

SAFETY INSURANCE GROUP INC

Form 10-Q

August 07, 2009

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended June 30, 2009**

**OR**

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

**For the transition period from                      to**

**Commission File Number: 000-50070**

**SAFETY INSURANCE GROUP, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**

(State or other jurisdiction of incorporation or organization)

**13-4181699**

(I.R.S. Employer Identification No.)

**20 Custom House Street, Boston, Massachusetts 02110**

(Address of principal executive offices including zip code)

**(617) 951-0600**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

As of August 5, 2009, there were 15,339,500 shares of common stock with a par value of \$0.01 per share outstanding.

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SAFETY INSURANCE GROUP, INC.

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

|   | June 30,<br>2009    | December 31,<br>2008 |
|---|---------------------|----------------------|
| <b>Assets</b>   |                     |                      |
| Investment securities available for sale:   |                     |                      |
| Fixed maturities, at fair value (amortized cost: \$982,299 and \$929,836)                             | \$ 994,533          | \$ 920,171           |
| Equity securities, at fair value (cost: \$9,569 and \$8,419)  | 9,558               | 8,040                |
| Short term securities, at amortized cost which approximates fair value                                |                     | 82,928               |
| Total investment securities   | 1,004,091           | 1,011,139            |
| Cash and cash equivalents   | 57,276              | 60,451               |
| Accounts receivable, net of allowance for doubtful accounts   | 147,197             | 138,792              |
| Accrued investment income   | 10,100              | 9,957                |
| Taxes recoverable   | 2,404               | 5,300                |
| Receivable from reinsurers related to paid loss and loss adjustment expenses                          | 9,602               | 10,835               |
| Receivable from reinsurers related to unpaid loss and loss adjustment expenses                        | 69,034              | 76,489               |
| Ceded unearned premiums   | 17,498              | 21,620               |
| Deferred policy acquisition costs   | 49,630              | 46,687               |
| Deferred income taxes   | 10,582              | 18,986               |
| Equity and deposits in pools  | 26,092              | 23,578               |
| Other assets  | 14,432              | 13,983               |
| <b>Total assets</b>   | <b>\$ 1,417,938</b> | <b>\$ 1,437,817</b>  |
| <b>Liabilities</b>  |                     |                      |
| Loss and loss adjustment expense reserves   | \$ 450,959          | \$ 467,559           |
| Unearned premium reserves   | 300,834             | 289,695              |
| Accounts payable and accrued liabilities  | 33,719              | 51,111               |
| Payable for securities purchased  | 3,679               |                      |
| Payable to reinsurers   | 11,512              | 8,291                |
| Other liabilities   | 15,546              | 17,790               |
| <b>Total liabilities</b>  | <b>816,249</b>      | <b>834,446</b>       |
| <b>Commitments and contingencies (Note 7)</b>   |                     |                      |
| <b>Shareholders equity</b>  |                     |                      |
| Common stock: \$0.01 par value; 30,000,000 shares authorized; 16,610,054 and 16,464,530 shares issued | 166                 | 165                  |
| Additional paid-in capital  | 142,357             | 140,261              |
| Accumulated other comprehensive income (loss), net of taxes   | 7,945               | (6,528)              |
| Retained earnings   | 491,169             | 476,989              |
| Treasury stock, at cost; 1,260,549 and 232,013 shares   | (39,948)            | (7,516)              |
| <b>Total shareholders equity</b>  | <b>601,689</b>      | <b>603,371</b>       |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 1,417,938</b> | <b>\$ 1,437,817</b>  |

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 share and per share data)

|   | Three Months Ended June 30, |                  | Six Months Ended June 30, |                  |
|---|-----------------------------|------------------|---------------------------|------------------|
|   | 2009                        | 2008             | 2009                      | 2008             |
| Net earned premiums   | \$ 131,306                  | \$ 147,002       | \$ 266,656                | \$ 297,750       |
| Net investment income   | 10,706                      | 11,207           | 21,128                    | 22,735           |
| Net realized gains (losses) on investments                    | 1                           | 2,072            | (317)                     | 2,103            |
| Finance and other service income                              | 4,293                       | 4,515            | 8,381                     | 9,013            |
| <b>Total revenue</b>  | <b>146,306</b>              | <b>164,796</b>   | <b>295,848</b>            | <b>331,601</b>   |
| Losses and loss adjustment expenses                           | 86,393                      | 91,078           | 179,275                   | 186,948          |
| Underwriting, operating and related expenses                  | 39,548                      | 44,474           | 80,620                    | 88,939           |
| Interest expenses   | 21                          | 18               | 43                        | 37               |
| <b>Total expenses</b>   | <b>125,962</b>              | <b>135,570</b>   | <b>259,938</b>            | <b>275,924</b>   |
| Income before income taxes                                    | 20,344                      | 29,226           | 35,910                    | 55,677           |
| Income tax expense  | 5,329                       | 8,295            | 9,051                     | 15,701           |
| <b>Net income</b>   | <b>\$ 15,015</b>            | <b>\$ 20,931</b> | <b>\$ 26,859</b>          | <b>\$ 39,976</b> |
| <b>Earnings per weighted average common share:</b>            |                             |                  |                           |                  |
| Basic   | \$ 0.96                     | \$ 1.29          | \$ 1.69                   | \$ 2.46          |
| Diluted   | \$ 0.96                     | \$ 1.28          | \$ 1.69                   | \$ 2.45          |
| <b>Cash dividends paid per common share</b>                   | <b>\$ 0.40</b>              | <b>\$ 0.40</b>   | <b>\$ 0.80</b>            | <b>\$ 0.80</b>   |
| <b>Number of shares used in computing earnings per share:</b> |                             |                  |                           |                  |
| Basic   | 15,629,005                  | 16,264,110       | 15,896,939                | 16,235,919       |
| Diluted   | 15,648,355                  | 16,316,703       | 15,916,826                | 16,290,874       |

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

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Consolidated Statements of Changes in Shareholders' Equity****(Unaudited)****(Dollars in thousands)**

|   | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>(Loss)/Income,<br/>Net of Taxes</b> | <b>Retained<br/>Earnings</b> | <b>Treasury<br/>Stock</b> | <b>Total<br/>Shareholders<br/>Equity</b> |
|---|-------------------------|---|--|------------------------------|---------------------------|--|
| Balance at December 31, 2007  | \$ 162                  | \$ 134,224                                | \$ 4,453   | \$ 432,746                   | \$ (1,585)                | \$ 570,000                               |
| Net income, January 1 to June 30, 2008  |                         |   |  | 39,976                       |                           | 39,976                                   |
| Other comprehensive loss, net of deferred federal income taxes  |                         |   | (7,996)  |                              |                           | (7,996)                                  |
| Exercise of options and unearned compensation on restricted stock, net of deferred federal income taxes | 2                       | 2,524                                     |  |                              |                           | 2,526                                    |
| Dividends paid  |                         |   |  | (12,984)                     |                           | (12,984)                                 |
| Acquisition of treasury stock   |                         |   |  |                              | (2,444)                   | (2,444)                                  |
| Balance at June 30, 2008  | \$ 164                  | \$ 136,748                                | \$ (3,543)   | \$ 459,738                   | \$ (4,029)                | \$ 589,078                               |

|   | <b>Common<br/>Stock</b> | <b>Additional<br/>Paid-in<br/>Capital</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income/(Loss),<br/>Net of Taxes</b> | <b>Retained<br/>Earnings</b> | <b>Treasury<br/>Stock</b> | <b>Total<br/>Shareholders<br/>Equity</b> |
|---|-------------------------|---|--|------------------------------|---------------------------|--|
| Balance at December 31, 2008  | \$ 165                  | \$ 140,261                                | \$ (6,528)   | \$ 476,989                   | \$ (7,516)                | \$ 603,371                               |
| Net income, January 1 to June 30, 2009  |                         |   |  | 26,859                       |                           | 26,859                                   |
| Other comprehensive income, net of deferred federal income taxes  |                         |   | 14,473   |                              |                           | 14,473                                   |
| Exercise of options and unearned compensation on restricted stock, net of deferred federal income taxes | 1                       | 2,096                                     |  |                              |                           | 2,097                                    |
| Dividends paid  |                         |   |  | (12,679)                     |                           | (12,679)                                 |
| Acquisition of treasury stock   |                         |   |  |                              | (32,432)                  | (32,432)                                 |
| Balance at June 30, 2009  | \$ 166                  | \$ 142,357                                | \$ 7,945   | \$ 491,169                   | \$ (39,948)               | \$ 601,689                               |

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

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

|  | <b>Three Months Ended June 30,</b> |                  | <b>Six Months Ended June 30,</b> |                  |
|--|------------------------------------|------------------|----------------------------------|------------------|
|  | <b>2009</b>                        | <b>2008</b>      | <b>2009</b>                      | <b>2008</b>      |
| <b>Net income</b>  | <b>\$ 15,015</b>                   | <b>\$ 20,931</b> | <b>\$ 26,859</b>                 | <b>\$ 39,976</b> |
| <b>Other comprehensive income, net of tax:</b>   |                                    |                  |                                  |                  |
| Unrealized holding gains (losses) during the period, net of tax expense (benefit) of \$2,451, \$(5,703), \$7,682, and \$(3,569)          | 4,551                              | (10,592)         | 14,267                           | (6,629)          |
| Reclassification adjustment for (gains) losses included in net income, net of tax (expense) benefit of \$(1), \$(725), \$111 and \$(736) | (1)                                | (1,347)          | 206                              | (1,367)          |
| Unrealized gains (losses) on securities available for sale   | 4,550                              | (11,939)         | 14,473                           | (7,996)          |
| <b>Comprehensive income</b>  | <b>\$ 19,565</b>                   | <b>\$ 8,992</b>  | <b>\$ 41,332</b>                 | <b>\$ 31,980</b> |

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)

|   | Six Months Ended June 30, |                  |
|---|---------------------------|------------------|
|   | 2009                      | 2008             |
| <b>Cash flows from operating activities:</b>                                      |                           |                  |
| Net income  | \$ 26,859                 | \$ 39,976        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |                  |
| Depreciation and amortization, net  | 6,237                     | 5,729            |
| Provision (benefit) for deferred income taxes                                     | 610                       | (1,336)          |
| Net realized losses (gains) on investments  | 317                       | (2,103)          |
| Changes in assets and liabilities:  |                           |                  |
| Accounts receivable   | (8,405)                   | (7,500)          |
| Accrued investment income   | (143)                     | 568              |
| Receivable from reinsurers  | 8,688                     | (5,342)          |
| Ceded unearned premiums   | 4,122                     | 1,371            |
| Deferred policy acquisition costs   | (2,943)                   | (3,533)          |
| Other assets  | (1,285)                   | 1,578            |
| Loss and loss adjustment expense reserves   | (16,600)                  | (8,728)          |
| Unearned premium reserves   | 11,139                    | 13,399           |
| Accounts payable and accrued liabilities  | (17,392)                  | (15,097)         |
| Payable to reinsurers   | 3,221                     | 8,148            |
| Other liabilities   | (2,527)                   | 366              |
| Net cash provided by operating activities   | 11,898                    | 27,496           |
| <b>Cash flows from investing activities:</b>                                      |                           |                  |
| Fixed maturities purchased  | (108,252)                 | (93,251)         |
| Equity securities purchased   | (3,232)                   | (3,494)          |
| Proceeds from sales, paydowns and calls of fixed maturities                       | 51,398                    | 85,756           |
| Proceeds from maturities of fixed maturities                                      | 5,322                     | 17,675           |
| Proceeds from sales of equity securities  | 1,764                     | 1,560            |
| Proceeds from maturities of short term securities                                 | 82,996                    |                  |
| Fixed assets purchased  | (132)                     | (3,143)          |
| Net cash provided by investing activities   | 29,864                    | 5,103            |
| <b>Cash flows from financing activities:</b>                                      |                           |                  |
| Proceeds and excess tax benefits from exercise of stock options                   | 175                       | 633              |
| Dividends paid to shareholders  | (12,679)                  | (12,984)         |
| Acquisition of treasury stock   | (32,433)                  | (2,444)          |
| Net cash used for financing activities  | (44,937)                  | (14,795)         |
| <b>Net (decrease) increase in cash and cash equivalents</b>                       | <b>(3,175)</b>            | <b>17,804</b>    |
| Cash and cash equivalents at beginning of year                                    | 60,451                    | 46,311           |
| <b>Cash and cash equivalents at end of period</b>                                 | <b>\$ 57,276</b>          | <b>\$ 64,115</b> |

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



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**Safety Insurance Group, Inc. and Subsidiaries**

**Notes to Unaudited Consolidated Financial Statements**

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

**1. Basis of Presentation**

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

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

The financial information as of June 30, 2009 and for the three and six months ended June 30, 2009 and 2008 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 on March 13, 2009.

The Company is a leading provider of personal lines property and casualty insurance focused primarily on the Massachusetts market. The Company s principal product line is private passenger automobile insurance, which accounted for 71.7% of its direct written premiums in 2008. The Company operates through its insurance company subsidiaries, Safety Insurance Company, Safety Indemnity Insurance Company and Safety Property and Casualty Company (together referred to as the Insurance Subsidiaries ).

The Company has evaluated subsequent events since the date of these consolidated financial statements through the issuance date of August 7, 2009.

**2. Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No.157, *Fair Value Measurements* ( FAS 157 ). FAS 157 defines fair value, sets out a framework for measuring fair value and requires additional disclosures about

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fair value measurements. This standard applies to fair value measurements already required or permitted by existing standards and was effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company adopted FAS157 on January 1, 2008. The adoption of FAS 157 did not have an impact on the Company's consolidated results of operations or financial position. See Note 5, Investments, for further information regarding the Company's investments and fair value measurements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115*, which was effective for fiscal years beginning after November 15, 2007. This statement permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The Company has chosen not to elect the fair value option permitted by this statement.

In June 2008, the FASB issued FASB Staff Position ( FSP ) Emerging Issues Task Force ( EITF ) 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities* ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting. FSP EITF 03-6-1 requires that such instruments that hold unforfeitable rights to dividends or dividend equivalents, regardless of whether paid or unpaid, should be considered participating securities and accordingly, should be included in the calculation of earnings per share under the two-class method instead of the treasury stock method. Under the Company's employee incentive compensation plan, restricted stock grantees have unforfeitable rights to dividends before the vesting period and are therefore, participating securities and treated as a separate class of securities in calculating earnings per share. The Company adopted FSP EITF 03-6-1 effective January 1, 2009, and has since used the two-class method to calculate earnings per share. In accordance with the adoption provisions of FSP EITF 03-6-1, all prior period earnings per share data has been adjusted retroactively to conform to the provisions

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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)**

of FSP EITF 03-6-1. For the six months ended June 30, 2008 basic and diluted EPS were reduced by \$0.03 cents per share from previously disclosed amounts. For the three months ending June 30, 2008, basic and diluted EPS were reduced by \$0.02 from previously disclosed amounts.

In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ( FSP FAS 115-2/124-2 ). This FSP replaces other-than-temporary impairment guidance for debt securities. FSP FAS 115-2/124-2 requires entities to separate an other-than-temporary impairment of a debt security into two components when there are credit related losses associated with the impaired debt security for which management 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. The amount of the other-than-temporary impairment related to a credit loss is recognized in earnings, and the amount of the other-than-temporary impairment related to other factors is recorded in other comprehensive loss. FSP FAS 115-2/124-2 is required to be adopted for periods ending after June 15, 2009. The Company adopted FSP FAS 115-2/124-2 effective for its interim reporting period ending June 30, 2009. The adoption of FSP FAS 115-2/124-2 did not have an impact on the Company's consolidated results of operations or financial position. For further information, see Note 5, Investments.

In April 2009, the FASB issued FSP FAS 107-1 and Accounting Principles Board ( APB28-1, *Interim Disclosures about Fair Value of Financial Instruments* ( FSP FAS 107-1 and APB 28-1 ). FSP FAS 107-1 and APB 28-1 require disclosures about fair value of financial instruments in interim and annual financial statements. FSP FAS 107-1 and APB 28-1 are effective for periods ending after June 15, 2009. The Company adopted FSP FAS 107-1 effective for its interim reporting period ending June 30, 2009, and its adoption did not have an impact on the Company's consolidated financial condition or results of operations. For further information, see Note 5, Investments.

In April 2009, the FASB issued FSP No. FAS 157-4, *Determining Fair Value When Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly* ( FSP FAS 157-4 ). FSP FAS 157-4 also amended SFAS No. 157, Fair Value Measurements, to expand certain disclosure requirements. FSP FAS 157-4 is effective for periods ending after June 15, 2009. The Company adopted FSP FAS 157-4 effective for its interim period ending June 30, 2009, and its adoption did not have an impact on the Company's consolidated financial condition or results of operations.

In May 2009, the FASB issued Statement of Financial Accounting Standard 165, *Subsequent Events* ( FASB 165 ). FASB 165 establishes principles and requirements for subsequent events. This statement shall be applied to the accounting for and disclosure of subsequent events not addressed in other applicable generally accepted accounting principles. This statement is effective for interim and annual financial periods ending after June 15, 2009, and shall be applied prospectively. See Note 1 for the date through which the Company evaluated subsequent events.

In June 2009, the FASB issued Statement of Financial Accounting Standard 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*, ( SFAS No. 168 ). SFAS No.168 will become the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants, EITF, and related accounting literature. SFAS No.168 reorganizes the thousands of GAAP pronouncements into roughly 90 accounting topics and displays them using a

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consistent structure. Also included is relevant Securities and Exchange Commission guidance organized using the same topical structure in separate sections. SFAS No.168 will be effective for financial statements issued for reporting periods that end after September 15, 2009. As a result, SFAS No.168 is effective for the Company in the three months ended September 30, 2009. This will have an impact on the Company's disclosures in its consolidated financial statements since all future references to authoritative accounting literature will be referenced in accordance with SFAS 168.

### **3. Earnings per Weighted Average Common Share**

Basic earnings per weighted average common share is calculated by dividing net income by the weighted average number of basic common shares outstanding during the period including unvested restricted shares which are considered participating securities. Diluted earnings per share amounts are based on the weighted average number of common shares including unvested restricted shares and the net effect of potentially dilutive common shares outstanding. At June 30, 2009 and 2008, the Company's potentially dilutive instruments were common shares under options of 229,503, and 304,290, respectively.

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

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

|   | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|---|-----------------------------|------------|---------------------------|------------|
|   | 2009                        | 2008       | 2009                      | 2008       |
| Net income as reported  | \$ 15,015                   | \$ 20,931  | \$ 26,859                 | \$ 39,976  |
| Less dividends:   |                             |            |                           |            |
| Distributed to common shareholders  | 6,093                       | 6,413      | 12,483                    | 12,829     |
| Distributed to participating security holders   | 112                         | 91         | 196                       | 153        |
| Total undistributed earnings  | \$ 8,810                    | \$ 14,427  | \$ 14,180                 | \$ 26,994  |
| Undistributed earnings to common shareholders   | \$ 8,659                    | \$ 14,224  | \$ 13,949                 | \$ 26,649  |
| Undistributed earnings to participating security holders  | \$ 151                      | \$ 203     | \$ 231                    | \$ 345     |
| Net income available to common shareholders for basic and diluted earnings per share                          | \$ 15,015                   | \$ 20,931  | \$ 26,859                 | \$ 39,976  |
| Weighted average number of common shares outstanding  | 15,350,120                  | 16,033,785 | 15,637,755                | 16,029,290 |
| Common equivalent shares- restricted stock  | 278,885                     | 230,325    | 259,184                   | 206,629    |
| Weighted average common and common equivalent shares outstanding used to calculate basic earnings per share   | 15,629,005                  | 16,264,110 | 15,896,939                | 16,235,919 |
| Common equivalent shares- stock options   | 19,350                      | 52,593     | 19,887                    | 54,955     |
| Weighted average common and common equivalent shares outstanding used to calculate diluted earnings per share | 15,648,355                  | 16,316,703 | 15,916,826                | 16,290,874 |
| Basic earnings per share  | \$ 0.96                     | \$ 1.29    | \$ 1.69                   | \$ 2.46    |
| Diluted earnings per share  | \$ 0.96                     | \$ 1.28    | \$ 1.69                   | \$ 2.45    |

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 167,925 anti-dilutive stock options for both the three and six months ended June 30, 2009. There were 174,925 anti-dilutive stock options for both the three and six months ended June 30, 2008.

**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.

The maximum number of shares of common stock with respect to which awards may be granted 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, 2009 there were 920,434 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.



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

A summary of stock based awards granted under the Incentive Plan during the six months ended June 30, 2009 is as follows:

| Type of Equity Awarded | Effective Date | Number of Awards Granted | Fair Value per Share (1) | Vesting Terms         |
|------------------------|----------------|--------------------------|--------------------------|-----------------------|
| RS                     | March 9, 2009  | 95,953                   | \$ 28.66                 | 3 years, 30%-30%-40%  |
| RS                     | March 9, 2009  | 4,000                    | \$ 28.66                 | No vesting period (2) |
| RS                     | March 19, 2009 | 38,046                   | \$ 33.24                 | 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 Statement of Financial Accounting Standards 123R (revised 2004), *Share-Based Payment* (FAS 123R), 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.

**Stock Options**

The fair value of stock options used to compute net income and earnings per share for the three and six month periods ended June 30, 2009 and 2008 is the estimated fair value at grant date using the Black-Scholes option-pricing model with the following assumptions:

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|                         | Three Months Ended June 30, |               | Six Months Ended June 30, |               |
|-------------------------|-----------------------------|---------------|---------------------------|---------------|
|                         | 2009                        | 2008          | 2009                      | 2008          |
| Expected dividend yield | <b>1.36% - 1.87%</b>        | 1.36% - 2.52% | <b>1.36% - 2.16%</b>      | 1.36% - 2.52% |
| Expected volatility     | <b>0.31 - 0.36</b>          | 0.20 - 0.36   | <b>0.28 - 0.36</b>        | 0.20 - 0.36   |
| Risk-free interest rate | <b>3.82% - 4.76%</b>        | 3.23% - 4.76% | <b>3.23% - 4.76%</b>      | 3.23% - 4.76% |
| Expected holding period | <b>6.5 - 7 years</b>        | 6.5 - 7 years | <b>6.5 - 7 years</b>      | 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. There were no stock options granted during the three and six month periods ended June 30, 2009 and 2008.

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The following table summarizes stock option activity under the Incentive Plan for the six months ended June 30, 2009.

|                                  | Shares<br>Under<br>Option | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|---------------------------|---------------------------------------|---|---------------------------------|
| Outstanding at beginning of year | 238,666                   | \$ 33.66                              |   |                                 |
| Forfeited                        | (1,000)                   | \$ 42.85                              |   |                                 |
| Exercised                        | (8,163)                   | \$ 14.81                              |   |                                 |
| Outstanding at end of period     | 229,503                   | \$ 34.29                              | 5.9 years   | \$ 841                          |
| Exercisable at end of period     | 167,013                   | \$ 31.92                              | 5.7 years   | \$ 823                          |

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based upon the Company's closing stock price of \$30.56 on June 30, 2009, 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, 2009 and 2008. The total intrinsic value of options exercised during the six months ended June 30, 2009 and 2008 was \$129 and \$664, respectively.

A summary of the status of non-vested options as of June 30, 2009, is presented below.

|                                 | Number of<br>Shares | Weighted Average<br>Grant Date<br>Exercise Price |
|---------------------------------|---------------------|--|
| Non-vested at beginning of year | 118,035             | \$ 37.06   |
| Vested                          | (54,545)            | \$ 32.88   |
| Forfeited                       | (1,000)             | \$ 42.85   |
| Non-vested at end of period     | 62,490              | \$ 40.63   |

As of June 30, 2009, there was \$678 of unrecognized compensation expense related to non-vested option awards that is expected to be recognized over a weighted average period of 1.1 years.

Cash received from options exercised was \$121 and \$416 for the six months ended June 30, 2009, and 2008, respectively.

**Restricted Stock**

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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, 2009.

|                                      | <b>Shares<br/>Under<br/>Restriction</b> |           | <b>Weighted<br/>Average<br/>Fair Value</b> |
|--------------------------------------|---|-----------|--|
| Outstanding at beginning of the year | <b>246,325</b>                          | <b>\$</b> | <b>38.77</b>                               |
| Granted                              | <b>137,999</b>                          | <b>\$</b> | <b>29.92</b>                               |
| Vested and unrestricted              | <b>(84,857)</b>                         | <b>\$</b> | <b>40.20</b>                               |
| Forfeited                            | <b>(638)</b>                            | <b>\$</b> | <b>36.57</b>                               |
| Outstanding at end of period         | <b>298,829</b>                          | <b>\$</b> | <b>34.28</b>                               |

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As of June 30, 2009, there was \$8,309 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 1.8 years. The total fair value of the shares that were vested and unrestricted during the six months ended June 30, 2009 and 2008 was \$3,412 and \$2,733, respectively. For the six months ended June 30, 2009 and 2008, the Company recorded compensation expense related to restricted stock of \$1,256 and \$1,118 net of income tax benefits of \$677 and \$602, respectively.

**5. Investments**

The gross unrealized gains and losses on investments in fixed maturity securities and equity securities, including interests in mutual funds, were as follows for the periods indicated:

|   | Cost or Amortized Cost | Gross Unrealized Gains | June 30, 2009<br>Gross Unrealized Losses (3) |                        | Estimated Fair Value |
|---|------------------------|------------------------|--|------------------------|----------------------|
|   |                        |                        | Non-OTTI Unrealized Losses                   | OTTI Unrealized Losses |                      |
| U.S. Treasury securities and obligations of U.S. Government agencies(1) | \$ 304,898             | \$ 10,229              | \$ (207)                                     | \$                     | \$ 314,920           |
| Obligations of states and political subdivisions                        | 484,852                | 12,751                 | (2,600)                                      |                        | 495,003              |
| Asset-backed securities (1)   | 94,734                 | 483                    | (9,279)                                      |                        | 85,938               |
| Corporate and other securities  | 97,815                 | 2,233                  | (1,376)                                      |                        | 98,672               |
| Subtotal, fixed maturity securities                                     | 982,299                | 25,696                 | (13,462)                                     |                        | 994,533              |
| Equity securities (2)   | 9,569                  | 29                     | (40)   |                        | 9,558                |
| Totals  | \$ 991,868             | \$ 25,725              | \$ (13,502)                                  | \$                     | \$ 1,004,091         |

|  | Cost or Amortized Cost | Gross Unrealized Gains | December 31, 2008<br>Gross Unrealized Losses (3) |                        | Estimated Fair Value |
|--|------------------------|------------------------|--|------------------------|----------------------|
|  |                        |                        | Non-OTTI Unrealized Losses                       | OTTI Unrealized Losses |                      |
| U.S. Treasury securities and obligations of U.S. Government agencies (1) | \$ 288,598             | \$ 8,532               | \$ (244)   | \$                     | \$ 296,886           |
| Obligations of states and political subdivisions                         | 498,339                | 9,414                  | (6,132)  |                        | 501,621              |
| Asset-backed securities (1)  | 77,656                 |                        | (17,122)   |                        | 60,534               |
| Corporate and other securities   | 65,243                 | 420                    | (4,533)  |                        | 61,130               |
| Subtotal, fixed maturity securities                                      | 929,836                | 18,366                 | (28,031)   |                        | 920,171              |
| Equity securities (2)  | 8,419                  |                        | (379)  |                        | 8,040                |
| Short term securities  | 82,928                 |                        |  |                        | 82,928               |
| Totals   | \$ 1,021,183           | \$ 18,366              | \$ (28,410)                                      | \$                     | \$ 1,011,139         |

(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 \$292,932 and \$286,100 at amortized cost and \$302,893 and \$294,064 at fair value as of June 30, 2009 and December 31, 2008, respectively. As such, the asset-backed securities presented exclude such issuers already presented under U.S. Treasury securities and obligations of U.S. Government Agencies.

(2) Equity securities consist solely of interests in mutual funds held to fund the Company's executive deferred compensation plan.

(3) The Company's investment portfolio included 109 and 161 securities in an unrealized loss position at June 30, 2009 and December 31, 2008, respectively.

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The amortized cost and the estimated fair value of fixed maturity securities, by maturity, are shown below for the periods 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 June 30, 2009 |                      | As of December 31, 2008 |                      |
|--|---------------------|----------------------|-------------------------|----------------------|
|  | Amortized Cost      | Estimated Fair Value | Amortized Cost          | Estimated Fair Value |
| Due in one year or less                  | \$ 30,950           | \$ 31,492            | \$ 10,572               | \$ 10,678            |
| Due after one year through five years    | 254,581             | 262,311              | 245,457                 | 249,425              |
| Due after five years through ten years   | 163,534             | 167,376              | 153,520                 | 154,817              |
| Due after ten years through twenty years | 132,318             | 131,535              | 143,278                 | 138,225              |
| Due after twenty years                   | 13,250              | 12,988               | 13,252                  | 12,428               |
| Asset-backed securities                  | 387,666             | 388,831              | 363,757                 | 354,598              |
| Totals                                   | \$ 982,299          | \$ 994,533           | \$ 929,836              | \$ 920,171           |

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

|  | Three Months Ended June 30, |          | Six Months Ended June 30, |          |
|--|-----------------------------|----------|---------------------------|----------|
|  | 2009                        | 2008     | 2009                      | 2008     |
| Gross realized gains                       |                             |          |                           |          |
| Fixed maturity securities                  | \$                          | \$ 2,072 | \$                        | \$ 2,128 |
| Short term securities                      | 1                           |          | 1                         |          |
| Gross realized losses                      |                             |          |                           |          |
| Fixed maturity securities                  |                             |          |                           | (25)     |
| Equity securities                          |                             |          | (318)                     |          |
| Net realized gains (losses) on investments | \$ 1                        | \$ 2,072 | \$ (317)                  | \$ 2,103 |

Proceeds from fixed maturities maturing were \$5,000 and \$11,000 for the three months ended June 30, 2009 and 2008, respectively. Proceeds from fixed maturities maturing were \$5,322 and \$17,675 for the six months ended June 30, 2009 and 2008, respectively.

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.





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The following tables as of June 30, 2009 and December 31, 2008 illustrate 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 illustrate the length of time that they have been in a continuous unrealized loss position.

|  | Less than 12 Months     |                      | As of June 30, 2009<br>12 Months or More |                      | Total                   |                      |
|--|-------------------------|----------------------|--|----------------------|-------------------------|----------------------|
|  | Estimated<br>Fair Value | Unrealized<br>Losses | Estimated<br>Fair Value                  | Unrealized<br>Losses | Estimated<br>Fair Value | Unrealized<br>Losses |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 15,977               | \$ 163               | \$ 942                                   | \$ 44                | \$ 16,919               | \$ 207               |
| Obligations of states and political subdivisions                     | 22,130                  | 269                  | 77,323                                   | 2,331                | 99,453                  | 2,600                |
| Asset-backed securities  |                         |                      | 64,183                                   | 9,279                | 64,183                  | 9,279                |
| Corporate and other securities                                       | 7,469                   | 28                   | 16,702                                   | 1,348                | 24,171                  | 1,376                |
| Subtotal, fixed maturity securities                                  | 45,576                  | 460                  | 159,150                                  | 13,002               | 204,726                 | 13,462               |
| Equity securities  | 36                      | 4                    | 271                                      | 36                   | 307                     | 40                   |
| Total temporarily impaired securities                                | \$ 45,612               | \$ 464               | \$ 159,421                               | \$ 13,038            | \$ 205,033              | \$ 13,502            |

|  | Less than 12 Months     |                      | As of December 31, 2008<br>12 Months or More |                      | Total                   |                      |
|--|-------------------------|----------------------|--|----------------------|-------------------------|----------------------|
|  | Estimated<br>Fair Value | Unrealized<br>Losses | Estimated<br>Fair Value                      | Unrealized<br>Losses | Estimated<br>Fair Value | Unrealized<br>Losses |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 4,300                | \$ 9                 | \$ 9,770                                     | \$ 235               | \$ 14,070               | \$ 244               |
| Obligations of states and political subdivisions                     | 116,605                 | 4,524                | 32,220                                       | 1,608                | 148,825                 | 6,132                |
| Asset-backed securities  | 24,036                  | 7,876                | 36,498                                       | 9,246                | 60,534                  | 17,122               |
| Corporate and other securities                                       | 21,503                  | 931                  | 16,307                                       | 3,602                | 37,810                  | 4,533                |
| Subtotal, fixed maturity securities                                  | 166,444                 | 13,340               | 94,795                                       | 14,691               | 261,239                 | 28,031               |
| Equity securities  | 2,458                   | 353                  | 33   | 26                   | 2,491                   | 379                  |
| Total temporarily impaired securities                                | \$ 168,902              | \$ 13,693            | \$ 94,828                                    | \$ 14,717            | \$ 263,730              | \$ 28,410            |

**Other-Than-Temporary Impairments**

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In April 2009, the FASB issued FSP FAS 115-2/124-2. FSP FAS 115-2/124-2 requires entities to separate an other-than-temporary impairment ( 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. Prior to April 1, 2009, the Company had to determine whether it had the intent and ability to hold the investment for a sufficient period of time for the value to recover. When the analysis of the above factors resulted in the Company's conclusion that declines in market values were other-than-temporary, the cost of the securities was written down to market value and the reduction in value was reflected as a realized loss.

Effective under FSP FAS 115-2/124-2, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors is recorded as a component of other comprehensive income (loss). In instances where no credit loss exists but it is more likely than not that the Company will have to sell the debt security prior to the anticipated recovery, the decline in market value below amortized cost is recognized as an OTTI in earnings. In periods after the recognition of an OTTI on debt securities, the Company accounts for such securities as if they had been purchased on the measurement date of the OTTI at an amortized cost basis equal to the previous amortized cost basis less the OTTI recognized in earnings. For debt securities for which OTTI was recognized in earnings, the difference between the new amortized cost basis and the cash flows expected to be collected will be accreted or amortized into net investment income

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As of June 30, 2009, with the exception of one security which represented 0.1% of the Company's total investment in fixed income securities, the Company's fixed income securities portfolio was comprised entirely of investment grade corporate fixed maturity securities, U.S. Government and Agency securities, states and political subdivision 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.) 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.

The unrealized losses in the Company's fixed income portfolio as of June 30, 2009 were reviewed for potential permanent asset impairments. The Company obtained specific qualitative analysis regarding certain debt securities held at June 30, 2009 with a material (20% or greater) unrealized loss for four or more consecutive quarters. Specific qualitative analysis was also performed for any additional securities appearing on our Watch List. Qualitative analysis considered such factors as the financial condition and the near term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, changes to the rating of the security by a rating agency and the historical volatility of the fair value of the security.

The qualitative analysis performed by the Company concluded that the unrealized losses recorded on the fixed maturity investment portfolio at June 30, 2009, 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.

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

FSP FAS 115-2/124-2 requires that the Company record, as of the beginning of the interim period of adoption, a cumulative effect adjustment to reclassify the noncredit component of a previously recognized OTTI from retained earnings to other comprehensive income (loss). The Company had one security for which an OTTI loss was previously recognized. For purposes of calculating the cumulative effect adjustment, the Company reviewed the OTTI it had recorded through realized losses on securities held at April 1, 2009, and estimated the portion related to credit losses (i.e., where the present value of cash flows expected to be collected are lower than the amortized cost basis of the security) and the portion related to all other factors. The Company determined that all of the OTTI previously recorded related to specific credit losses. At June 30, 2009 and December 31, 2008, there were no amounts included in accumulated other comprehensive income related to securities which were considered by the Company to be permanently impaired.

**Net Investment Income**

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The components of net investment income were as follows:

|  | Three Months Ended June 30, |           | Six Months Ended June 30, |           |
|--|-----------------------------|-----------|---------------------------|-----------|
|  | 2009                        | 2008      | 2009                      | 2008      |
| Interest and dividends on fixed maturities | \$ 10,935                   | \$ 11,178 | \$ 21,492                 | \$ 22,701 |
| Dividends on equity securities             | 32                          | 71        | 71                        | 122       |
| Interest on short term securities          | 27                          |           | 71                        |           |
| Interest on cash and cash equivalents      | 45                          | 291       | 151                       | 580       |
| Total investment income                    | 11,039                      | 11,540    | 21,785                    | 23,403    |
| Investment expenses                        | 333                         | 333       | 657                       | 668       |
| Net investment income                      | \$ 10,706                   | \$ 11,207 | \$ 21,128                 | \$ 22,735 |

### Fair Value Measurements

The Company adopted FAS157 on January 1, 2008. FAS 157 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 FAS 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly

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transaction between market participants (an exit price). The statement 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 FAS 157 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.

Management uses observable inputs for the vast majority of the Company s investment portfolio. Fair value measurements for securities for which quoted prices are unavailable are estimated based upon reference to observable inputs, such as benchmark interest rates, market comparables, broker quotes and other relevant inputs. In circumstances where quoted prices or observable inputs are adjusted to reflect management s best estimate of fair value, such fair value measurements are considered a lower level measurement in the FAS 157 fair value hierarchy.

Generally, management obtains a minimum of two quotes or prices per instrument. As of June 30, 2009 and December 31, 2008, no quotes or prices obtained were adjusted by management. All broker quotes obtained were non-binding.

As of June 30, 2009, approximately 99.8% of the investment portfolio recorded at fair value was priced based upon quoted market prices or other observable inputs. The following tables summarize our total fair value measurements and the fair value measurements based on Level 3 inputs for investments for the periods indicated.

|  | June 30, 2009 |                |                |                |
|--|---------------|----------------|----------------|----------------|
|  | Total         | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 314,920    | \$             | \$ 314,920     | \$             |

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|  |              |          |            |          |
|--|--------------|----------|------------|----------|
| Obligations of states and political subdivisions | 495,003      |          | 495,003    |          |
| Asset-backed securities                          | 85,938       |          | 84,096     | 1,842    |
| Corporate and other securities                   | 98,672       |          | 98,672     |          |
| Equity securities                                | 9,558        | 9,558    |            |          |
| Total investment securities                      | \$ 1,004,091 | \$ 9,558 | \$ 992,691 | \$ 1,842 |

|  | December 31, 2008 |                |                |                |
|--|-------------------|----------------|----------------|----------------|
|  | Total             | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 296,886        | \$             | \$ 296,886     | \$             |
| Obligations of states and political subdivisions                     | 501,621           |                | 501,621        |                |
| Asset-backed securities  | 60,534            |                | 58,692         | 1,842          |
| Corporate and other securities                                       | 61,130            |                | 61,130         |                |
| Equity securities  | 8,040             | 8,040          |                |                |
| Short term securities  | 82,928            |                | 82,928         |                |
| Total investment securities  | \$ 1,011,139      | \$ 8,040       | \$ 1,001,257   | \$ 1,842       |

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

The following table summarizes the changes in the Company's Level 3 fair value measurements for the three months ended June 30, 2009.

|   | <b>Asset Backed<br/>Securities</b> |
|---|------------------------------------|
| Balance at April 1, 2009  | \$ 1,842                           |
| Net gains and losses included in earnings   |                                    |
| Net gains included in other comprehensive income  |                                    |
| Purchases and sales   |                                    |
| Transfers in (out) of Level 3   |                                    |
| Balance at June 30, 2009  | \$ 1,842                           |
| Amount of total losses included in earnings attributable to the change in unrealized losses related to assets still held at June 30, 2009 | \$                                 |

The following table summarizes the changes in the Company's Level 3 fair value measurements for the six months ended June 30, 2009.

|   | <b>Asset Backed<br/>Securities</b> |
|---|------------------------------------|
| Balance at January 1, 2009  | \$ 1,842                           |
| Net gains and losses included in earnings   |                                    |
| Net gains included in other comprehensive income  |                                    |
| Purchases and sales   |                                    |
| Transfers in (out) of Level 3   |                                    |
| Balance at June 30, 2009  | \$ 1,842                           |
| Amount of total losses included in earnings attributable to the change in unrealized losses related to assets still held at June 30, 2009 | \$                                 |

On January 1 and June 30, 2009, one fixed maturity security was manually priced solely using broker quotes. This was deemed to render the fair value measurements as based upon unobservable inputs and accordingly, it was classified within Level 3. Transfers in and out of Level 3 would be attributable to changes in the ability to observe significant inputs in determining fair value exit pricing. As noted in the tables above, no transfers were made in or out of Level 3 inputs during the three and six months ended June 30, 2009.

Table of Contents**Safety Insurance Group, Inc. and Subsidiaries****Notes to Unaudited Consolidated Financial Statements****(Dollars in thousands except per share and share data)****6. Loss and Loss Adjustment Expense 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:

|  | <b>Six Months Ended June 30,</b> |             |
|--|----------------------------------|-------------|
|  | <b>2009</b>                      | <b>2008</b> |
| Reserves for losses and LAE at beginning of year       | \$ 467,559                       | \$ 477,720  |
| Less reinsurance recoverable on unpaid losses and LAE  | (76,489)                         | (84,290)    |
| Net reserves for losses and LAE at beginning of year   | 391,070                          | 393,430     |
| Incurring losses and LAE, related to:                  |                                  |             |
| Current year   | 197,421                          | 201,641     |
| Prior years  | (18,146)                         | (14,693)    |
| Total incurred losses and LAE                          | 179,275                          | 186,948     |
| Paid losses and LAE related to:                        |                                  |             |
| Current year   | 95,053                           | 94,503      |
| Prior years  | 93,367                           | 95,279      |
| Total paid losses and LAE                              | 188,420                          | 189,782     |
| Net reserves for losses and LAE at end of period       | 381,925                          | 390,596     |
| Plus reinsurance recoverables on unpaid losses and LAE | 69,034                           | 78,396      |
| Reserves for losses and LAE at end of period           | \$ 450,959                       | \$ 468,992  |

At the end of each period, the reserves were re-estimated for all prior accident years. The Company's prior year reserves decreased by \$18,146 and \$14,693 for the six months ended June 30, 2009 and 2008, respectively, and resulted from re-estimations of prior years ultimate loss and LAE liabilities. The decrease in prior years reserves during the 2009 period is primarily composed of reductions of \$7,958 in the Company's retained automobile reserves, \$6,324 in reserves assumed from Commonwealth Automobile Reinsurers (CAR), and \$2,729 in the Company's retained homeowners reserve. The decrease in prior year reserves during the 2008 period is primarily composed of reductions of \$9,588 in the Company's retained automobile reserves and \$4,294 in CAR assumed reserves.

The Company's private passenger automobile line of business prior year reserves decreased by \$11,654 for the six months ended June 30, 2009. The decrease was primarily due to improved retained private passenger results of \$4,735 for the accident years 2004 through 2008, and improved assumed CAR results for the private passenger automobile pool of \$5,046 for accident years 2005 through 2008. The Company's private passenger automobile line of business prior year reserves decreased by \$13,427 for the six months ended June 30, 2008. The decrease was primarily due to improved retained private passenger results of \$8,156 for accident years 2002 through 2006 and improved assumed CAR results for the private passenger automobile pool of \$3,858 for accident years 2004 through 2007. The improved CAR results were due primarily to improved CAR private passenger loss ratios as published and reported by the CAR Loss Reserving Committee. The improved retained private passenger results were primarily due to fewer incurred but not yet reported claims than previously estimated and better than previously estimated severity on the Company's established bodily injury and property damage case reserves.



Due to the nature of the risks that the Company underwrites and has historically underwritten, management does not believe that it has an exposure to asbestos or environmental pollution liabilities.

#### **7. Commitments and Contingencies**

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

Massachusetts law requires that insurers licensed to do business in Massachusetts participate in the Massachusetts Insurers Insolvency Fund ( Insolvency Fund ). Members of the Insolvency Fund are assessed a proportionate share of the obligations and

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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)**

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.

In addition, on November 21, 2008, the Massachusetts Office of the Attorney General (the "AG") delivered a civil investigative demand (the "CID") to Safety Insurance Company, one of the Company's operating subsidiaries. The CID directed the Company to produce certain information related to its policies and practices in connection with underwriting insurance policies on motorcycles and adjusting total loss claims under such policies. We understand that certain other insurance companies are also being investigated by the AG related to their policies and practices related to motorcycle insurance.

The focus of the AG's attention appears to be on the insured values determined by us for purposes of charging premiums for physical damage insurance coverage. In 2008, coverage for motorcycles represented 1.9% of the Company's total private passenger automobile insurance. The Company has been cooperating with the AG and responding to the CID and various related additional requests for information by the AG since that time.

In connection with the matters addressed by the CID, the AG delivered a letter to Safety Insurance Company dated February 2, 2009, in which the AG stated that it has reason to believe that Safety Insurance Company has violated the Massachusetts Consumer Protection Act, G.L. c. 93A, § 2, by engaging in unfair and deceptive acts and practices regarding motorcycle insurance. Specifically, the Attorney General has reason to believe that the Company overcharged its customers for motorcycle insurance and engaged in related unfair claims settlement practices. By issuing this letter the AG has met a statutory prerequisite to filing a civil complaint under the Massachusetts Consumer Protection Act against the Company.

The Company is engaged in ongoing discussions with the AG with respect to the matters raised in the February 2, 2009 letter. In view of the uncertainties involved in this matter and its early stage, management is unable to predict the outcome of this matter and has not established any reserve in connection with it.

**8. Debt**

On August 14, 2008, we entered into an Amended and Restated Revolving Credit Agreement (the "New Credit Agreement") with RBS Citizens, NA ( "RBS Citizens"). The New Credit Agreement amended and restated the terms of our existing Revolving Credit Agreement with RBS Citizens prior to its expiration date of August 17, 2008. The New Credit Agreement extends the maturity date to August 14, 2013 and provides a \$30,000 revolving credit facility with an accordion feature allowing for future expansion of the committed amount up to \$50,000. Loans under the credit facility bear interest at the Company's option at either (i) the LIBOR rate plus 1.25% per annum or (ii) the higher of RBS Citizens prime rate or

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0.5% above the federal funds rate plus 1.25% per annum. Interest only is payable prior to maturity.

The Company's obligations under the credit facility are secured by pledges of its assets and the capital stock of its operating subsidiaries. The credit facility is guaranteed by the Company's non-insurance company subsidiaries. The credit facility contains covenants including requirements to maintain minimum risk based capital ratios and statutory surplus of Safety Insurance Company as well as limitations or restrictions on indebtedness, liens, and other matters. Among other covenants, the credit facility restricts the Company's payment of dividends (i) if a default under the credit facility is continuing or would result therefrom or (ii) in an amount in excess of 50% of the Company's prior year's net income, as determined in accordance with GAAP. As of June 30, 2009, the Company was in compliance with all such covenants. In addition, the credit facility includes customary events of default, including a cross-default provision permitting the lenders to accelerate the facility if the Company (i) defaults in any payment obligation under debt having a principal amount in excess of \$10,000 or (ii) fails to perform any other covenant permitting acceleration of all such debt.

The Company had no amounts outstanding on its credit facility at June 30, 2009 and December 31, 2008. 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, 2009 and 2008.

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**Safety Insurance Group, Inc. and Subsidiaries**

**Notes to Unaudited Consolidated Financial Statements**

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

**9. Income Taxes**

Federal income tax expense for the three and six months ended June 30, 2009 and 2008 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 FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes-an Interpretation of FASB Statement 109* ( 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 have a more likely than not chance 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. The Company believes that the positions taken on its income tax returns for open tax years will be sustained upon examination by the Internal Revenue Service. Therefore, the Company has not recorded a liability under FIN 48.

During the three and six months ended June 30, 2009, there were no material changes to the amount of the Company's unrecognized tax benefits or to any assumptions regarding the amount of its FIN 48 liability.

As of June 30, 2009 and December 31, 2008, the Company was no longer subject to examination of its U.S. federal tax returns for years prior to 2005. The Company is not currently under examination by the Internal Revenue Service. During the three months ended June 30, 2009, the Massachusetts Department of Revenue concluded its review of the 2005 and 2006 tax periods. The resulting audit adjustments were immaterial to the Company's financial position.

**10. Share Repurchase Program**

On August 3, 2007, the Board of Directors approved a share repurchase program of up to \$30,000 of the Company's outstanding common shares. On March 24, 2009, the Board of Directors increased this existing share repurchase program by authorizing repurchase of up to \$60,000 of the Company's outstanding common shares. Under the program, the Company may repurchase shares of its common stock for cash in public or private transactions, in the open market or otherwise, 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 the Company to repurchase any specific number of shares and may be modified, suspended or terminated at any time without prior notice.

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During the six months ended June 30, 2009, the Company purchased 1,028,536 of its common shares on the open market under the program at a cost of \$32,433. During July 2009, purchases of 10,005 of the Company's common shares were made at a cost of \$300. At December 31, 2008, we had purchased 232,013 of our common shares on the open market under the program at a cost of \$7,516.

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**Item 2.**

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

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

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

**Executive Summary and Overview**

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

We are a leading provider of private passenger automobile insurance in Massachusetts. In addition to private passenger automobile insurance (which represented 71.7% of our direct written premiums in 2008), we offer a portfolio of other insurance products, including commercial automobile (13.2% of 2008 direct written premiums), homeowners (11.6% of 2008 direct written premiums), dwelling fire, umbrella and business owner policies (totaling 3.5% of 2008 direct written premiums). Operating virtually exclusively in Massachusetts through our insurance company subsidiaries, Safety Insurance, Safety Indemnity, and Safety P&C, (together referred to as the Insurance Subsidiaries ), we have established strong relationships with 827 independent insurance agents in 969 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 11.5% and 12.3% share, respectively, of the Massachusetts private passenger and commercial automobile markets in 2009, according to the Commonwealth Automobile Reinsurers ( CAR ) Cession Volume Analysis Report of July 22, 2009, 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.

Our Insurance Subsidiaries began writing private passenger automobile and homeowners insurance in New Hampshire on October 15, 2008. For the six months ended June 30, 2009, we wrote approximately 420 policies and \$355 in direct written premiums in New Hampshire.

*Massachusetts Automobile Insurance Market*

We have been subject to extensive regulation in the private passenger automobile insurance industry in Massachusetts, which represented 71.7% of our direct written premiums in 2008. Owners of registered automobiles in Massachusetts are required to maintain minimum automobile insurance coverage. Prior to April 1, 2008, the Commissioner of Insurance (the Commissioner) had fixed and established the maximum rates that could be charged for private passenger automobile insurance. Prior to April 1, 2008, as a servicing carrier of CAR, we were required to issue a policy to all qualified applicants. CAR 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, prior to April 1, 2009 we had been assigned certain licensed producers by CAR that were 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 changed how private passenger automobile insurance is regulated in Massachusetts. In the first decision, the Commissioner approved and set a time table for the

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implementation of new CAR rules pursuant to which the current reinsurance program run by CAR has been replaced with an assigned risk plan, the Massachusetts Automobile Insurance Plan ( MAIP ). Under these new rules, as of April 1, 2009 we no longer are assigned ERPs whose business we must insure (subject to the option of ceding it to CAR) and instead, we are assigned individual policies by CAR. The MAIP began with business effective on or after April 1, 2008 for new business and those risks that have 10 or more Safe Driver Points. Beginning April 1, 2009, all business was eligible for MAIP except those risks that have no violations or accidents in the preceding three year period (so called Clean in three risks). The last policy effective date on which any risk can be ceded to CAR in accordance with the current reinsurance program was 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.

In the second decision referenced above, the Commissioner announced that she would 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 would institute a system that introduces competitive pricing to the Massachusetts private passenger automobile insurance market, which the Commissioner has described as managed competition ( Managed Competition ). On October 5, 2007, the Commissioner issued a Competitive Rating Regulation; 211 CMR 79.00: Private Passenger Motor Vehicle Insurance Rates that describes the technical details of Managed Competition (the Regulation ). The Regulation governs the rate filing that an insurer can file.

In addition, the Regulation prohibits the following rating and underwriting factors:

- *Rating Factors:* Insurers are prohibited from using credit information, sex, marital status, race, creed, national origin, religion, occupation, income, education, home ownership and age (except to produce the reduction in rates for insureds age 65 and over).
- *Underwriting Factors:* Insurers are prohibited from refusing to issue or renew a private passenger auto insurance policy based on credit information, sex, marital status, race, creed, national origin, religion, age, occupation, income, principal place of garaging, education and home ownership.

The Commissioner has issued a number of bulletins addressing issues related to the implementation of Managed Competition (the Rating Bulletins ). Rating Bulletin 2008-11 limits voluntary market rates to a level no higher than the rates in the residual market. Rating Bulletin 2008-17 describes how companies may place risks among company affiliates within an insurer group.

We are not able at this time to determine what effect these bulletins will have on our business over the long term.

CAR runs a reinsurance pool for commercial automobile policies and beginning January 1, 2006, CAR implemented a Limited Servicing Carrier Program ( LSC ) for ceded commercial automobile policies. CAR approved Safety Insurance and five other servicing carriers through a Request



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for Proposal to process ceded commercial automobile business, which is 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 the Commissioner's review, CAR sets the premium rates for commercial automobile policies reinsured through CAR and this reinsurance pool can generate an underwriting result that is a profit or deficit based upon CAR's rate level. This underwriting result is allocated among every Massachusetts commercial automobile insurance company, including us, based on a company's commercial automobile voluntary market share.

CAR also runs a reinsurance pool for Taxi, Limousine and Car Service risks (the Taxi/Limo Program). On April 25, 2007, Safety 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.

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 which agents receive for selling private passenger automobile insurance, as a percentage of premiums, compared to a commission rate of 11.8% in 2006.

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Under Managed Competition, we decreased our rates an average 6.7% in 2008. We have filed and been approved for modifications in our rates effective April 1, 2009 that are expected to result in no change in our average total rates. We will also begin using three rating tiers effective April 1, 2009. A Companion Policy Client Tier, which is policyholders that have a non private passenger automobile policy with us will receive a rate decrease of 2.5%. A Loyal Automobile Client Tier, which is policyholders who have been insured with Safety two or more years, will see no rate change. A New Insurance Client Tier, which is policyholders that do not qualify for the other two tiers, will have a rate increase of 2.5%. Our rates include a 13.0% commission rate for agents.

For the six months ended June 30, 2009, our average private passenger automobile premium per exposure decreased by 7.4% from the six months ended June 30, 2008. The table below shows the filed and approved average Massachusetts private passenger automobile premium rate changes and the resulting changes in our average premium per automobile exposure. The 7.4% decrease in average premium per personal automobile exposure is the result of our rounded account pricing strategy introduced under Managed Competition that began April 1, 2008, which has favorable pricing for policyholders that insure an automobile and home with us, and unfavorable pricing for stand-alone automobile policies. More automobile policyholders than we originally estimated have insured both their automobile and home with us, and thus are eligible for our account discount of 10%.

**Massachusetts Private Passenger Automobile Rates**

| Year        | Average Rate Change (1) | Safety Change in Average Premium per Automobile Exposure (2) |
|-------------|-------------------------|--|
| <b>2009</b> | <b>0.0%</b>             | <b>(7.4)%</b>  |
| 2008        | (6.7)%                  | (7.9)%   |
| 2007        | (11.7)%                 | (5.5)%   |
| 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%  |

(1) Source: Commissioner rate decisions for 1998 – 2007, and Safety Insurance for 2008 and 2009. The 11.7% average rate decrease in 2007 was in effect for the period April 1, 2007 through March 31, 2008. Under Managed Competition, the 6.7% average rate decrease in 2008 was effective for the period April 1, 2008 through March 31, 2009.

(2) Source: Safety Insurance.

*Statutory Accounting Principles*

Our results are reported in accordance with 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 ninety 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 of 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 fair 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.
- 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

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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, |       | Six Months Ended June 30, |       |
|--------------------------|-----------------------------|-------|---------------------------|-------|
|                          | 2009                        | 2008  | 2009                      | 2008  |
| <b>Statutory Ratios:</b> |                             |       |                           |       |
| Loss Ratio               | <b>65.8%</b>                | 62.0% | <b>67.2%</b>              | 62.8% |
| Expense Ratio            | <b>29.2%</b>                | 30.4% | <b>29.4%</b>              | 29.3% |
| Combined Ratio           | <b>95.0%</b>                | 92.4% | <b>96.6%</b>              | 92.1% |

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, |       | Six Months Ended June 30, |       |
|---------------------|-----------------------------|-------|---------------------------|-------|
|                     | 2009                        | 2008  | 2009                      | 2008  |
| <b>GAAP Ratios:</b> |                             |       |                           |       |
| Loss Ratio          | <b>65.8%</b>                | 62.0% | <b>67.2%</b>              | 62.8% |
| Expense Ratio       | <b>30.1%</b>                | 30.3% | <b>30.2%</b>              | 29.9% |
| Combined Ratio      | <b>95.9%</b>                | 92.3% | <b>97.4%</b>              | 92.7% |

*Stock-Based Compensation*

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Long-term incentive compensation is provided under the our 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.

The maximum number of shares of common stock with respect to which awards may be granted 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, 2009, there were 920,434 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, 2009 is as follows:

| Type of Equity Awarded | Effective Date        | Number of Awards Granted | Fair Value per Share (1) | Vesting Terms                |
|------------------------|-----------------------|--------------------------|--------------------------|------------------------------|
| <b>RS</b>              | <b>March 9, 2009</b>  | <b>95,953</b>            | <b>\$ 28.66</b>          | <b>3 years, 30%-30%-40%</b>  |
| <b>RS</b>              | <b>March 9, 2009</b>  | <b>4,000</b>             | <b>\$ 28.66</b>          | <b>No vesting period (2)</b> |
| <b>RS</b>              | <b>March 19, 2009</b> | <b>38,046</b>            | <b>\$ 33.24</b>          | <b>5 years, 20% annually</b> |

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

(2) The shares cannot be sold, assigned, pledged, or otherwise transferred, encumbered or disposed of until the recipient is no longer a member of our 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, the reinsurance market has seen from the various software modelers, increases in the estimate of damage from hurricanes in the southern and northeast portions of the United States due to revised estimations of increased hurricane activity and increases in the estimation of demand surge in the periods following a significant event. We continue to adjust our reinsurance programs as a result of the changes to the models. As of January 1 2009, our catastrophe reinsurance provides gross per occurrence reinsurance coverage up to \$350,000. As a result of the changes to the models, and our revised reinsurance program, our catastrophe reinsurance protects us in the event of a 140-year storm (that is, a storm of a severity expected to occur once in a 140-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 PARIS RE which is 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 increased and as a result, the FAIR Plan decided to buy reinsurance to reduce their exposure to catastrophe losses. On July 1, 2009, the FAIR Plan purchased \$1,100,000 of catastrophe reinsurance for property losses in excess of \$180,000. At June 30, 2009, 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

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

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



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accident. Projected ultimate bodily injury claims are then segregated into expected claims by type of injury (e.g. soft tissue injury vs. hard tissue injury) based on past experience. An ultimate severity, or average paid loss amounts, is estimated based upon extrapolating historic trends. Projected ultimate loss estimates using this method are the aggregate of estimated losses by injury type.

Such techniques assume that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting our ultimate losses, total reserves and resulting IBNR reserves. It is possible that the final outcome may fall above or below these amounts as a result of a number of factors, including immature data, sparse data, or significant growth in a line of business. Using these methodologies our actuaries established a range of reasonably possible estimations for net reserves of approximately \$338,104 to \$385,766 as of June 30, 2009. 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 our actuaries was \$381,925 as of June 30, 2009.

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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, 2009.

| Line of Business             | Low               | Recorded          | High              |
|------------------------------|-------------------|-------------------|-------------------|
| Private passenger automobile | \$ 230,530        | \$ 263,828        | \$ 264,493        |
| Commercial automobile        | 53,298            | 57,140            | 57,507            |
| Homeowners                   | 37,938            | 41,181            | 42,808            |
| All other                    | 16,338            | 19,776            | 20,958            |
| <b>Total</b>                 | <b>\$ 338,104</b> | <b>\$ 381,925</b> | <b>\$ 385,766</b> |

The following table presents our total net reserves and the corresponding case reserves and IBNR reserves by line of business as of June 30, 2009.

| Line of Business                             | Case              | IBNR             | Total             |
|--|-------------------|------------------|-------------------|
| Private passenger automobile                 | \$ 215,654        | \$ 18,296        | \$ 233,950        |
| CAR assumed private passenger auto           | 20,106            | 9,772            | 29,878            |
| Commercial automobile                        | 34,293            | 6,839            | 41,132            |
| CAR assumed commercial automobile            | 8,886             | 7,122            | 16,008            |
| Homeowners                                   | 16,802            | 9,002            | 25,804            |
| FAIR Plan assumed homeowners                 | 6,077             | 9,300            | 15,377            |
| All other                                    | 9,682             | 10,094           | 19,776            |
| <b>Total net reserves for losses and LAE</b> | <b>\$ 311,500</b> | <b>\$ 70,425</b> | <b>\$ 381,925</b> |

For our private passenger automobile, commercial automobile and homeowners lines of business as of June 30, 2009, 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 our all other lines of business as of June 30, 2009, 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. We have recorded reserves closer to the high in the ranges of our projections.

Our IBNR reserves for CAR assumed private passenger and commercial automobile business are 32.7% and 44.5% respectively of our total reserves for CAR assumed private passenger and commercial automobile business as of June 30, 2009 due to the reporting delays in the information we receive from CAR, as described further in the section on *CAR Loss and Loss Adjustment Expense Reserves*.

The following table presents information by line of business for our total net reserves and the corresponding retained (i.e. direct less ceded) reserves and assumed reserves as of June 30, 2009.

| Line of Business                         | Retained   | Assumed   | Net               |
|--|------------|-----------|-------------------|
| Private passenger automobile             | \$ 233,950 |           |                   |
| CAR assumed private passenger automobile |            | \$ 29,878 |                   |
| <b>Net private passenger automobile</b>  |            |           | <b>\$ 263,828</b> |
| Commercial automobile                    | 41,132     |           |                   |
| CAR assumed commercial automobile        |            | 16,008    |                   |

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|                                       |               |                |               |                |
|---------------------------------------|---------------|----------------|---------------|----------------|
| Net commercial automobile             |               |                |               | <b>57,140</b>  |
| Homeowners                            | <b>25,804</b> |                |               |                |
| FAIR Plan assumed homeowners          |               |                | <b>15,377</b> |                |
| Net homeowners                        |               |                |               | <b>41,181</b>  |
| All other                             | <b>19,776</b> |                |               | <b>19,776</b>  |
| Total net reserves for losses and LAE | \$            | <b>320,662</b> | \$            | <b>61,263</b>  |
|                                       |               |                | \$            | <b>381,925</b> |

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*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 premium ceded to CAR less CAR losses and LAE, 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 under-priced 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, 2008, we had nine months of reported 2008 CAR financial data, and we had to estimate and record as IBNR reserves 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, 2007, we had to estimate our 2007 policy year CAR Participation Ratio beginning with the first quarter of 2007 through the second quarter of 2008.

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 for which we have to estimate our Participation Ratio and these reserves are subject to significant judgments and estimates.

The portion of reserves based upon CAR estimates for private passenger automobile line of business has declined over time as a result of the institution of the MAIP and phase-out of the private passenger automobile CAR reinsurance pool, as described elsewhere in this report.

*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, 2009, a 1 percentage-point change in the loss and LAE ratio would result in a change in reserves of \$2,667. Each 1 percentage-point change in the loss and loss expense ratio would have had a \$1,733 effect on net income, or \$0.11 per diluted share.

Our assumptions consider that past experience, adjusted for the effects of current developments and anticipated trends, are an appropriate basis for establishing our reserves. Our individual key assumptions could each have a reasonable possible

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range of plus or minus 5 percentage-points for each estimation, although there is no guarantee that our assumptions will not have more than a 5 percentage point variation. The following sensitivity tables present information for each of our primary lines of business on the effect each 1 percentage-point change in each of our key assumptions on unpaid frequency and severity could have on our retained (i.e., direct minus ceded) loss and LAE reserves and net income for the six months ended June 30, 2009. 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<br>Change in<br>Frequency | No<br>Change in<br>Frequency | +1 Percent<br>Change in<br>Frequency |
|--|--------------------------------------|------------------------------|--------------------------------------|
| <b>Private passenger automobile retained loss and LAE reserves</b> |                                      |                              |                                      |
| -1 Percent Change in Severity                                      |                                      |                              |                                      |
| Estimated decrease in reserves                                     | \$ (4,679)                           | \$ (2,340)                   | \$                                   |
| Estimated increase in net income                                   | 3,041                                | 1,521                        |                                      |
| No Change in Severity  |                                      |                              |                                      |
| Estimated (decrease) increase in reserves                          | (2,340)                              |                              | 2,340                                |
| Estimated increase (decrease) in net income                        | 1,521                                |                              | (1,521)                              |
| +1 Percent Change in Severity                                      |                                      |                              |                                      |
| Estimated increase in reserves                                     |                                      | 2,340                        | 4,679                                |
| Estimated decrease in net income                                   |                                      | (1,521)                      | (3,041)                              |
| <b>Commercial automobile retained loss and LAE reserves</b>        |                                      |                              |                                      |
| -1 Percent Change in Severity                                      |                                      |                              |                                      |
| Estimated decrease in reserves                                     | (823)                                | (411)                        |                                      |
| Estimated increase in net income                                   | 535                                  | 267                          |                                      |
| No Change in Severity  |                                      |                              |                                      |
| Estimated (decrease) increase in reserves                          | (411)                                |                              | 411                                  |
| Estimated increase (decrease) in net income                        | 267                                  |                              | (267)                                |
| +1 Percent Change in Severity                                      |                                      |                              |                                      |
| Estimated increase in reserves                                     |                                      | 411                          | 823                                  |
| Estimated decrease in net income                                   |                                      | (267)                        | (535)                                |
| <b>Homeowners retained loss and LAE reserves</b>                   |                                      |                              |                                      |
| -1 Percent Change in Severity                                      |                                      |                              |                                      |
| Estimated decrease in reserves                                     | (516)                                | (258)                        |                                      |
| Estimated increase in net income                                   | 335                                  | 168                          |                                      |
| No Change in Severity  |                                      |                              |                                      |
| Estimated (decrease) increase in reserves                          | (258)                                |                              | 258                                  |
| Estimated increase (decrease) in net income                        | 168                                  |                              | (168)                                |
| +1 Percent Change in Severity                                      |                                      |                              |                                      |
| Estimated increase in reserves                                     |                                      | 258                          | 516                                  |
| Estimated decrease in net income                                   |                                      | (168)                        | (335)                                |
| <b>All other retained loss and LAE reserves</b>                    |                                      |                              |                                      |
| -1 Percent Change in Severity                                      |                                      |                              |                                      |
| Estimated decrease in reserves                                     | (396)                                | (198)                        |                                      |
| Estimated increase in net income                                   | 257                                  | 129                          |                                      |
| No Change in Severity  |                                      |                              |                                      |
| Estimated (decrease) increase in reserves                          | (198)                                |                              | 198                                  |
| Estimated increase (decrease) in net income                        | 129                                  |                              | (129)                                |
| +1 Percent Change in Severity                                      |                                      |                              |                                      |
| Estimated increase in reserves                                     |                                      | 198                          | 396                                  |
| Estimated decrease in net income                                   |                                      | (129)                        | (257)                                |





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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 of the effect each 1 percentage-point change in our assumptions on our share of reserves for CAR and other residual markets could have on our assumed loss and LAE reserves and net income for the six months ended June 30, 2009. 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<br>Change in<br>Estimation | +1 Percent<br>Change in<br>Estimation |
|---|---------------------------------------|---------------------------------------|
| <b>CAR assumed private passenger automobile</b> |                                       |                                       |
| Estimated (decrease) increase in reserves       | \$ (299)                              | \$ 299                                |
| Estimated increase (decrease) in net income     | 194                                   | (194)                                 |
| <b>CAR assumed commercial automobile</b>        |                                       |                                       |
| Estimated (decrease) increase in reserves       | (160)                                 | 160                                   |
| Estimated increase (decrease) in net income     | 104                                   | (104)                                 |
| <b>FAIR Plan assumed homeowners</b>             |                                       |                                       |
| Estimated (decrease) increase in reserves       | (154)                                 | 154                                   |
| Estimated increase (decrease) in net income     | 100                                   | (100)                                 |

### *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 \$18,146, and \$14,693 for the six months ended June 30, 2009 and 2008, 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, 2009 and 2008. Each accident year represents all claims for an annual accounting period in which loss events occurred, regardless of when the losses are actually reported, booked or paid. Our financial statements reflect the aggregate results of the current and all prior accident years.

| Accident<br>Year | Six Months Ended June 30, |          |
|------------------|---------------------------|----------|
|                  | 2009                      | 2008     |
| 1999 & prior     | \$ (237)                  | \$ (146) |
| 2000             | (193)                     | (310)    |
| 2001             | (818)                     | (647)    |
| 2002             | (842)                     | (1,334)  |
| 2003             | (600)                     | (1,399)  |
| 2004             | (1,851)                   | (2,775)  |
| 2005             | (3,534)                   | (3,510)  |
| 2006             | (3,023)                   | (2,442)  |
| 2007             | (2,465)                   | (2,130)  |

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|                 |    |          |    |          |
|-----------------|----|----------|----|----------|
| 2008            |    | (4,583)  |    |          |
| All prior years | \$ | (18,146) | \$ | (14,693) |

The decreases in prior years reserves during the six months ended June 30, 2009 and 2008 resulted from re-estimations of prior year ultimate loss and LAE liabilities. The 2009 decrease is primarily composed of reductions of \$7,958 in our retained automobile reserves, \$2,729 in our retained homeowners reserves and \$6,324 in CAR assumed reserves. The 2008 decrease is primarily composed of reductions of \$9,588 in our retained automobile reserves and \$4,294 in CAR assumed 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, 2009.

| Accident Year   | Private Passenger<br>Automobile | Commercial<br>Automobile | Homeowners | Total       |
|-----------------|---------------------------------|--------------------------|------------|-------------|
| 1999 & prior    | \$ (236)                        | \$ (1)                   | \$         | (237)       |
| 2000            | (193)                           |                          |            | (193)       |
| 2001            | (373)                           | (149)                    | (296)      | (818)       |
| 2002            | (494)                           | (193)                    | (155)      | (842)       |
| 2003            | (343)                           | (59)                     | (198)      | (600)       |
| 2004            | (1,157)                         | (351)                    | (343)      | (1,851)     |
| 2005            | (2,380)                         | (520)                    | (634)      | (3,534)     |
| 2006            | (1,777)                         | (603)                    | (643)      | (3,023)     |
| 2007            | (1,292)                         | (440)                    | (733)      | (2,465)     |
| 2008            | (3,409)                         | (312)                    | (862)      | (4,583)     |
| All prior years | \$ (11,654)                     | \$ (2,628)               | \$ (3,864) | \$ (18,146) |

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, 2009; that is, all our reserves except for business ceded or assumed from CAR and other residual markets.

| Accident Year   | Retained<br>Private Passenger<br>Automobile | Retained<br>Commercial<br>Automobile | Retained<br>Homeowners | Total       |
|-----------------|---|--------------------------------------|------------------------|-------------|
| 1999 & prior    | \$ (236)                                    | \$ (1)                               | \$                     | (237)       |
| 2000            | (193)                                       |                                      |                        | (193)       |
| 2001            | (321)                                       | (145)                                | (296)                  | (762)       |
| 2002            | (335)                                       | (189)                                | (155)                  | (679)       |
| 2003            | (166)                                       | (81)                                 | (198)                  | (445)       |
| 2004            | (923)                                       | (496)                                | (343)                  | (1,762)     |
| 2005            | (1,753)                                     | (600)                                | (634)                  | (2,987)     |
| 2006            | (1,127)                                     | (464)                                | (617)                  | (2,208)     |
| 2007            | (436)                                       | 1                                    | (486)                  | (921)       |
| 2008            | (496)                                       | 3                                    |                        | (493)       |
| All prior years | \$ (5,986)                                  | \$ (1,972)                           | \$ (2,729)             | \$ (10,687) |

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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, 2009.

| Accident Year   | CAR Assumed<br>Private Passenger<br>Automobile | CAR Assumed<br>Commercial<br>Automobile | FAIR Plan<br>Homeowners | Total      |
|-----------------|--|---|-------------------------|------------|
| 1999 & prior    | \$   | \$                                      | \$                      | \$         |
| 2000            |  |   |                         |            |
| 2001            | (52)   | (4)                                     |                         | (56)       |
| 2002            | (159)  | (4)                                     |                         | (163)      |
| 2003            | (177)  | 22                                      |                         | (155)      |
| 2004            | (234)  | 145                                     |                         | (89)       |
| 2005            | (627)  | 80                                      |                         | (547)      |
| 2006            | (650)  | (139)                                   | (26)                    | (815)      |
| 2007            | (856)  | (441)                                   | (247)                   | (1,544)    |
| 2008            | (2,913)  | (315)                                   | (862)                   | (4,090)    |
| All prior years | \$ (5,668)                                     | \$ (656)                                | \$ (1,135)              | \$ (7,459) |

Our private passenger automobile line of business prior year reserves decreased by \$11,654 for the six months ended June 30, 2009. The decrease was primarily due to improved retained private passenger results of \$4,735 for the accident years 2004 through 2008, and improved assumed CAR results for the private passenger automobile pool of \$5,046 for accident years 2005 through 2008. The improved CAR results were due primarily to improved CAR private passenger loss ratios as published and reported by the CAR Loss Reserving Committee. The improved retained private passenger results were primarily due to fewer IBNR claims than previously estimated and better than previously estimated severity on our established bodily injury and property damage case reserves.

Our commercial automobile line of business prior year reserves decreased by \$2,628 for the six months ended June 30, 2009 due primarily to fewer IBNR claims than previously estimated.

Our retained homeowners line of business prior year reserves decreased by \$2,729 for the six months ended June 30, 2009. Our FAIR Plan homeowners reserve decreased by \$1,135 for the six months ended June 30, 2009.

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 Enterprise* 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*.

Table of Contents**Results of Operations****Three and Six Months Ended June 30, 2009 Compared to Three and Six Months Ended June 30, 2008**

The following table shows certain of our selected financial results.

|  | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|--|-----------------------------|------------|---------------------------|------------|
|  | 2009                        | 2008       | 2009                      | 2008       |
| Direct written premiums                      | \$ 149,582                  | \$ 151,774 | \$ 295,059                | \$ 320,118 |
| Net written premiums                         | \$ 140,961                  | \$ 148,272 | \$ 281,916                | \$ 312,519 |
| Net earned premiums                          | \$ 131,306                  | \$ 147,002 | \$ 266,656                | \$ 297,750 |
| Investment income                            | 10,706                      | 11,207     | 21,128                    | 22,735     |
| Net realized gains (losses) on investments   | 1                           | 2,072      | (317)                     | 2,103      |
| Finance and other service income             | 4,293                       | 4,515      | 8,381                     | 9,013      |
| Total revenue                                | 146,306                     | 164,796    | 295,848                   | 331,601    |
| Loss and loss adjustment expenses            | 86,393                      | 91,078     | 179,275                   | 186,948    |
| Underwriting, operating and related expenses | 39,548                      | 44,474     | 80,620                    | 88,939     |
| Interest expenses                            | 21                          | 18         | 43                        | 37         |
| Total expenses                               | 125,962                     | 135,570    | 259,938                   | 275,924    |
| Income before income taxes                   | 20,344                      | 29,226     | 35,910                    | 55,677     |
| Income tax expense                           | 5,329                       | 8,295      | 9,051                     | 15,701     |
| Net income                                   | \$ 15,015                   | \$ 20,931  | \$ 26,859                 | \$ 39,976  |
| Earnings per weighted average common share:  |                             |            |                           |            |
| Basic  | \$ 0.96                     | \$ 1.29    | \$ 1.69                   | \$ 2.46    |
| Diluted                                      | \$ 0.96                     | \$ 1.28    | \$ 1.69                   | \$ 2.45    |
| Cash dividends paid per common share         | \$ 0.40                     | \$ 0.40    | \$ 0.80                   | \$ 0.80    |

*Direct Written Premiums.* Direct written premiums for the quarter ended June 30, 2009, decreased by \$2,192, or 1.4% to \$149,582 from \$151,774 for the comparable 2008 period. Direct written premiums for the six months ended June 30, 2009 decreased by \$25,059 or 7.8% to \$295,059 from \$320,118 for the comparable 2008 period. The 2009 decrease occurred primarily in our personal and commercial automobile lines, which experienced decreases of 7.4% and 7.3%, respectively, in average written premium per exposure and decreases of 3.9% and 7.0%, respectively, in written exposures. The decrease in our personal automobile line was primarily a result of rate decreases totaling 6.7% which we filed under the competitive pricing system introduced to the private passenger automobile market in Massachusetts beginning April 1, 2008. Partially offsetting these decreases, our homeowners line average written premium per exposure increased by 3.4% with a 16.4% increase in written exposures. The 3.9% decrease in personal automobile exposures and 16.4% increase in homeowners exposures is the result of our rounded account pricing strategy under managed competition that began April 1, 2008, which has favorable pricing for policyholders that insure an automobile and home with us, and unfavorable pricing for stand-alone automobile policies.

*Net Written Premiums.* Net written premiums for the quarter ended June 30, 2009, decreased by \$7,311 or 4.9% to \$140,961 from \$148,272 for the comparable 2008 period. Net written premiums for the six months ended June 30, 2009 decreased by \$30,603 or 9.8% to \$281,916 from \$312,519 for the comparable 2008 period. This decrease was due to the factors that decreased direct written premiums combined with decreases in premiums assumed from CAR, and partially offset by decreases in premiums ceded to CAR. Written premiums assumed and ceded to CAR decreased as a result of the phase-out of the CAR personal automobile reinsurance pool, which was replaced by an assigned risk plan, the MAIP. Beginning with policy effective dates after March 31, 2009, all personal automobile business was eligible for MAIP and could no longer be ceded to CAR.

*Net Earned Premiums.* Net earned premiums for the quarter ended June 30, 2009, decreased by \$15,696 or 10.7%, to \$131,306 from \$147,002 for the comparable 2008 period. Net earned premiums for the six months ended June 30, 2008 decreased by \$31,094 or 10.4% to \$266,656 from \$297,750 for the comparable 2008 period. This decrease was due to the factors that decreased direct and net written premiums.

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

|                         | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|-------------------------|-----------------------------|------------|---------------------------|------------|
|                         | 2009                        | 2008       | 2009                      | 2008       |
| <b>Written Premiums</b> |                             |            |                           |            |
| Direct                  | \$ 149,582                  | \$ 151,774 | \$ 295,059                | \$ 320,118 |
| Assumed                 | 454                         | 10,402     | 9,388                     | 24,992     |
| Ceded                   | (9,075)                     | (13,904)   | (22,531)                  | (32,591)   |
| Net written premiums    | \$ 140,961                  | \$ 148,272 | \$ 281,916                | \$ 312,519 |
| <b>Earned Premiums</b>  |                             |            |                           |            |
| Direct                  | \$ 138,050                  | \$ 151,001 | \$ 276,709                | \$ 302,717 |
| Assumed                 | 6,035                       | 12,745     | 16,599                    | 28,995     |
| Ceded                   | (12,779)                    | (16,744)   | (26,652)                  | (33,962)   |
| Net earned premiums     | \$ 131,306                  | \$ 147,002 | \$ 266,656                | \$ 297,750 |

*Net Investment Income.* Net investment income for the quarter ended June 30, 2009, was \$10,706 compared to \$11,207 for the comparable 2008 period, a decrease of 4.5%. Net investment income for the six months ended June 30, 2009 was \$21,128 compared to \$22,735 for the comparable 2008 period. Average cash and investment securities (at cost) increased by \$10,137, or 1.0%, to \$1,059,515 for the six months ended June 30, 2009, from \$1,049,378 for the comparable 2008 period. Net effective annualized yield on the investment portfolio decreased to 4.0% during the six months ended June 30, 2009, from 4.3% during the comparable 2008 period. Our duration increased to 3.3 years at June 30, 2009, up from 3.2 years at December 31, 2008.

*Net Realized Gains(Losses) on Investments.* Net realized gains on investments were \$1 for the quarter ended June 30, 2009, compared to net realized gains of \$2,072 for the comparable 2008 period. Net realized losses on investments were \$317 for the six months ended June 30, 2009 compared to net realized gains on investments of \$2,103 for the comparable 2008 period.

The gross unrealized gains and losses on investments in fixed maturity securities and equity securities, including interests in mutual funds, were as follows:

|   | Cost or Amortized Cost | Gross Unrealized Gains | June 30, 2009<br>Gross Unrealized Losses (3) |                        | Estimated Fair Value |
|---|------------------------|------------------------|--|------------------------|----------------------|
|   |                        |                        | Non-OTTI Unrealized Losses                   | OTTI Unrealized Losses |                      |
| U.S. Treasury securities and obligations of U.S. Government agencies(1) | \$ 304,898             | \$ 10,229              | \$ (207)                                     | \$                     | \$ 314,920           |
| Obligations of states and political subdivisions                        | 484,852                | 12,751                 | (2,600)                                      |                        | 495,003              |
| Asset-backed securities (1)   | 94,734                 | 483                    | (9,279)                                      |                        | 85,938               |
| Corporate and other securities  | 97,815                 | 2,233                  | (1,376)                                      |                        | 98,672               |
| Subtotal, fixed maturity securities                                     | 982,299                | 25,696                 | (13,462)                                     |                        | 994,533              |
| Equity securities (2)   | 9,569                  | 29                     | (40)   |                        | 9,558                |
| Totals  | \$ 991,868             | \$ 25,725              | \$ (13,502)                                  | \$                     | \$ 1,004,091         |



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(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 \$292,932 at amortized cost and \$302,893 at fair value as of June 30, 2009. As such, the asset-backed securities presented exclude such issuers already presented under U.S. Treasury securities and obligations of U.S. Government Agencies.

(2) Equity securities consist solely of interests in mutual funds held to fund the Company's executive deferred compensation plan.

(3) The Company's investment portfolio included 109 securities in an unrealized loss position at June 30, 2009.

As of June 30, 2009, with the exception of one security which represented 0.1% of our total investment in fixed income securities, 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. All of our securities received a rating assigned by Moody's of Baa or higher, except the few securities not rated by Moody's. 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.

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

|  | As of June 30, 2009  |         |
|--|----------------------|---------|
|  | Estimated Fair Value | Percent |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 314,920           | 31.7%   |
| Aaa/Aa   | 444,855              | 44.7    |
| A  | 161,084              | 16.2    |
| Baa  | 42,853               | 4.3     |
| Not rated (Standard & Poor's rating of A- or higher)                 | 30,124               | 3.0     |
| Not rated  | 697                  | 0.1     |
| Total  | \$ 994,533           | 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.

The following table illustrates the gross unrealized losses included in our investment portfolio and the fair value of those securities, aggregated by investment category. The table also illustrates the length of time that they have been in a continuous unrealized loss position as of June 30, 2009.

|  | Less than 12 Months  |                   | As of June 30, 2009<br>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 | \$ 15,977            | \$ 163            | \$ 942                                   | \$ 44             | \$ 16,919            | \$ 207            |
| Obligations of states and political subdivisions                     | 22,130               | 269               | 77,323                                   | 2,331             | 99,453               | 2,600             |
| Asset-backed securities  |                      |                   | 64,183                                   | 9,279             | 64,183               | 9,279             |
| Corporate and other securities                                       | 7,469                | 28                | 16,702                                   | 1,348             | 24,171               | 1,376             |
| Subtotal, fixed maturity securities                                  | 45,576               | 460               | 159,150                                  | 13,002            | 204,726              | 13,462            |
| Equity securities  | 36                   | 4                 | 271                                      | 36                | 307                  | 40                |
| Total temporarily impaired securities                                | \$ 45,612            | \$ 464            | \$ 159,421                               | \$ 13,038         | \$ 205,033           | \$ 13,502         |

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ( FSP FAS 115-2/124-2 ). This FSP replaces other-than-temporary impairment ( OTTI ) guidance for debt securities. FSP FAS 115-2/124-2 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. Prior to April 1, 2009, we had to determine whether we had the intent and ability to hold the investment for a sufficient period of time for the value to recover. When the analysis of the above factors resulted in our conclusion that declines in market values were other-than-temporary, the cost of the securities was written down to market value and the reduction in value was reflected as a realized loss. We adopted FSP FAS 115-2/124-2 effective for our interim reporting period ending June 30, 2009. The adoption of FSP FAS 115-2/124-2 did not have an impact on our consolidated results of operations or financial position.

Effective under FSP FAS 115-2/124-2, the amount of the OTTI related to a credit loss is recognized in earnings, and the amount of the OTTI related to other factors is recorded as a component of other comprehensive income (loss). In instances where no credit loss exists but it is more likely than not that we 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, we account 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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We reviewed the unrealized losses in our fixed income portfolio as of June 30, 2009 for potential other than temporary asset impairments. We obtained specific qualitative analysis regarding certain debt securities held at June 30, 2009 with a material (20% or greater) unrealized loss for four or more consecutive quarters. Specific qualitative analysis was also performed for any additional securities appearing on our Watch List. Qualitative analysis considered such factors as the financial condition and the near term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, changes to the rating of the security by a rating agency and the historical volatility of the fair value of the security.

Of the \$13,502 gross unrealized losses as of June 30, 2009, \$2,807 relates to fixed maturity obligations of U.S. Government agencies and obligations of states and political subdivisions. The remaining \$10,695 of gross unrealized losses relates primarily to holdings of investment grade asset-backed, corporate, other fixed maturity and equity securities.

The unrealized losses recorded on the fixed maturity investment portfolio at June 30, 2009, resulted from fluctuations in market interest rates and other temporary market conditions as opposed to fundamental changes in the credit quality of the issuers of such securities. Given our current level of liquidity, the fact that we do not intend to sell these securities, and that it is more likely than not that we will not be required to sell these securities prior to recovery of the cost basis of these securities, these decreases in values are viewed as being temporary.

During the six months ended June 30, 2009 and 2008, there was no significant deterioration in the credit quality of any of our holdings and no other than temporary impairment charges were recorded related to our portfolio of investment securities.

On January 1, 2008, we adopted Statement of Financial Accounting Standards 157, *Fair Value Measurements* ( FAS157 ). FAS 157 provides a revised definition of fair value, establishes a framework for measuring fair value and expands financial statement disclosure requirements for fair value information. The adoption of FAS 157 did not have an impact on our consolidated results of operations or financial position.

Under FAS 157, 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). The statement 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 FAS 157 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.

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We use observable inputs for the vast majority of our investment portfolio. Fair value measurements for securities for which quoted prices are unavailable are estimated based upon reference to observable inputs, such as benchmark interest rates, market comparables, broker quotes and other relevant inputs. In circumstances where quoted prices or observable inputs are adjusted to reflect management's best estimate of fair value, such fair value measurements are considered a lower level measurement in the FAS 157 fair value hierarchy.

Generally, management obtains a minimum of two quotes or prices per instrument. As of June 30, 2009 and December 31, 2008, no quotes or prices obtained were adjusted by management. All broker quotes obtained were non-binding.

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As of June 30, 2009, approximately 99.8% of the investment portfolio recorded at fair value was priced based upon quoted market prices or other observable inputs. The following table summarizes our total fair value measurements and the fair value measurements based on Level 3 inputs for investments at June 30, 2009.

|  | Total        | As of June 30, 2009 |                |                |
|--|--------------|---------------------|----------------|----------------|
|  |              | Level 1 Inputs      | Level 2 Inputs | Level 3 Inputs |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 314,920   | \$                  | \$ 314,920     | \$             |
| Obligations of states and political subdivisions                     | 495,003      |                     | 495,003        |                |
| Asset-backed securities  | 85,938       |                     | 84,096         | 1,842          |
| Corporate and other securities                                       | 98,672       |                     | 98,672         |                |
| Equity securities  | 9,558        | 9,558               |                |                |
| Total investment securities  | \$ 1,004,091 | \$ 9,558            | \$ 992,691     | \$ 1,842       |

The following table summarizes the changes in our Level 3 fair value measurements for the three months ended June 30, 2009.

|   | Asset Backed Securities |
|---|-------------------------|
| Balance at April 1, 2009  | \$ 1,842                |
| Net gains and losses included in earnings   |                         |
| Net gains included in other comprehensive income  |                         |
| Purchases and sales   |                         |
| Transfers in (out) of Level 3   |                         |
| Balance at June 30, 2009  | \$ 1,842                |
| Amount of total losses included in earnings attributable to the change in unrealized losses related to assets still held at June 30, 2009 | \$                      |

The following table summarizes the changes in our Level 3 fair value measurements for the six months ended June 30, 2009.

|   | Asset Backed Securities |
|---|-------------------------|
| Balance at January 1, 2009  | \$ 1,842                |
| Net gains and losses included in earnings   |                         |
| Net gains included in other comprehensive income  |                         |
| Purchases and sales   |                         |
| Transfers in (out) of Level 3   |                         |
| Balance at June 30, 2009  | \$ 1,842                |
| Amount of total losses included in earnings attributable to the change in unrealized losses related to assets still held at June 30, 2009 | \$                      |

On January 1 and June 30, 2009, one fixed maturity security was manually priced solely using broker quotes. This was deemed to render the fair value measurements as based upon unobservable inputs and accordingly, it was classified within Level 3. Transfers in and out of Level 3 would be attributable to changes in the ability to observe significant inputs in determining fair value exit pricing. As noted in the table above, no transfers were made in or out of Level 3 inputs during the three and six months ended June 30, 2009.

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*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 decreased by

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\$222, or 4.9% to \$4,293 for the quarter ended June 30, 2009 from \$4,515 for the comparable 2008 period. Finance and other service income decreased by \$632 or 7.0% to \$8,381 for the six months ended June 30, 2009 from \$9,013 for the comparable 2008 period.

*Losses and Loss Adjustment Expenses.* Losses and loss adjustment expenses incurred for the quarter ended June 30, 2009, decreased by \$4,685 or 5.1%, to \$86,393 from \$91,078 for the comparable 2008 period. Losses and loss adjustment expenses incurred during the six months ended June 30, 2009 decreased by \$7,673 or 4.1% to \$179,275 from \$186,948 for the comparable 2008 period. Our GAAP loss ratio for the quarter ended June 30, 2009 increased to 65.8% from 62.0% for the comparable 2008 period. Our GAAP loss ratio for the six months ended June 30, 2009 increased to 67.2% from 62.8% for the comparable 2008 period. Our GAAP loss ratio excluding loss adjustment expenses for the quarter ended June 30, 2009 increased to 56.2% from 52.9% for the comparable 2008 period. Our GAAP loss ratio excluding loss adjustment expenses for the six months ended June 30, 2009 increased to 57.9% from 54.2% for the comparable 2008 period. The loss ratio increased primarily as a result of a decrease in our personal automobile earned premiums per exposure. Total prior year favorable development included in the pre-tax results for the quarter and six months ended June 30, 2009 was \$9,618 and \$18,146, respectively, compared to prior year favorable development of \$5,481 and \$14,693, respectively, for the comparable 2008 periods.

*Underwriting, Operating and Related Expenses.* Underwriting, operating and related expense for the quarter ended June 30, 2009 decreased by \$4,926, or 11.1%, to \$39,548 from \$44,474 for the comparable 2008 period. Underwriting, operating and related expense for the six months ended June 30, 2009 decreased by \$8,319, or 9.4%, to \$80,620 from \$88,939 for the comparable 2008 period. Our GAAP expense ratios for the quarter ended June 30, 2009 decreased to 30.1% from 30.3% for the comparable 2008 period. Our GAAP expense ratios for the six months ended June 30, 2009 increased to 30.2% from 29.9% for the comparable 2008 period.

*Interest Expenses.* Interest expense for the quarter ended June 30, 2009 was \$21, compared to \$18 for the comparable 2008 period. The credit facility commitment fee included in interest expense was \$18 for both the three months and six months ended June 30, 2009 and 2008.

*Income Tax Expense.* Our effective tax rate was 26.2% and 28.4% for the quarters ended June 30, 2009 and 2008, respectively. Our effective tax rate was 25.2% and 28.2% for the six months ended June 30, 2009 and 2008, respectively. These effective rates were lower than the statutory rate of 35.0% 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 source of funds to meet our obligations and pay dividends to shareholders, therefore, is dividends and other permitted payments from our subsidiaries, principally Safety Insurance. Safety is the borrower under our credit facility.

Safety Insurance's sources of funds primarily include premiums received, investment income and proceeds from sales and redemptions of investments. Safety Insurance's principal uses of cash are the payment of claims, operating expenses and taxes, the purchase of investments and payment of dividends to Safety.



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Net cash provided by operating activities was \$11,898 and \$27,496 during the six months ended June 30, 2009 and 2008, respectively. The decline in 2009 was primarily due to the decrease in direct written premiums and net earned premiums, as discussed above. Our operations typically generate positive cash flows from operations as most premiums are received in advance of the time when claim and benefit payments are required. These positive operating cash flows are expected to continue to meet our liquidity requirements.

Net cash provided by investing activities was \$29,864 during the six months ended June 30, 2009 due primarily from sales, paydowns, calls and maturities of fixed maturity and short term securities exceeding purchases of fixed maturity securities. Net cash provided by investing activity during the six months ended June 30, 2008 was \$5,103 and was primarily the result of sales, paydowns, calls and maturities of fixed maturity securities exceeding purchases.

Net cash used for financing activities increased to \$44,937 during the six months ended June 30, 2009 from \$14,795 during the comparable 2008 period. The increase in 2009 is due to the purchase of 1,028,536 of our common shares under our share buyback program at a cost of \$32,433 during the six months ended June 30, 2009 compared to a purchase of 74,200 common shares at a cost of \$2,444 during the comparable 2008 period. Net cash used for financing activities is primarily comprised of the acquisition of treasury stock and dividend payments to shareholders.

The Insurance Subsidiaries maintain a high degree of liquidity within their respective investment portfolios in fixed maturity investments. Recently, the financial markets have experienced unprecedented declines in value, including many securities currently held by us. We believe that recent and ongoing government actions, including The Emergency Economic Stabilization Act

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of 2008, the 2009 American Recovery and Reinvestment Act and other U.S. and global government programs and the quality of the assets we hold will allow us to realize these securities' anticipated long-term economic value. Furthermore, as of June 30, 2009, we had the intent and ability to retain such investments for the period of time anticipated to allow for this expected recovery in fair value. We do not anticipate the need to sell these securities to meet the Insurance Subsidiaries cash requirements. We expect the Insurance Subsidiaries to generate sufficient operating cash to meet all short-term and long-term cash requirements. However, there can be no assurance that unforeseen business needs or other items will not occur causing us to have to sell securities before their values fully recover; thereby causing us to recognize additional impairment charges in that time period.

*Credit Facility*

On August 14, 2008, we entered into an Amended and Restated Revolving Credit Agreement (the "New Credit Agreement") with RBS Citizens, NA ("RBS Citizens"). The New Credit Agreement amended and restated the terms of our existing Revolving Credit Agreement with RBS Citizens prior to its expiration date of August 17, 2008. The New Credit Agreement extends the maturity date to August 14, 2013 and provides a \$30,000 revolving credit facility with an accordion feature allowing for future expansion of the committed amount up to \$50,000. Loans under the credit facility bear interest at the Company's option at either (i) the LIBOR rate plus 1.25% per annum or (ii) the higher of RBS Citizens prime rate or 0.5% above the federal funds rate plus 1.25% per annum. Interest only is payable prior to maturity.

Our obligations under the credit facility are secured by pledges of our 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 Company as well as limitations or restrictions on indebtedness, liens, and other matters. Among other covenants, the credit facility restricts our payment of dividends (i) if a default under the credit facility is continuing or would result therefrom or (ii) in an amount in excess of 50% of our prior year's net income, as determined in accordance with GAAP. As of June 30, 2009, we were in compliance with all such covenants. In addition, the credit facility includes customary events of default, including a cross-default provision permitting the lenders to accelerate the facility if we (i) default in any payment obligation under debt having a principal amount in excess of \$10,000 or (ii) fail to perform any other covenant permitting acceleration of all such debt.

We had no amounts outstanding on our credit facility at June 30, 2009 and December 31, 2008. The credit facility commitment fee included in interest expenses was computed at a rate of 0.25% on the \$30,000 commitment for the six months ended June 30, 2009 and 2008.

*Regulatory Matters*

The 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 2008, the statutory surplus of Safety Insurance was \$560,462, and its net income for 2008 was \$68,509. As a result, a maximum of \$68,509 is available in 2009 for such dividends without

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prior approval of the Commissioner. During the six months ended June 30, 2009, Safety Insurance recorded dividends to Safety of \$42,477.

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 17, 2009, our Board approved and declared a quarterly cash dividend on our common stock of \$0.40 per share, or \$6,474, which was paid on March 13, 2009, to shareholders of record on March 2, 2009. On May 5, 2009, our Board approved and declared a quarterly cash dividend of \$0.40 per share or \$6,205 which was paid on June 15, 2009 to shareholders of record on June 1, 2009. On August 4, 2009 our Board approved a \$0.40 per share quarterly cash dividend on our common stock, payable on September 15, 2009 to shareholders of record on September 1, 2009. We plan to continue to declare and pay quarterly cash dividends in 2009, depending on our financial position and the regularity of our cash flows.

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On August 3, 2007, our Board approved a share repurchase program of up to \$30,000 of Safety's outstanding common shares. On March 24, 2009, the Board of Directors increased this existing share repurchase program by authorizing repurchase of up to \$60,000 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. During the six months ended June 30, 2009, we purchased 1,028,536 of our common shares on the open market under the program at a cost of \$32,433. During July 2009, purchases of 10,005 of the Company's common shares were made at a cost of \$300. During the year ending December 31, 2008, we purchased 232,013 of our common shares on the open market under the program at a cost of \$7,516.

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 Interpretation No. 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.

**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;

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- Forecasts of future economic performance, liquidity, need for funding and income;
- Descriptions of assumptions underlying or relating to any of the foregoing; and
- Future performance of credit markets.

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

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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. Refer to Part I, Item 1A Risk Factors.

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

| -100 Basis<br>Point Change | No Change | +100 Basis<br>Point Change |
|----------------------------|-----------|----------------------------|
|----------------------------|-----------|----------------------------|

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**As of June 30, 2009**

|   |    |           |    |         |    |          |
|---|----|-----------|----|---------|----|----------|
| Estimated fair value                        | \$ | 1,029,280 | \$ | 994,533 | \$ | 955,016  |
| Estimated increase (decrease) in fair value | \$ | 34,747    | \$ |         | \$ | (39,517) |

With respect to floating rate debt, we are exposed to the effects of changes in prevailing interest rates. At June 30, 2009, we had no debt outstanding under our credit facility. Assuming the full utilization of our current available credit facility, a 2.0% increase in the prevailing interest rate on our variable rate debt would result in interest expense increasing approximately \$600 for 2009, assuming that all of such debt is outstanding for the entire year.

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

*Equity Risk.* Equity risk is the risk that we will incur economic losses due to adverse changes in equity prices. 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, presently we hold none, except for interests in mutual funds to fund the executive deferred compensation plan. 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.

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**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 subsequent material changes from the risk factors previously disclosed in the Company's 2008 Annual Report on Form 10-K and the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2009.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On August 3, 2007, our Board approved a share repurchase program of up to \$30 million of Safety's outstanding common shares. On March 24, 2009, the Board of Directors increased this existing share repurchase program by authorizing repurchase of up to \$60 million 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



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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.

| Period     | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan | Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plan |
|------------|----------------------------------|------------------------------|---|---|
| April 1-30 | 139,297                          | \$ 32.69                     | 826,158   | \$ 33,816   |
| May 1-31   | 313,432                          | \$ 31.66                     | 1,139,590   | \$ 23,894   |
| June 1-30  | 120,959                          | \$ 31.76                     | 1,260,549   | \$ 20,052   |

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

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

Our Annual Meeting of Shareholders was held on May 18, 2009.

The following two proposals were adopted by the margins indicated:

1. Election of two Class I Directors to serve a three year term expiring in 2012.

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|                  | Number of Shares |           |
|------------------|------------------|-----------|
|                  | For              | Withheld  |
| Peter J. Manning | 13,922,668       | 227,214   |
| David K. McKown  | 12,905,369       | 1,244,513 |

In addition, the terms of the following directors continued after the Annual Meeting: David F. Brussard, A. Richard Caputo, Jr., Frederic H. Lindeberg,

- To ratify the appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm for 2009.

|         | Votes Cast |
|---------|------------|
| For     | 14,119,342 |
| Against | 23,636     |
| Abstain | 6,904      |

**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 7, 2009

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

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**SAFETY INSURANCE GROUP, INC.**

**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 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 is included as part of this Form 10-Q, Item 1 - Financial Statements, Note 3, Earnings per Weighted Average Common Share.

(2) Included herein.