

State Auto Financial CORP  
Form 10-Q  
May 09, 2012  
Table of Contents

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

**FORM 10-Q**

x **Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended March 31, 2012

or

.. **Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-19289

**STATE AUTO FINANCIAL CORPORATION**

(Exact name of Registrant as specified in its charter)

<b>Ohio</b> (State or other jurisdiction of incorporation or organization)	<b>31-1324304</b> (I.R.S. Employer Identification No.)
<b>518 East Broad Street, Columbus, Ohio</b> (Address of principal executive offices)	<b>43215-3976</b> (Zip Code)

Registrant's telephone number, including area code: (614) 464-5000

## Edgar Filing: State Auto Financial CORP - Form 10-Q

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes  No

On April 27, 2012, the Registrant had 40,376,941 Common Shares outstanding.

**Table of Contents**

**Index to Form 10-Q Quarterly Report for the three month period ended March 31, 2012**

**Part I. Financial Information**

Item 1.	Financial Statements (Unaudited)	
	<u>Condensed consolidated balance sheets – March 31, 2012 and December 31, 2011</u>	1
	<u>Condensed consolidated statements of income – Three months ended March 31, 2012 and 2011</u>	2
	<u>Condensed consolidated statements of cash flows – Three months ended March 31, 2012 and 2011</u>	4
	<u>Notes to condensed consolidated financial statements – March 31, 2012</u>	5
Item 2.	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	24
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	53
Item 4.	<u>Controls and Procedures</u>	53

**Part II. Other Information**

Item 1.	<u>Legal Proceedings</u>	54
Item 1A.	<u>Risk Factors</u>	55
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	55
Item 3.	<u>Defaults upon Senior Securities</u>	55
Item 4.	<u>Reserved</u>	55
Item 5.	<u>Other Information</u>	55
Item 6.	<u>Exhibits</u>	55
	<u>Signatures</u>	56

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**PART I FINANCIAL STATEMENTS****Item 1. Condensed Consolidated Balance Sheets**

(\$ millions, except per share amount)

	<b>March 31</b>	December 31
	<b>2012</b>	2011
	(unaudited)	As adjusted (see note 1)
<b>Assets</b>		
Fixed maturities, available-for-sale, at fair value (amortized cost \$1,787.1 and \$1,817.3, respectively)	<b>\$ 1,904.1</b>	1,934.9
Equity securities, available-for-sale, at fair value (cost \$142.7 and \$141.7, respectively)	<b>179.9</b>	167.3
Other invested assets, available-for-sale, at fair value (cost \$48.9 and \$48.6, respectively)	<b>61.5</b>	57.2
Other invested assets	<b>0.5</b>	0.5
Notes receivable from affiliate	<b>70.0</b>	70.0
<b>Total investments</b>	<b>2,216.0</b>	2,229.9
Cash and cash equivalents	<b>63.0</b>	356.0
Accrued investment income and other assets	<b>30.9</b>	30.2
Deferred policy acquisition costs	<b>94.2</b>	91.7
Reinsurance recoverable on losses and loss expenses payable (affiliates none)	<b>27.0</b>	25.5
Prepaid reinsurance premiums (affiliates none)	<b>8.5</b>	7.9
Current federal income taxes	<b>12.3</b>	12.3
Net deferred federal income taxes	<b>0.6</b>	0.5
Property and equipment, at cost	<b>10.3</b>	10.4
<b>Total assets</b>	<b>\$ 2,462.8</b>	2,764.4
<b>Liabilities and Stockholders Equity</b>		
Losses and loss expenses payable (affiliates \$368.6 and \$376.8, respectively)	<b>\$ 920.2</b>	907.1
Unearned premiums (affiliates \$108.3 and \$98.4, respectively)	<b>479.3</b>	470.2
Notes payable (affiliates \$15.5 and \$15.5, respectively)	<b>116.3</b>	116.4
Postretirement and pension benefits	<b>111.1</b>	112.8
Due to affiliate	<b>2.0</b>	349.4
Other liabilities	<b>101.6</b>	84.7
<b>Total liabilities</b>	<b>1,730.5</b>	2,040.6
<b>Stockholders equity:</b>		
Class A Preferred stock (nonvoting), without par value. Authorized 2.5 shares; none issued		
Class B Preferred stock, without par value. Authorized 2.5 shares; none issued		

## Edgar Filing: State Auto Financial CORP - Form 10-Q

Common stock, without par value. Authorized 100.0 shares; 47.1 and 47.1 shares issued, respectively, at stated value of \$2.50 per share	<b>117.8</b>	117.8
Treasury stock, 6.8 and 6.8 shares, respectively, at cost	<b>(115.8)</b>	(115.8)
Additional paid-in capital	<b>128.1</b>	127.3
Accumulated other comprehensive income	<b>79.5</b>	63.8
Retained earnings	<b>522.7</b>	530.7
<b><i>Total stockholders equity</i></b>	<b>732.3</b>	723.8
<b><i>Total liabilities and stockholders equity</i></b>	<b>\$ 2,462.8</b>	2,764.4

See accompanying notes to condensed consolidated financial statements.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Condensed Consolidated Statements of Income**

(\$ millions, except per share amounts)

(unaudited)	Three months ended March 31	
	2012	2011 As adjusted (see note 1)
Earned premiums (ceded to affiliates \$196.9 and \$205.5, respectively)	\$ 254.9	350.2
Net investment income (affiliate \$1.2 and \$1.2, respectively)	17.5	21.0
Net realized gain on investments:		
Total other-than-temporary impairment losses	(0.4)	(0.1)
Portion of loss recognized in other comprehensive income		
Other net realized investment gains	7.5	8.3
Total net realized gain on investments	7.1	8.2
Other income from affiliates	0.8	0.8
<b>Total revenues</b>	<b>280.3</b>	<b>380.2</b>
Losses and loss expenses (ceded to affiliates \$156.1 and \$143.4, respectively)	191.3	242.6
Acquisition and operating expenses	87.6	117.9
Interest expense (affiliates \$0.2 and \$0.2, respectively)	1.8	1.8
Other expenses	1.6	2.3
<b>Total expenses</b>	<b>282.3</b>	<b>364.6</b>
<b>(Loss) income before federal income taxes</b>	<b>(2.0)</b>	<b>15.6</b>
Federal income tax expense		2.8
<b>Net (loss) income</b>	<b>\$ (2.0)</b>	<b>12.8</b>
(Loss) earnings per common share:		
Basic	\$ (0.05)	0.32
Diluted	\$ (0.05)	0.32
Dividends paid per common share	\$ 0.15	0.15

See accompanying notes to condensed consolidated financial statements.



**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Consolidated Statements of Comprehensive Income**

(\$ millions, except per share amounts)

(unaudited)	Three months ended March 31	
	2012	2011 As adjusted (see note 1)
Net (loss) income	\$ (2.0)	12.8
Other comprehensive income, net of tax:		
Net unrealized holding gains on investments:		
Unrealized holding gain arising during year	22.1	15.0
Reclassification adjustments for gains realized in net (loss) income	(7.1)	(8.2)
Income tax expense		(2.3)
<i>Total net unrealized holding gains on investments</i>	<b>15.0</b>	4.5
Net unrecognized benefit plan obligations:		
Reclassification adjustments for amortization to statements of income:		
Transition asset	0.1	(0.1)
Negative prior service cost	(1.3)	(0.3)
Net actuarial loss	1.9	1.7
Income tax benefit		(0.5)
<i>Total net unrecognized benefit plan obligations</i>	<b>0.7</b>	0.8
<i>Other comprehensive income</i>	<b>15.7</b>	5.3
<b>Comprehensive income</b>	<b>\$ 13.7</b>	18.1

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Condensed Consolidated Statements of Cash Flows**

<i>(\$ millions)</i>	Three months ended March 31	
(unaudited)	<b>2012</b>	2011 As adjusted (see Note 1)
<b>Cash flows from operating activities:</b>		
Net (loss) income	\$ (2.0)	12.8
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization, net	2.7	2.1
Share-based compensation	0.8	0.8
Net realized gain on investments	(7.1)	(8.2)
Changes in operating assets and liabilities:		
Deferred policy acquisition costs	(2.5)	1.1
Accrued investment income and other assets	(0.8)	(2.4)
Postretirement and pension benefits	(1.1)	5.7
Other liabilities and due to/from affiliates, net	(16.6)	(16.8)
Reinsurance recoverable on losses and loss expenses payable and prepaid reinsurance premiums	(2.1)	0.6
Losses and loss expenses payable	13.1	13.7
Unearned premiums	9.0	(6.9)
Federal income taxes		2.8
Cash used in Homeowners Quota Share initial net unearned premium transfer	(75.5)	
Cash (used in) provided from pooling changes, December 31, 2011 and January 1, 2011 (see Note 4)	(261.4)	69.1
<b>Net cash (used in) provided by operating activities</b>	<b>(343.5)</b>	<b>74.4</b>
<b>Cash flows from investing activities:</b>		
Purchases of fixed maturities available-for-sale	(76.8)	(188.2)
Purchases of equity securities available-for-sale	(24.0)	(56.2)
Purchases of other invested assets	(0.5)	(0.5)
Maturities, calls and pay downs of fixed maturities available-for-sale	84.7	89.7
Sales of fixed maturities available-for-sale	45.9	21.4
Sales of equity securities available-for-sale	27.0	45.6
Sales of other invested assets	0.2	0.3
Sale of subsidiary, net of expenses		13.2
<b>Net cash provided by (used in) investing activities</b>	<b>56.5</b>	<b>(74.7)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock		0.4

Edgar Filing: State Auto Financial CORP - Form 10-Q

Payment of dividends	(6.0)	(6.0)
<i>Net cash used in financing activities</i>	(6.0)	(5.6)
Net decrease in cash and cash equivalents	(293.0)	(5.9)
Cash and cash equivalents at beginning of period	356.0	88.3
<b>Cash and cash equivalents at end of period</b>	<b>\$ 63.0</b>	82.4
<u>Supplemental disclosures:</u>		
Interest paid (affiliates \$0.2 and \$0.2, respectively)	\$ 0.2	0.2
Federal income taxes paid	\$	

See accompanying notes to condensed consolidated financial statements.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements of State Auto Financial Corporation and Subsidiaries ( State Auto Financial or the Company ) have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles ( GAAP ) for complete financial statements. In the opinion of the Company, all adjustments (consisting of normal, recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The balance sheet at December 31, 2011 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2011 (the 2011 Form 10-K ). Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the 2011 Form 10-K.

*Adoption of Accounting Pronouncements**Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*

In October 2010, the FASB issued updated guidance to address diversity in practice for the accounting of costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. This guidance was effective for fiscal years beginning after December 15, 2011. The Company adopted this guidance, with retrospective application, at January 1, 2012. The cumulative effect of the retrospective adoption of this guidance reduced stockholders equity by \$20.5 million, after-tax, at January 1, 2010. Previously reported financial information has been revised to reflect the effect of the Company s adoption of this accounting standard.

The effect of adoption of this new guidance on the Company s consolidated balance sheet as of December 31, 2011 and 2010 and on stockholder s equity as of December 31, 2009 was as follows:

<i>(\$ in millions)</i>	As Previously Reported	Effect of Change	As Adjusted
<b>December 31, 2011:</b>			
Deferred policy acquisition costs	\$ 118.1	\$ (26.4)	\$ 91.7
Other liabilities	76.6	8.1	84.7
Deferred federal income taxes	0.5		0.5
Retained earnings	565.2	(34.5)	530.7
Stockholders equity	758.3	(34.5)	723.8
<b>December 31, 2010:</b>			
Deferred policy acquisition costs	\$ 150.2	\$ (31.7)	\$ 118.5

Edgar Filing: State Auto Financial CORP - Form 10-Q

Deferred income tax liability	(86.3)	(11.1)	(97.4)
Retained earnings	736.1	(20.6)	715.5
Stockholders' equity	851.8	(20.6)	831.2
<b>December 31, 2009:</b>			
Retained earnings	\$ 735.6	\$ (20.5)	\$ 715.1
Stockholders' equity	849.4	(20.5)	828.9

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The effect of adoption of this new guidance on the consolidated income statement for the three months ended March 31, 2011 was as follows:

(\$ in millions, except per share amounts)

Three Months Ended March 31, 2011

As

	Previously Reported	Effect of Change	As Adjusted
Acquisition and operating expenses	\$ 118.1	\$ (0.2)	\$ 117.9
Income tax expense	2.7	0.1	2.8
Net income	12.7	0.1	12.8
Earnings Per Share:			
Basic	\$ 0.32	\$	\$ 0.32
Diluted	\$ 0.32	\$	\$ 0.32

*Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*

The amendments in this guidance result in common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards ( IFRS ). Consequently, the amendments in the guidance change the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend for the amendments in the guidance to result in a change in the application of the requirements in the Fair Value Measurements Topic. The guidance also clarifies the FASB's intent about the application of existing fair value measurement requirements as well as changes to a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. This guidance was effective on a prospective basis for fiscal years and interim periods beginning after December 15, 2011. The Company's adoption of this guidance at January 1, 2012 and did not have a material impact on its consolidated financial statements.

*Testing Goodwill for Impairment*

In September 2011, the FASB issued updated guidance in relation to testing goodwill for impairment. The amendments in the update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment. The more-likely-than-not threshold is defined as having a likelihood of a more than 50 percent. Previous guidance under Topic 350 (Intangibles, Goodwill and Other), required an entity to test goodwill for impairment on an annual basis. Under this updated guidance, the test for impairment should be performed on an annual basis unless an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. If the fair value of a reporting unit is less than its carrying amount, the second step of the test must be performed to measure the amount of the impairment loss, if any. However, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This guidance was effective for fiscal years and interim periods beginning after December 15, 2011, with early adoption permitted. The Company's adoption of this guidance at January 1, 2012 and did not have any impact on its consolidated financial statements.



**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**2. Investments**

The following tables set forth the cost or amortized cost and fair value of available-for-sale securities by lot at March 31, 2012 and December 31, 2011:

(\$ millions)

**At March 31, 2012:**

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
<b>Fixed maturities:</b>				
U.S. treasury securities and obligations of U.S. government agencies	\$ 417.6	34.2	(0.4)	451.4
Obligations of states and political subdivisions	731.9	51.1	(0.1)	782.9
Corporate securities	230.1	14.4	(0.1)	244.4
U.S. government agencies residential mortgage-backed securities	407.5	19.1	(1.2)	425.4
<i>Total fixed maturities</i>	<b>1,787.1</b>	<b>118.8</b>	<b>(1.8)</b>	<b>1,904.1</b>
<b>Equity securities:</b>				
Large-cap securities	105.8	26.0	(1.7)	130.1
Small-cap securities	36.9	12.9		49.8
<i>Total equity securities</i>	<b>142.7</b>	<b>38.9</b>	<b>(1.7)</b>	<b>179.9</b>
Other invested assets	48.9	12.6		61.5
<i>Total available-for-sale securities</i>	<b>\$ 1,978.7</b>	<b>170.3</b>	<b>(3.5)</b>	<b>2,145.5</b>

(\$ millions)

**At December 31, 2011:**

	Cost or amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Fair value
<b>Fixed maturities:</b>				
U.S. treasury securities and obligations of U.S. government agencies	\$ 433.8	35.0	(0.1)	468.7
Obligations of states and political subdivisions	761.3	50.0	(0.1)	811.2
Corporate securities	231.4	13.7	(0.3)	244.8
U.S. government agencies residential mortgage-backed securities	390.8	20.3	(0.9)	410.2
<i>Total fixed maturities</i>	<b>1,817.3</b>	<b>119.0</b>	<b>(1.4)</b>	<b>1,934.9</b>
<b>Equity securities:</b>				
Large-cap securities	106.4	18.9	(3.2)	122.1

Edgar Filing: State Auto Financial CORP - Form 10-Q

Small-cap securities	35.3	9.9		45.2
<i>Total equity securities</i>	141.7	28.8	(3.2)	167.3
Other invested assets	48.6	8.6		57.2
<i>Total available-for-sale securities</i>	\$ 2,007.6	156.4	(4.6)	2,159.4

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's gross unrealized losses and fair value on its investments by lot, aggregated by investment category and length of time for individual securities that have been in a continuous unrealized loss position at March 31, 2012 and December 31, 2011:

(\$ millions, except # of positions)

	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
<b>At March 31, 2012:</b>									
<b>Fixed maturities:</b>									
U.S. treasury securities and obligations of U.S. government agencies	\$ 40.9	\$ (0.4)	11	\$ 3.4	\$	2	\$ 44.3	\$ (0.4)	13
Obligations of states and political subdivisions	2.6	(0.1)	1				2.6	(0.1)	1
Corporate securities	16.2	(0.1)	5				16.2	(0.1)	5
U.S. government agencies residential mortgage-backed securities	25.6	(0.3)	8	33.9	(0.9)	12	59.5	(1.2)	20
<i>Total fixed maturities</i>	<b>85.3</b>	<b>(0.9)</b>	<b>25</b>	<b>37.3</b>	<b>(0.9)</b>	<b>14</b>	<b>122.6</b>	<b>(1.8)</b>	<b>39</b>
Large-cap equity securities	14.6	(1.7)	8				14.6	(1.7)	8
<i>Total temporarily impaired securities</i>	<b>\$ 99.9</b>	<b>\$ (2.6)</b>	<b>33</b>	<b>\$ 37.3</b>	<b>\$ (0.9)</b>	<b>14</b>	<b>\$ 137.2</b>	<b>\$ (3.5)</b>	<b>47</b>

(\$ millions, except # of positions)

	Less than 12 months			12 months or more			Total		
	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions	Fair value	Unrealized losses	Number of positions
<b>At December 31, 2011:</b>									
<b>Fixed maturities:</b>									
U.S. treasury securities and obligations of U.S. government agencies	\$ 5.0	\$	1	\$ 9.0	\$ (0.1)	3	\$ 14.0	\$ (0.1)	4
Obligations of states and political subdivisions	8.9	(0.1)	4	2.1		1	11.0	(0.1)	5
Corporate securities	23.0	(0.3)	9				23.0	(0.3)	9
U.S. government agencies residential mortgage-backed securities	18.3	(0.1)	4	35.3	(0.8)	13	53.6	(0.9)	17

Edgar Filing: State Auto Financial CORP - Form 10-Q

<i>Total fixed maturities</i>	55.2	(0.5)	18	46.4	(0.9)	17	101.6	(1.4)	35
Large-cap equity securities	19.3	(3.0)	9	2.7	(0.2)	1	22.0	(3.2)	10
<i>Total temporarily impaired securities</i>	\$ 74.5	\$ (3.5)	27	\$ 49.1	\$ (1.1)	18	\$ 123.6	\$ (4.6)	45

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the realized losses related to other-than-temporary impairments on the Company's investment portfolio recognized for the three months ended March 31, 2012 and 2011:

(\$ millions)	Three months ended	
	March 31	
	2012	2011
Equity securities:		
Small-cap securities	\$ 0.4	0.1
<b>Total other-than-temporary impairments</b>	<b>\$ 0.4</b>	<b>0.1</b>

The Company did not recognize other-than-temporary impairments on its fixed maturity securities for the three months ended March 31, 2012 and 2011. The Company reviewed its investments at March 31, 2012, and determined no additional other-than-temporary impairment existed in the gross unrealized holding losses.

The Company regularly monitors its investments that have fair values less than cost or amortized cost for signs of other-than-temporary impairment, an assessment that requires significant management judgment regarding the evidence known. Such judgments could change in the future as more information becomes known, which could negatively impact the amounts reported. Among the factors that management considers for fixed maturity securities are the financial condition of the issuer including receipt of scheduled principal and interest cash flows, and intent to sell including if it is more likely than not that the Company will be required to sell the investments before recovery. When a fixed maturity has been determined to have an other-than-temporary impairment, the impairment charge is separated into an amount representing the credit loss, which is recognized in earnings as a realized loss, and the amount related to non-credit factors, which is recognized in accumulated other comprehensive income. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income.

Among the factors that management considers for equity securities and other invested assets are the length of time and/or the significance of decline below cost, the Company's ability and intent to hold these securities through their recovery periods, the current financial condition of the issuer and its future business prospects, and the ability of the market value to recover to cost in the near term. When an equity security or other invested asset has been determined to have a decline in fair value that is other-than-temporary, the cost basis of the security is adjusted to fair value. This results in a charge to earnings as a realized loss, which is not reversed for subsequent recoveries in fair value. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income.

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at March 31, 2012:

(\$ millions)	Amortized cost	Fair value
Due in 1 year or less	\$ 37.2	37.6
Due after 1 year through 5 years	354.6	374.0

## Edgar Filing: State Auto Financial CORP - Form 10-Q

Due after 5 years through 10 years	<b>502.5</b>	<b>542.1</b>
Due after 10 years	<b>485.3</b>	<b>525.0</b>
U.S. government agencies residential mortgage-backed securities	<b>407.5</b>	<b>425.4</b>
<i>Total</i>	<b>\$ 1,787.1</b>	<b>1,904.1</b>

Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay the obligations with or without call or prepayment penalties.

Fixed maturities with fair values of \$9.9 million were on deposit with insurance regulators as required by law at March 31, 2012 and December 31, 2011.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the components of net investment income for the three months ended March 31, 2012 and 2011:

(\$ millions)	Three months ended March 31	
	2012	2011
Fixed maturities	\$ 15.7	18.9
Equity securities	1.0	1.3
Cash and cash equivalents, and other	1.4	1.4
<i>Investment income</i>	<b>18.1</b>	21.6
<i>Investment expenses</i>	<b>0.6</b>	0.6
<i>Net investment income</i>	<b>\$ 17.5</b>	21.0

The Company's current investment strategy does not rely on the use of derivative financial instruments.

The following table sets forth the realized and unrealized holding gains (losses) on the Company's investment portfolio for the three months ended March 31, 2012 and 2011:

(\$ millions)	Three months ended March 31	
	2012	2011
<b>Realized gains:</b>		
Fixed maturities	\$ 3.1	\$ 0.9
Equity securities	4.4	8.8
<i>Total realized gains</i>	<b>7.5</b>	9.7
<b>Realized losses:</b>		
Equity securities:		
Sales		(1.4)
OTTI	(0.4)	(0.1)
<i>Total realized losses</i>	<b>(0.4)</b>	(1.5)
<i>Net realized gain on investments</i>	<b>\$ 7.1</b>	\$ 8.2
<b>Change in unrealized holding gains (losses), net of tax:</b>		

Edgar Filing: State Auto Financial CORP - Form 10-Q

Fixed maturities	<b>\$ (0.6)</b>	\$ (3.1)
Equity securities	<b>11.6</b>	7.2
Other invested assets	<b>4.0</b>	2.7
Deferred federal income tax liability thereon	<b>(5.4)</b>	(2.3)
Valuation allowance	<b>5.4</b>	
<i>Change in net unrealized holding gains (losses), net of tax</i>	<b>\$ 15.0</b>	\$ 4.5

There was a deferred federal income tax liability on the net unrealized holding gains at March 31, 2012 and December 31, 2011, of \$53.1 million, net of a valuation allowance of \$5.4 million, and \$53.1 million, respectively.

---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**3. Fair Value of Financial Instruments**

Below is the fair value hierarchy that categorizes into three levels the inputs to valuation techniques that are used to measure fair value:

Level 1 includes observable inputs which reflect quoted prices for identical assets or liabilities in active markets at the measurement date.

Level 2 includes observable inputs for assets or liabilities other than quoted prices included in Level 1, and it includes valuation techniques which use prices for similar assets and liabilities.

Level 3 includes unobservable inputs which reflect the reporting entity's estimates of the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

The Company utilizes one nationally recognized pricing service to estimate the majority of its available-for-sale investment portfolio's fair value. The Company obtains one price per security and the processes and control procedures employed by the Company are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, the Company gains an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, the Company compares to other fair value pricing information gathered from other independent pricing sources. At March 31, 2012 and December 31, 2011, the Company did not adjust any of the prices received from the pricing service.

Transfers between level categorizations may occur due to changes in the availability of market observable inputs. Transfers in and out of level categorizations are reported as having occurred at the beginning of the quarter in which the transfer occurred. There were no transfers between level categorizations during the three months ended March 31, 2012 and 2011.

The following sections describe the valuation methods used by the Company for each type of financial instrument it holds that are carried at fair value:

*Fixed Maturities*

The Company utilizes a third party pricing service to estimate fair value measurements for the majority of its fixed maturities. The fair value estimate of the Company's fixed maturity investments are determined by evaluations that are based on observable market information rather than market quotes. Inputs to the evaluations include, but are not limited to, market prices from recently completed transactions and transactions of comparable securities, interest rate yield curves, credit spreads, and other market-observable information. The fixed maturity portfolio pricing obtained from the pricing service is reviewed for reasonableness. Regularly, a sample of security prices are referred back to the pricing service for more detailed explanation as to how the pricing service arrived at that particular price. The explanations are reviewed for reasonableness by the portfolio manager and investment officer. Additionally, the prices and assumptions are verified against an alternative pricing source for reasonableness and accuracy. Any discrepancies with the pricing are returned to the pricing service for further explanation and if necessary, adjustments are made. To date, the Company has not identified any significant discrepancies in the pricing provided by its third party pricing service. Investments valued using these inputs include U.S. treasury securities and obligations of U.S. government agencies, obligations of states and political subdivisions, corporate securities (except for one security discussed below), and U.S. government agencies residential mortgage-backed securities. All unadjusted estimates of fair value for fixed maturities priced by the pricing service are included in the amounts disclosed in Level 2 of the hierarchy. If market inputs are unavailable, then no fair value is provided by the pricing service. For these securities, fair value is determined either by requesting brokers who are knowledgeable about these securities to provide a quote; or the Company internally

## Edgar Filing: State Auto Financial CORP - Form 10-Q

determines the fair values by employing widely accepted pricing valuation models, and depending on the level of observable market inputs, renders the fair value estimate as Level 2 or Level 3. The Company holds one fixed maturity corporate security for which the Company estimates the fair value of this security using the present value of the future cash flows. Due to the limited amount of observable market information, the Company includes the fair value estimates for this security in Level 3.

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

*Equities*

The fair value of each equity security is based on an observable market price for an identical asset in an active market and is priced by the same pricing service discussed above. All equity securities are recorded using unadjusted market prices and have been disclosed in Level 1.

*Other Invested Assets*

Included in other invested assets are two international private equity funds ( the funds ) that invest in equity securities of foreign issuers and are managed by third party investment managers. The funds had a fair value of \$56.2 million and \$52.6 million at March 31, 2012 and December 31, 2011, respectively, which was determined using each fund s net asset value. The Company employs procedures to assess the reasonableness of the fair value of the funds including obtaining and reviewing each fund s audited financial statements. There are no unfunded commitments related to the funds. The Company may not sell its investment in the funds; however, the Company may redeem all or a portion of its investment in the funds at net asset value per share with the appropriate prior written notice. Due to the Company s ability to redeem its investment in the funds at net asset value per share at the measurement date, the funds have been disclosed in Level 2.

The remainder of the Company s other invested assets consist primarily of holdings in publicly-traded mutual funds. The Company believes that its prices for these publicly-traded mutual funds based on an observable market price for an identical asset in an active market reflect their fair values and consequently these securities have been disclosed in Level 1.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following tables set forth the Company's available-for-sale investments within the fair value hierarchy at March 31, 2012 and December 31, 2011:

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>At March 31, 2012:</b>				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 451.4		451.4	
Obligations of states and political subdivisions	782.9		782.9	
Corporate securities	244.4		241.5	2.9
U.S. government agencies residential mortgage-backed securities	425.4		425.4	
<i>Total fixed maturities</i>	<b>1,904.1</b>		<b>1,901.2</b>	<b>2.9</b>
Equity securities:				
Large-cap securities	130.1	130.1		
Small-cap securities	49.8	49.8		
<i>Total equity securities</i>	<b>179.9</b>	<b>179.9</b>		
Other invested assets	61.5	5.3	56.2	
<i>Total available-for-sale investments</i>	<b>\$ 2,145.5</b>	<b>185.2</b>	<b>1,957.4</b>	<b>2.9</b>

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>At December 31, 2011:</b>				
Fixed maturities:				
U.S. treasury securities and obligations of U.S. government agencies	\$ 468.7		468.7	
Obligations of states and political subdivisions	811.2		811.2	
Corporate securities	244.8		241.9	2.9
	410.2		410.2	

## Edgar Filing: State Auto Financial CORP - Form 10-Q

U.S. government agencies residential mortgage-backed securities

<i>Total fixed maturities</i>	1,934.9		1,932.0	2.9
Equity securities:				
Large-cap securities	122.1	122.1		
Small-cap securities	45.2	45.2		
<i>Total equity securities</i>	167.3	167.3		
Other invested assets	57.2	4.6	52.6	
<i>Total available-for-sale investments</i>	\$ 2,159.4	171.9	1,984.6	2.9

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

For assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3), the following tables set forth a reconciliation of the beginning and ending balances for the three months ended March 31, 2012 and the year ended December 31, 2011, separately for each major category of assets:

<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2012	\$ 2.9
Total realized gains (losses) included in earnings	
Total unrealized gains (losses) included in other comprehensive income	
Purchases	
Sales	
Transfers into Level 3	
Transfers out of Level 3	
Balance at March 31, 2012	\$ 2.9
<i>(\$ millions)</i>	Fixed maturities
Balance at January 1, 2011	\$ 2.7
Total realized gains (losses) included in earnings	
Total unrealized gains (losses) included in other comprehensive income	
Purchases	0.6
Sales	(0.4)
Transfers into Level 3	
Transfers out of Level 3	
Balance at December 31, 2011	\$ 2.9

The following sections describe the valuation methods used by the Company for each type of financial instrument it holds that is not measured at fair value but for which fair value is disclosed:

*Notes Receivable from Affiliates*

In May 2009, the Company entered into two separate credit agreements with State Auto Mutual pursuant to which it loaned State Auto Mutual a total of \$70.0 million. Under these agreements, State Auto Financial earned interest of \$1.2 million for the three months ended March 31, 2012 and 2011. Interest income is included in net investment income on the condensed consolidated statements of income.

The Company estimates the fair value of the notes receivable from affiliate using market quotations for U.S. treasury securities with similar maturity dates and applies an appropriate credit spread. Consequently this has been placed in Level 2 of the fair value hierarchy.

Edgar Filing: State Auto Financial CORP - Form 10-Q

*(\$ millions, except interest rates)*

	March 31, 2012			December 31, 2011		
	Carrying value	Fair value	Interest rate	Carrying value	Fair value	Interest rate
Notes receivable from affiliate	\$ 70.0	\$ 77.6	7.00%	\$ 70.0	\$ 77.5	7.00%

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

*Notes Payable*

Included in notes payable are Senior Notes and Subordinated Debentures. The fair value of the Senior Notes is based on the observable market price and has been disclosed in Level 2. The carrying amount of the Subordinated Debentures approximates its fair value as the interest rate adjusts quarterly and has been disclosed in Level 3.

(\$ millions, except interest rates)

	March 31, 2012			December 31, 2011		
	Carrying value	Fair value	Interest rate	Carrying value	Fair value	Interest rate
Senior Notes due 2013: issued \$100.0, November 2003 with fixed interest	\$ 100.8	\$ 98.9	6.25%	\$ 100.9	\$ 100.3	6.25%
Affiliate Subordinated Debentures due 2033: issued \$15.5, May 2003 with variable interest	15.5	15.5	4.69	15.5	15.5	4.73
<b>Total notes payable</b>	<b>\$ 116.3</b>	<b>\$ 114.4</b>		<b>\$ 116.4</b>	<b>\$ 115.8</b>	

The following table sets forth the Company's assets and liabilities within the fair value hierarchy at March 31, 2012:

(\$ millions)

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b>At March 31, 2012:</b>				
<b>Assets:</b>				
Notes receivable from affiliate	\$ 77.6		77.6	
<b>Liabilities:</b>				
Senior Notes	98.9		98.9	
Affiliate Subordinated Debentures	15.5			15.5
<b>Total liabilities</b>	<b>\$ 114.4</b>		<b>98.9</b>	<b>15.5</b>

**4. Reinsurance**

The insurance subsidiaries of State Auto Financial, including State Auto Property & Casualty Insurance Company ( State Auto P&C ), Milbank Insurance Company, Farmers Casualty Insurance Company and State Auto Insurance Company of Ohio (collectively referred to as the STFC Pooled Companies ) participate in a quota share reinsurance pooling arrangement ( the Pooling Arrangement ) with State Automobile Mutual Insurance Company ( State Auto Mutual ) and its subsidiaries and affiliates, State Auto Insurance Company of Wisconsin, State Auto Florida Insurance Company, Meridian Citizens Mutual Insurance Company, Meridian Security Insurance Company, Beacon National Insurance

## Edgar Filing: State Auto Financial CORP - Form 10-Q

Company, Patrons Mutual Insurance Company of Connecticut, Litchfield Mutual Fire Insurance Company, Rockhill Insurance Company ( RIC ), Plaza Insurance Company ( Plaza ), American Compensation Insurance Company ( American Compensation ) and Bloomington Compensation Insurance Company ( Bloomington Compensation ), (collectively referred to as the Mutual Pooled Companies ). RIC, Plaza, American Compensation and Bloomington Compensation are referred to as the Rockhill Insurers.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

In conjunction with the January 1, 2011 Pooling Arrangement amendment, which added the Rockhill Insurers to the pool, the STFC Pooled Companies received \$149.8 million (\$69.1 million in cash and \$80.7 million in investment securities) from the Rockhill Insurers for net insurance liabilities transferred on January 1, 2011. The following table sets forth the impact on the Company's balance sheet at January 1, 2011, relating to this Pooling Arrangement amendment:

<i>(\$ millions)</i>	
Losses and loss expenses payable	\$ 124.1
Unearned premiums	34.1
Other liabilities	(0.1)
Less:	
Deferred acquisition costs	8.3
<i>Net cash and investment securities received</i>	\$ 149.8

On December 31, 2011, the Pooling Arrangement was amended to reduce the overall participation percentage of the STFC Pooled Companies from 80% to 65% and to include the pooling of applicable balance sheet accounts such as applicable accumulated other comprehensive income related to employee benefit plans. In conjunction with this amendment, the STFC Pooled Companies paid \$261.4 million in cash to the Mutual Pooled Companies in the first quarter 2012 for the net liabilities transferred on December 31, 2011. The following table sets forth the impact on the Company's balance sheet at December 31, 2011, relating to this amendment:

<i>(\$ millions)</i>		<i>(Decrease)/Increase</i>
Losses and loss expenses payable	\$	(203.4)
Unearned premiums		(106.8)
Pension and postretirement liabilities		(52.3)
Other liabilities		27.6
Accumulated other comprehensive income		59.1
Less:		
Deferred acquisition costs		(21.8)
Other assets		7.4
<i>Net cash paid</i>	\$	(261.4)

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth a summary of the Company's external reinsurance transactions, as well as reinsurance transactions with State Auto Mutual under the Pooling Arrangement, for the three months ended March 31, 2012 and 2011:

(\$ millions)	Three months ended March 31	
	2012	2011
<b>Premiums earned:</b>		
Assumed from external insurers and reinsurers	\$ 1.0	8.5
Assumed under Pooling Arrangement	254.9	350.2
Ceded to external insurers and reinsurers	(7.4)	(6.1)
Ceded under Pooling Arrangement	(196.9)	(205.5)
<i>Net assumed premiums earned</i>	\$ 51.6	147.1
<b>Losses and loss expenses incurred:</b>		
Assumed from external insurers and reinsurers	\$ 0.9	5.7
Assumed under Pooling Arrangement	191.5	241.6
Ceded to external insurers and reinsurers	(5.8)	(5.3)
Ceded under Pooling Arrangement	(156.1)	(143.4)
<i>Net assumed losses and loss expenses incurred</i>	\$ 30.5	98.6

**5. Income Taxes**

The following table sets forth the reconciliation between actual federal income tax benefit and the amount computed at the indicated statutory rate for the three months ended March 31, 2012 and 2011:

(\$ millions)	Three months ended March 31			
	2012		2011	
		%		%
Amount at statutory rate	\$ (0.7)	35	\$ 5.5	35
Tax-exempt interest and dividends received deduction	(2.2)	115	(3.1)	(20)
Other, net	0.1	(5)	0.4	2
Valuation allowance	2.8	(145)		
<i>Federal income tax expense and effective rate</i>	\$		\$ 2.8	17



**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the tax effects of temporary differences that give rise to significant portions of deferred tax assets and deferred tax liabilities at March 31, 2012 and December 31, 2011:

<i>(\$ millions)</i>	<b>March 31, 2012</b>	December 31, 2011
<b>Deferred tax assets:</b>		
Unearned premiums not currently deductible	\$ 33.1	32.4
Losses and loss expenses payable discounting	25.3	25.0
Postretirement and pension benefits	38.8	39.4
Realized loss on other-than-temporary impairment	9.4	11.4
Other liabilities	13.7	14.9
Net operating loss carryforward	62.0	56.0
Tax credit carryforward	0.7	0.7
Other	9.5	9.2
<i>Total deferred tax assets</i>	<b>192.5</b>	189.0
<b>Deferred tax liabilities:</b>		
Deferral of policy acquisition costs	33.0	32.1
Net unrealized holding gains on investments	58.4	53.1
<i>Total deferred tax liabilities</i>	<b>91.4</b>	85.2
<i>Total net deferred tax assets before valuation allowance</i>	<b>101.1</b>	103.8
Less valuation allowance	100.5	103.3
<i>Net deferred federal income taxes</i>	<b>\$ 0.6</b>	0.5

Deferred income tax assets and liabilities represent the tax effect of the differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. The Company periodically evaluates its deferred tax assets, which requires significant judgment, to determine if they are realizable based upon weighing all available evidence, both positive and negative, including loss carryback potential, past operating results, existence of cumulative losses in the most recent years, projected performance of the business, future taxable income, including the ability to generate capital gains, and prudent and feasible tax planning strategies. In making such judgments, significant weight is given to evidence that can be objectively verified. At March 31, 2012 and December 31, 2011 the Company recorded a valuation allowance of \$100.5 million and \$103.3 million, respectively. The \$0.6 million and \$0.5 million of deferred income tax asset remaining after recognition of the valuation allowance represents a deferred tax asset on the gross unrealized fixed maturity losses where management determined this portion of the asset to be realizable due to management's assertion that it has both the ability and intent to hold these securities through recovery or maturity at March 31, 2012 and December 31, 2011, respectively. Based on FASB ASC 740 Intraproduct tax allocation, the change in the valuation allowance attributable to continuing operations and other comprehensive income for the three months ended March 31, 2012 is as follows:

## Edgar Filing: State Auto Financial CORP - Form 10-Q

*(\$ millions)*

Continuing operations	\$ 2.8
Other comprehensive income	(5.6)
<i>Change in valuation allowance</i>	<i>\$ (2.8)</i>

In future periods the Company will re-assess its judgments and assumptions regarding the realization of its net deferred tax assets, but until such time the positive evidence exceeds the negative evidence the Company will maintain a valuation allowance against its net deferred tax assets.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

**6. Pension and Postretirement Benefit Plans**

The following table sets forth the components of net periodic cost for the State Auto Group's pension and postretirement benefit plans for the three months ended March 31, 2012 and 2011:

(\$ millions)	Pension		Postretirement	
	Three months ended March 31			
	2012	2011	2012	2011
Service cost	\$ 1.9	2.6	\$	1.6
Interest cost	2.5	3.8	0.2	1.6
Expected return on plan assets	(2.9)	(4.5)	(0.1)	(0.1)
Amortization of:				
Prior service costs (benefits)		0.1	(1.3)	(0.4)
Transition assets		(0.1)	0.1	
Net loss	1.7	1.7	0.2	
<i>Net periodic cost (benefit)</i>	<b>\$ 3.2</b>	3.6	<b>\$ (0.9)</b>	2.7

The Company contributed \$3.3 million for the three months ended March 31, 2012 and expects to contribute an additional \$9.8 million to the pension plan during 2012.

**7. (Loss) Earnings per Common Share**

The following table sets forth the compilation of basic and diluted net (loss) earnings per common share for the three months ended March 31, 2012 and 2011:

(\$ millions, except per share amounts)	Three months ended	
	March 31	
	2012	2011
<b>Numerator:</b>		
Net income for basic (loss) earnings per common share	\$ (2.0)	12.8
<b>Denominator:</b>		
Weighted average shares for basic net (loss) earnings per common share	40.3	40.1
Effect of dilutive share-based awards		0.1
<i>Adjusted weighted average shares for diluted net (loss) earnings per common share</i>	<b>40.3</b>	40.2

Edgar Filing: State Auto Financial CORP - Form 10-Q

Basic net (loss) earnings per common share	<b>\$ (0.05)</b>	0.32
Diluted net (loss) earnings per common share	<b>\$ (0.05)</b>	0.32

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth the options to purchase shares of common stock that were not included in the computation of diluted earnings per common share because the exercise price of the options was greater than the average market price or their inclusion would have been antidilutive for the three months ended March 31, 2012 and 2011:

<i>(number of options in millions)</i>	Three months ended March 31	
	2012	2011
Number of options	3.7	2.9

**8. Segment Information**

The Company has four reportable segments: personal insurance, business insurance, specialty insurance and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve or products they provide or services they offer. The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. The specialty insurance segment provides commercial coverages, including workers' compensation for both legacy State Auto Group and RTW, Inc.'s insurance subsidiaries, that require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources. The investment operations segment, managed by Stateco, provides investment services.

The Company evaluates the performance of its insurance segments using industry financial measurements based on Statutory Accounting Practices (SAP), which include loss and loss adjustment expense ratios, underwriting expense ratios, combined ratios, statutory underwriting gain (loss), net premiums earned and net written premiums. One of the most significant differences between SAP and GAAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred and amortized over the same period the premium is earned. The investment operations segment is evaluated based on investment returns of assets managed by Stateco.

Asset information by segment is not reported for the insurance segments because the Company does not produce such information internally.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth financial information regarding the Company's reportable segments for the three months ended March 31, 2012 and 2011:

(\$ millions)	Three months ended March 31	
	2012	2011
<b>Revenues from external sources:</b>		
Insurance segments		
Personal insurance	\$ 117.5	203.6
Business insurance	77.3	94.8
Specialty insurance	60.1	51.8
<i>Total insurance segments</i>	<b>254.9</b>	350.2
Investment operations segment		
Net investment income	17.5	21.0
Net realized capital gains	7.1	8.2
<i>Total investment operations segment</i>	<b>24.6</b>	29.2
All other	0.8	0.8
<i>Total revenues from external sources</i>	<b>280.3</b>	380.2
Intersegment revenues	(2.5)	(2.6)
<i>Total revenues</i>	<b>277.8</b>	377.6
Reconciling items:		
Eliminate intersegment revenues	2.5	2.6
<i>Total consolidated revenues</i>	<b>\$ 280.3</b>	380.2
Segment (loss) income before federal income tax:		
Insurance segments		
Personal insurance SAP underwriting (loss) gain	\$ (0.9)	12.5
Business insurance SAP underwriting loss	(16.7)	(11.9)
Specialty insurance SAP underwriting loss	(12.2)	(15.3)
<i>Total insurance segments</i>	<b>(29.8)</b>	(14.7)
Investment operations segment		
Net investment income	17.5	21.0
Net realized capital gains	7.1	8.2

Edgar Filing: State Auto Financial CORP - Form 10-Q

<i>Total investment operations segment</i>	<b>24.6</b>	29.2
All other	<b>0.4</b>	0.1
<i>Total segment (loss) income before tax expense</i>	<b>(4.8)</b>	14.6
Reconciling items:		
GAAP expense adjustments	<b>5.3</b>	3.3
Interest expense on corporate debt	<b>(1.8)</b>	(1.8)
Corporate expenses	<b>(0.7)</b>	(0.5)
<i>Total reconciling items</i>	<b>2.8</b>	1.0
<i>Total consolidated (loss) income before federal income tax expense</i>	<b>\$ (2.0)</b>	15.6

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

The following table sets forth revenues from external sources for reportable segments for the three months ended March 31, 2012 and 2011:

(\$ millions)	Three months ended March 31	
	2012	2011
Earned premiums:		
Personal insurance:		
Personal auto	\$ 96.0	127.1
Homeowners	14.6	67.9
Other personal	6.9	8.6
<i>Total personal insurance earned premiums</i>	<b>117.5</b>	203.6
Business insurance:		
Commercial auto	19.1	23.4
Commercial multi-peril	22.2	25.1
Fire & allied lines	18.6	24.2
Other & product liability	13.1	16.6
Other business	4.3	5.5
<i>Total business insurance earned premiums</i>	<b>77.3</b>	94.8
Specialty insurance	60.1	51.8
<i>Total earned premiums</i>	<b>254.9</b>	350.2
Investment operations:		
Net investment income	17.5	21.0
Net realized capital gain	7.1	8.2
<i>Total investment operations</i>	<b>24.6</b>	29.2
<i>Total revenues from reportable segments</i>	<b>\$ 279.5</b>	379.4

Investable assets attributable to the Company's investment operations segment totaled \$2,279.0 million and \$2,585.9 million at March 31, 2012 and December 31, 2011, respectively.

**9. Contingencies and Litigation**

The Company is involved in numerous lawsuits arising in the ordinary course of the Company's business operations arising out of or otherwise related to its insurance policies. Certain of these lawsuits allege extra-contractual damages. These lawsuits are in various stages of development. The Company will generally contest these matters vigorously but may pursue settlement if appropriate. The Company considers all such litigation in establishing its loss and loss adjustment expense reserves. Based on currently available information, the Company does not

## Edgar Filing: State Auto Financial CORP - Form 10-Q

believe it is reasonably possible that any such lawsuit or related lawsuits will be material to its results of operations or have a material adverse effect on its consolidated financial or cash flow position.

Additionally, from time to time the Company may be involved in lawsuits arising in the ordinary course of business but not arising out of or otherwise related to its insurance policies. Based on currently available information, the Company does not believe it is reasonably possible that any such lawsuit or related lawsuits will be material to its results of operations or have a material adverse effect on its consolidated financial or cash flow position.

In accordance with the Contingencies Topic of the FASB ASC, the Company accrues for a litigation-related liability when it is probable that such a liability has been incurred and the amount can be reasonably estimated. Based on currently available information known to the Company, the Company believes that its reserves for litigation-related liabilities are reasonable. Given the inherent uncertainty surrounding the ultimate resolution of these legal proceedings, an adverse outcome could have a material impact to the Company's results of operations in a future period, though in the opinion of the Company's management, none would likely have a material adverse effect on its consolidated financial or cash flow position.

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Notes to Condensed Consolidated Financial Statements, Continued (Unaudited)

Additionally, the Company may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope originally contemplated in its insurance policies. The Company believes that the effects, if any, of such regulatory actions and published court decisions are not likely to have a material adverse effect on its financial or its cash flow position.

---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation**

The term "State Auto Financial" as used below refers only to State Auto Financial Corporation and the terms "our Company," "we," "us," and "our" used below refer to State Auto Financial Corporation and its consolidated subsidiaries. The term "first quarter" as used below refers to the three months ended March 31 for the time period then ended. For a glossary of terms for State Auto Financial Corporation and its subsidiaries and affiliates and a glossary of selected insurance and accounting terms, see the section entitled "Important Defined Terms Used in this Form 10-K" included in our Annual Report on Form 10-K for the year ended December 31, 2011 (the "2011 Form 10-K").

The discussion and analysis presented below relates to the material changes in financial condition and results of operations for our consolidated balance sheets as of March 31, 2012 and December 31, 2011, and for the consolidated statements of income for the three-month periods ended March 31, 2012 and 2011. This discussion and analysis should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in the 2011 Form 10-K, and in particular the discussions in those sections thereof entitled "Overview," "Executive Summary" and "Critical Accounting Policies." Readers are encouraged to review the entire 2011 Form 10-K, as it includes information regarding our Company not discussed in this Form 10-Q. This information will assist in your understanding of the discussion of our current period financial results.

The discussion and analysis presented below includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements generally can be identified by the use of forward-looking terminology such as "may," "will," "expect," "intend," "estimate," "anticipate," "project," "believe" or "continue" or the negative variations thereon or similar terminology. Forward-looking statements speak only as of the date the statements were made. Although we believe that the expectations reflected in forward-looking statements have a reasonable basis, we can give no assurance that these expectations will prove to be correct. Forward-looking statements are subject to risks and uncertainties that could cause actual events or results to differ materially from those expressed in or implied by the statements. For a discussion of the most significant risks and uncertainties that could cause our actual results to differ materially from those projected, see "Risk Factors" in Item 1A of the 2011 Form 10-K, updated by Part II, Item 1A of this Form 10-Q. Except to the limited extent required by applicable law, we undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

The Company has four reportable segments: personal insurance, business insurance, specialty insurance and investment operations. The reportable insurance segments are business units managed separately because of the differences in the type of customers they serve or products they provide or services they offer. The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. The specialty insurance segment provides commercial coverages, including workers' compensation for both the legacy State Auto Group and the RTW, Inc. insurance subsidiaries, that require specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources. The investment operations segment, managed by Stateco, provides investment services. See "Personal and Business Insurance" and "Specialty Insurance" in Item 1 of the 2011 Form 10-K for more information about our insurance segments. Financial information about our reportable segments for 2012 is set forth in Note 8 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**CRITICAL ACCOUNTING POLICIES**

*Deferred Acquisition Costs*

As of January 1, 2012, we adopted retrospectively the FASB guidance *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*. See *New Accounting Standards Adoption of Accounting Pronouncements-Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* included in this Item 2 and Note 1 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q for the impact of this adoption at January 1, 2010. Acquisition costs, consisting of commissions, premium taxes and certain underwriting expenses related to the successful acquisition of acquiring or renewing the production of property and casualty business, are deferred and amortized over the same period in which the related premiums are earned. The method followed for computing the acquisition costs limits the amount of such deferred costs to their estimated realizable value. In determining estimated realizable value, the computation gives effect to the premiums to be earned, losses and loss expenses expected to be incurred, and certain other costs expected to be incurred as premium is earned. Future changes in estimates, the most significant of which is expected losses and loss adjustment expenses, that indicate a reduction in expected future profitability may result in unrecoverable deferred acquisition costs. The impact of the adoption at December 31, 2011, was a reduction to shareholders' equity of \$34.5 million, or \$0.86 book value per share, resulting in an adjusted book value per share of \$17.95. The previously reported book value per share as of December 31, 2011 was \$18.81 per share. All applicable prior period amounts have been adjusted to conform to current period presentation.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**POOLING ARRANGEMENT**

The STFC Pooled Companies and the Mutual Pooled Companies participate in a quota share reinsurance pooling arrangement referred to as the Pooling Arrangement. Under the Pooling Arrangement, State Auto Mutual assumes premiums, losses and expenses from each of the Pooled Companies and in turn cedes to each of the Pooled Companies a specified portion of premiums, losses and expenses based on each of the Pooled Companies' respective pooling percentages. State Auto Mutual then retains the balance of the pooled business.

In 2011, we made two changes to the Pooling Arrangement. First, as of January 1, 2011, we added the Rockhill Insurers to the pool each with a participation percentage of 0.0% (the 1.1.11 pool change). In conjunction with the 1.1.11 pool change, the STFC Pooled Companies received \$149.8 million (\$69.1 million in cash and \$80.7 million in investment securities) from the Rockhill Insurers for net insurance liabilities transferred on January 1, 2011. The following table sets forth the impact on our balance sheet at January 1, 2011:

<i>(\$ millions)</i>	<b>(Decrease)/Increase</b>
Losses and loss expenses payable	\$ 124.5
Unearned premiums	34.1
Other liabilities	(0.5)
Less:	
Deferred policy acquisition costs	8.3
<i>Net cash and investment securities received</i>	\$ 149.8

Second, at the close of business on December 31, 2011, the Pooling Arrangement was amended to reduce the overall participation percentage of the STFC Pooled Companies from 80% to 65% and to include the pooling of applicable balance sheet accounts such as accumulated other comprehensive income related to employee benefit plans (the 12.31.11 pool change). In conjunction with the 12.31.11 pool change, the STFC Pooled Companies paid \$261.4 million in cash to the Mutual Pooled Companies subsequent to year end for net liabilities transferred on December 31, 2011. The following table sets forth the impact on our balance sheet at December 31, 2011:

<i>(\$ millions)</i>	<b>(Decrease)/Increase</b>
Losses and loss expenses payable	\$ (203.4)
Unearned premiums	(106.8)
Pension and postretirement liabilities	(52.3)
Other liabilities	27.6
Accumulated other comprehensive income	59.1
Less:	
Deferred policy acquisition costs	(21.8)
Other assets	7.4
<i>Net cash paid</i>	\$ (261.4)



**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

The following table sets forth the participants and their participation percentages in the Pooling Arrangement for the period indicated:

	Close of business December 31, 2011 March 31, 2012	January 1, 2011 December 31, 2011
<b>STFC Pooled Companies:</b>		
State Auto P&C	51.0%	59.0%
Milbank	14.0	17.0
Farmers	0.0	3.0
SA Ohio	0.0	1.0
SA National	N/A	0.0
<i>Total STFC Pooled Companies</i>	<b>65.0</b>	80.0
<b>State Auto Mutual Pooled Companies:</b>		
State Auto Mutual	34.0	19.0
SA Wisconsin	0.0	0.0
SA Florida	0.0	0.0
Meridian Security	0.0	0.0
Meridian Citizens Mutual	0.5	0.5
Beacon National	0.0	0.0
Patrons Mutual	0.4	0.4
Litchfield	0.1	0.1
RIC	0.0	0.0
Plaza	0.0	0.0
American Compensation	0.0	0.0
Bloomington Compensation	0.0	0.0
<i>Total State Auto Mutual Pooled Companies</i>	<b>35.0</b>	20.0

**RESULTS OF OPERATIONS**

Our net loss was \$2.0 million for the first quarter of 2012 compared to net income of \$12.8 million for the first quarter of 2011. Our pretax loss was \$2.0 million for the first quarter of 2012 compared to pretax income of \$15.6 million for the first quarter of 2011. Our 2012 results, when compared to our 2011 results, have been and will continue to be impacted by the reduction in our participation in the Pooling Arrangement to 65% from 80% in 2011, as well as the recently implemented quota share reinsurance arrangement covering our homeowners book of business, discussed below. Our first quarter 2012 results were also impacted by an increase in the level of weather-related catastrophe losses in comparison to our first quarter 2011.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

The following table sets forth certain key performance indicators we use to monitor our operations for the three months ended March 31, 2012 and 2011:

(\$ millions, except per share amounts)

	Three months ended March 31	
	2012	2011
<b>GAAP Basis:</b>		
Total revenues	\$ 280.3	380.2
Net (loss) income	\$ (2.0)	12.8
Basic (loss) earnings per share	(0.05)	0.32
Diluted (loss) earnings per share	(0.05)	0.32
Stockholders' equity	\$ 732.3	844.4
Return on average equity	(22.3)%	2.8
Book value per share	\$ 18.16	21.03
Debt to capital ratio	13.7	12.1
Cat loss and ALAE ratio	7.8%	4.6
Non-cat loss and LAE ratio	67.2%	64.7
Loss and LAE ratio	75.0%	69.3
Expense ratio	34.4%	33.7
Combined ratio	109.4%	103.0
Premium written growth <sup>(1)</sup>	(30.2)%	24.7
Investment yield	3.1%	3.5

	Three months ended March 31	
	2012	2011
<b>SAP Basis:</b>		
Cat loss and ALAE points	7.8%	4.6
Non-cat loss and ALAE	60.0%	58.7
ULAE	7.4%	6.0
Loss and LAE ratio	75.2%	69.3
Expense ratio	35.3%	32.4
Combined ratio	110.5%	101.7

	Twelve months ended March 31	
	2012	2011
Net premiums written to surplus	2.1	1.7

- <sup>(1)</sup> Includes an increase of 11.8 points for 2011 related to the one-time \$34.1 million transfer of unearned premium by the Rockhill Insurers on January 1, 2011, in conjunction with the 1.1.11 pool change.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

*Homeowners Quota Share Arrangement*

To reduce risk and volatility in our homeowners book of business, while providing us with additional catastrophe reinsurance protection, the State Auto Group entered into a quota share reinsurance agreement on December 31, 2011 with a syndicate of unaffiliated reinsurers covering its homeowners book of business (the HO QS Arrangement). Under the HO QS Arrangement, the State Auto Group ceded to the reinsurers 75% of its homeowners business under policies in force at December 31, 2011 and new and renewal policies thereafter issued during the term of the agreement. The HO QS Arrangement is in effect until December 31, 2014. See *Liquidity and Capital Resources - Reinsurance Arrangements* for a discussion of the HO QS Arrangement. The HO QS Arrangement worked as expected in the first quarter of 2012, and we believe the long term benefits of our homeowner actions will be a more predictable and profitable book of homeowners business and reduced risk to our capital base.

For the three months ended March 31, 2012, the HO QS Arrangement reduced our GAAP net underwriting loss by \$7.1 million and improved our GAAP combined ratio by 1.1 points. The following table sets forth, on a pro forma GAAP basis, certain of our key performance indicators excluding the impact of the HO QS Arrangement cession for the three months ended March 31, 2012.

Reconciliation Table 1

(\$ millions)	GAAP HO QS Arrangement Cession - Overall Results		
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession
Earned premiums	\$ 254.9	\$ 41.7	\$ 296.6
Losses and LAE incurred:			
Cat loss and ALAE	20.0	17.4	37.4
Non-cat loss and LAE	171.3	19.3	190.6
<i>Total Loss and LAE incurred</i>	191.3	36.7	228.0
Acquisition and operating expenses	87.6	12.1	99.7
<i>Net underwriting loss</i>	(24.0)	(7.1)	(31.1)
Cat loss and ALAE ratio	7.8%	41.7%	12.6%
Non-cat loss and LAE ratio	67.2%	46.3%	64.3%
<i>Total Loss and LAE ratio</i>	75.0%	88.0%	76.9%
Expense ratio	34.4%	29.0%	33.6%
<i>Combined ratio</i>	109.4%	117.0%	110.5%

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

For the three months ended March 31, 2012, the HO QS Arrangement reduced our SAP net underwriting loss by \$5.5 million and improved our SAP combined ratio by 1.0 point. The following table sets forth, on a pro forma SAP basis, certain of our key performance indicators excluding the impact of the HO QS Arrangement cession for the three months ended March 31, 2012.

Reconciliation Table 2

(\$ millions)	SAP HO QS Arrangement Cession - Overall Results		
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession
Net written premiums	\$ 263.3	\$ 36.2	\$ 299.5
Earned premiums	254.9	41.7	296.6
Losses and LAE incurred:			
Cat loss and ALAE	20.0	17.4	37.4
Non-cat loss and ALAE	152.8	19.3	172.1
<i>Total Loss and ALAE</i>	172.8	36.7	209.5
ULAE	18.9		18.9
<i>Total Loss and ALAE incurred</i>	191.7	36.7	228.4
Underwriting expenses	93.0	10.5	103.5
<i>Net underwriting loss</i>	\$ (29.8)	\$ (5.5)	\$ (35.3)
Cat loss and ALAE ratio	7.8%	41.7%	12.6%
Non-cat loss and ALAE ratio	60.0%	46.3%	58.0%
<i>Total loss and ALAE ratio</i>	67.8%	88.0%	70.6%
ULAE ratio	7.4%		6.4%
<i>Total loss and LAE ratio</i>	75.2%	88.0%	77.0%
Expense ratio	35.3%	29.0%	34.5%
<i>Combined ratio</i>	110.5%	117.0%	111.5%

See additional pro forma reconciliation tables for the HO QS Arrangement cession on our personal insurance segment's SAP underwriting results and our homeowners' line of business at Reconciliation Tables 3 and 5, respectively.

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Use of Non-GAAP Financial Measures**

Certain information and results in our personal, business and specialty insurance segments are presented in a manner which, on a pro forma basis, (i) excludes the impact of the HO QS Arrangement cession for the three months ended March 31, 2012, (ii) excludes the one-time impact of the 1.1.11 pool change for the three months ended March 31, 2011, and (iii) assumes the 12.31.11 pool change from an 80% to 65% participation percentage had been in effect as of January 1, 2011. These presentations are non-GAAP financial measures. We believe these non-GAAP financial measures will enable investors to (a) better understand the significance the reinsurance arrangement cession is contributing to our reported results for the three months ended March 31, 2012, and (b) perform a meaningful comparison of our results of operations for the three months ended March 31, 2012 and 2011. See Reconciliation Tables 1 and 2 above and Reconciliation Tables 3, 4 and 5 below.

**Insurance Segments**

The insurance segments market a broad line of property and casualty insurance products throughout the United States through independent insurance agencies, which include retail agents and wholesale brokers. The personal insurance segment provides primarily personal automobile and homeowners to the personal insurance market. The business insurance segment provides primarily commercial automobile, commercial multi-peril, fire & allied and general liability insurance covering small-to-medium sized commercial exposures in the business insurance market. The specialty insurance segment provides commercial coverages requiring specialized product underwriting, claims handling or risk management services through a distribution channel of retail agents and wholesale brokers, which may include program administrators and other specialty sources.

Insurance industry regulators require our insurance subsidiaries to report their financial condition and results of operations using SAP. We use SAP financial results, along with industry standard financial measures determined on a SAP basis and certain measures determined on a GAAP basis, to internally monitor the performance of our insurance segments and reward our employees.

One of the more significant differences between GAAP and SAP is that SAP requires all underwriting expenses to be expensed immediately and not deferred over the same period that the premium is earned. In converting SAP underwriting results to GAAP underwriting results, acquisition costs are deferred and amortized over the periods the related written premiums are earned. For a discussion of deferred acquisition costs, see Critical Accounting Policies – Deferred Acquisition Costs – section included in Item 7 of our 2011 Form 10-K.

The accounting for retroactive reinsurance contributes to the difference between our GAAP loss and expense ratios and our SAP loss and expense ratios. Retroactive reinsurance balances result from reinsurance placed to cover losses on insured events occurring prior to the inception of a reinsurance contract. For GAAP reporting, retroactive reinsurance balances are included in losses and loss expenses in the condensed consolidated statements of income and the GAAP loss ratio. Statutory accounting practices require retroactive reinsurance balances to be recorded in other expenses rather than in losses and loss expenses, and included in the SAP expense ratio.

All references to financial measures or components thereof in this discussion are calculated on a GAAP basis, unless otherwise noted.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

The following tables set forth a summary of our insurance segments' SAP underwriting gain (loss) and SAP combined ratio for the three months ended March 31, 2012 and 2011:

(\$ millions)

	Personal <sup>(1)</sup>		Business		Specialty		Total <sup>(2)</sup>	% Ratio
	\$	%	\$	%	\$	%		
Written premiums	\$ 113.0		80.0		70.3		263.3	
Earned premiums	117.5		77.3		60.1		254.9	
Cat loss and ALAE	5.8	4.9	14.2	18.3	60.1	75.6	20.0	7.8
Non-cat loss and ALAE	69.4	59.1	37.9	49.1	45.5	3.1	152.8	60.0
ULAE	11.3	9.6	5.8	7.4	1.8	3.1	18.9	7.4
Underwriting expenses	31.9	28.2	36.1	45.2	25.0	35.5	93.0	35.3
SAP underwriting loss and SAP combined ratio	\$ (0.9)	101.8	(16.7)	120.0	(12.2)	114.2	(29.8)	110.5

(\$ millions)

	Personal		Business		Specialty		Total	% Ratio <sup>(3)</sup>
	\$	%	\$	%	\$	% <sup>(3)</sup>		
Written premiums <sup>(3)</sup>	\$ 189.5		94.5		93.1		377.1	
Earned premiums	203.6		94.8		51.8		350.2	
Cat loss and ALAE	13.5	6.6	2.5	2.6	51.8	62.2	16.0	4.6
Non-cat loss and ALAE	115.5	56.7	58.0	61.2	32.2	3.5	205.7	58.7
ULAE	12.6	6.2	6.4	6.8	1.9	3.5	20.9	6.0
Underwriting expenses	49.5	26.1	39.8	42.1	33.0	35.5	122.3	32.4
SAP underwriting gain (loss) and SAP combined ratio	\$ 12.5	95.6	(11.9)	112.7	(15.3)	101.2	(14.7)	101.7

(1) See Reconciliation Table 4 below for the impact of the HO QS Arrangement cession on the SAP personal insurance segment's SAP underwriting results.

(2) See Reconciliation Table 2 above for the impact of the HO QS Arrangement cession on our SAP underwriting results.

## Edgar Filing: State Auto Financial CORP - Form 10-Q

- <sup>(3)</sup> Written premium includes a one-time transfer of \$34.1 million of unearned premiums by the Rockhill Insurers to our specialty insurance segment in conjunction with the 1.1.11 pool change. In connection with this unearned premium transfer, we paid a one-time ceding commission of \$8.3 million to the Rockhill Insurers. Combined, these one-time transactions benefitted our specialty insurance segment's statutory expense ratio by 6.3 points and our overall expense ratio by 0.8 points.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

*Revenue*

We measure top-line growth for our insurance segments based on net written premiums, which represent the premiums on the policies we have issued for a period, net of reinsurance. Net written premiums provide us with an indication of how well we are doing in terms of revenue growth before it is actually earned. Our policies provide a fixed amount of coverage for a stated period of time, often referred to as the policy term. As such, our written premiums are recognized as earned ratably over the policy term. The unearned portion of written premiums, called unearned premiums, is reflected on our balance sheet as a liability and represents our obligation to provide coverage for the unexpired term of the policies.

The following table sets forth the reconciliation of the one-time impact on net written premiums for the three months ended March 31, 2011, of the unearned premiums transferred by the Rockhill Insurers to us on January 1, 2011, in conjunction with the 1.1.11 pool change and for the three months ended March 31, 2011, on a pro forma basis which assumes that the 12.31.11 pool change from an 80% to 65% participation percentage had been in effect as of January 1, 2011:

Reconciliation Table 3

Net Written Premiums Reconciliation Table From 80% to Pro Forma 65%  
Pro-Forma

(\$ millions)

	As Reported		2011				% Pro Forma Change <sup>(2)</sup>	
	2012 Net Written Premiums	As Reported 2011 Net Written Premiums	01.01.11 Pool Change Impact	Net Written 01.01.11 Excluding Change	12.31.11 Pool Change Impact	Pro Forma 3/31/11		% Change <sup>(1)</sup>
<b><u>Personal insurance segment:</u></b>								
Personal auto	\$ 94.0	\$ 122.6	\$	\$ 122.6	\$ 23.0	\$ 99.6	(23.3)	(5.6)
Homeowners	11.8	58.2		58.2	10.9	47.3	(79.7)	(75.1)
Other personal	7.2	8.7		8.7	1.6	7.1	(17.2)	1.4
<b>Total personal</b>	<b>113.0</b>	<b>189.5</b>		<b>189.5</b>	<b>35.5</b>	<b>154.0</b>	<b>(40.4)</b>	<b>(26.6)</b>
<b><u>Business insurance segment:</u></b>								
Commercial auto	21.0	23.3		23.3	4.4	18.9	(9.9)	11.1
Commercial multi-peril	23.7	26.4		26.4	5.0	21.4	(10.2)	10.7
Fire & allied lines	17.9	23.4		23.4	4.4	19.0	(23.5)	(5.8)
Other & product liability	13.4	16.2		16.2	3.0	13.2	(17.3)	1.5
Other commercial	4.0	5.2		5.2	1.0	4.2	(23.1)	(4.8)
<b>Total business</b>	<b>80.0</b>	<b>94.5</b>		<b>94.5</b>	<b>17.8</b>	<b>76.7</b>	<b>(15.3)</b>	<b>4.3</b>
<b><u>Specialty insurance segment:</u></b>								
RED	31.5	23.6		23.6	4.5	19.1	33.5	64.9
Rockhill	20.5	39.3	24.3	15.0	2.7	12.3	(47.8)	66.7
Workers compensation	18.3	30.2	9.8	20.4	3.8	16.6	(39.4)	10.2

Edgar Filing: State Auto Financial CORP - Form 10-Q

<i>Total specialty</i>	70.3	93.1	34.1	59.0	11.0	48.0	(24.5)	46.5
<i>Total net written premiums</i>	\$ 263.3	\$ 377.1	\$ 34.1	\$ 343.0	\$ 64.3	\$ 278.7	(30.2)	(5.5)

- (1) Calculated based on as reported March 31, 2012 net written premiums change from as reported March 31, 2011 net written premiums.
- (2) Calculated based on as reported March 31, 2012 net written premiums change from pro forma March 31, 2011 net written premiums.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

*Personal Insurance Segment*

The following table sets forth a summary of net written premiums, by major product line of business for our personal insurance segment for the three months ended March 31, 2012 and 2011, on a pro forma basis which assumes that the 12.31.11 pool change from an 80% to 65% participation percentage was in effect as of January 1, 2011 (See Reconciliation Table 3 above).

(\$ millions)	Net written premiums		
	2012	Pro-Forma 2011	% Change
<b>Personal insurance segment:</b>			
Personal auto	\$ 94.0	99.6	(5.6)
Homeowners	11.8	47.3	(75.1)
Other personal	7.2	7.1	1.4
<b>Total personal</b>	<b>\$ 113.0</b>	<b>154.0</b>	<b>(26.6)</b>

The following table sets forth a summary of SAP loss and ALAE ratios by major product line of business for our personal insurance segment with the catastrophe and non-catastrophe impact shown separately for the three months ended March 31:

Statutory Loss and LAE Ratios	(\$ millions)				% Non-Cat Total Loss and LAE		
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat loss Ratio	loss Ratio	Ratio
2012							
<b>Personal insurance segment:</b>							
Personal auto	\$ 96.0	\$ 2.8	\$ 59.5	\$ 62.3	3.0	61.9	64.9
Homeowners	14.6	0.1	7.7	7.8	0.5	52.6	53.1
Other personal	6.9	2.9	2.2	5.1	41.9	31.6	73.5
<b>Total personal</b>	<b>117.5</b>	<b>5.8</b>	<b>69.4</b>	<b>75.2</b>	<b>4.9</b>	<b>59.1</b>	<b>64.0</b>
ULAE				11.3			9.6
<b>Total Loss and LAE</b>	<b>\$ 117.5</b>	<b>\$ 5.8</b>	<b>\$ 69.4</b>	<b>\$ 86.5</b>	<b>4.9</b>	<b>59.1</b>	<b>73.6</b>
2011							
<b>Personal insurance segment:</b>							
Personal auto	\$ 127.1	\$ 0.2	\$ 78.1	\$ 78.3	0.2	61.4	61.6
Homeowners	67.9	13.3	34.8	48.1	19.5	51.3	70.8
Other personal	8.6		2.6	2.6	(0.1)	30.0	29.9

Edgar Filing: State Auto Financial CORP - Form 10-Q

<i>Total personal</i>	203.6	13.5	115.5	129.0	6.6	56.7	63.3
<b>ULAE</b>				12.6			6.2
<i>Total Loss and LAE</i>	\$ 203.6	\$ 13.5	\$ 115.5	\$ 141.6	6.6	56.7	69.5

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

For the three months ended March 31, 2012, the HO QS Arrangement reduced our SAP net underwriting loss in our personal insurance segment by \$5.5 million and improved our SAP combined ratio in our personal insurance segment by 4.0 points. The following table sets forth our personal insurance segment which excludes, on a pro forma SAP basis, the impact of the HO QS Arrangement cession for the three months ended March 31, 2012.

Reconciliation Table 4

(\$ millions)	SAP HO QS Arrangement Cession - Personal Insurance		
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession
Net written premiums	\$ 113.0	\$ 36.2	\$ 149.2
Earned premiums	117.5	41.7	159.2
Losses and LAE Incurred:			
Cat loss and ALAE	5.8	17.4	23.2
Non-cat loss and ALAE	69.4	19.3	88.7
<i>Total Loss and ALAE</i>	75.2	36.7	111.9
ULAE	11.3		11.3
<i>Total Loss and LAE incurred</i>	86.5	36.7	123.2
Underwriting expenses	31.9	10.5	42.4
<i>Net underwriting loss</i>	\$ (0.9)	\$ (5.5)	\$ (6.4)
Cat loss and ALAE ratio	4.9%	41.7%	14.6%
Non-cat loss and ALAE ratio	59.1%	46.3%	55.7%
<i>Total Loss and ALAE ratio</i>	64.0%	88.0%	70.3%
ULAE ratio	9.6%		7.1%
<i>Total Loss and LAE ratio</i>	73.6%	88.0%	77.4%
Expense ratio	28.2%	29.0%	28.4%
<i>Combined ratio</i>	101.8%	117.0%	105.8%

Catastrophe losses on our personal insurance segment were \$5.8 million, or 4.9 catastrophe loss ratio points, for the three months ended March 31, 2012 and included \$3.9 million, or 3.3 catastrophe loss ratio points, of prior period favorable development. For the three months ended March 31, 2012, cessions under the HO QS Arrangement reduced our personal insurance segment catastrophe losses by \$17.4 million, or 9.7 catastrophe loss ratio points. Catastrophe losses on our personal insurance segment were \$13.5 million, or 6.6 loss ratio points, for the three months ended March 31, 2011, and included \$0.1 million, or 0.1 catastrophe loss ratio points, of prior period favorable development.

## Edgar Filing: State Auto Financial CORP - Form 10-Q

Personal auto net written premiums for the three months ended March 31, 2012 decreased 23.3% compared to the same 2011 period. Personal auto net written premiums for the three months ended March 31, 2012 decreased 5.6% compared to the three months ended March 31, 2011 pro forma net written premiums. While we are experiencing a decline in premiums in our personal auto business, we continue to grow premiums in several states consistent with our strategy to expand our geographic footprint outside the Midwest. Much of this premium growth is from the states of Texas, Colorado, Connecticut and Georgia. In addition, we have had

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

continued personal auto premium growth in underserved Midwest states, such as Illinois and Michigan. While the overall premiums are down, we are experiencing a slight increase in personal auto new business premiums and improved issue to quote ratios. We are also experiencing a higher percentage of companion auto and home policies. We also believe our aggressive actions in addressing profit levels in our homeowners book of business has impacted the entire account and caused the loss of some auto policies, which has also contributed to the overall premium decline in personal auto.

The personal auto SAP non-catastrophe loss ratio for the three months ended March 31, 2012 increased 0.5 points compared to the same 2011 period primarily due to an increase in number of personal auto bodily injury losses.

Homeowners net written premiums for the three months ended March 31, 2012 decreased \$46.4 million compared to the same 2011 period. Homeowners net written premiums for the three months ended March 31, 2012, decreased \$35.5 million compared to three months ended March 31, 2011 pro forma net written premiums. The \$35.6 million of net written premiums ceded under the HO QS Arrangement accounted for this decline when compared to the same 2011 period. The following table sets forth, on a pro forma SAP basis, the homeowners line of business excluding the impact of the HO QS Arrangement cession for the three months ended March 31, 2012.

Reconciliation Table 5

(\$ millions)	SAP HO QS Arrangement Cession - Homeowners		
	As Reported	HO QS Cession	Pro-Forma without HO QS Cession
Net written premiums	\$ 11.8	\$ 35.6	\$ 47.4
Earned premiums	14.6	41.0	55.6
Losses and LAE incurred:			
Cat loss and ALAE	0.1	17.4	17.5
Non-cat loss and ALAE	7.7	19.3	27.0
Total Loss and ALAE incurred	\$ 7.8	\$ 36.7	\$ 44.5
Cat loss and ALAE ratio	0.5%	42.4%	31.4%
Non-cat loss and ALAE ratio	52.6%	47.2%	48.6%
<b>Total Loss and ALAE ratio</b>	<b>53.1%</b>	<b>89.6%</b>	<b>80.0%</b>

The homeowners SAP non-catastrophe loss ratio for the three months ended March 31, 2012 increased slightly when compared to the same 2011 period. The reported homeowners SAP non-catastrophe loss ratio for the three months ended March 31, 2012 was 4.0 points higher than the homeowners SAP non-catastrophe loss ratio pro forma without the HO QS Arrangement due to unfavorable development from prior accident years which were not subject to the HO QS Arrangement. We continue to aggressively address our rate needs in the homeowners book of business and intend to file double digit rate increases in 17 out of 28 active states and in all of our wind and weather prone states.

We continue to implement strategies to improve our homeowner results. As of March 31, 2012, our CustomFit<sup>SM</sup> homeowners product, which uses by-peril rating, had been deployed in 16 out of 28 active states. We have placed a priority of introducing our CustomFit homeowners product in states which have historically experienced significant catastrophe losses. States in which CustomFit homeowners is currently offered represent approximately 75% of our homeowners premium and account for 82% of our five year wind/hail losses. We are in the process of

developing our second generation of CustomFit homeowners in 2012.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

In addition to rate increases and the continued deployment of our CustomFit homeowners product, we are aggressively evaluating and monitoring unprofitable agencies, which includes the review of an agency's existing policies, implementation of tighter new business and renewal guidelines for that agency, and/or the application of other loss mitigation tools for use by that agency, all with the purpose of improving operating results at the agency level. We are continuing with a proactive insurance to value program, which is designed to have our insureds maintain an amount of coverage sufficient to replace their home and contents in the case of a total loss consistent with our loss settlement provisions. In addition, we have implemented mandatory wind and hail deductibles in all targeted states. We will continue to monitor to determine if this loss mitigation tool is necessary in additional states.

We continue to execute various initiatives implemented in prior periods within our property claims operations, which we believe will improve our loss ratio results. For example, our dependence on outside appraisers has declined by deploying in-house property adjusters working from their homes. In addition, all but a few large property claims and a significant percentage of catastrophe claims are now being handled in-house by State Auto adjusters. These changes are intended to improve service and reduce expenses, which we believe improve loss ratio results.

*Business Insurance Segment*

The following table sets forth a summary of net written premiums by major product line of business for our business insurance segment for the three months ended March 31, 2012 and 2011, on a pro forma basis which assumes that the 12.31.11 pool change from an 80% to 65% participation percentage was in effect as of January 1, 2011 (See Reconciliation Table 3 above).

(\$ millions)	Net written premiums		
	2012	Pro-Forma 2011	% Change
<b><u>Business insurance segment:</u></b>			
Commercial auto	\$ 21.0	18.9	11.1
Commercial multi-peril	23.7	21.4	10.7
Fire & allied lines	17.9	19.0	(5.8)
Other & product liability	13.4	13.2	1.5
Other commercial	4.0	4.2	(4.8)
<b><i>Total business</i></b>	<b>\$ 80.0</b>	<b>76.7</b>	<b>4.3</b>

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

The following table sets forth a summary of SAP loss and ALAE ratios by major product line of business for our business insurance segment with the catastrophe and non-catastrophe impact shown separately for the three months ended March 31:

	(\$ millions)				%		Total Loss and LAE Ratio
	Earned Premium	Cat Loss & ALAE	Non-Cat Loss & ALAE	Statutory Loss & LAE	Cat Ratio	Non-Cat Ratio	
<b>Statutory Loss and LAE Ratios</b>							
2012							
<u>Business insurance segment:</u>							
Commercial auto	\$ 19.1	\$ 0.2	\$ 11.7	\$ 11.9	1.0	61.1	62.1
Commercial multi-peril	22.2	4.5	10.2	14.7	20.4	45.9	66.3
Fire & allied lines	18.6	9.5	6.3	15.8	50.7	34.0	84.7
Other & product liability	13.1		8.5	8.5		64.8	64.8
Other commercial	4.3		1.2	1.2	0.2	29.2	29.4
<i>Total business</i>	<i>77.3</i>	<i>14.2</i>	<i>37.9</i>	<i>52.1</i>	<i>18.3</i>	<i>49.1</i>	<i>67.4</i>
ULAE				5.8			7.4
<i>Total Loss and LAE</i>	<i>\$ 77.3</i>	<i>\$ 14.2</i>	<i>\$ 37.9</i>	<i>\$ 57.9</i>	<i>18.3</i>	<i>49.1</i>	<i>74.8</i>
2011							
<u>Business insurance segment:</u>							
Commercial auto	\$ 23.4	\$	\$ 15.7	\$ 15.7	(0.1)	67.2	67.1
Commercial multi-peril	25.1	1.6	12.6	14.2	6.4	50.3	56.7
Fire & allied lines	24.2	0.4	15.2	15.6	1.8	62.8	64.6
Other & product liability	16.6		13.1	13.1		79.0	79.0
Other commercial	5.5	0.5	1.4	1.9	8.2	25.6	33.8
<i>Total business</i>	<i>94.8</i>	<i>2.5</i>	<i>58.0</i>	<i>60.5</i>	<i>2.6</i>	<i>61.2</i>	<i>63.8</i>
ULAE				6.4			6.8
<i>Total Loss and LAE</i>	<i>\$ 94.8</i>	<i>\$ 2.5</i>	<i>\$ 58.0</i>	<i>\$ 66.9</i>	<i>2.6</i>	<i>61.2</i>	<i>70.6</i>

Net written premiums for the business insurance segment for the three months ended March 31, 2012 decreased 15.3% compared to the same 2011 period. The business insurance segment net written premiums for the three months ended March 31, 2012 increased 4.3% compared to the three months ended March 31, 2011 pro forma net written premiums. Business insurance continues to be impacted by rate competition, general economic conditions, and flat premium bases, such as payrolls, sales and number of vehicles. We are experiencing modest improvement in new business and overall business insurance premiums. However, we are seeking to balance our traditional underwriting discipline with new products, improved automation and pricing tools that support the production of profitable new business.

In 2011, we began introducing policy download capabilities for most business insurance lines. Download capabilities will allow agents to import policy information directly into their agency management systems to better serve their customers. Commercial auto and businessowners policies can now be downloaded to our agents, and we expect other commercial package policies will be available to download in 2012. Workers compensation policies in our specialty insurance segment can also be downloaded.



**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

We have also expanded the eligibility of our businessowners products to facilitate businesses with greater liability exposures, such as artisan contractors, auto service garages, manufacturers and restaurants. While we regularly insure these types of businesses through other insurance products, offering these products in our businessowners program leverages our bizXpress<sup>SM</sup> technology, simplifies the agent rating and submission processes, and allows us to offer broader base coverages for these types of risks. In 2010, we completed the implementation of our enhanced businessowners product, BOP Choice, which has been introduced in all of our active states. The majority of our new business premium has been generated from this new product, which is included in our commercial multi-peril line. Our product revisions have also produced a greater proportion of casualty business, which we believe is desirable given our Midwest property concentrations.

Catastrophe losses in our business insurance segment for the three months ended March 31, 2012 were \$14.2 million, or 18.3 catastrophe loss ratio points, and included \$0.5 million, or 0.6 catastrophe loss ratio points, of prior period favorable development. Catastrophe losses in our business insurance segment for the three months ended March 31, 2011 were \$2.5 million, or 2.6 loss ratio points, and included \$0.9 million, or 0.9 catastrophe loss ratio points, of prior period unfavorable development.

Our SAP non-catastrophe loss ratio in our business insurance segment for the three months ended March 31, 2012 decreased 12.1 points compared to the same 2011 period. This decrease was primarily due to improvements in our large loss ratios in our fire and allied lines, as well as improvements in our liability and commercial auto lines.

Intense competition in the business insurance segment continues to impact our ability to implement price increases, although we are seeing modest increases in rates. We will continue to use modeled pricing in all standard lines of business to more accurately price individual accounts. In addition, new deductible guidelines have been introduced to require higher, wind only deductibles on risks that have multiple buildings at a single location susceptible to identified wind zones.

Similar to the personal insurance segment, we believe that the continued implementation of the pre-2011 initiatives within our claims operations will improve our business insurance loss ratio, particularly in fire and commercial multi-peril.

In 2012, we believe we will begin to see the benefits from our new commercial lines project, Business Insurance Evolution. We believe this project will enhance our pricing models and business rules and improve work processes. Updated models will be in place to provide more granular rating. Our business processes will change to promote greater efficiency and quicker quoting for our agents. Business rules will be implemented to improve workflow and underwriting decision making. Ultimately, we expect more profitable and consistent underwriting results and lower expenses to result from the completion of this project.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

*Specialty Insurance Segment*

The following table sets forth a summary of net written premiums by major product line of business for our specialty insurance segment for the three months ended March 31, 2012 and 2011, on a pro forma basis which assumes that the 12.31.11 pool change from an 80% to 65% participation percentage was in effect as of January 1, 2011 (See Reconciliation Table 3 above).

(\$ millions)	Net written premiums		
	2012	Pro-Forma 2011	% Change
<b>Specialty insurance segment:</b>			
RED	\$ 31.5	19.1	64.9
Rockhill	20.5	12.3	66.7
Workers Compensation	18.3	16.6	10.2
<b>Total specialty</b>	<b>\$ 70.3</b>	<b>48.0</b>	<b>46.5</b>

The following table sets forth a summary of SAP loss and LAE ratios for our specialty insurance segment with the catastrophe and non-catastrophe impact shown separately for the three months ended March 31:

(\$ millions)	Earned Premium	Cat Loss & ALAE	Non-Cat		Cat loss Ratio	Non-Cat loss Ratio	Total Loss and LAE Ratio
			Loss & ALAE	Statutory Loss & LAE			
<b>Statutory Loss and LAE Ratios</b>							
Specialty insurance segment:							
2012	\$ 60.1		45.5	45.5		75.6	75.6
ULAE				1.8			3.1
<b>Total Loss and LAE</b>	<b>\$ 60.1</b>		<b>45.5</b>	<b>47.3</b>		<b>75.6</b>	<b>78.7</b>
2011	\$ 51.8		32.2	32.2		62.2	62.2
ULAE				1.9			3.5
<b>Total Loss and LAE</b>	<b>\$ 51.8</b>		<b>32.2</b>	<b>34.1</b>		<b>62.2</b>	<b>65.7</b>

Net written premiums for the specialty insurance segment for the three months ended March 31, 2012 decreased 24.5% compared to the same 2011 period. The specialty insurance segment net written premiums for the three months ended March 31, 2012 increased 46.5% compared to the three months ended March 31, 2011 pro forma net written premiums.

## Edgar Filing: State Auto Financial CORP - Form 10-Q

Net written premiums for our RED unit for the three months ended March 31, 2012 increased 33.5% compared to the same 2011 period. The RED unit net written premiums for the three months ended March 31, 2012 increased 64.9% compared to the three months ended March 31, 2011 pro forma net written premiums. Commercial auto coverage primarily contributed to this growth. However, due to the cancellation of a large commercial auto program as of April 1, 2012, lower levels of net written premiums in the RED unit are expected in future periods.

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Net written premiums for our Rockhill unit for the three months ended March 31, 2012 decreased 47.8% compared to the same 2011 period. The Rockhill unit net written premiums for the three months ended March 31, 2012 increased 66.7% compared to the three months ended March 31, 2011 pro forma net written premiums. The increase was impacted by the following.

Significant rate increases in our property business and increased business opportunities through our excess and surplus channel for catastrophe exposed businesses due to recent global catastrophe events and recent industry catastrophe model changes. Volume growth in our excess and surplus casualty lines, which we believe was attributable to early signs of stabilization in pricing in the commercial lines market and the strengthening of broker relationships and marketing initiatives. Recent changes in the structure of two liability lines and all other perils reinsurance programs, which resulted in our retaining additional written premium of \$3.0 million for the three months ended March 31, 2012. See Liquidity and Capital Resources Reinsurance Arrangements section included in Item 7 of the 2011 Form 10-K. Addition of a new general binding authority program during the first quarter of 2012.

Net written premiums for our workers' compensation unit for the three months ended March 31, 2012 decreased 39.4% compared to the same 2011 period. The workers' compensation unit net written premiums for the three months ended March 31, 2012 increased 10.2% when compared to the three months ended March 31, 2011 pro forma net written premiums. The premium growth in our workers' compensation unit was driven by increases in our mono-line product and the introduction of our small account products due to the market firming.

The SAP non-catastrophe loss ratio for the specialty lines insurance segment for the three months ended March 31, 2012 increased 13.4 points compared to the same 2011 period. This increase was due primarily to losses within our RED unit with respect to a large commercial auto trucking program. As previously discussed, this program was cancelled as of April 1, 2012.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

*Losses and loss expenses payable*

The following table sets forth losses and loss expenses payable by major line of business at March 31, 2012 and December 31, 2011:

<i>(\$ millions)</i>	<b>March 31, 2012</b>	December 31, 2011	\$ Change
<b><u>Personal insurance segment:</u></b>			
Personal auto	<b>\$ 191.1</b>	195.9	(4.8)
Homeowners	<b>56.0</b>	71.9	(15.9)
Other personal	<b>11.8</b>	11.2	0.6
<i>Total personal</i>	<b>258.9</b>	279.0	(20.1)
<b><u>Business insurance segment:</u></b>			
Commercial auto	<b>78.3</b>	76.9	1.4
Commercial multi-peril	<b>77.1</b>	73.5	3.6
Fire & allied lines	<b>29.4</b>	24.3	5.1
Other & product liability	<b>159.3</b>	158.6	0.7
Other business	<b>3.5</b>	3.6	(0.1)
<i>Total business</i>	<b>347.6</b>	336.9	10.7
<b>Specialty insurance segment</b>	<b>286.7</b>	265.7	21.0
<i>Total losses and loss expenses payable net of reinsurance recoverable on losses and loss expenses payable</i>	<b>\$ 893.2</b>	881.6	11.6

Losses and loss expenses payable increased \$11.6 million since December 31, 2011. Our specialty insurance segment increased \$21.0 million, primarily due to the premium growth in our RED unit during the period and the corresponding increase in claims activity. Our homeowners line of business declined \$15.9 million, primarily due to the ceding of reserves to unaffiliated reinsurers in connection with the HO QS Arrangement, partially offset by an increase in our catastrophe loss reserves. Commercial multi-peril and fire & allied lines of business were also affected by increased catastrophe loss reserves. We conduct quarterly reviews of loss development reports and make judgments in determining the reserves for ultimate losses and loss expenses payable. Several factors are considered by us when estimating ultimate liabilities including consistency in relative case reserve adequacy, consistency in claims settlement practices, recent legal developments, historical data, actuarial projections, accounting projections, exposure changes, anticipated inflation, current business conditions, catastrophe developments, late reported claims, and other reasonableness tests.

The risks and uncertainties inherent in our estimates include, but are not limited to, actual settlement experience different from historical data, trends, changes in business and economic conditions, court decisions creating unanticipated liabilities, ongoing interpretation of policy provisions by the courts, inconsistent decisions in lawsuits regarding coverage and additional information discovered before settlement of claims. Our results of operations and financial condition could be impacted, perhaps significantly, in the future if the ultimate payments required

## Edgar Filing: State Auto Financial CORP - Form 10-Q

to settle claims vary from the liability currently recorded. For a discussion of our reserving methodologies as well as a measure of sensitivity discussion see Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Loss and Loss Expenses Payable in Item 7 of the 2011 Form 10-K.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

*Acquisition and Operating Expenses*

Our GAAP expense ratios were 34.4% and 33.7% for the first quarter of 2012 and 2011, respectively. The HO QS Arrangement accounted for 0.8 points of our GAAP expense ratio for the three months ended March 31, 2012. See Results of Operations GAAP HO QS Arrangement Reconciliation Table.

**Investment Operations Segment**

Our investments in fixed maturities, equity securities and certain other invested assets are held as available-for-sale and carried at fair value. The unrealized holding gains or losses, net of applicable deferred taxes, are included as a separate component of stockholders' equity as accumulated other comprehensive income and as such are not included in the determination of net income.

For further discussion regarding the management of our investment portfolio, see Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Investment Operations Segment in Item 7 of the 2011 Form 10-K.

*Composition of Investment Portfolio*

The following table sets forth the composition of our investment portfolio at carrying value at March 31, 2012 and December 31, 2011:

<i>(\$ millions)</i>	<b>March 31, 2012</b>	<b>% of Total</b>	December 31, 2011	<b>% of Total</b>
Cash and cash equivalents	\$ 63.0	2.8	\$ 356.0	13.8
Fixed maturities, at fair value:				
Fixed maturities	1,653.1	72.5	1,674.5	64.8
Treasury inflation-protected securities	251.0	11.0	260.4	10.1
<i>Total fixed maturities</i>	<b>1,904.1</b>	<b>83.5</b>	1,934.9	74.9
Notes receivable from affiliate <sup>(1)</sup>	70.0	3.1	70.0	2.7
Equity securities, at fair value:				
Large-cap securities	130.1	5.7	122.1	4.7
Small-cap securities	49.8	2.2	45.2	1.7
<i>Total equity securities</i>	<b>179.9</b>	<b>7.9</b>	167.3	6.4
Other invested assets, at fair value:				
International instruments	56.2	2.5	52.6	2.0
Other invested assets	5.3	0.2	4.6	0.2
<i>Total other invested assets, at fair value</i>	<b>61.5</b>	<b>2.7</b>	57.2	2.2
Other invested assets, at cost	0.5	0.0	0.5	0.0
<i>Total portfolio</i>	<b>\$ 2,279.0</b>	<b>100.0</b>	\$ 2,585.9	100.0

- (1) In May 2009, we entered into two separate Credit Agreements with State Auto Mutual. Under these Credit Agreements, State Auto Mutual borrowed a total of \$70.0 million from us on an unsecured basis. Interest is payable semi-annually at a fixed annual interest rate of 7.00%. Principal is payable May 2019.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

The following table sets forth the amortized cost and fair value of available-for-sale fixed maturities by contractual maturity at March 31, 2012:

<i>(\$ millions)</i>	<b>Amortized cost</b>	<b>Fair value</b>
Due in 1 year or less	\$ 37.2	37.6
Due after 1 year through 5 years	354.6	374.0
Due after 5 years through 10 years	502.5	542.1
Due after 10 years	485.3	525.0
U.S. government agencies residential mortgage-backed securities	407.5	425.4
<i>Total</i>	<b>\$ 1,787.1</b>	<b>1,904.1</b>

Expected maturities may differ from contractual maturities as the issuers may have the right to call or prepay the obligations with or without call or prepayment penalties. The duration of the fixed maturity portfolio was approximately 3.94 and 3.71 as of March 31, 2012 and December 31, 2011, respectively.

*Investment Operations Revenue*

The following table sets forth the components of net investment income for the three months ended March 31, 2012 and 2011:

<i>(\$ in millions)</i>	Three months ended March 31	
	2012	2011
<b><u>Gross investment income:</u></b>		
Fixed maturities	\$ 15.7	18.9
Equity securities	1.0	1.3
Other	1.4	1.4
<b><i>Total gross investment income</i></b>	<b>18.1</b>	21.6
Less: Investment expenses	0.6	0.6
<b><i>Net investment income</i></b>	<b>\$ 17.5</b>	21.0
Average invested assets (at cost)	\$ 2,229.8	2,381.4
Annualized investment yield	3.1%	3.5
Annualized investment yield, after tax	2.4%	2.8
Net investment income, after tax	\$ 13.6	16.7
Effective tax rate	22.0%	20.5

Our investment operations revenue for the three months ended March 31, 2012 was primarily impacted by the following factors.

There was a cash outflow of \$336.9 million relating to the settlement of the 12.31.11 pool change and the HO QS Arrangement. The amount of interest earned on our fixed maturity securities declined due to call and maturity activity of our tax exempt portfolio. The current environment of lower interest rates has also impacted the amount of interest earned on our fixed maturity portfolio. As our higher yielding bonds mature or are called by the issuers, the proceeds are being reinvested at a lower interest rate. The amortized cost value of our tax exempt portfolio at March 31, 2012 was \$731.9 million compared to \$911.2 million at March 31, 2011.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

The income earned on our Treasury Inflation-Protected Securities, which is dependent on changes in the CPI Index, decreased by \$1.1 million for the three months ended March 31, 2012 when compared to the same 2011 period. The following table sets forth realized gains (losses) and the proceeds received on sale for our investment portfolio for the three months ended March 31, 2012 and 2011:

(\$ in millions)	2012		2011	
	Realized gains (losses)	Proceeds received on sale	Realized gains (losses)	Proceeds received on sale
<b>Realized gains:</b>				
Fixed maturities	\$ 3.1	45.9	0.9	27.3
Equity securities	4.4	27.0	8.8	35.3
<i>Total realized gains</i>	<b>7.5</b>	<b>72.9</b>	9.7	62.6
<b>Realized losses:</b>				
Equity securities:				
Sales			(1.4)	10.4
OTTI	(0.4)		(0.1)	
<i>Total realized losses</i>	<b>(0.4)</b>		(1.5)	10.4
<i>Net realized gain on investments</i>	<b>\$ 7.1</b>	<b>72.9</b>	8.2	73.0

During the first quarter 2012, equity sales were executed for various reasons, including: (i) to accumulate cash for settlement of the transfers related to the 12.31.11 pool change (ii) the achievement of our price target, (iii) in response to negative outlook announcements or changes in business conditions, which in our opinion diminished the future business prospects on these securities, and (iv) in order to manage our equity holdings consistent with our investment policy.

When a fixed maturity security has been determined to have an other-than-temporary decline in fair value, the impairment charge is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to non-credit factors, which is recognized in accumulated other comprehensive income. See Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Investments included in Item 7 of the 2011 Form 10-K for other-than-temporary impairment ( OTTI ) indicators. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income. We did not recognize OTTI on our fixed maturity portfolio for the three months ended March 31, 2012 or 2011.

When an equity security or other invested asset has been determined to have a decline in fair value that is other-than-temporary, we adjust the cost basis of the security to fair value. See Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Investments included in Item 7 of the 2011 Form 10-K for OTTI impairment indicators. This results in a charge to earnings as a realized loss, which is not reversed for subsequent recoveries in fair value. Future increases or decreases in fair value, if not other-than-temporary, are included in accumulated other comprehensive income.



**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

The following table sets forth the realized losses related to OTTI on our investment portfolio recognized for the three months ended March 31, 2012:

*(\$ millions, except # of positions)*

	Number of positions	Total impairment
Small-cap equity securities	7	\$ 0.4

*Gross Unrealized Investment Gains and Losses*

Based upon our review of our investment portfolio at March 31, 2012, we determined that there were no individual investments with an unrealized holding loss that had a fair value significantly below cost continually for more than one year. The following table sets forth detailed information on our available-for-sale investment portfolio by lot at fair value for our gross unrealized holding gains (losses) at March 31, 2012:

*(\$ millions, except # of positions)*

	Cost or amortized cost	Gross unrealized holding gains	Number of gain positions	Gross unrealized holding losses	Number of loss positions	Fair value
<b>Fixed maturities:</b>						
U.S. treasury securities and obligations of U.S. government agencies	\$ 417.6	\$ 34.2	71	\$ (0.4)	13	\$ 451.4
Obligations of states and political subdivisions	731.9	51.1	323	(0.1)	1	782.9
Corporate securities	230.1	14.4	83	(0.1)	5	244.4
U.S. government agencies residential mortgage-backed securities	407.5	19.1	131	(1.2)	20	425.4
<i>Total fixed maturities</i>	1,787.1	118.8	608	(1.8)	39	1,904.1
<b>Equity securities:</b>						
Large-cap securities	105.8	26.0	43	(1.7)	8	130.1
Small-cap securities	36.9	12.9	72			49.8
<i>Total equity securities</i>	142.7	38.9	115	(1.7)	8	179.9
Other invested assets	48.9	12.6	3			61.5
<i>Total available-for-sale investments</i>	\$ 1,978.7	\$ 170.3	726	\$ (3.5)	47	\$ 2,145.5

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

The following table sets forth our unrealized holding gains by investment type, net of deferred tax that was included as a component of accumulated comprehensive income (loss) at March 31, 2012 and December 31, 2011, and the change in unrealized holding gains, net of deferred tax, for the three months ended March 31, 2012:

<i>(\$ millions)</i>	<b>March 31, 2012</b>	December 31, 2011	\$ Change
<b><u>Available-for-sale investments:</u></b>			
Unrealized holding gains:			
Fixed maturities	\$ 117.0	117.6	(0.6)
Equity securities	37.2	25.6	11.6
Other invested assets	12.6	8.6	4.0
<i>Unrealized gains</i>	<b>166.8</b>	151.8	15.0
Deferred federal income tax liability, net	<b>(53.1)</b>	(53.1)	
<i>Unrealized gains, net of tax</i>	<b>\$ 113.7</b>	98.7	15.0

**Fair Value Measurements**

We primarily use one independent nationally recognized pricing service in developing fair value estimates. We obtain one price per security, and our processes and control procedures are designed to ensure the value is accurately recorded on an unadjusted basis. Through discussions with the pricing service, we gain an understanding of the methodologies used to price the different types of securities, that the data and the valuation methods utilized are appropriate and consistently applied, and that the assumptions are reasonable and representative of fair value. To validate the reasonableness of the valuations obtained from the pricing service, we compare to other fair value pricing information gathered from other independent pricing sources. See Note 3, Fair Value of Financial Instruments to our condensed consolidated financial statements included in Item 1 of this Form 10-Q for a presentation of our available-for-sale investments within the fair value hierarchy at March 31, 2012 and December 31, 2011.

As of March 31, 2012, Level 3 assets as a percentage of total assets were 0.1% which we have determined to be insignificant.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Other Items***Income Taxes*

Deferred income tax assets and liabilities represent the tax effect of the differences between the financial statement carrying value of existing assets and liabilities and their respective tax bases. In accordance with the Financial Accounting Standards Board's Accounting Standards Codification 740, Income Taxes (ASC 740), we periodically evaluate our deferred tax assets, which requires significant judgment, to determine if they are realizable based upon weighing all available evidence, both positive and negative, including our historical and anticipated future taxable income. In making such judgments, significant weight is given to evidence that can be objectively verified. At March 31, 2012 and December 31, 2011, we recorded a valuation of \$100.5 million and \$103.3 million, respectively. The following table sets forth, the components of our federal income tax expense for the three months ended March 30, 2012.

<i>(\$ millions)</i>	<b>Three Months Ended March 31 2012</b>
Loss before federal income taxes	\$ (2.0)
Current tax benefit	
Deferred tax benefit	(2.8)
	(2.8)
Valuation allowance	2.8
Total Federal income tax expense	
<i>Net loss</i>	\$ (2.0)

In future periods we will re-assess our judgments and assumptions regarding the realization of our net deferred tax assets, but until such time as the positive evidence exceeds the negative evidence we will maintain a valuation allowance against our net deferred tax assets. Until that time, as we report net earnings and generate taxable income, we do not expect our consolidated statements of income to reflect any federal income tax expense as we utilize our net operating loss carryforward and release a corresponding amount of the net deferred tax asset valuation allowance, unless we are in an exception position as described by the intraperiod allocation guidance included in ASC 740.

**Table of Contents**

## STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

Based on ASC 740 intraperiod tax allocation guidelines, the following sets forth the change in valuation allowance attributable to continuing operations and other comprehensive income for the three months ended March 31, 2012:

(\$ millions)

Continuing operations	\$ 2.8
Other comprehensive income	(5.6)
<i>Change in valuation allowance</i>	<i>\$ (2.8)</i>

See Note 5 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

**LIQUIDITY AND CAPITAL RESOURCES****General**

Liquidity refers to our ability to generate adequate amounts of cash to meet our short- and long-term needs. Our primary sources of cash are premiums, investment income, investment sales and the maturity of fixed income security investments. The significant outflows of cash are payments of claims, commissions, premium taxes, operating expenses, income taxes, dividends, interest and principal payments on debt and investment purchases. The cash outflows may vary due to uncertainties regarding settlement of large losses or catastrophe events. As a result, we continually monitor our investment and reinsurance programs to ensure they are appropriately structured to enable the insurance subsidiaries to meet anticipated short- and long-term cash requirements without the need to sell investments to meet fluctuations in claim payments.

**Liquidity**

Our insurance subsidiaries must have adequate liquidity to ensure that their cash obligations are met. However, the STFC Pooled Companies do not have the daily liquidity concerns normally associated with an insurance company due to their participation in, and the terms of, the Pooling Arrangement. Under the terms of the Pooling Arrangement, State Auto Mutual receives all premiums and pays all losses and expenses associated with the insurance business produced by the STFC Pooled Companies and the other pool participants, and then it settles the intercompany balances generated by these transactions with the pool participants within 45 days following each quarter end. We believe this provides State Auto Mutual with sufficient liquidity to pay losses and expenses of our insurance operations on a timely basis. When settling the intercompany balances, State Auto Mutual provides the pool participants with full credit for the premiums written net of losses paid during the quarter, retaining all receivable amounts from insureds and agents and reinsurance recoverable on paid losses from unaffiliated reinsurers. Any receivable amounts that are ultimately deemed to be uncollectible are charged-off by State Auto Mutual and allocated to the pool participant on the basis of its pooling percentage. As a result, we have an off-balance sheet credit risk related to the balances due to State Auto Mutual from insureds, agents and reinsurers, which are offset by the unearned premiums from the respective policies. While the total amount due to State Auto Mutual from policyholders and agents is significant, the individual amounts due are relatively small at the policyholder and agency level. Based on historical data, this credit risk exposure is not considered to be material to our financial position, though the impact to income on a quarterly basis may be material. The State Auto Group mitigates its exposure to this credit risk through its in-house collections unit for both personal and commercial accounts which is supplemented by third party collection service providers. The amounts deemed uncollectible by State Auto Mutual and allocated to the STFC Pooled Companies are included in the other expenses line item in the accompanying consolidated statements of income.

## Edgar Filing: State Auto Financial CORP - Form 10-Q

We generally manage our cash flows through current operational activity and maturing investments, without a need to liquidate any of our other investments. However, should our written premiums decline or paid losses increase significantly, or a combination thereof, our cash flows from operations could be impacted requiring us to liquidate investments at losses. This action was not necessary for the three months ended March 31, 2012.

---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

We maintain a portion of our investment portfolio in relatively short-term and highly liquid investments to ensure the immediate availability of funds to pay claims and expenses. At March 31, 2012 and December 31, 2011, we had \$63.0 million and \$356.0 million, respectively, in cash and cash equivalents, and \$2,145.5 million and \$2,159.4 million, respectively, of total available-for-sale investments. Included in our fixed maturities available-for-sale were \$9.9 million of securities on deposit with insurance regulators as required by law at March 31, 2012 and December 31, 2011. In addition, substantially all of our fixed maturity and equity securities are traded on public markets. For a further discussion regarding investments, see "Investments Operations Segment" included in this Item 2.

Net cash used in operating activities was \$343.5 million for the first quarter of 2012 compared to net cash provided by operating activities of \$74.4 million for the first quarter 2011. Net cash from operations will vary from period to period if there are significant changes in underwriting results, primarily a combination of the level of premiums written and loss and loss expenses paid, changes in cash flows from investment income or federal income tax activity. The majority of the change between periods was due to our settlement payment of \$261.4 million related to the 12.31.11 pool change and our payment of \$75.5 million related to our share of the State Auto Group's initial net unearned premium transfer under the HO QS Arrangement.

Net cash provided by investing activities was \$56.5 million for the first quarter of 2012 compared to net cash used in investing activities of \$74.7 million for the first quarter 2011. In the first quarter 2012, we continued to raise funds to complete the settlement of amounts owned related to the 12.31.11 pool change and the HO QS Arrangement.

Net cash used in financing activities was \$6.0 million and \$5.6 million for the first quarter 2012 and 2011, respectively.

*Other Capital Transactions*

On May 4, 2012, State Auto Financial's board of directors declared a quarterly cash dividend of \$0.15 per share. The dividend is payable June 29, 2012 to shareholders of record at the close of business on June 13, 2012. This is the 84th consecutive quarterly cash dividend declared since State Auto Financial had its initial public offering in 1991.

**Borrowing Arrangements**

*Credit Agreement*

State Auto Financial has a \$100.0 million unsecured revolving credit facility with a syndicate of lenders which matures in September 2016 (the "Credit Facility"). During the term of the Credit Facility, we have the right to increase the total facility to a maximum amount of \$150.0 million, provided that no event of default has occurred and is continuing. The Credit Facility is available for general corporate purposes and provides for interest-only payments during its term, with principal and interest due in full at maturity. Interest is based on LIBOR or a base rate plus a calculated margin amount. The Credit Facility includes certain covenants, including financial covenants that require us to maintain a minimum net worth and not exceed a certain debt to capitalization ratio. As of March 31, 2012, State Auto Financial had not made any borrowings and was in compliance with all of its covenants.

*Senior Notes*

State Auto Financial has outstanding \$100.0 million of unsecured Senior Notes due November 2013. The Senior Notes bear interest at a fixed rate of 6.25% per annum, which is payable each May 15 and November 15. The Senior Notes are general unsecured obligations ranking senior to all existing and future subordinated indebtedness and equal with all existing and future senior indebtedness. The Senior Notes are not guaranteed by any of State Auto Financial's subsidiaries and thereby are effectively subordinated to all State Auto Financial's subsidiaries existing and future indebtedness.



---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

*Subordinated Debentures*

State Auto Financial's Delaware business trust subsidiary (the Capital Trust) has outstanding \$15.0 million liquidation amount of capital securities, due 2033. In connection with the Capital Trust's issuance of the capital securities and the related purchase by State Auto Financial of all of the Capital Trust's common securities (liquidation amount of \$0.5 million), State Auto Financial has issued to the Capital Trust \$15.5 million aggregate principal amount of unsecured Floating Rate Junior Subordinated Debt Securities due 2033 (the Subordinated Debentures). The sole assets of the Capital Trust are the Subordinated Debentures and any interest accrued thereon. Interest on the Capital Trust's capital and common securities is payable quarterly at a rate equal to the three-month LIBOR rate plus 4.20%, adjusted quarterly. The applicable interest rates for March 31, 2012 and 2011 were 4.69% and 4.50%, respectively.

**Reinsurance Arrangements**

Members of the State Auto Group follow the customary industry practice of reinsuring a portion of their exposures and paying to the reinsurers a portion of the premiums received. Insurance is ceded principally to reduce net liability on individual risks or for individual loss occurrences, including catastrophic losses. Although reinsurance does not legally discharge the individual members of the State Auto Group from primary liability for the full amount of limits applicable under their policies, it does make the assuming reinsurer liable to the extent of the reinsurance ceded.

To minimize the risk of reinsurer default, the State Auto Group cedes only to third-party reinsurers who are rated A- or better by A.M. Best and also utilizes both domestic and international markets to diversify its credit risk. We utilize reinsurance to limit our loss exposure and contribute to our liquidity and capital resources.

*Homeowners Quota Share Reinsurance Arrangement*

The State Auto Group entered into the HO QS Arrangement on December 31, 2011, with a syndicate of unaffiliated reinsurers covering its homeowners book of business. The HO QS Arrangement is in effect until December 31, 2014. Under the HO QS Arrangement, the State Auto Group ceded to the reinsurers 75% of its homeowners business under policies in force at December 31, 2011 and new and renewal policies thereafter issued during the term of the agreement. A reinsurer may terminate its participation in the HO QS Arrangement upon the occurrence of certain events, including, without limitation, if the policyholders' surplus of the State Auto Group is reduced by more than 25% from the amount of its surplus as of September 30, 2011 or the State Auto Group is assigned an A.M. Best rating below A-.

Under the HO QS Arrangement, the State Auto Group receives a 29.0% commission on all premiums ceded to the reinsurers, and also may receive a profit commission.

The HO QS Arrangement provides the reinsurers with certain contractual rights in the event that a material adverse change, as defined in the agreement, occurs to the State Auto Group. For example, the reinsurers may request the revision or renegotiation of certain terms of the agreement if the State Auto Group's homeowners exposure growth exceeds specified levels or if the State Auto Group makes significant underwriting, claim handling or business mix changes that adversely impact the business reinsured under the agreement. In the event the parties do not agree on revised terms, the reinsurers may cancel the HO QS Arrangement. Under the material adverse change provisions, the reinsurers may reduce the ceding commission proportionally in the event the homeowners rate changes implemented fall short of our pricing plan by more than certain stipulated contractual amounts.

Under the HO QS Arrangement, the reinsurers have agreed to accept 75% of the State Auto Group's subject homeowners net liability, except for ULAE expenses which are not subject to recovery. The liability of the reinsurers will not exceed any of the following: \$3.0 million as to any one risk with respect to property losses; \$2.0 million as to any one insured with respect to liability losses; \$55.0 million as to all losses arising from

## Edgar Filing: State Auto Financial CORP - Form 10-Q

any one loss occurrence; 50% of the ceded net earned premium for the first contract year with respect to all losses arising from all catastrophe loss occurrences commencing during the first contract year, subject to an amount not to exceed \$181.0 million for the first contract year; 40% of the ceded net earned premium for the second contract year with respect to all losses arising from all catastrophe loss occurrences commencing during the second contract year, subject to an

---

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

amount not to exceed \$150.0 million for the second contract year; 30% of the ceded net earned premium for the third contract year with respect to all losses arising from all catastrophe loss occurrences commencing during the third contract year, subject to an amount not to exceed \$117.0 million for the third contract year; or 34% of the ceded net earned premium for the term of the agreement with respect to all losses arising from all catastrophe loss occurrences commencing during the term of the agreement, subject to an amount not to exceed \$380.0 million for the term of the contract. A catastrophe loss occurrence is defined as any one loss occurrence which has been assigned a catastrophe number by the ISO PCS. We believe this reinsurance arrangement reduces risk and volatility in the homeowners line of business and to our overall book of business while providing us with additional catastrophe protection.

*Other Reinsurance Arrangements*

For a discussion of our reinsurance arrangements other than the HO QS Arrangement, see Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Reinsurance Arrangements in Item 7 of the 2011 Form 10-K. There have been no material changes in these other reinsurance arrangements since December 31, 2011.

**Regulatory Considerations**

At March 31, 2012, all of our insurance subsidiaries were in compliance with statutory requirements relating to capital adequacy.

**ADOPTION OF RECENT ACCOUNTING PRONOUNCEMENTS**

*Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*

In October 2010, the FASB issued updated guidance to address diversity in practice for the accounting of costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. This guidance was effective for fiscal years beginning after December 15, 2011. The Company adopted this guidance, with retrospective application, at January 1, 2012. The cumulative effect of the retrospective adoption of this guidance reduced stockholders' equity by \$20.5 million, after-tax, at January 1, 2010. See Note 1 of our condensed consolidated financial statements included in Item 1 of this Form 10-Q.

*Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*

The amendments in this guidance result in common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards (IFRS). Consequently, the amendments in the guidance change the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend for the amendments in the guidance to result in a change in the application of the requirements in the Fair Value Measurements Topic. The guidance also clarifies the FASB's intent about the application of existing fair value measurement requirements as well as changes to a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. This guidance was effective on a prospective basis for fiscal years and interim periods beginning after December 15, 2011. The Company's adoption of this guidance at January 1, 2012 did not have a material impact on its consolidated financial statements.

*Testing Goodwill for Impairment*

In September 2011, the FASB issued updated guidance in relation to testing goodwill for impairment. The amendments in the update permit an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment. The more-likely-than-not

## Edgar Filing: State Auto Financial CORP - Form 10-Q

threshold is defined as having a likelihood of a more than 50 percent. Previous guidance under Topic 350 (Intangibles, Goodwill and Other), required an entity to test goodwill for impairment on an annual basis. Under this updated guidance, the test for impairment should be performed on an annual basis unless an event occurs or circumstances change that would

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

more likely than not reduce the fair value of a reporting unit below its carrying amount. If the fair value of a reporting unit is less than its carrying amount, the second step of the test must be performed to measure the amount of the impairment loss, if any. However, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. This guidance was effective for fiscal years and interim periods beginning after December 15, 2011, with early adoption permitted. The Company's adoption of this guidance at January 1, 2012 did not have a material impact on its consolidated financial statements.

**MARKET RISK**

With respect to Market Risk, see the discussion regarding this subject at Management's Discussion and Analysis of Financial Condition and Results of Operations - Investment Operations Segment - Market Risk in Item 7 of the 2011 Form 10-K. There have been no material changes from the information reported regarding Market Risk in the 2011 Form 10-K.

**Item 3. Quantitative and Qualitative Disclosure of Market Risk**

The information called for by this item is provided in this Form 10-Q under the caption Market Risk under Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Item 4. Controls and Procedures**

**Disclosure Controls and Procedures**

With the participation of our principal executive officer and principal financial officer, our management has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this report. Based upon that evaluation, our principal executive officer and principal financial officer have concluded that, as of the end of the period covered by this report:

1. Information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission;
2. Information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure; and
3. Our disclosure controls and procedures are effective in timely making known to them material information required to be included in our periodic filings with the Securities and Exchange Commission.

**Changes in Internal Control over Financial Reporting**

There has been no change in our internal controls over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.



**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are involved in numerous lawsuits arising in the ordinary course of our business operations arising out of or otherwise related to our insurance policies. Certain of these lawsuits allege extra-contractual damages. These lawsuits are in various stages of development. We generally contest these matters vigorously but may pursue settlement if appropriate. We consider all such litigation in establishing our loss and loss adjustment expense reserves. Based on currently available information, we do not believe it is reasonably possible that any such lawsuit or related lawsuits will be material to our results of operations or have a material adverse effect on our consolidated financial or cash flow position.

Additionally, from time to time we may be involved in lawsuits arising in the ordinary course of business but not arising out of or otherwise related to our insurance policies. Based on currently available information, we do not believe it is reasonably possible that any such lawsuit or related lawsuits will be material to our results of operations or have a material adverse effect on our consolidated financial or cash flow position.

We accrue for a litigation-related liability when it is probable that such a liability has been incurred and the amount can be reasonably estimated. Based on currently available information known to us, we believe that our reserves for litigation-related liabilities are reasonable. Given the inherent uncertainty surrounding the ultimate resolution of these legal proceedings, an adverse outcome could have a material impact to our results of operations in a future period, though in the opinion of management, none would likely have a material adverse effect on our consolidated financial or cash flow position.

Additionally, we may be impacted by adverse regulatory actions and adverse court decisions where insurance coverages are expanded beyond the scope originally contemplated in our insurance policies. We believe that the effects, if any, of such regulatory actions and published court decisions are not likely to have a material adverse effect on our financial or cash flow position.

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those disclosed in the 2011 Form 10-K under Part I, Item 1A Risk Factors.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. (Removed and Reserved)**

**Item 5. Other Information**

None.

**Item 6. Exhibits**

Exhibit No.	Description of Exhibits
31.01	CEO certification required by Section 302 of Sarbanes Oxley Act of 2002
31.02	CFO certification required by Section 302 of Sarbanes Oxley Act of 2002
32.01	CEO certification required by Section 906 of Sarbanes Oxley Act of 2002
32.02	CFO certification required by Section 906 of Sarbanes Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

**Table of Contents**

STATE AUTO FINANCIAL CORPORATION AND SUBSIDIARIES

(a majority-owned subsidiary of State Automobile Mutual Insurance Company)

**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 hereunto duly authorized.

**State Auto Financial Corporation**

/s/ Steven E. English

Steven E. English  
Chief Financial Officer  
(Duly Authorized Officer and  
Principal Financial Officer)

Date: May 9, 2012