







The Commissioner further indicated that she will introduce a regulatory framework that will set forth the parameters within which insurance companies will be free to propose premiums . . . . The Commissioner has announced that she anticipates promulgating regulations, after a public hearing, concerning this issue. Although we cannot be certain at this time of the details of the Commissioner's new system or what effect it will have on our business, we anticipate that we will file rates and forms, subject to the disapproval of the Commissioner, to be effective April 1, 2008, for use in connection with our private passenger automobile insurance business in a manner similar to that which we file for our commercial automobile and homeowners insurance lines of business.

In the second decision, the Commissioner approved and set a time table for the implementation of new CAR rules pursuant to which the current reinsurance program run by CAR will be replaced with an assigned risk plan. Under these new rules, we will no longer be assigned ERPs whose business we must insure (subject to the option of ceding it to CAR) and, instead, we will be assigned individual policies by CAR. The new assigned risk plan will begin to be implemented on April 1, 2008 for new business written on and after that date. The last policy effective date on which any risk can be ceded to CAR in accordance with the current reinsurance program is March 31, 2009. We are not able at this time to determine what effect these new CAR rules will have on our business.

The Commissioner's decision to implement an assigned risk plan brought to a close a lengthy period of regulatory and judicial consideration of the Massachusetts private passenger residual market as described below.

On December 31, 2004, the former Commissioner approved new rules for CAR, which became effective on January 1, 2005 (the Approved Rules). The Approved Rules provided for the adoption of an assigned risk plan by CAR. Shortly thereafter, litigation was commenced in Suffolk Superior Court by Commerce Insurance Company against the Commissioner seeking an order permanently enjoining implementation and/or enforcement of the Approved Rules. Certain ERPs, Arbella Mutual Insurance Company and the Center for Insurance Research intervened as plaintiffs and CAR intervened as a defendant in this lawsuit. On June 20, 2005, the Massachusetts Superior Court ruled that the Commissioner lacked the statutory authority to implement the Approved Rules and ordered them vacated. As a result, the Approved Rules did not go into effect. The Commissioner appealed the decision of the Massachusetts Superior Court. On August 23, 2006, the Massachusetts Supreme Judicial Court overturned the decision of the Massachusetts Superior Court and unanimously ruled that the Commissioner did not need legislative approval to put in place the provisions in the Approved Rules which establish an assigned risk plan. On October 18, 2006, the Commissioner reviewed the Approved Rules and proposed changes (the Revised Rules) that would, in part, establish an assigned risk plan called the Massachusetts Automobile Insurance Plan (the MAIP). As proposed, the Revised Rules would: 1) eliminate provisions in the current CAR Rules that are no longer necessary in light of the litigation described above; 2) integrate the Revised Rules into the current CAR Rules; 3) set a timetable for the implementation of the MAIP; and 4) revise the MAIP to conform with the Supreme Judicial Court's remand regarding the so-called clean in three provisions contained in the Approved Rules. A hearing was held November 10, 2006, on the Revised Rules and on December 13, 2006, the Commissioner approved changes to the MAIP rules (the MAIP Rules) that called for a three year phase in of an assigned risk plan beginning April 1, 2007.

On January 5, 2007, Deval L. Patrick was sworn in as Governor of the Commonwealth of Massachusetts replacing outgoing Governor Mitt Romney. The Commissioner, Julianne M. Bowler, was replaced by the new Governor and on January 19, 2007, Acting Commissioner Joseph G. Murphy, suspended the MAIP Rules (the Suspended Rules) for a period not to exceed 90 days. A hearing was held on February 15, 2007, for testimony regarding recommendations or amendments to the Suspended Rules. On February 26, 2007, Governor Patrick selected former Massachusetts Superior Court Justice, Nonnie S. Burns, to be Commissioner. On April 19, 2007, the Commissioner issued a Decision and Order on the Suspended Rules which approved CAR Rules 1 through 20, but remanded to CAR the MAIP Rules, 21 through 40 to make amendments to the clean in three provisions (which define those risks that are not eligible for placement in the MAIP), as well as any other appropriate amendments related to clean in three that may be contained in other portions of the MAIP Rules. On May 16, 2007, CAR submitted amended clean in three provisions to the Commissioner. After a hearing, the Commissioner on July 16, 2007 approved the clean in three provisions as submitted and determined that the MAIP Rules are no longer suspended. The Commissioner ordered that the MAIP will begin to phase into operation on April 1, 2008 starting with new business and April 1, 2009 for all other business declined in the voluntary market subject to the clean-in three provisions that limit the number of policies that can be non-renewed by companies through April 1, 2011.

While the litigation described above was pending and before the MAIP Rules were approved, in order to address certain perceived inequities in the distribution of ERP exposures, CAR approved on June 15, 2005, rules to modify the ERP subscription relief process, making the reassignment of ERP exposures from an oversubscribed servicing carrier more timely and responsive, while enhancing equity in the ERP distribution for all servicing carriers (the ERP Subscription Rules). Also, the practice of two and three-party agreements between ERPs and servicing carriers, in which carriers would negotiate the transfer of selected ERPs



from one carrier to another was prohibited. On September 30, 2005, the Commissioner approved the ERP Subscription Rules, and instructed CAR to complete a redistribution of all ERPs to establish for all servicing carriers overall parity in the quantity and quality of their ERP exposures. The redistribution plan for ERPs, as adopted by the CAR Governing Committee on November 16 and December 14, 2005, was approved by the Commissioner on January 27, 2006. On January 31, 2006, CAR notified each reassigned ERP and all servicing carriers of the redistribution. According to the January 31, 2006 CAR Private Passenger ERP Redistribution Summary, 18 Safety ERPs with 25,590 exposures were assigned to other servicing carriers beginning with new business effective March 1, 2006 and renewal business May 1, 2006. In addition, CAR assigned 29 ERPs with 24,670 exposures from other servicing carriers to Safety. However 25 of these ERPs with 23,116 exposures were given voluntary contracts by their former servicing carrier or other carriers and were, as a result, no longer eligible for assignment to Safety as ERPs. The redistribution of ERPs has eliminated our disproportionate share of high loss ratio ERP business. The Commissioner also ordered CAR to amend the ongoing ERP Subscription Rules after the completion of the ERP physical redistribution. Accordingly, CAR has amended Rule 13 to change the ongoing subscription methodology to measure both the quantity and quality of an ERP by incorporating ERP loss ratios into the determination of subscription relief. CAR amended Rule 13 on June 4, 2007, and the Commissioner held a hearing on July 25, 2007 at which Safety testified in favor of the changes proposed by CAR. A decision on the amended Rule 13 has not been issued by the Commissioner. If approved, this rule will be in effect until the phase-in of the MAIP is completed.

CAR runs a reinsurance pool for commercial automobile policies and beginning January 1, 2006, CAR implemented a Limited Servicing Carrier Program ( LSC ) for ceded commercial automobile policies. CAR approved Safety and five other servicing carriers through a Request for Proposal to process approximately \$200,000 of ceded commercial automobile business based on CAR data as of December 31, 2005, which was spread equitably among the six servicing carriers. Each Massachusetts commercial automobile insurer must bear a portion of the losses of the commercial reinsurance pool that is serviced by the six servicing carriers in the LSC program. Subject to Commissioner review, CAR sets the premium rates for commercial automobile policies reinsured through CAR and this reinsurance pool can generate an underwriting result that is a profit or deficit based upon CAR's rate level. This underwriting result is allocated among every Massachusetts commercial automobile insurance company, including us, based on a company's commercial automobile voluntary market share.

CAR also runs a reinsurance pool for Taxi, Limousine and Car Service risks (the Taxi/Limo Program ). On April 25, 2007, Safety submitted through a Request for Proposal a bid to process a portion of the Taxi/Limo Program. CAR approved Safety as one of the two servicing carriers for this program beginning January 1, 2008. Based on CAR data, Safety would process approximately half of the \$19,000 of the ceded Taxi/Limo business.

As noted above, in 2007 and previous years, the Commissioner set the maximum premium rates that could be charged and minimum commissions that had to be paid to agents for private passenger automobile insurance. Beginning in 2007, the effective date of the Commissioner's rate decision was April 1st as compared to January 1st of 2006 and prior rate decisions. The 2006 rates were in effect from January 1, 2006 until March 31, 2007. The Commissioner announced on December 15, 2006, an 11.7% statewide average private passenger automobile insurance rate decrease for 2007, compared to an 8.7% decrease for 2006. Coinciding with the 2007 rate decision, the Commissioner also approved a 13.0% commission rate agents receive for selling private passenger automobile insurance, as a percentage of premiums, compared to a commission rate of 11.8% in 2006.

Our direct written premiums increased by 33.4% between 2001 and 2006, from \$471,866 to \$629,511. However, our direct written premiums decreased by 3.0% between 2005 and 2006 as a result of the state mandated private passenger automobile rate decrease effective January 1, 2006. We anticipate a further reduction in private passenger automobile direct written premiums for 2007 as a result of the state mandated rate decrease effective April 1, 2007.



Rates did not change January 1, 2007 and the 2006 rates were in effect from January 1, 2006 until March 31, 2007. Our average premium for the six months ended June 30, 2007 decreased by 3.3% from the six months ended June 30, 2006 primarily as a result of the state mandated average rate change. The table below shows average Massachusetts-mandated private passenger automobile premium rate changes and changes in our average premium per automobile exposure.

#### Massachusetts Private Passenger Rate Decisions

Year	State Mandated Average Rate Change(1)	Safety Change in Average Premium per Automobile Exposure(2)
2007	(11.7 )%	(3.3 )%
2006	(8.7 )%	(6.8 )%
2005	(1.7 )%	0.1 %
2004	2.5 %	6.1 %
2003	2.7 %	6.9 %
2002	0.0 %	5.2 %
2001	(8.3 )%	0.0 %
2000	0.7 %	7.4 %
1999	0.7 %	10.9 %
1998	(4.0 )%	2.8 %

(1) Source: Commissioner rate decisions for 1998 - 2007. The 2007 rate decrease became effective on April 1, 2007.

(2) Source: Safety Insurance.

#### Statutory Accounting Principles

Our results are reported in accordance with United States generally accepted accounting principles ( GAAP ), which differ from amounts reported in accordance with statutory accounting principles ( SAP ) as prescribed by insurance regulatory authorities. Specifically, under GAAP:

- Policy acquisition costs such as commissions, premium taxes and other variable costs incurred in connection with writing new and renewal business are capitalized and amortized on a pro rata basis over the period in which the related premiums are earned, rather than expensed as incurred, as required by SAP.
- Certain assets are included in the consolidated balance sheets whereas, under SAP, such assets are designated as non-admitted assets and charged directly against statutory surplus. These assets consist primarily of premium receivables that are outstanding over 90 days, federal deferred tax assets in excess of statutory limitations, furniture, equipment, leasehold improvements and prepaid expenses.
- Amounts related to ceded reinsurance are shown gross as ceded unearned premiums and reinsurance recoverables, rather than netted against unearned premium reserves and loss and loss adjustment expense reserves, respectively, as required by SAP.
- Fixed maturities securities, which are classified as available-for-sale, are reported at current market values, rather than at amortized cost, or the lower of amortized cost or market, depending on the specific type of security, as required by SAP.
- Equity securities are reported at quoted market values, which may differ from the National Association of Insurance Commissioners market values as required by SAP.
- The differing treatment of income and expense items results in a corresponding difference in federal income tax expense. Changes in deferred income taxes are reflected as an item of income tax benefit or expense, rather than recorded directly to surplus as regards policyholders, as required by SAP. Admittance testing may result in a charge to



unassigned surplus for non-admitted portions of deferred tax assets. Under GAAP reporting, a valuation allowance may be recorded against the deferred tax asset and reflected as an expense.



*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 expenses as a percent of net written premiums, if calculated on a SAP basis, or net earned premiums, if 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 statutory insurance ratios are outlined in the following table.

	Three Months Ended June 30, 2007				Six Months Ended June 30, 2007			
	2006		2006		2006		2006	
<b>Statutory Ratios:</b>								
Loss Ratio	<b>60.3</b>	%	54.1	%	<b>60.3</b>	%	54.2	%
Expense Ratio	<b>28.3</b>	%	26.7	%	<b>26.5</b>	%	25.8	%
Combined Ratio	<b>88.6</b>	%	80.8	%	<b>86.8</b>	%	80.0	%

Under GAAP, the loss ratio is computed in the same manner as under SAP, but the expense ratio is determined by matching underwriting expenses to the period over which net premiums were earned, rather than to the period that net premiums were written.

Our GAAP insurance ratios are outlined in the following table.

	Three Months Ended June 30, 2007				Six Months Ended June 30, 2007			
	2006		2006		2006		2006	
<b>GAAP Ratios:</b>								
Loss Ratio	<b>60.3</b>	%	54.1	%	<b>60.3</b>	%	54.2	%
Expense Ratio	<b>27.9</b>	%	26.7	%	<b>27.2</b>	%	26.2	%
Combined Ratio	<b>88.2</b>	%	80.8	%	<b>87.5</b>	%	80.4	%

*Stock-Based Compensation*

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

On March 10, 2006, the Board of Directors approved amendments to the Incentive Plan, subject to shareholder approval, to (i) increase the number of shares of common stock available for issuance by 1,250,000 shares, (ii) remove obsolete provisions, and (iii) make other non-material changes. A total of 1,250,000 shares of common stock had previously been authorized for issuance under the Incentive Plan. The Incentive Plan, as amended, was approved by the shareholders at the 2006 Annual Meeting of Shareholders which was held on May 19, 2006.

The maximum number of shares of common stock with respect to which awards may be granted under the Incentive Plan is 2,500,000. Shares of stock covered by an award under the Incentive Plan that are forfeited will again be available for issuance in connection with future grants of awards under the plan. At June 30, 2007, there were 1,170,260 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. Grants outstanding under the Incentive Plan as of June 30, 2007 were comprised of 188,781 restricted shares and 356,268 nonqualified stock options.



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There were no grants made under the Incentive Plan during the quarter ended June 30, 2007. A summary of stock-based awards granted under the Incentive Plan during the six months ended June 30, 2007 is as follows:

Type of Equity Awarded	Effective Date	Number of Awards Granted	Fair Value per Share(1)	Vesting Terms
RS	February 26, 2007	65,760	\$ 45.62	3 years, 30%-30%-40%
RS	February 26, 2007	4,000	\$ 45.62	No vesting period(2)
RS	March 22, 2007	49,971	\$ 38.78	5 years, 20% annually

(1) The fair value per share of the restricted stock grant is equal to the closing price of the common stock on the grant date.

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

### *Reinsurance*

We reinsure with other insurance companies a portion of our potential liability under the policies we have underwritten, thereby protecting us against an unexpectedly large loss or a catastrophic occurrence that could produce large losses, primarily in our homeowners line of business. We use various software products to measure our exposure to catastrophe losses and the probable maximum loss to us for catastrophe losses such as hurricanes. The models include estimates for our share of the catastrophe losses generated in the residual market for property insurance by the Massachusetts Property Insurance Underwriting Association ( FAIR Plan ). In the aftermath of Hurricane Katrina in 2005, various software modelers of storm damage have increased their estimates of damage from hurricanes in the southern and northeast portions of the United States due to revised estimations of increased hurricane activity and increases in the estimation of demand surge in the periods following a significant event. We have adjusted our reinsurance programs as a result of the changes to the models. As of January 2007, our catastrophe reinsurance provides gross per occurrence reinsurance coverage up to \$280,000. As a result of the changes to the models, and our revised reinsurance program, our catastrophe reinsurance protects us in the event of a 246-year storm (that is, a storm of a severity expected to occur once in a 246-year period). Swiss Re, our primary reinsurer, maintains an A.M. Best rating of A+ (Superior). All of our other reinsurers have an A.M. Best rating of A (Excellent) or better except for Montpelier Re, Endurance Re, AXA Re and Amlin Bermuda which are rated A- (Excellent). We are a participant in CAR, a state-established body that runs the residual market reinsurance programs for both private passenger and commercial automobile insurance in Massachusetts under which premiums, expenses, losses and loss adjustment expenses on ceded business are shared by all insurers writing automobile insurance in Massachusetts. We also participate in the FAIR Plan in which premiums, expenses, losses and loss adjustment expenses on homeowners business that cannot be placed in the voluntary market are shared by all insurers writing homeowners insurance in Massachusetts. The FAIR Plan has grown dramatically over the past few years as insurance carriers have reduced their exposure to coastal property. The FAIR Plan's exposure to catastrophe losses has increased and as a result the FAIR Plan has decided to buy reinsurance to reduce their exposure to catastrophe losses. On July 1, 2006, the FAIR Plan purchased \$455,000 of catastrophe reinsurance for property losses in excess of \$180,000. Beginning on July 1, 2007, the FAIR Plan increased the purchase to \$979,500 of catastrophe reinsurance for property losses in excess of \$180,000. At June 30, 2007, we had no material amounts recoverable from any reinsurer, excluding the residual markets described above.

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

### *Effects of Inflation*

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



## Critical Accounting Policies and Estimates

### *Loss and Loss Adjustment Expense Reserves.*

Significant periods of time can elapse between the occurrence of an insured loss, the reporting to us of that loss and our final payment of that loss. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities. Our reserves represent estimates of amounts needed to pay reported and unreported losses and the expenses of investigating and paying those losses, or loss adjustment expenses. Every quarter, we review our previously established reserves and adjust them, if necessary.

When a claim is reported, claims personnel establish a case reserve for the estimated amount of the ultimate payment. The amount of the reserve is primarily based upon an evaluation of the type of claim involved, the circumstances surrounding each claim and the policy provisions relating 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.

In accordance with industry practice, we also maintain reserves for estimated losses incurred but not yet reported ( IBNR ). IBNR reserves are determined in accordance with commonly accepted actuarial reserving techniques on the basis of our historical information and experience. We review and make adjustments to incurred but not yet reported reserves quarterly.

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.

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

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







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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, are 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 \$337,928 to \$383,466 as of June 30, 2007. 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. The Company's selected point estimate of net loss and LAE reserves, based upon the analysis of the Company's actuaries, was \$378,777 as of June 30, 2007.

The following table presents the point estimation of the recorded reserves and the range of estimations by line of business for net loss and LAE reserves as of June 30, 2007.

Line of Business	Low	Recorded	High
Private passenger automobile	\$ 247,586	\$ 275,505	\$ 276,975
Commercial automobile	51,130	56,828	57,811
Homeowners	28,411	32,393	33,508
All other	10,801	14,051	15,172
<b>Total</b>	<b>\$ 337,928</b>	<b>\$ 378,777</b>	<b>\$ 383,466</b>

For our private passenger, commercial automobile and homeowners lines of business as of June 30, 2007, due to the relatively long time we have been writing these lines of insurance, and our stable long-term trends in frequency and severity, the range of reserves is relatively narrow. For all our other lines of business as of June 30, 2007, due to the relatively short time we have been writing these lines of business, the sparse amount of data and the resulting immature history available for our analysis, the range of reserves is relatively wide. For all four lines of business we recorded reserves higher than the mid-point of the range.

The following table presents our total net reserves and the corresponding case reserves and IBNR reserves for each line of business as of June 30, 2007.

Line of Business	Case	IBNR	Total
Private passenger automobile	\$ 201,918	\$ 21,131	\$ 223,049
CAR assumed private passenger auto	29,014	23,442	52,456
Commercial automobile	29,011	8,506	37,517
CAR assumed commercial automobile	9,022	10,289	19,311
Homeowners	14,961	6,099	21,060
FAIR Plan assumed homeowners	5,228	6,105	11,333
All other	5,566	8,485	14,051
<b>Total net reserves for losses and LAE</b>	<b>\$ 294,720</b>	<b>\$ 84,057</b>	<b>\$ 378,777</b>

Our IBNR reserves for CAR assumed private passenger and CAR assumed commercial automobile business are 44.7% and 53.3%, respectively, of our total reserves for CAR assumed private passenger and CAR assumed commercial automobile business as of June 30, 2007 due to the reporting delays in the information we receive from CAR, as described further in the section below entitled *CAR Loss and Loss Adjustment Expense Reserves*.



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The following table presents information by line of business for our total net reserves and the corresponding direct less ceded (retained) reserves and assumed reserves as of June 30, 2007.

Line of Business	Retained	Assumed	Net
Private passenger automobile	\$ 223,049		
CAR assumed private passenger automobile		\$ 52,456	
Net private passenger automobile			\$ 275,505
Commercial automobile	37,517		
CAR assumed commercial automobile		19,311	
Net commercial automobile			56,828
Homeowners	21,060		
FAIR Plan assumed homeowners		11,333	
Net homeowners			32,393
All other	14,051		14,051
Total net reserves for losses and LAE	\$ 295,677	\$ 83,100	\$ 378,777

### *CAR Loss and Loss Adjustment Expense Reserves*

We are a participant in CAR and assume a significant portion of losses and LAE on business ceded by the industry participants to CAR. We estimate reserves for assumed losses and LAE that have not yet been reported to us by CAR. 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 from CAR.

The CAR deficit, which consists of CAR losses and LAE less premiums ceded to CAR, is allocated among every automobile insurance company writing business in Massachusetts based on a complex formula (the Participation Ratio ) that takes into consideration a company's voluntary market share, the amount of business it cedes to CAR and credits the company earns under a system CAR has designed to encourage carriers to voluntarily write business in selected underpriced classes and territories.

We receive a Settlement of Balances report from CAR that reports our share of CAR premium, losses and LAE, on a lagged basis, seventy-five days after the end of every quarter. CAR-published financial data is always at least one quarter behind the financial data we report. For example, when we reported our financial results for the year ended December 31, 2006, we had nine months of reported 2006 CAR financial data, and we had to estimate what CAR would report to us for the last three months of the year.

We receive our final calendar year Participation Ratio report from CAR eight months after the end of that year, and thus we have to estimate for six quarters our share of the CAR deficit. For example, for the year ended December 31, 2006 we had to estimate our 2006 policy year CAR Participation Ratio beginning with the first quarter of 2006 through the second quarter of 2007.

Because of the lag in CAR estimates, and in order to try to validate to the extent possible the information CAR does provide, we must try to estimate the effects of the actions of our competitors in order to establish our Participation Ratio. Before final Participation Ratios are available, we estimate the size of CAR and the resulting deficit based on historical analysis of CAR results, and estimations of our competitors' current cession strategies. Even after our final Participation Ratio is available from CAR, we must continue to estimate the size of CAR, and the resulting deficit based upon data published by CAR and our own continuing analysis. As a result, changes in our reserves for CAR may continue to occur until all claims are finally settled. The Loss Reserving Committee at CAR meets 70 days after the end of each quarter to estimate the CAR deficit for all active policy years and publishes estimations, which we use to estimate our share of the deficit. The estimation that CAR calculates is based on data it collects from 19 servicing carriers which settle, reserve and report claims using a variety of methods. Any delays or errors in the collection of this data could have a significant impact on the accuracy of CAR's estimations.

Although we rely to a significant extent in setting our reserves on the information CAR provides, we are cautious in our use of that information, both because of the delays described above and because the CAR estimates incorporate data CAR receives from all other CAR servicing carriers in Massachusetts. We do not have direct access to that data or firsthand knowledge of how those carriers are currently conducting their operations. As a result, we are cautious in recording CAR reserves for the



calendar years that we have to estimate our Participation Ratio and these reserves are subject to significant judgments and estimates.

*Sensitivity Analysis*



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Establishment of appropriate reserves is an inherently uncertain process. There can be no certainty that currently established reserves based on our key assumptions regarding frequency and severity in our lines of business, or our assumptions regarding our share of the CAR loss, will prove adequate in light of subsequent actual experience. To the extent that reserves are inadequate and are strengthened, the amount of such increase is treated as a charge to earnings in the period that the deficiency is recognized. To the extent that reserves are redundant and are released, the amount of the release is a credit to earnings in the period the redundancy is recognized. For the six months ended June 30, 2007 a 1 percentage-point change in the loss and LAE ratio would result in a change in reserves of \$3,075. Each 1 percentage-point change in the loss and loss expense ratio would have a \$1,999 effect on net income, or \$0.12 per diluted share.

Our assumptions consider that past experience, adjusted for the effects of current developments and anticipated trends, are an appropriate basis for establishing our reserves. Our 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 by 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 direct minus ceded loss and LAE reserves and net income for the six months ended June 30, 2007. 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
<b>Private Passenger Auto Direct minus Ceded Loss and LAE Reserves</b>			
-1 Percent Change in Severity			
Estimated decrease in reserves	\$ (4,461 )	\$ (2,230 )	\$
Estimated increase in net income	2,900	1,450	
No Change in Severity			
Estimated (decrease) increase in reserves	(2,230 )		2,230
Estimated increase (decrease) in net income	1,450		(1,450 )
+1 Percent Change in Severity			
Estimated increase in reserves		2,230	4,461
Estimated decrease in net income		(1,450 )	(2,900 )
<b>Commercial Auto Direct minus Ceded Loss and LAE Reserves</b>			
-1 Percent Change in Severity			
Estimated decrease in reserves	(750 )	(375 )	
Estimated increase in net income	488	244	
No Change in Severity			
Estimated (decrease) increase in reserves	(375 )		375
Estimated increase (decrease) in net income	244		(244 )
+1 Percent Change in Severity			
Estimated increase in reserves		375	750
Estimated decrease in net income		(244 )	(488 )
<b>Homeowners Direct minus Ceded Loss and LAE Reserves</b>			
-1 Percent Change in Severity			
Estimated decrease in reserves	(421 )	(211 )	
Estimated increase in net income	274	137	
No Change in Severity			
Estimated (decrease) increase in reserves	(211 )		211
Estimated increase (decrease) in net income	137		(137 )
+1 Percent Change in Severity			
Estimated increase in reserves		211	421
Estimated decrease in net income		(137 )	(274 )
<b>All Other Direct minus Ceded Loss and LAE Reserves</b>			
-1 Percent Change in Severity			
Estimated decrease in reserves	(281 )	(141 )	
Estimated increase in net income	183	92	
No Change in Severity			
Estimated (decrease) increase in reserves	(141 )		141
Estimated increase (decrease) in net income	92		(92 )
+1 Percent Change in Severity			
Estimated increase in reserves		141	281
Estimated decrease in net income		(92 )	(183 )

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







estimation. The following sensitivity table presents information on the effect each 1 percentage-point change in our assumptions about our share of reserves for CAR and other residual markets could have on our assumed loss and LAE reserves and net income for the six months ended June 30, 2007. 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
<b>CAR assumed private passenger automobile</b>		
Estimated (decrease) increase in reserves	\$ (525 )	\$ 525
Estimated increase (decrease) in net income	341	(341 )
<b>CAR assumed commercial automobile</b>		
Estimated (decrease) increase in reserves	(193 )	193
Estimated increase (decrease) in net income	125	(125 )
<b>FAIR Plan assumed homeowners</b>		
Estimated (decrease) increase in reserves	(113 )	113
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 \$14,721 and \$25,379 for the six months ended June 30, 2007 and 2006, respectively.

The following table presents a comparison of prior year development of our net reserves for losses and LAE for the six months ended June 30, 2007 and 2006. Each accident year represents all claims for an annual accounting period in which the loss events occurred, regardless of when the losses were actually reported, booked or paid. Our financial statements reflect the aggregate results of the current and all prior accident years.

Accident Year	Six Months Ended June 30,	
	2007	2006
1997 & prior	\$ (5 )	\$ (42 )
1998	(7 )	1
1999	(84 )	(32 )
2000	(406 )	(26 )
2001	(69 )	(1,359 )
2002	110	(1,338 )
2003	5	(2,592 )
2004	(1,882 )	(7,198 )
2005	(4,416 )	(12,793 )
2006	(7,967 )	
All prior years	\$ (14,721 )	\$ (25,379 )

The decreases in prior years reserves during the six months ended June 30, 2007 and June 30, 2006 resulted from re-estimations of prior year ultimate loss and LAE liabilities. The 2007 decrease is primarily composed of reductions of \$7,813 in reserves assumed from CAR and \$6,028 in our retained automobile reserves. The 2006 decrease is primarily composed of reductions of \$10,261 in CAR assumed reserves, \$11,721 in our retained automobile reserves and \$2,605 in our retained homeowners reserves.



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The following table presents information by line of business for prior year development of our net reserves for losses and LAE for the six months ended June 30, 2007.

Accident Year	Private Passenger Automobile	Commercial Automobile	Homeowners	All Other	Total
1997 & prior	\$ (1 )	\$ (4 )	\$	\$	\$ (5 )
1998	(1 )	(6 )			(7 )
1999	(81 )	(3 )			(84 )
2000	(390 )	(18 )	2		(406 )
2001	(47 )	(31 )	9		(69 )
2002	2	93	15		110
2003	(2 )	89	23	(105 )	5
2004	(1,588 )	(96 )	2	(200 )	(1,882 )
2005	(3,680 )	(707 )	(29 )		(4,416 )
2006	(6,889 )	(481 )	(524 )	(73 )	(7,967 )
All prior years	\$ (12,677 )	\$ (1,164 )	\$ (502 )	\$ (378 )	\$ (14,721 )

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

The following table presents information by line of business for prior year development of retained reserves for losses and LAE for the six months ended June 30, 2007; that is, all our reserves except for business ceded or assumed from CAR and other residual markets.

Accident Year	Retained Private Passenger Automobile	Retained Commercial Automobile	Retained Homeowners	Retained All Other	Total
1997 & prior	\$ (1 )	\$ (1 )	\$	\$	\$ (2 )
1998	(1 )				(1 )
1999	1				1
2000	(261 )				(261 )
2001	2				2
2002	2				2
2003	(2 )	1		(105 )	(106 )
2004	(923 )	(76 )		(200 )	(1,199 )
2005	(1,756 )	(650 )			(2,406 )
2006	(2,363 )		(209 )	(73 )	(2,645 )
All prior years	\$ (5,302 )	\$ (726 )	\$ (209 )	\$ (378 )	\$ (6,615 )



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The following table presents information by line of business for prior year development of reserves assumed from CAR and other residual markets for losses and LAE for the six months ended June 30, 2007.

Accident Year	CAR Assumed Private Passenger Automobile	CAR Assumed Commercial Automobile	FAIR Plan Homeowners	All Other	Total
1997 & prior	\$ (3	) \$ (3	) \$ (3	) \$ (3	) \$ (3
1998	(6	) (6	) (6	) (6	) (6
1999	(82	) (82	) (82	) (82	) (82
2000	(129	) (129	) (129	) (129	) (129
2001	(49	) (49	) (49	) (49	) (49
2002	93	93	15	15	108
2003	88	88	23	23	111
2004	(665	) (665	) (665	) (665	) (665
2005	(1,924	) (1,924	) (1,924	) (1,924	) (1,924
2006	(4,526	) (4,526	) (4,526	) (4,526	) (4,526
All prior years	\$ (7,375	) \$ (438	) \$ (293	) \$ (293	) \$ (8,106

Our private passenger automobile line of business prior year reserves decreased by \$12,677 for the six months ended June 30, 2007. The decrease was due to improved assumed CAR results for the private passenger automobile pool for the 2006, 2005 and 2004 accident years of \$4,526, \$1,924 and \$665, respectively. The improved CAR results were due primarily to improved CAR private passenger loss ratios for 2006, 2005 and 2004 as published and reported by the CAR Loss Reserving Committee at the June 6, 2007 meeting as compared to the March 7, 2007 meeting. In addition, the decrease was due to reductions in our retained private passenger automobile reserves for the 2006, 2005 and 2004 accident years by \$2,363, \$1,756, and \$923 respectively, primarily due to better than previously estimated severity on our established bodily injury and property damage case reserves and fewer IBNR claims than previously estimated.

Our commercial automobile line of business prior year reserves decreased by \$1,164 for the six months ended June 30, 2007. Our retained commercial automobile reserves decreased by \$726 primarily due to fewer IBNR claims than previously estimated for the 2005 accident year. Additionally, the decrease was due to improved assumed CAR results for the commercial automobile pool for the 2006 accident year of \$481.

Our homeowners line of business prior year reserves decreased by \$502 for the six months ended June 30, 2007 primarily as a result of improved FAIR Plan results for 2006.

In estimating all our loss reserves, including CAR, we follow the guidance prescribed by Statement of Financial Accounting Standards ( FAS ) No. 60, Accounting and Reporting by Insurance Enterprises and FAS No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.

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 market 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 market value below amortized cost is an other-than-temporary impairment, we consider and evaluate several factors and circumstances including the issuer's overall financial condition, the issuer's credit and financial strength ratings, a weakening of the general market conditions in the industry or geographic region in which the issuer operates, a prolonged period (typically six months or longer) in which the fair value of an issuer's securities remains below our amortized cost, our ability and intent to hold these investments for a period of time sufficient to allow for recovery of our costs, and any other factors that may raise doubt about the issuer's ability to continue as a going concern.



We record other-than-temporary impairments as realized losses, which serve to reduce net income and earnings per share. We record temporary losses as unrealized losses, which do not impact net income and earnings per share but reduce other comprehensive net income. The risks inherent in our assessment of other-than-temporary impairments include the risk that market factors may differ from our expectations, or that the credit assessment could change in the near term, resulting in a charge to earnings.

For further information, see Results of Operations: *Net Realized Investment Losses*.

## Results of Operations

### Three and Six Months Ended June 30, 2007 Compared to Three and Six Months Ended June 30, 2006

The following table shows certain of our selected financial results.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Direct written premiums	\$ 158,536	\$ 162,492	\$ 340,042	\$ 340,528
Net written premiums	156,613	162,323	330,527	335,642
Net earned premiums	153,925	156,261	307,515	314,039
Net investment income	10,780	9,834	21,819	19,212
Net realized losses on investments	(162 )	(187 )	(91 )	(261 )
Finance and other service income	3,995	3,720	7,988	7,579
Total revenue	168,538	169,628	337,231	340,569
Loss and loss adjustment expenses	92,769	84,604	185,327	170,355
Underwriting, operating and related expenses	43,021	41,757	83,719	82,152
Interest expenses	19	20	41	44
Total expenses	135,809	126,381	269,087	252,551
Income before income taxes	32,729	43,247	68,144	88,018
Income tax expense	9,813	14,109	20,580	28,078
Net income	\$ 22,916	\$ 29,138	\$ 47,564	\$ 59,940
Earnings per weighted average common share:				
Basic	\$ 1.43	\$ 1.84	\$ 2.97	\$ 3.80
Diluted	\$ 1.42	\$ 1.81	\$ 2.95	\$ 3.75
Cash dividends paid per common share	\$ 0.25	\$ 0.18	\$ 0.50	\$ 0.36
Weighted average number of common shares outstanding:				
Basic	16,052,236	15,826,992	16,022,487	15,769,133
Diluted	16,127,154	16,056,362	16,096,412	15,992,337

**Direct Written Premiums.** Direct written premiums for the quarter ended June 30, 2007 decreased by \$3,956, or 2.4%, to \$158,536 from \$162,492 for the comparable 2006 period. Direct written premiums for the six months ended June 30, 2007 decreased by \$486, or 0.1%, to \$340,042 from \$340,528 for the comparable 2006 period. The 2007 decrease occurred primarily in our personal automobile line, which experienced a decrease in average written premium of 3.3% with an increase of 1.9% in written exposures. In addition, our commercial automobile line experienced a decrease of 2.4% in average written premium and a decrease of 0.6% in written exposures. Partially offsetting these decreases was an increase in average written premium in our homeowners line of 5.9% and an increase of 8.8% in written exposures.

**Net Written Premiums.** Net written premiums for the quarter ended June 30, 2007 decreased by \$5,710, or 3.5%, to \$156,613 from \$162,323 for the comparable 2006 period. Net written premiums for the six months ended June 30, 2007 decreased by \$5,115, or 1.5%, to \$330,527 from \$335,642 for the comparable 2006 period. These decreases were due to the factors that







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decreased direct written premiums combined with decreases in premiums assumed from CAR, and partially offset by decreases in premiums ceded to CAR.

*Net Earned Premiums.* Net earned premiums for the quarter ended June 30, 2007 decreased by \$2,336 or 1.5%, to \$153,925 from \$156,261 for the comparable 2006 period. Net earned premiums for the six months ended June 30, 2007 decreased by \$6,524, or 2.1%, to \$307,515 from \$314,039 for the comparable 2006 period.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<b>Written Premiums</b>				
Direct	\$ 158,536	\$ 162,492	\$ 340,042	\$ 340,528
Assumed	16,964	19,165	30,491	36,448
Ceded	(18,887 )	(19,334 )	(40,006 )	(41,334 )
Net written premiums	\$ 156,613	\$ 162,323	\$ 330,527	\$ 335,642
<b>Earned Premiums</b>				
Direct	\$ 158,264	\$ 160,228	\$ 315,862	\$ 319,215
Assumed	15,173	20,085	31,567	36,479
Ceded	(19,512 )	(24,052 )	(39,914 )	(41,655 )
Net earned premiums	\$ 153,925	\$ 156,261	\$ 307,515	\$ 314,039

*Net Investment Income.* Net investment income for the quarter ended June 30, 2007 was \$10,780 compared to \$9,834 for the comparable 2006 period. Net investment income for the six months ended June 30, 2007 was \$21,819 compared to \$19,212 for the comparable 2006 period. Average cash and investment securities (at cost) increased by \$85,391, or 9.5%, to \$980,430 for the six months ended June 30, 2007 from \$895,039 for the comparable 2006 period. Net effective annualized yield on the investment portfolio increased to 4.5% during the six months ended June 30, 2007 from 4.3% during 2006. Our duration decreased to 4.4 years at June 30, 2007 from 4.6 years at December 31, 2006.

*Net Realized Losses on Investments.* Net realized losses on investments was \$162 for the quarter ended June 30, 2007 compared to net realized losses of \$187 for the comparable 2006 period. Net realized losses on investments was \$91 for the six months ended June 30, 2007 compared to net realized losses of \$261 for the comparable 2006 period.

The gross unrealized appreciation (depreciation) of investments in fixed maturity securities and equity securities, including interests in mutual funds, was as follows:

	June 30, 2007			
	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. Government agencies(1)	\$ 213,233	\$ 39	\$ (5,243 )	\$ 208,029
Obligations of states and political subdivisions	489,466	1,500	(5,475 )	485,491
Asset-backed securities(1)	111,370	26	(2,203 )	109,193
Corporate and other securities	77,943	239	(1,790 )	76,392
Subtotal, fixed maturity securities	892,012	1,804	(14,711 )	879,105
Equity securities	6,481	377	(10 )	6,848
Totals	\$ 898,493	\$ 2,181	\$ (14,721 )	\$ 885,953

(1) Obligations of U.S. Government agencies include 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 SmallBusiness Administration (SBA). The total of these fixed maturity securities was \$203,238 at amortized cost and \$198,120 at estimated fair value as of June 30, 2007. As such, the asset-backed securities presented exclude such issuers already presented under U.S. Treasury securities and obligations of U.S. Government agencies.

As of June 30, 2007, our portfolio of fixed maturity investments was comprised entirely of investment grade corporate fixed maturity securities, U.S. government and agency securities and asset-backed securities (i.e., all our securities received a rating assigned by Moody's Investors Service, Inc. of Baa or higher, except the few securities not rated by Moody's which received S&P ratings of A- or higher, as well as a rating assigned by the Securities Valuation Office of the National Association of Insurance Commissioners of 1 or 2). We hold no subprime mortgage debt securities. All of our mortgage-backed securities are either U.S. Government or Agency guaranteed or are rated Aaa/AAA. We expect the recent subprime mortgage market deterioration to have little or no effect on our portfolio.

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

	June 30, 2007 Estimated Fair Value	Percent	
U.S. Treasury securities and obligations of U.S. Government agencies	\$ 208,029	23.7	%
Aaa/Aa	558,862	63.6	%
A	66,715	7.6	%
Baa	28,624	3.2	%
Not rated (Standard & Poor's rating of A- or higher)	16,875	1.9	%
Total	\$ 879,105	100.0	%

Ratings are assigned by Moody's, or the equivalent, as discussed above. Such 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.

In our determination of other-than-temporary impairments, we consider several factors and circumstances including the issuer's overall financial condition, the issuer's credit and financial strength ratings, a weakening of the general market conditions in the industry or geographic region in which the issuer operates, a prolonged period (typically six months or longer) in which the fair value of an issuer's securities remains below our amortized cost, our ability and intent to hold these investments for a period of time sufficient to allow for recovery of our costs, and any other factors that may raise doubt about the issuer's ability to continue as a going concern.

Other-than-temporary impairments are recorded as realized losses, which serve to reduce net income and earnings per share. Temporary losses are recorded as unrealized losses, which do not impact net income and earnings per share but reduce other comprehensive net income. The risks inherent in the assessment of other-than-temporary impairments include the risk that market factors may differ from our expectations; we may decide to subsequently sell a security for unforeseen business needs; or the credit assessment could change in the near term, resulting in a charge to earnings.



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The following table illustrates the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities, aggregated by investment category. The table also illustrates the length of time that they have been in a continuous unrealized loss position as of June 30, 2007.

	As of June 30, 2007					
	Less than 12 Months	Unrealized	12 Months or More	Unrealized	Total	Unrealized
	Estimated	Losses	Estimated	Losses	Estimated	Losses
	Fair Value		Fair Value		Fair Value	
U.S. Treasury securities and obligations of U.S. Government agencies	\$ 104,547	\$ 1,865	\$ 101,754	\$ 3,378	\$ 206,301	\$ 5,243
Obligations of states and political subdivisions	253,223	2,705	103,974	2,770	357,197	5,475
Asset-backed securities	44,983	1,006	52,796	1,197	97,779	2,203
Corporate and other securities	27,525	558	38,381	1,232	65,906	1,790
Subtotal, fixed maturity securities	430,278	6,134	296,905	8,577	727,183	14,711
Equity securities	626	10			626	10
Total temporarily impaired securities	\$ 430,904	\$ 6,144	\$ 296,905	\$ 8,577	\$ 727,809	\$ 14,721

The unrealized losses recorded on the fixed maturity investment portfolio at June 30, 2007 resulted from fluctuations in market interest rates as opposed to fundamental changes in the credit quality of the issuers of such securities. Therefore, these decreases in values are viewed as being temporary as we have the intent and ability to retain such investments for a period of time sufficient to allow for recovery in market value.

Of the \$14,721 gross unrealized losses as of June 30, 2007, \$10,718 relates to fixed maturity obligations of states and political subdivisions, U.S. Treasury, and U.S. Government agencies. The remaining \$4,003 of gross unrealized losses relates primarily to holdings of investment grade asset-backed, equity, corporate and other fixed maturity securities.

During the six months ended June 30, 2007 and 2006, there was no significant deterioration in the credit quality of any of the Company's holdings and no other-than-temporary impairment charges were recorded related to the Company's portfolio of investment securities.

*Finance and Other Service Income.* Finance and other service income includes revenues from premium installment charges, which we recognize when earned, and other miscellaneous income and fees. Finance and other service income increased by \$275, or 7.4%, to \$3,995 for the quarter ended June 30, 2007 from \$3,720 for the comparable 2006 period. Finance and other service income increased by \$409, or 5.4%, to \$7,988 for the six months ended June 30, 2007 from \$7,579 for the comparable 2006 period.

*Losses and Loss Adjustment Expenses.* Losses and loss adjustment expenses incurred during the quarter ended June 30, 2007 increased by \$8,165, or 9.7 %, to \$92,769 from \$84,604 for the comparable 2006 period. Losses and loss adjustment expenses incurred during the six months ended June 30, 2007 increased by \$14,972, or 8.8%, to \$185,327 from \$170,355 for the comparable 2006 period. Our GAAP loss ratio for the quarter ended June 30, 2007 increased to 60.3% from 54.1% for the comparable 2006 period. Our GAAP loss ratio for the six months ended June 30, 2007 increased to 60.3% from 54.2% for the comparable 2006 period. Our GAAP loss ratio excluding loss adjustment expenses for the quarter ended June 30, 2007 increased to 51.9% from 46.7% for the comparable 2006 period. Our GAAP loss ratio excluding loss adjustment expenses for the six months ended June 30, 2007 increased to 51.9% from 47.0% for the comparable 2006 period. The loss ratio increased as a result of an increase in personal and commercial automobile claim frequency combined with decreases in favorable loss development. Total prior year favorable development included in the pre-tax results for the quarter and six months ended June 30, 2007 was \$5,355 and \$14,721, respectively, compared to prior year favorable development of \$12,086 and \$25,379, respectively, for the comparable 2006 periods.

*Underwriting, Operating and Related Expenses.* Underwriting, operating and related expense for the quarter ended June 30, 2006 increased by \$1,264, or 3.0%, to \$43,021 from \$41,757 for the comparable 2006 period. Underwriting, operating and related expense for the six months ended June 30, 2007 increased by \$1,567, or 1.9%, to \$83,719 from \$82,152 for the comparable 2006 period. Our GAAP expense ratios for the second quarter of 2006 increased to 27.9% from 26.7% for the comparable 2006 period. Our GAAP expense ratios for the six months ended June 30, 2007 increased to 27.2% from 26.2% for







the comparable 2006 period. The expense ratio increased primarily as a result of the decreases in net earned premiums as discussed above.

*Interest Expenses.* Interest expense for the quarter ended June 30, 2007 was \$19 compared to \$20 for the comparable 2006 period. Interest expense for the six months ended June 30, 2007 was \$41 compared to \$44 for the comparable 2006 period. The credit facility commitment fee included in interest expense was \$18 and \$37 for the three and six months ended June 30, 2007, respectively, compared to \$19 and \$37, respectively, for the comparable 2006 periods.

*Income Tax Expense.* Our effective tax rate was 30.0% and 32.6% for the quarters ended June 30, 2007 and 2006, respectively. Our effective tax rate was 30.2% and 31.9% for the six months ended June 30, 2007 and 2006, respectively. These effective rates were lower than the statutory rate of 35% primarily due to adjustments for tax-exempt investment income.

### **Liquidity and Capital Resources**

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

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 payment of dividends to Safety.

Net cash provided by operating activities was \$43,598 and \$38,391 during the six months ended June 30, 2007 and 2006, respectively. Our operations typically generate substantial positive cash flows from operations as most premiums are received in advance of the time when claim and benefit payments are required. These positive operating cash flows are expected to continue to meet our liquidity requirements.

Net cash provided by investing activities was \$30,241 during the six months ended June 30, 2007 compared to net cash used of \$167,559 during the six months ended June 30, 2006. Net cash provided during the six months ended June 30, 2007 was primarily the result of sales and maturities of fixed maturity securities in excess of purchases. Net cash used during the six months ended June 30, 2006 was primarily the result of investing cash and cash equivalents in fixed maturities securities.

Net cash used for financing activities increased to \$7,671 during the six months ended June 30, 2007 from \$2,316 during the comparable 2006 period. The increase was due to an increase in dividends paid to shareholders combined with a decrease in proceeds and excess tax benefits from exercise of stock options.

### *Credit Facility*

Safety has a \$30,000 revolving credit facility with Citizens Bank of Massachusetts which expires on June 17, 2008. Loans under the credit facility bear interest at our option at either (i) the LIBOR rate plus 1.5% per annum or (ii) the higher of Citizens Bank of Massachusetts' prime rate or 0.5% above the federal funds rate plus 1.5% per annum. Interest only is payable prior to maturity. The obligations of Safety under the credit facility are secured by pledges of Safety's assets and the capital stock of our operating subsidiaries. The credit facility is guaranteed by our non-insurance company subsidiaries. The credit facility contains covenants including requirements to maintain minimum risk based capital ratios and statutory surplus of Safety Insurance as well as limitations or restrictions on indebtedness, liens, dividends, and other matters. As of June 30, 2007, we were in compliance with all such covenants.

We had no amounts outstanding on our credit facility at June 30, 2007 and 2006. The credit facility commitment fee included in interest expenses was computed at a rate of 0.25% on the \$30,000 commitment at June 30, 2007 and 2006.

### *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 2006, the statutory surplus of Safety Insurance was \$457,505, and its net income for 2006 was \$110,075. As a result, a maximum of \$110,075 is available in 2007 for such dividends without prior approval of the Division. During the six months ended June 30, 2007, Safety Insurance paid dividends to Safety of \$9,097.

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.

On February 15, 2007, our Board approved a quarterly cash dividend on our common stock of \$0.25 per share, or \$4,043 which was paid on March 15, 2007 to shareholders of record on March 1, 2007. On May 7, 2007, our Board approved a quarterly cash dividend on our common stock of \$0.25 per share or \$4,057 which was paid on June 15, 2007 to shareholders of record on June 1, 2007. On August 3, 2007, our Board approved a \$0.40 per share quarterly cash dividend on our common stock, payable on September 14, 2007 to shareholders of record on September 3, 2007. We plan to continue to declare and pay quarterly cash dividends in 2007, depending on our financial position and the regularity of our cash flows.

On August 3, 2007, the Board approved a share repurchase program of up to \$30,000 of Safety's outstanding common shares. Under the program, Safety may repurchase shares of its common stock for cash in public or private transactions, in the open market or otherwise, at management's discretion. 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 Safety to repurchase any specific number of shares and may be modified, suspended or terminated at any time without prior notice.

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.

#### *Off-Balance Sheet Arrangements*

We have no material obligations under a guarantee contract meeting the characteristics identified in paragraph 3 of Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 45, Guarantor's Accounting and Disclosure Requirements, Including Indirect Guarantees of Indebtedness of Others. We have no material retained or contingent interests in assets transferred to an unconsolidated entity. We have no material obligations, including contingent obligations, under contracts that would be accounted for as derivative instruments. We have no obligations, including contingent obligations, arising out of a variable interest in an unconsolidated entity held by, and material to, us, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with us. We have no direct investments in real estate and no holdings of mortgages secured by commercial real estate. Accordingly, we have no material off-balance sheet arrangements.



*Contractual Obligations*

We have obligations to make future payments under contracts and credit-related financial instruments and commitments. At June 30, 2007, certain long-term aggregate contractual obligations and credit-related commitments are as follows:

	<b>Payments Due by Period</b>				
	<b>Within One Year</b>	<b>Two to Three Years</b>	<b>Four to Five Years</b>	<b>After Five Years</b>	<b>Total</b>
Loss and LAE reserves	\$ 224,535	\$ 201,623	\$ 27,494	\$ 4,582	\$ 458,234
Purchase commitments	1,587	1,758	1,758	3,590	8,693
Operating leases	3,865	7,811	7,589	24,422	43,687
Total contractual obligations	\$ 229,987	\$ 211,192	\$ 36,841	\$ 32,594	\$ 510,614

As of June 30, 2007, the Company had loss and LAE reserves of \$458,234, reinsurance recoverables of \$79,457 and net loss and LAE reserves of \$378,777. Our loss and LAE reserves are estimates as described in more detail under Critical Accounting Policies and Estimates. The specific amounts and timing of obligations related to case reserves, IBNR reserves and related LAE reserves are not set contractually, and the amounts and timing of these obligations are unknown. Nonetheless, based upon our cumulative claims paid over the last ten years, the Company estimates that its loss and LAE reserves will be paid in the period shown above. While management believes that historical performance of loss payment patterns is a reasonable source for projecting future claims payments, there is inherent uncertainty in this estimated projected settlement of loss and LAE reserves, and as a result these estimates will differ, perhaps significantly, from actual future payments. Our operations typically generate substantial positive cash flows from operations as most premiums are received in advance of the time when claim and benefit payments are required. These positive operating cash flows are expected to continue to meet our liquidity requirements, including any unexpected variations in the timing of claim settlements.

**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; and
- Descriptions of assumptions underlying or relating to any of the foregoing.

Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include words such as believe, expect, anticipate, intend, plan, estimate, aim, projects, or words of similar meaning and expressions that indicate future conditions, events, results or trends, or future or conditional verbs such as will, would, should, could, or may. All statements that address expectations or projections about the future, including statements about the Company's strategy for growth, product development, market position, expenditures and financial results, are forward-looking statements.

Forward-looking statements are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. There are a number of factors, many of which are beyond our control, that could cause actual future conditions, events, results or trends to differ significantly and/or materially from historical results or those projected in the forward-looking statements. These factors include but are not limited to the competitive nature of our industry and the possible adverse effects of such competition. Although a number of national insurers that are much larger than we are do not currently compete in a material way in the Massachusetts private passenger automobile market, if one or more of these companies decided to aggressively enter the market it could have a material adverse effect on us. Other significant factors include conditions for business operations and restrictive regulations in Massachusetts, the possibility of losses due to claims resulting from severe weather, the possibility that the Commissioner may approve future Rule changes that change the operation of the residual market, 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, such as those set forth under the caption Risk Factors in our Form 10-K for the year ended December 31, 2006 filed with the SEC on March 1, 2007.







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

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

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

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

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

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 tables show 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).

As of June 30, 2007	-100 Basis Point Change	No Change	+100 Basis Point Change
Estimated fair value	\$ 923,117	\$ 879,105	\$ 833,911
Estimated increase (decrease) in fair value	\$ 44,012	\$	\$ (45,194 )

An important market risk for all of our long-term debt is interest rate risk. We continue to monitor the interest rate environment and to evaluate refinancing opportunities as maturity dates approach. With respect to floating rate debt, we are also exposed to the effects of changes in prevailing interest rates. We had no debt outstanding under our credit facility during the six months ended June 30, 2007. Assuming maximum utilization of our credit facility for the entire year, a 2.0% change in the prevailing interest rate on our variable rate debt would result in interest expense fluctuating approximately \$600.

**Equity Risk.** Equity risk is the risk that we will incur economic losses due to adverse changes in equity prices. In the past, our exposure to changes in equity prices primarily resulted from our holdings of common stocks, mutual funds and other equities. While we have in the past held common equity securities in our investment portfolio, we presently hold none, except for interests in mutual funds to fund the Safety Insurance Company Executive Incentive Compensation Plan, a non qualified deferred compensation plan maintained for the purpose of providing deferred compensation to a select group of management. We continuously evaluate market conditions and we expect in the future to purchase equity securities. We principally managed 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 and Chief Financial Officer, 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 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and that information required to be disclosed in such reports is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, 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.

**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 material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds** **None.**

**Item 3. Defaults upon Senior Securities** **None.**

**Item 4. Submission of Matters to a Vote of Security Holders.**

The annual Meeting of Shareholders was held on May 18, 2007.

The following proposals were adopted by the margins indicated:

1. Election of one Class II Director to serve a three year term expiring in 2010.

	Number of Shares For	Withheld
Frederic H. Lindeberg	14,470,685	447,899

2. To ratify the appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm for 2007:

For	14,907,420
Against	9,753
Abstain	1,411



**Item 5.** Other Information None.

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

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**SIGNATURE**

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

**SAFETY INSURANCE GROUP, INC. (Registrant)**

Date: August 9, 2007

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



**SAFETY INSURANCE GROUP, INC.**

**EXHIBIT INDEX**

**Exhibit**

**Number      Description**

- |      |  |
|------|--|
| 11   | Statement re: Computation of Per Share Earnings.(1)  |
| 31.1 | CEO Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(2) |
| 31.2 | CFO Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.(2) |
| 32.1 | CEO Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(2)      |
| 32.2 | CFO Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.(2)      |
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(1) Not included herein as the information can be calculated from the face of the Consolidated Statements of Operations (see page 4).

(2) Included herein.