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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2019

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

20 Custom House Street, Boston, Massachusetts 02110

(Address of principal executive offices including zip code)

(617) 951-0600

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

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

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

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

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

Yes No

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol	Name of each exchange on which registered
Common	SAFT	NASDAQ

As of May 1, 2019 there were 15,383,794 shares of common stock with a par value of $0.01 per share outstanding.

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Balance Sheets

(Dollars in thousands, except share data)

	March 31, 2019 (Unaudited)	December 31, 2018
Assets		
Investments:		
Fixed maturities, available for sale, at fair value (amortized cost: $1,161,552 and $1,175,413)	$ 1,173,384	$ 1,161,862
Equity securities, at fair value (cost: $143,608 and $142,948)	160,471	148,011
Other invested assets	26,238	23,481
Total investments	1,360,093	1,333,354
Cash and cash equivalents	22,892	37,582
Accounts receivable, net of allowance for doubtful accounts	188,654	190,062
Receivable for securities sold	1,079	1,039
Accrued investment income	9,450	8,420
Receivable from reinsurers related to paid loss and loss adjustment expenses	29,881	13,691
Receivable from reinsurers related to unpaid loss and loss adjustment expenses	109,200	108,398
Ceded unearned premiums	33,537	33,974
Deferred policy acquisition costs	71,905	73,355
Deferred income taxes	2,949	8,749
Equity and deposits in pools	28,505	28,094
Operating lease right-of-use-assets	36,992	—
Other assets	22,881	19,522
Total assets	$ 1,918,018	$ 1,856,240
Liabilities		
Loss and loss adjustment expense reserves	$ 581,762	$ 584,719
Unearned premium reserves	430,389	435,380
Accounts payable and accrued liabilities	53,875	71,896
Payable for securities purchased	5,494	5,156
Payable to reinsurers	18,939	12,220
Taxes payable	8,286	6,090
Operating lease liabilities	36,992	—
Other liabilities	27,219	22,135
Total liabilities	1,162,956	1,137,596
Commitments and contingencies (Note 7)		
Shareholders’ equity		
Common stock: $0.01 par value; 30,000,000 shares authorized; 17,663,364 and 17,566,180 shares issued	177	176

Additional paid-in capital	198,014	196,292
Accumulated other comprehensive income (loss), net of taxes	9,347	(10,706)
Retained earnings	631,359	616,717
Treasury stock, at cost: 2,279,570 shares	(83,835)	(83,835)
Total shareholders' equity	755,062	718,644
Total liabilities and shareholders' equity	$ 1,918,018	$ 1,856,240

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Operations

(Unaudited)

(Dollars in thousands, except per share data)

	Three Months Ended March 31,	
	2019	2018
Net earned premiums	$ 194,491	$ 192,033
Net investment income	11,751	10,531
Earnings from partnership investments	835	4,864
Net realized (losses) gains on investments	(164)	1,306
Change in net unrealized gains on equity investments	11,801	(3,482)
Net impairment losses on investments (a)	(220)	—
Finance and other service income	4,085	4,467
Total revenue	222,579	209,719
Losses and loss adjustment expenses	126,027	137,644
Underwriting, operating and related expenses	60,434	60,856
Interest expense	22	22
Total expenses	186,483	198,522
Income before income taxes	36,096	11,197
Income tax expense	6,150	2,072
Net income	$ 29,946	$ 9,125
Earnings per weighted average common share:		
Basic	$ 1.97	$ 0.60
Diluted	$ 1.95	$ 0.60
Cash dividends paid per common share	$ 0.80	$ 0.80
Number of shares used in computing earnings per share:		
Basic	15,140,804	15,045,962
Diluted	15,305,785	15,191,139

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

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(Unaudited)

(Dollars in thousands)

	Three Months Ended March 31,	
	2019	2018
Net income	$ 29,946	$ 9,125
Other comprehensive income (loss), net of tax:		
Unrealized holding gains (losses) during the period, net of income tax expense (benefit) of $5,296 and ($3,390).	19,923	(12,753)
Reclassification adjustment for net realized losses (gains) on investments included in net income, net of income tax benefit (expense) of $35 and ($274).	130	(1,032)
Other comprehensive income (loss), net of tax:	20,053	(13,785)
Comprehensive income (loss)	$ 49,999	$ (4,660)

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Changes in Shareholders' Equity

(Unaudited)

(Dollars in thousands)

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Loss, Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2017	$ 175	$ 189,714	$ 24,269	$ 570,693	$ (83,835)	$ 701,016
Cumulative effect of adoption of updated accounting guidance for equity financial instruments at January 1, 2018			(16,895)	16,895		—
Reclassification of certain tax effects from accumulated other comprehensive income at January 1, 2018			4,736	(4,736)		—
Net income, January 1 to March 31, 2018				9,125		9,125
Unrealized losses on securities available for sale, net of deferred federal income taxes			(13,785)			(13,785)
Restricted share awards issued	1	375				376
Recognition of employee share-based compensation, net of deferred federal income taxes		1,239				1,239
Dividends paid and accrued				(12,326)		(12,326)
	$ 176	$ 191,328	$ (1,675)	$ 579,651	$ (83,835)	$ 685,645

Balance at March 31, 2018

	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Income, Net of Taxes	Retained Earnings	Treasury Stock	Total Shareholders' Equity
Balance at December 31, 2018	$ 176	$ 196,292	$ (10,706)	$ 616,717	$ (83,835)	$ 718,644
Cumulative effect of adoption of updated accounting guidance for callable debt securities at January 1, 2019				(3,004)		(3,004)
Net income, January 1 to March 31, 2019				29,946		29,946
Unrealized gains on securities available for sale, net of deferred federal income taxes			20,053			20,053
Restricted share awards issued	1	462				463
Recognition of employee share-based compensation, net of deferred federal income taxes		1,260				1,260
Dividends paid and accrued				(12,300)		(12,300)
Balance at March 31, 2019	$ 177	$ 198,014	$ 9,347	$ 631,359	$ (83,835)	$ 755,062

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

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Safety Insurance Group, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

	Three Months Ended March 31, 2019	2018
Cash flows from operating activities:		
Net income	$ 29,946	$ 9,125
Adjustments to reconcile net income to net cash provided by operating activities:		
Investment amortization, net	777	1,243
Fixed Asset depreciation, net	1,207	1,153
Stock based compensation	1,723	1,614
Provision for deferred income taxes	469	34
Net realized losses (gains) on investments	164	(1,306)
Net impairment losses on investments	220	—
Earnings from partnership investments	(835)	(2,526)
Change in net unrealized gains on equity investments	(11,801)	3,482
Changes in assets and liabilities:		
Accounts receivable	1,408	(2,564)
Accrued investment income	(1,030)	(1,156)
Receivable from reinsurers	(16,992)	(6,554)
Ceded unearned premiums	437	(995)
Deferred policy acquisition costs	1,450	985
Taxes recoverable	—	(1,660)
Other assets	(3,849)	(5,653)
Loss and loss adjustment expense reserves	(2,957)	5,720
Unearned premium reserves	(4,991)	(1,026)
Taxes payable	2,196	—
Accounts payable and accrued liabilities	(17,357)	(9,412)
Payable to reinsurers	6,719	5,655
Other liabilities	5,084	1,847
Net cash used for operating activities	(8,012)	(1,994)
Cash flows from investing activities:		
Fixed maturities purchased	(31,389)	(54,567)
Equity securities purchased	(5,169)	(12,664)
Other invested assets purchased	(1,750)	(129)
Proceeds from sales and paydowns of fixed maturities	33,587	35,247
Proceeds from maturities, redemptions, and calls of fixed maturities	7,260	23,272
Proceed from sales of equity securities	4,874	5,911
Proceeds from other invested assets redeemed	—	944

Fixed assets purchased	(1,127)	(558)
Net cash provided by (used for) investing activities	6,286	(2,544)
Cash flows from financing activities:		
Dividends paid to shareholders	(12,964)	(12,340)
Net cash used for financing activities	(12,964)	(12,340)
Net decrease in cash and cash equivalents	(14,690)	(16,878)
Cash and cash equivalents at beginning of year	37,582	41,708
Cash and cash equivalents at end of period	$ 22,892	$ 24,830

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

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

1. Basis of Presentation

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

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

The financial information for the three months ended March 31, 2019 and 2018 is unaudited; however, in the opinion of the Company, the information includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial condition, results of operations, and cash flows for the periods. The financial information as of December 31, 2018 is derived from the audited financial statements included in the Company's 2018 Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission ("SEC") on February 28, 2019.

These unaudited interim consolidated financial statements may not be indicative of financial results for the full year and should be read in conjunction with the audited financial statements included in the Company's 2018 Annual Report on Form 10-K filed with the SEC on February 28, 2019.

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

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

Management has assessed and concluded that there were no conditions or events, considered in the aggregate, that raise substantial doubt about the Company’s ability to continue as a going concern within one year after the date the financial statements were issued.

2. Recent Accounting Pronouncements

On March 20, 2019, the SEC adopted amendments to Regulation S-K and related rules and forms to modernize and simplify certain disclosure requirements for public companies. The amendments are intended to reduce the costs and burdens of the disclosure process and while continuing to require disclosure of all material information. The amended rules generally are effective on May 2, 2019 and reduce disclosures but some provisions added new requirements. The adoption of the new rules did not have a material impact on the Company’s financial posision, results of operations, cash flows, or disclosures.

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

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

In February 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The ASU permits a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the newly enacted federal corporate income tax rate as a result of the 2017 Tax Cuts and Jobs Act ("TCJA"). The amount of the reclassification is the difference between the historical corporate income tax rate of thirty-five percent and the newly enacted twenty-one percent corporate income tax rate. The ASU is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. The Company adopted the updated guidance effective January 1, 2018 and elected to reclassify the income tax effects of the TCJA from accumulated other comprehensive income ("AOCI") to retained earnings at the beginning of the period of adoption. This reclassification resulted in a decrease of $4,736 in retained earnings as of January 1, 2018 and an increase in AOCI by the same amount.

In March 2017, the FASB issued ASU 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities, which requires certain premiums on callable debt securities to be amortized to the earliest call date. The amortization period for callable debt securities purchased at a discount will not be impacted. For public business entities with calendar year ends, the amendments in ASU No. 2017-08 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company adopted ASU 2017-08 effective January 1, 2019 which resulted in the recognition of $3,004 of additional amortization as a cumulative effect adjustment which decreased retained earnings by that amount.

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

Flows.

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

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Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

nature and characteristics of the Company's portfolio at the adoption date, and the macroeconomic conditions and forecasts at the date.

In March 2016, the FASB issued ASU 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This ASC update requires all excess tax benefits and tax deficiencies to be recognized as income tax expense or benefit in the income statement, and be treated as discrete items in the reporting period in which they occur. Additionally, excess tax benefits will be classified with other income tax cash flows as an operating activity and cash paid by an employer when directly withholding shares for tax withholding purposes will be classified as a financing activity. Awards that are used to settle employee tax liabilities will be allowed to qualify for equity classification for withholdings up to the maximum statutory tax rates in applicable jurisdictions. Regarding forfeitures, a company can make an entity-wide accounting policy election to either continue estimating the number of awards that are expected to vest or account for forfeitures when they occur. The updated guidance is effective for annual periods beginning after December 15, 2016 and interim periods within those annual periods. The impact of the adoption of ASU 2016-09 was not material to the Company's financial position, results of operations or cash flows.

In February 2016, the FASB issued ASU 2016-02, Leases. ASU 2016-02 establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. In 2018, the FASB issued two additional updates, ASU 2018-10, Codification Improvements to Topic 842, Leases and ASU 2018-11, Leases (Topic 842): Targeted Improvements, both of which have the same effective date and transition requirements as ASU 2016-02. ASU 2018-10 makes sixteen technical corrections to alleviate unintended consequences from applying the new standard and does not make any substantive changes to the core provisions or principals of the new standard. ASU 2019-11 creates an additional transition method which allows companies to elect to not adjust their comparative period financial information and disclosures for the effects of the new lease standard and also creates a practical expedient for lessors to not separate lease and non-lease components. The Company adopted ASU 2016-02, ASU 2018-10 and ASU 2018-11 effective January 1, 2019 ("the application date") using the required modified retrospective transition approach. In accordance with the guidance, the Company has elected not to adjust comparative periods. As such, Accounting Standards Codification ("ASC") 842 will be applied to each lease that had commenced as of the application date with a cumulative effect adjustment as of that date. As of January 1, 2019, a right of use asset and lease liability of $35,984 were recorded in the Consolidated Balance Sheets. All periods prior to the application date presented in the financial statements will not change and the guidance in ASC 840, Leases, will apply. There was no impact on retained earnings or other components of equity in the Consolidated Balance Sheets as of March 31, 2019 and December 31, 2018.

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

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(Dollars in thousands except per share and share data)

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

3. Earnings per Weighted Average Common Share

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

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

	Three Months Ended March 31,	
	2019	2018
Earnings attributable to common shareholders - basic and diluted:		
Net income from continuing operations	$ 29,946	$ 9,125
Allocation of income for participating shares	(167)	(56)
Net income from continuing operations attributed to common shareholders	$ 29,779	$ 9,069

Earnings per share denominator - basic and diluted		
Total weighted average common shares outstanding, including participating shares	15,225,774	15,139,036
Less: weighted average participating shares	(84,970)	(93,074)
Basic earnings per share denominator	15,140,804	15,045,962
Common equivalent shares- stock options	—	—
Common equivalent shares- non-vested performance stock grants	164,981	145,177
Diluted earnings per share denominator	15,305,785	15,191,139
Basic earnings per share	$ 1.97	$ 0.60
Diluted earnings per share	$ 1.95	$ 0.60
Undistributed earnings attributable to common shareholders - basic and diluted:		
Net income from continuing operations attributable to common shareholders -Basic	$ 1.97	$ 0.60
Dividends declared	(0.80)	(0.80)
Undistributed earnings	$ 1.17	$ (0.20)
Net income from continuing operations attributable to common shareholders -Diluted	$ 1.95	$ 0.60
Dividends declared	(0.80)	(0.80)
Undistributed earnings	$ 1.15	$ (0.20)

Diluted EPS excludes non vested performance stock grants with exercise prices and exercise tax benefits greater than the average market price of the Company’s common stock during the period because their inclusion would be anti-dilutive. There were no anti-dilutive non vested performance stock grants for the three months ended March 31, 2019 and 2018.

Safety Insurance Group, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands except per share and share data)

4. Share-Based Compensation

2018 Long Term Incentive Plan

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

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

The maximum number of shares of common stock between both the 2018 Plan and 2002 Incentive Plan with respect to which awards may be granted is 2,850,000. No further grants will be allowed under the 2002 Incentive Plan. At March 31, 2019, there were 293,031 shares available for future grant.

Accounting and Reporting for Stock-Based Awards

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

Restricted Stock

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

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

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

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(Dollars in thousands except per share and share data)

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

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

The following table summarizes restricted stock activity under the Incentive Plan during the three months ended March 31, 2019 assuming a target payout for the 2019 performance-based shares.

	Shares Under Restriction	Weighted Average Fair Value	Performance-based Shares Under Restriction		Weighted Average Fair Value
Outstanding at beginning of year	89,135	$ 68.70	105,170		$ 66.79
Granted	33,778	92.52	63,447	(1)	69.61
Vested and unrestricted	(43,894)	68.42	(84,512)		56.42
Forfeited	(41)	53.64	—		—
Outstanding at end of period	78,978	$ 79.05	84,105		$ 79.34

(1) Includes a true-up of previously awarded performance-based restricted share awards. The updated shares were calculated based on the attainment of pre-established performance objectives and granted under the 2002 Incentive Plan.

As of March 31, 2019, there was $9,818 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 1.9 years. The total fair value of the shares that were vested and unrestricted during the three months ended March 31, 2019 and 2018 was $7,771 and $4,292, respectively. For the three months ended March 31, 2019 and 2018, the Company recorded compensation expense related to restricted stock of $1,361 and $1,275, net of income tax benefits of $362 and $339, respectively.

5. Investments

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

	As of March 31, 2019				
			Gross Unrealized Losses (3)		
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	$ 1,806	$ —	$ (17)	$ —	$ 1,789
Obligations of states and political subdivisions	250,415	10,063	(383)	—	260,095
Residential mortgage-backed securities (1)	298,494	2,707	(3,315)	—	297,886
Commercial mortgage-backed securities	60,867	1,427	(361)	—	61,933
Other asset-backed securities	55,401	156	(175)	—	55,382
Corporate and other securities	494,569	6,554	(4,824)	—	496,299
Subtotal, fixed maturity securities	1,161,552	20,907	(9,075)	—	1,173,384
Equity securities (2)	143,608	20,164	(3,301)	—	160,471
Other invested assets (5)	26,238	—	—	—	26,238
Totals	$ 1,331,398	$ 41,071	$ (12,376)	$ —	$ 1,360,093

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	As of December 31, 2018				
			Gross Unrealized Losses (3)		
	Cost or Amortized Cost	Gross Unrealized Gains	Non-OTTI Unrealized Losses	OTTI Unrealized Losses (4)	Estimated Fair Value
U.S. Treasury securities	$ 1,807	$ —	$ (30)	$ —	$ 1,777
Obligations of states and political subdivisions	262,772	5,098	(1,672)	—	266,198
Residential mortgage-backed securities (1)	300,387	1,477	(4,841)	—	297,023
Commercial mortgage-backed securities	60,897	337	(898)	—	60,336
Other asset-backed securities	61,310	95	(329)	—	61,076
Corporate and other securities	488,240	1,775	(14,563)	—	475,452
Subtotal, fixed maturity securities	1,175,413	8,782	(22,333)	—	1,161,862
Equity securities (2)	142,948	15,419	(10,356)	—	148,011
Other invested assets (5)	23,481	—	—	—	23,481
Totals	$ 1,341,842	$ 24,201	$ (32,689)	$ —	$ 1,333,354

(1) Residential mortgage-backed securities consists primarily of obligations of U.S. Government agencies including collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA) and the Federal Home Loan Bank (FHLB).
(2) Equity securities include common stock, preferred stock, mutual funds and interests in mutual funds held to fund the Company’s executive deferred compensation plan.
(3) The Company’s investment portfolio included 665 and 958 securities in an unrealized loss position at March 31, 2019 and December 31, 2018, respectively.
(4) Amounts in this column represent other-than-temporary impairment (“OTTI”) recognized in accumulated other comprehensive (loss) income.
(5) Other invested assets are accounted for under the equity method which approximated fair value.

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

	As of March 31, 2019	
	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 46,084	$ 46,322
Due after one year through five years	278,570	281,177
Due after five years through ten years	286,839	289,857
Due after ten years through twenty years	132,045	137,575
Due after twenty years	3,252	3,252
Asset-backed securities	414,762	415,201
Totals	$ 1,161,552	$ 1,173,384

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

	Three Months Ended March 31,	
	2019	2018
Gross realized gains		
Fixed maturity securities	$ 115	$ 135
Equity securities	953	1,644
Gross realized losses		
Fixed maturity securities	(667)	(84)
Equity securities	(565)	(389)
Net realized (losses) gains on investments	$ (164)	$ 1,306

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

The following tables as of March 31, 2019 and December 31, 2018 present the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities aggregated by investment category. The tables also present the length of time that they have been in a continuous unrealized loss position.

	As of March 31, 2019					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. Treasury securities	$ —	$ —	$ 1,789	$ 17	$ 1,789	$ 17
Obligations of states and political subdivisions	—	—	16,564	383	16,564	383
Residential mortgage-backed securities	18,137	176	149,209	3,139	167,346	3,315
Commercial mortgage-backed securities	1,700	23	15,445	338	17,145	361
Other asset-backed securities	9,036	47	24,819	128	33,855	175
Corporate and other securities	109,005	1,711	144,710	3,113	253,715	4,824
Subtotal, fixed maturity securities	137,878	1,957	352,536	7,118	490,414	9,075
Equity securities	48,261	2,790	3,224	511	51,485	3,301
Total temporarily impaired securities	$ 186,139	$ 4,747	$ 355,760	$ 7,629	$ 541,899	$ 12,376

	As of December 31, 2018					
	Less than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
U.S. Treasury securities	$ —	$ —	$ 1,777	$ 30	$ 1,777	$ 30
Obligations of states and political subdivisions	80,856	707	16,049	965	96,905	1,672
Residential mortgage-backed securities	64,101	694	138,572	4,147	202,673	4,841
Commercial mortgage-backed securities	22,652	270	13,117	628	35,769	898
Other asset-backed securities	33,866	112	23,532	217	57,398	329
Corporate and other securities	288,786	10,149	87,546	4,414	376,332	14,563
Subtotal, fixed maturity securities	490,261	11,932	280,593	10,401	770,854	22,333
Equity securities	71,439	9,955	2,072	401	73,511	10,356
Total temporarily impaired securities	$ 561,700	$ 21,887	$ 282,665	$ 10,802	$ 844,365	$ 32,689

Other-Than-Temporary Impairments

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

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

The unrealized losses in the Company's fixed income and equity portfolio as of March 31, 2019 were reviewed for potential other-than-temporary asset impairments. As a result of the analysis, during the three months ended March 31, 2019, the Company recognized $220 of OTTI losses which consisted entirely of credit losses related to a single fixed maturity security. During the three months ended March 31, 2018, the company recognized no OTTI losses.

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

The qualitative analysis performed by the Company concluded that outside of the securities that were recognized through OTTI, the unrealized losses recorded on the investment portfolio at March 31, 2019 resulted from fluctuations in market interest rates and other temporary market conditions as opposed to fundamental changes in the credit quality of the issuers of such securities. Therefore, decreases in fair values of the Company's securities are viewed as being temporary.

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

	Three Months Ended March 31,

	2019	2018
Credit losses on fixed maturity securities, beginning of period	$ 844	$ 892
Add: credit losses on OTTI not previously recognized	220	—
Less: credit losses on securities sold	—	(276)
Less: credit losses on securities impaired due to intent to sell	—	—
Add: credit losses on previously impaired securities	—	—
Less: increases in cash flows expected on previously impaired securities	—	—
Credit losses on fixed maturity securities, end of period	$ 1,064	$ 616

At March 31, 2019 and December 31, 2018, there were no amounts included in accumulated other comprehensive income related to securities which were considered by the Company to be other-than-temporarily impaired.

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

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Net Investment Income

The components of net investment income were as follows:

	Three Months Ended March 31,	
	2019	2018
Interest on fixed maturity securities	$ 11,127	$ 10,109
Dividends on equity securities	1,082	785
Equity in earnings of other invested assets	282	341
Interest on other assets	9	22
Total investment income	12,500	11,257
Investment expenses	749	726
Net investment income	$ 11,751	$ 10,531

Fair Value of Financial Instruments

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

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

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

Level 3 — Valuations based on unobservable inputs.

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

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

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